



COHEN INDEPENDENT RESEARCH GROUP

Wall Street's #1 Independent Research Firm

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QUICK VIEW

DOWNEY FINANCIAL CORPORATION

Recent Price: \$20.29
Target Price: \$15.54
Symbol: NYSE: DSL
Recommendation: SELL
Industry: Financial Services/ Commercial Banking

Downey Financial Corporation, founded in October 1994, operates as the holding company for Downey Savings and Loan Association and conducts its business through 172 retail deposit branches, including 90 full-service, in-store branches. Downey, the second-largest thrift operating in California, provides banking and financial services to individual and corporate customers, and engages in real estate development activities. As a result of the ongoing economic downturn, we expect higher levels of defaults with limited growth opportunities. Further, declining real estate prices will result in higher defaults on payments, thereby increasing net charge-offs. We recommend a SELL on Downey with a price target of \$15.54 for aggressive investors.

Price Targets vs. Growth Rates

Downey Financial's Valuation	2%	3%	4%	5%	6%
Optimistic Case	18.93	20.95	23.38	26.39	30.18
Base Case	9.66	11.25	13.17	15.54	18.52
Pessimistic Case	5.43	6.89	8.65	10.82	13.55

Net Interest Income

	2008E	2009E	2010E	2011E	2012E
Optimistic Case	335.53	324.26	330.75	351.50	412.44
Base Case	330.84	274.63	276.47	272.22	298.43
Pessimistic Case	308.16	238.05	178.71	175.66	183.77

Non-Distributed Research



EXECUTIVE SUMMARY

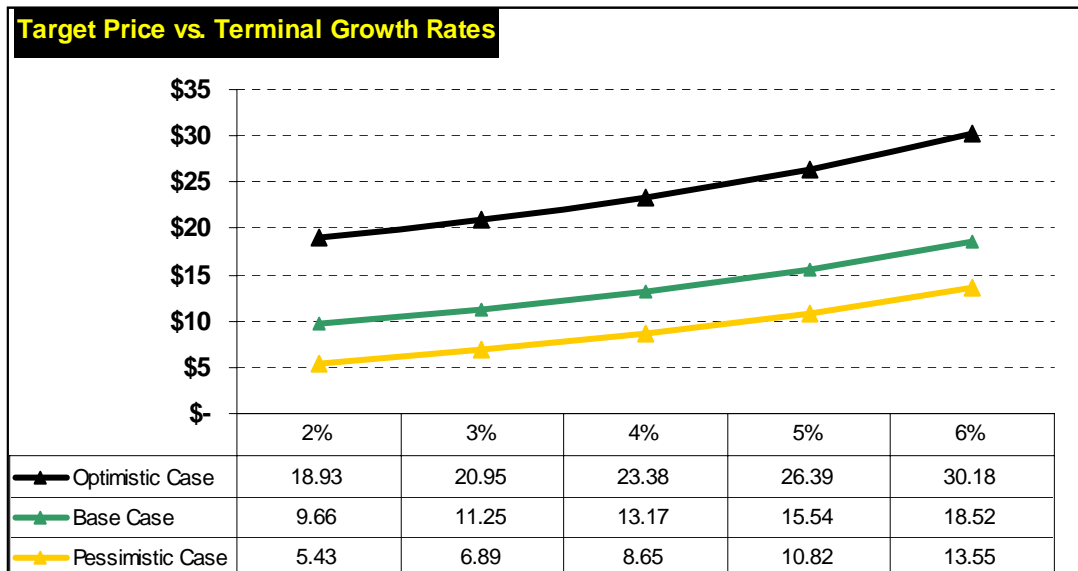
- Downey Financial Corporation, a savings and loan holding company, is primarily involved in borrowing funds from various sources and originating and investing in loans, predominantly residential real estate mortgage loans.
- The company's major business comes from the residential lending one-to four units which constitutes of adjustable rate and fixed rate loans. More than 95% of the total loan portfolio is adjustable rate loans fixed to a specific index such as COFI, MTA, LIBOR and CMT. The company's loan portfolio has maturity tenure at origination of 15 to 40 years. Apart from the residential one to four loan, it also sells other home equity loans and commercial loans. It also indulges in other direct real estate activities through its subsidiary DSL services.
- The company's lending strategy involves selling option adjustable rate mortgage (ARM) loans, thereby attracting customers to avail loans at lower initial installments. This also aids the company to expand its loan portfolio. However, the negative amortization and its capitalization in the loan book, increases the risk of default. At present, 61% of the total loan portfolio is utilizing the negative amortization, which suggests that a greater number of customers have opted for lower installments. In 2007, out of the net interest income of \$424 million, \$245 million was non cash capitalized interest from negative amortization and \$179 million was net cash interest income.
- Downey's business is completely concentrated in California with around 89% of the total residential one-to-four unit loans coming from the state. This makes the company's business particularly dependent on the real estate rates prevalent in California. The company is geographically focused in California and has thus been impacted adversely by California's weakening economic environment in general and real estate market, in particular.
- The company's non-performing assets (NPAs) to total loans ratio have gone up drastically in the last year (from less than 1% to more than 9% as of Jan 08). Besides, credit provision which have generally been above 50%. In some cases, close to 100%, have plunged to levels below 40%. TDR (Troubled Debt Restructuring) has also contributed to the growth in non-performing assets. Due to accelerated resets of ARMs in the next 8-12 quarters, we believe that a further rise in inferior assets will occur.



INVESTMENT THESIS AND RECOMMENDATION

Downey Financial Corp (DSL) is at the very core of the financial and real estate meltdown. DSL's loan portfolio is extremely precarious given the sluggish real estate environment and weak macro environment. Although the company's shares have been under tremendous pressure in the last one year (losing about 70% of its market capital), we believe there is still some room on the downside. The high level of capitalized interest income on negative amortization (CINA) and 10 fold rise in non-performing assets (NPAs) is factored into share the prices. However, going forward both quality of earnings and balance-sheet health should deteriorate further as optional rate mortgage is reset at higher levels. This would pose serious issues for the bank going forward. The rise in 30-59 day delinquency class is indicative of the fact that the rise in NPA is expected to accelerate. We believe that operating and macro environment may taper off going forward which would have a profound impact on the performance of the company. The company's dependence in California also increases its risk profile and makes it a short sale candidate given the uncertainty for its future outlook. We used three different scenarios – Base Case, Optimistic Case and Pessimistic Case – for valuing the Company through our Discounted Cash Flow method. Under our most realistic long-term valuation approach based on the Base Case Scenario, Downey is valued at \$15.54 per share, 23.4% lower than the current market price. Therefore, we recommend a SELL on Downey Financial Corp.

Our price target is estimated by discounting the free cash flow to equity using our discounted cash flow (DCF) analysis. We have used the interest rate on 10-year US treasury notes as the proxy for the risk-free rate of interest; at the time of this report the 10-year US treasury had a yield of 3.4%. Based on the preceding inputs and the Capital Asset Pricing Model, we arrive at a Cost of Equity of 13.60%. Using a two-stage DCF model, where we have forecasted for a 5-year period until 2012, a terminal growth rate (g) of 5% has been assigned to the free cash flows (based on the GDP growth rate supplemented with the inflation rate in U.S). Considering the fundamental approach, we arrive at a target price of **US\$15.54** per share.





COHEN GROWTH DRIVER ANALYSIS – BASE CASE SCENARIO

	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12
Net Revenue	470.31	382.45	326.78	323.82	323.56	351.83
Growth (%)		-18.7%	-14.6%	-0.9%	-0.1%	8.7%
Net Interest Margin	2.96%	2.61%	2.34%	2.51%	2.50%	2.75%
Growth (%)		-11.97%	-10.14%	7.19%	-0.51%	9.89%
Diluted EPS	-2.03	-3.35	-3.28	-2.09	-0.91	0.33
Free Cash Flows to Equity		(188.94)	(94.37)	11.67	50.53	90.94
Average Interest Earning Assets	14309.01	12688.89	11721.19	11007.97	10894.45	10868.34
Interest capitalized on loans	245.40	213.90	125.88	57.79	57.12	56.51
Growth (%)		-12.84%	-41.15%	-54.10%	-1.15%	-1.08%
NPA's	926.15	1481.83	1467.02	1026.91	821.53	492.92
% of Total Loans		9.44%	17.43%	17.99%	12.79%	10.19%

We project the Downey's earning capacity to fall drastically in the future. The company's existence in the California market, which is at the core of the real estate meltdown, is expected to impact the company severely. Adjustable rate loans, substantial composition of negative amortization in interest income, lower credit provisions and increasing NPAs create a stern loop for the company's problems. A potential downfall is unlikely, but not impossible, due to a possible takeover. Moreover, real estate rates are not expected to improve in the near term, thus putting further pressure on the company's revenue model as well as loan book. Negative amortization as a facility, indicates the customer's inability to afford loans. Resetting of such loans in the near term and lower incentives to hold houses in a decreasing price scenario, would further impact the bank's loan portfolio. In such a demand-supply mismatch, we expect the company's business to be affected significantly and remain uncertain until housing problems improve.



COHEN SHORT SALE MATRIX

The Cohen Short Sale Matrix analyses the impact on Downey's book value as a result of increases in NPAs on one hand and decline in value of collateralized assets on the other. Given that NPAs increased 10 times last year, we assume a growth in NPAs by >150 % in 2008. We have created a scenario analysis, aligning the NPA growth with varying charge offs. Charge off is essentially the gap between the loan and home value (collateral) of the loan. It is the economic loss that DSL will bear in the event of a loan going bust.

In the case of a financial entity, leverage plays a huge role. DSL is no different with equity assets comprising 10% of the total assets. It is also important to look at the adjusted book value, and the impact of NPA growth on the same. By analyzing NPAs and their recoverability, we can assess the true economic value of DSL's loan portfolio.

Growth in charge offs coupled with incremental NPAs accentuate erosion of shareholders' wealth. The size of the book value, which is only 15% of the total loan portfolio, is not significant enough to sustain huge write offs. Shareholders will have to face the brunt of incremental charge-offs. Going forward, we believe that this can act as a catalyst for the stocks underperformance.

Bankruptcy ?

More than 85% of DSL's asset base is funded by deposits and funds. This makes the company's equity holders highly dependent on the quality of assets, as any deterioration in loan portfolio would have a direct impact on its shareholders. The scenario analysis, which is based on the price to book value, clearly indicates the impact of reduction in the loan book on the equity base.

Currently, 41% of the NPAs have a loss allowance provision, which gives the equity base some leeway against loan write offs; however, any further charge offs would have a direct impact on shareholders. In the short sale matrix, it is evident that if the NPAs grow by 200%, and DSL has to provide additional charge off of 30%, then the company's equity will turn negative. This might force the company into bankruptcy. Over the last year, DSL's NPAs have grown by over 1000% while its realization in auction sales has also plummeted. Consequently, the assumed deterioration in asset quality looks fairly reasonable. Moreover, with the company's loan book consisting of ARMs, which are yet to be reset, the NPAs are likely to increase, as more customers are expected to face defaults. In such a case, the company's situation can only be expected to weaken.

		Additional Charge offs					
		5%	10%	15%	20%	25%	30%
N	150%	1,062.55	895.03	727.51	559.99	392.47	224.95
	200%	1,022.44	814.81	607.18	399.55	191.92	(15.71)
P	250%	982.33	734.59	486.85	239.11	(8.63)	(256.37)
	300%	942.22	654.37	366.52	78.67	(209.18)	(497.03)
A	350%	902.11	574.15	246.19	(81.77)	(409.73)	(737.69)
	400%	862.00	493.93	125.86	(242.21)	(610.28)	(978.35)



NPAs	1,042	4,011	4,011	4,011	4,011	4,011	4,011
Loan Reserves	349	661	661	661	661	661	661
Net NPA	692	3,350	3,350	3,350	3,350	3,350	3,350
Total Assets	13,409	12,560	12,560	12,560	12,560	12,560	12,560
Additional Charge offs	N/A	168	335	503	670	838	1,005
Adjusted Total Assets	N/A	12,393	12,225	12,058	11,890	11,723	11,555
Liabilities	12,075	11,330	11,330	11,330	11,330	11,330	11,330
Adjusted Book Value	1,334	1,063	895	728	560	392	225
Price	533	533	533	533	533	533	533
Price/ Adjusted Book Value	0.40	0.50	0.60	0.73	0.95	1.36	2.37

NPAs	1,042	4,813	4,813	4,813	4,813	4,813	4,813
Loan Reserves	349	661	661	661	661	661	661
Net NPA	692	4,153	4,153	4,153	4,153	4,153	4,153
Total Assets	13,409	12,560	12,560	12,560	12,560	12,560	12,560
Additional Charge offs	N/A	208	415	623	831	1,038	1,246
Adjusted Total Assets	N/A	12,353	12,145	11,937	11,730	11,522	11,314
Liabilities	12,075	11,330	11,330	11,330	11,330	11,330	11,330
Adjusted Book Value	1,334	1,022	815	607	400	192	-16
Price	533	533	533	533	533	533	533
Price/ Adjusted Book Value	0.40	0.52	0.65	0.88	1.33	2.78	-33.93

NPAs	1,042	5,615	5,615	5,615	5,615	5,615	5,615
Loan Reserves	349	661	661	661	661	661	661
Net NPA	692	4,955	4,955	4,955	4,955	4,955	4,955
Total Assets	13,409	12,560	12,560	12,560	12,560	12,560	12,560
Additional Charge offs	N/A	248	495	743	991	1,239	1,486
Adjusted Total Assets	N/A	12,312	12,065	11,817	11,569	11,322	11,074
Liabilities	12,075	11,330	11,330	11,330	11,330	11,330	11,330
Adjusted Book Value	1,334	982	735	487	239	-9	-256
Price	533	533	533	533	533	533	533
Price/ Adjusted Book Value	0.40	0.54	0.73	1.09	2.23	-61.77	-2.08

NPAs	1,042	6,418	6,418	6,418	6,418	6,418	6,418
Loan Reserves	349	661	661	661	661	661	661
Net NPA	692	5,757	5,757	5,757	5,757	5,757	5,757
Total Assets	13,409	12,560	12,560	12,560	12,560	12,560	12,560
Additional Charge offs	N/A	288	576	864	1,151	1,439	1,727
Adjusted Total Assets	N/A	12,272	11,985	11,697	11,409	11,121	10,833
Liabilities	12,075	11,330	11,330	11,330	11,330	11,330	11,330
Adjusted Book Value	1,334	942	654	367	79	-209	-497
Price	533	533	533	533	533	533	533
Price/ Adjusted Book Value	0.40	0.57	0.81	1.45	6.77	-2.55	-1.07

NPAs	1,042	7,220	7,220	7,220	7,220	7,220	7,220
Loan Reserves	349	661	661	661	661	661	661
Net NPA	692	6,559	6,559	6,559	6,559	6,559	6,559
Total Assets	13,409	12,560	12,560	12,560	12,560	12,560	12,560
Additional Charge offs	N/A	328	656	984	1,312	1,640	1,968
Adjusted Total Assets	N/A	12,232	11,904	11,576	11,248	10,920	10,592
Liabilities	12,075	11,330	11,330	11,330	11,330	11,330	11,330
Adjusted Book Value	1,334	902	574	246	-82	-410	-738
Price	533	533	533	533	533	533	533
Price/ Adjusted Book Value	0.40	0.59	0.93	2.16	-6.52	-1.30	-0.72



PRICE AND VOLUME



	Last Month	Last 3 Months	Last 6 Months	Last 9 Months	Last 12 Months
High Price	30.33	34.61	62.26	70.85	74.12
Low Price	17.94	17.94	17.94	17.94	17.94
Close Price	27.19	28.9	38.77	59.01	61.96
Total Volume ('000)	18,954	55,849.5	12,7862	183,527.3	230,252.9
Average Daily Volume	631,800	613,732	702,539	672,261	630,830

This Week Vol. Times Week's \$ Change (\$000s)	.29	Current Market Value (\$ Million)	\$565.16
This Week's Dollar Volume (million)	24.51	Market Value As % Of Revenues	55%
Weekly Volume As % Of Shares Out.	5.37	Float (\$ Million)	21.02
Reported Shares Out. (2007/12) (#)	27,853,783	Float As % Of Shares Outstanding	76.13%

5 Day Moving Average	19.53	200 Day Price Index vs Market (%)	n.a.
10 Day Moving Average	21.80	Price Momentum This Week (%)	2.6%
10 Week Moving Average	27.23	Price Momentum Prior Week (%)	-22.5%
30 Week Moving Average	39.14	Beta (12 Month)	1.98
200 Day Moving Average	45.35	Beta (36 Month) Average	1.88



The Report

DOWNEY FINANCIAL CORPORATION

(NYSE: DSL)

\$20.29 NYSE

SELL



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The Report

DOWNEY FINANCIAL CORP. (NYSE: DSL)

SELL \$20.29

March 14, 2008

THE COMPANY

Downey Financial provides various financial services to individual and corporate customers.

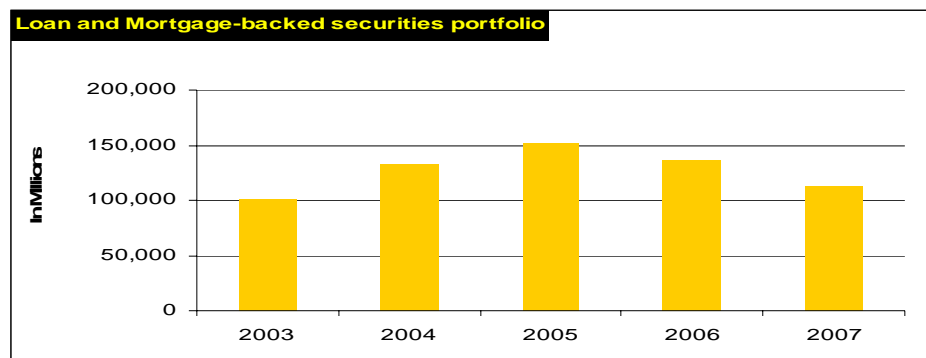
Based in California, Downey Financial Corp. is involved in banking services and real estate investments through its wholly owned subsidiaries, Downey Savings and Loan Association and DSL Services Company. DSL's banking business (accounting for 99% of the net interest income) focuses on attracting borrowings; originating and investing in loans, (predominantly residential real estate mortgage loans, investment securities and mortgage-backed securities). While originating loans is at the core of the company's business, it holds certain investments till maturity and sells the remaining in secondary markets. The company's real estate investment activities contribute marginally in the current housing slump. This involves investing in real estate business through joint ventures with other qualified real estate developers.

Business Activities

Banking Activities

*Home equity loans and lines
Commercial real estate loans
Construction and land loans
Residential lot loans
Consumer loans*

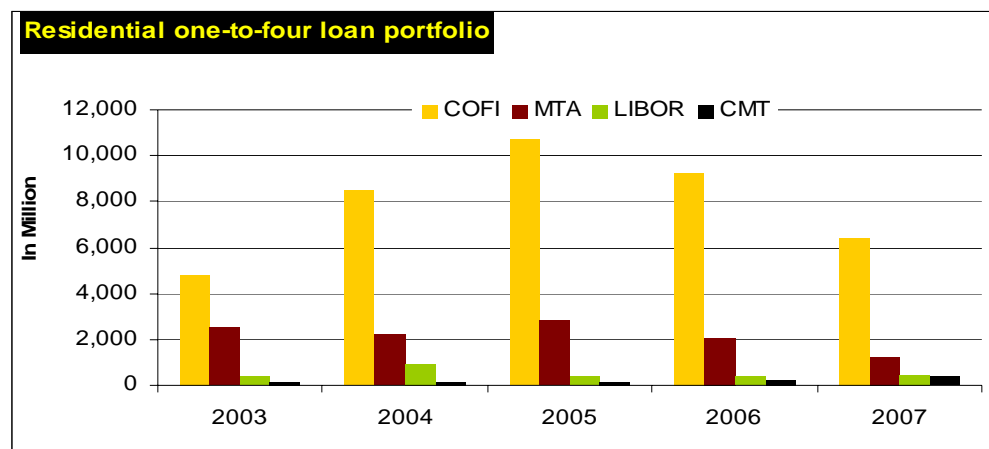
Loan and Mortgage-Backed Securities Portfolio: The majority of the company's loan portfolio is residential first mortgage loans. In order to attract larger customers, the company continues to focus on adjustable rate single family mortgage loans. However, it also originates other loans such as home equity loans and lines of credit, real estate multi-family loans, commercial real estate loans, construction and land loans, loans to individuals for construction and permanent financing, residential lot loans and consumer loans.





Its concentration in the real estate market exposes the company to the downturn in the housing market. However, by not retaining all the loans originated and selling certain loans in the secondary market, the company not only curtails its risk but also leverage its originating capacity (by generating income over and above its capital adequacy requirement).

Residential Real Estate Lending: The company's lending activities includes originating first mortgage loans secured by residential properties. Constituting about 89% of the total loan exposure, residential one-to-four unit properties are mainly concentrated in Californian region. This region, at present, is going through a state of economic turmoil. Originated by mortgage brokers (contributing 65% of portfolio) or loan officers, the company provides these loans for borrowers to purchase residences or to refinance their existing mortgage loans, with contractual maturities in the range of 15 to 40 years. Longer maturity periods expose the company to high interest rate and default risk.



It also originates residential fixed rate mortgage loans to meet consumer demand and increase income generation. At the same time, it sells majority of these loans in the secondary market, thus leveraging its operating capacities and mitigating default risk to a certain extent. It also places residential fixed rate loans in own portfolio of loans if they meet specific guidelines like yield, interest rate risk etc. Past data suggests that the tenure of fixed rate mortgage loans have been significantly shorter than contractual maturity as a result of refinancing and prepayments.

To reduce the default rate, the company limits the maximum loan balance to 110% of the original loan amount if the original loan-to-value ratio is greater than 75% and to 115%, if the loan-to-value ratio is 75% or less. It also has a lifetime interest rate cap, but no periodic cap on interest rate adjustments and includes a payment cap (that limits the change in required minimum monthly loan payments to 7.5% per year).



The maximum home loan disbursed by the company is equal to 85% of a property's appraised value. However, any loan in excess of 80% of appraised value generally requires private mortgage insurance. Typically, this ensures that the loan-to-value ratio does not exceed 75% which is consistent with secondary market requirements. Yet if a loan incurs negative amortization, the loan-to-value ratio could increase, which aggravates the credit risk. In this situation, the fair value of the underlying collateral could be insufficient to satisfy the outstanding loan obligation in the event of a loan default.

Secondary Marketing and Loan Servicing Activities: The company originates residential real estate ARM loans and fixed rate mortgage loans to sell in the secondary market. These loans are primarily secured by first liens on one-to-four unit residential properties and generally have maturities of 40 years or less. Downey sells loans which can be categorized as either servicing retained or servicing released. As a part of the secondary market activity, the company enters into forward sale commitments with investors to deliver an MBS collateralized by own loans. Accomplished through a securitization transaction, this involves the receipt of an MBS from a Government Sponsored Entity (GSE) in exchange for loans that DSL sells to GSE.

Multi-Family and Commercial Real Estate Lending: The company provides permanent loans secured by multi-family and retail neighborhood shopping center properties. Multi-family and commercial real estate loans generally entail additional risks as compared with single family residential mortgage lending. Thus stringent evaluation of the borrower's credit worthiness and amount of the borrower's equity in the project is conducted. Besides, to protect the value of the loan, borrowers are required to maintain casualty insurance. Moreover, for non-residential loans in excess of \$500,000, Downey asks borrowers to obtain comprehensive general liability insurance.

Construction and Land Lending: Downey also provides loan financing for construction of single family and multi-family residential properties and commercial real estate projects and for land development, which are originated mainly by the loan officers. The company makes construction and land loans at floating interest rates based upon the prime or reference rate of a major commercial bank. Besides, to reduce the default risk, loans are placed with only loan-to-value ratio of 80% or less.

Commercial Lending: The company maintains traditional private banking credit product and services for existing high net worth relationship-based customers. The commercial lending portfolio's emphasis is on floating interest rate loans and lines of credit. The company also provides deposit account products and services to meet the needs of business relationships maintained at the bank.

Consumer Lending: The bank originates lines of credit and other consumer loan products by either assessing the financial capability or securing collateral.



Besides, it also offers customers a credit card through a third party, who extends the credit and services the loans.

Investment Activities: The company's investing activities relate to the investments in various bonds and other asset classes and are either held for sale or till maturity. Regulated by OTS regulations and the Home Owners' Loan Act, the company's aim is to increase the yield on investments by seeking opportunity in various asset classes.

Deposit Activities: Deposit activities remain at the core of company's business operations as it enables it to fund the lending activities. Besides due to the lower cost of these funds vis-à-vis other funding sources (with comparable maturities), it makes the deposits activity even more important. The company sources its deposit mainly from the retail branch system. Deposits that stood at \$10.5 billion have shown diminishing trend since the past two years.

Borrowing Activities: The Company's other sources of funds include borrowings from the FHLB of San Francisco as well as the issuance of corporate debt.

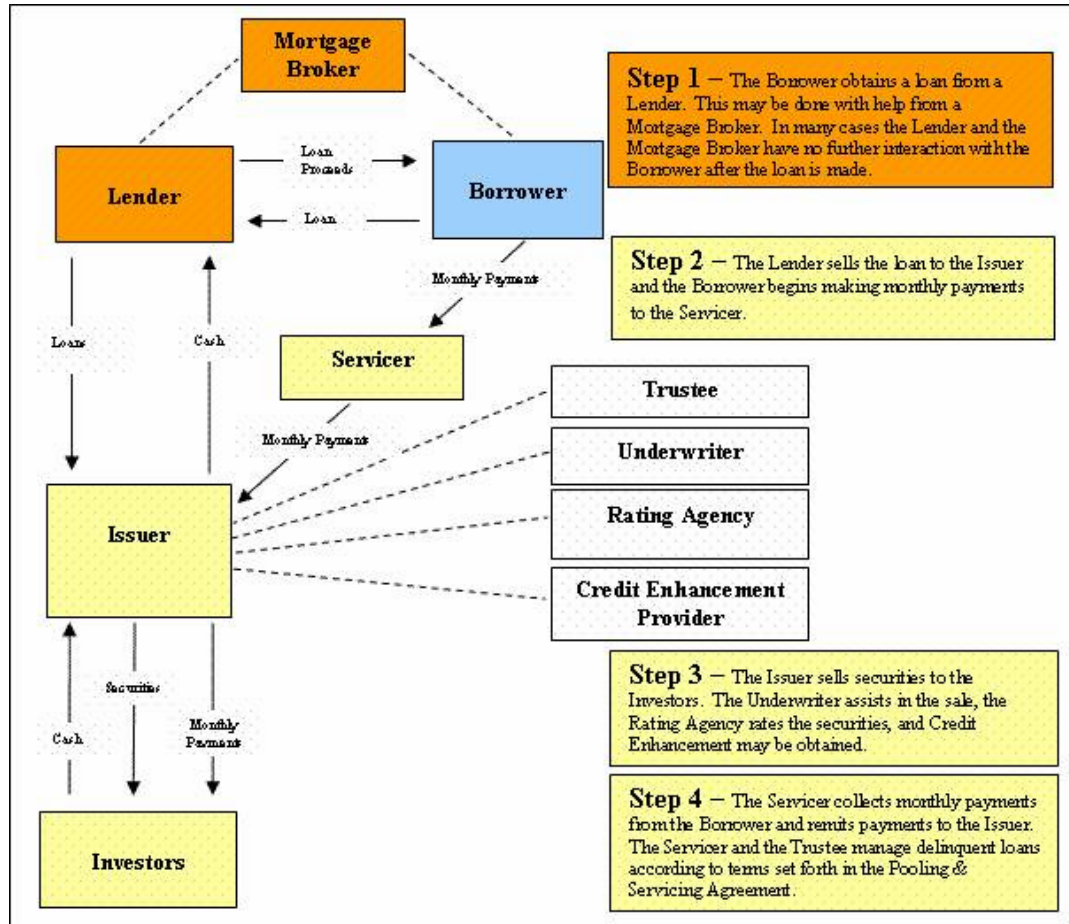
Downey sells securities and mortgage loans under agreements to repurchase in order to provide additional funding. These repurchase agreements are generally short-term and are collateralized by either mortgage-backed and investment securities or mortgage loans. Dealing with only investment banking firms that are recognized as primary dealers in U.S., the company limits the amount of borrowings from any single institution to reduce the risk of asset liability management.

Real Estate Investment Activities

The company engages in the real estate investment activities through DSL Service Company, a wholly owned subsidiary of the bank. Its operations include development, construction and property management activities of portfolio projects in California and Arizona. With primary revenue sources of rental income and gains from sale of real estate investments, DSL Service Company also invests in joint ventures with other qualified real estate developers.



Hands in the Pie



The Process

The process of securitization involves slicing up cash flows from a pool of mortgage, repackaging them and selling it to investors. Cash flows are sliced to create bonds of different risk profiles so as to match the requirement of different set of investors.

The Bubble

Easy credit, combined with the assumption that housing prices would continue to appreciate, encouraged many borrowers in the US housing bubble to obtain flexible loans like ARMs and interest only payments. The enabling financial climate resulted in huge investments in the real estate sector.

Tempted by the market demand, lenders on the other hand, originated loans and transferred to issuers thereby profiting from the transaction without taking up any risk.

Another market participant - Underwriters ensured that the risks of absorbing high amount of loans are mitigated. Determining whether the credit risk is acceptable, underwriters started automatic underwriting (constituting 40% of all subprime loans written in 2007). Thus borrowers with lower credential were also given loans increasing the risk of default.



Credit rating agencies (now under scrutiny) gave investment-grade ratings to securitization transactions which increased the investor demand. Critics claim that conflicts of interest were involved, as rating agencies are paid by those companies selling the MBS to investors, such as investment banks.

The virtuous cycle of reckless lending and passing the buck (securitization) came to haunt the financial markets when the risky mortgages (that were backing the bonds) started defaulting. This triggered a chain reaction resulting in higher foreclosures, tumbling real-estate market and a credit squeeze. Investors across the board (from hedge funds to insurance companies) that have subscribed to such papers are feeling the heat as they are clueless about its worth.



Recent Developments

Increased loan defaults in the month of February

Downey witnessed its share prices declining by almost 5% on March 17 due to increasing loan defaults; 10.93% of its loans were in default in the month of February, which was up from 9.14% in January, 08. The increase in NPAs was a consequence of the re-negotiations (TDR) with borrowers that rose to 4.30% from 3.59% and are considered flawed as per the recently altered accounting terms. The company has been re-negotiating the terms of the adjustable rate home loans with borrowers who are unable to make payments. Typical resets happen two years after the start of a loan, with rates increasing by about 30%. As the majority of Downey's loan portfolio is in option ARMs, and a substantial part of the loan book consists of loans given in 2005 and 2006, we can anticipate high resets and negotiations in the near future.

Citadel Investment Group picks up 5% stake in Downey Financial

Citadel has acquired a 5% stake (1,387,817 shares) in DSL adding to its total of 990,338 shares being held as of December 2007. Citadel Investment Group, a \$15 billion dollar hedge fund, founded by Kenneth Griffin in 1990, has grown into one of the world's largest and most successful alternative investment firms. Citadel's move to acquire these shares at a time when the stock is being beaten down significantly seems to be driven by a view which is divergent from the market.

Standard & Poor's cuts Downey's financial ratings on deteriorating credit performance

In the last week of January 08, S&P lowered its ratings on Downey Financial Corp. endorsing the ongoing concerns about the company's credit performance and profitability. The credit rating agency cut Downey's investment-grade long-term ratings to "BBB-" from "BBB." The company's short-term ratings were lowered to "A-3" from "A-2." Stating that company's credit performance is weakening, Standard & Poor's credit analyst Robert Hoban said that the action was also due to the expectation that credit costs and a prolonged difficult operating environment will continue to make profitability a challenge in the coming years. If this was a set back to the company's ratings, S&P said it may reduce Downey's ratings further, if economic and home price trends deteriorate beyond current expectations.



Downey Financial authorizes regular quarterly dividend of 12 cents per share

In spite of a poor performance in 2007, the company's management declared a regular quarterly dividend of 12 cents per share. Given the bank's financial condition with increased NPA's, higher provisioning, reduced interest income, it only adds to the company problems.

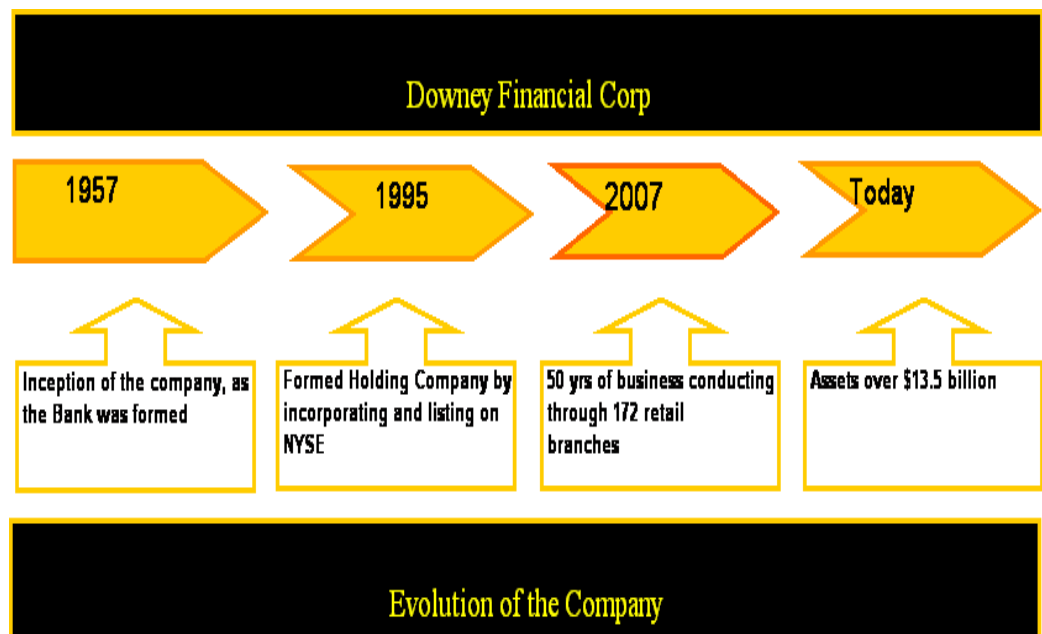


History

Downey Savings, a federally chartered financial institution focuses on the single residential homes. Incorporated in October 1994, the company opened its first office in the city of Downey, California in 1957. Counting its 50 years of operations, the company acquired 100% of the capital of Downey Savings and Loan Association in January 1995 which, at present, operates as the Bank's holding company.

Traded on the New York Stock Exchange, the Bank as of December 2007, conducts its business primarily through 172 retail deposit branches, including 90 full-service, in-store branches. Currently the company's diversified business offers home loan programs – both fixed and adjustable. The company primarily operates as a mortgage financier although it also provides other financial services.

Figure 1: Evolution of the Company





BULL CASE

- The recent Fed announcement to accept mortgage backed securities as collateral in exchange of treasuries not only infuses \$200 billion in the system but also provides much needed liquidity to the MBS market. The latest effort has eased the credit contraction and augurs well for financial markets. The Fed's auctions of treasuries will begin on March 27, and will be secured by collateral including agency and private residential mortgage-backed securities. The measures are the latest in Chairman Ben Bernanke's effort to alleviate increasing strains in financial markets that are curtailing credit to homeowners and companies, even after the Fed lowered its primary interest rate by 2.25 percentage points. The central bank's move is intended to ease the gridlock in credit markets, which has cast its shadow on all global markets since 2007-end.
- Troubled Debt Restructuring (TDR), considered as NPA, includes 95% of borrowers who have made all due payments. While NPA's have shot up to above 7.77%, if one excludes TDR the NPAs reduce to below 5%. There are possibilities that many would enter delinquent segment. The bank also announced its support to assist borrowers who held option ARM mortgages. The program was offered to borrowers whose loans were current at the time; therefore the bank initially didn't include them as troubled debt restructurings (TDRs). However, upon further consideration, its accountants counseled that unless the new loan terms were accompanied by an updated property valuation, credit report, and income analysis, they had to be considered TDRs. As Downey had not performed those additional requirements, it had to reclassify them all as non-performing assets, even though a substantial portion of them are still current in their payments.
- Huge short interest is piled up on the counter. Short positions held as of 12-Feb-08 are a strong 11.47 million, which constitutes a whopping 42.9% of the float. Besides, the short ratio is also 13.8. This suggests any short covering in the counter could lead to steep rise in the stock price.
- Downey's complete loan portfolio is largely concentrated in California. Around 89% of the total loans originate in California, which makes the company's asset base directly dependent on California real estate prices. The Fed's recent decision to cut interest rates by 75 basis points, has attracted many home builders and home finance companies. Some companies have started offering clients free mortgage and refinancing education in order to help them understand how the new rate cut will impact California home loans. The rationale behind this initiative is to infuse demand and help the Southern California real estate market to become balanced. If this proves positive, this will not only improve credit off-takes but it will also enhance real estate rates, thus reducing the risk of defaults and improving Downey's asset quality.
- **Acquisition Target:** The regional bank sector has experienced significant M&A activity in recent years. Generally, larger banks have been acquiring smaller firms in an attempt to achieve greater scale and in some cases the acquisitions have happened at 2.0-3.0+ multiple of book value. Despite the expected problems DLS could have with its loan portfolio, a large bank could absorb that exposure and the potential losses in exchange for the expanded retail presence and a large loan portfolio. A large bank would have a strong distribution channel and could dispose off the less attractive loans and affect a "clean-up" of DSL's balance sheet once it is acquired. In return, while



taking some possible write downs through losing sales and/or bad loans, the acquirer would receive entrance/expansion into an attractive geography, the Company's deposit base, and could generate incremental revenue by driving its own products through the 100 chain bank.

At the time when the credit markets are weakening, consolidation remains an important activity to restrain losses. Recently, J P Morgan Chase rescued Bear Stearns, buying the company at \$2 per share. Increasing losses led by higher defaults are making things difficult for financial companies. In such a scenario, sustaining a market downturn becomes critical. Moreover, steep declines in share prices make companies attractive buys for larger players.

Buyout?

The latest round of speculation pertaining to the acquisition of Downey stems from the move by Gerald J. Ford, who acquired a 6.8% stake in Downey during November last year. In his filing with the SEC, (Securities and Exchange Commission) he said, he had met with Maurice McAlister - Cofounder and Chairman, and other Downey officials with regards to his investment and Downey's long-term strategies, including potential business combinations. This makes the investment important from a takeover perspective though past acquisition speculation about Downey did not materialize. Downey has however, declined to comment on either any succession plans or Ford's investment plans.

Recently, Jim Cramer of TV's "Mad Money" called Downey "the next Golden West," referring to Oakland-based Golden West Financial Corp., which Wachovia Corp. bought for \$25 billion in late 2006. McAlister has only a 20% stake in Downey. Thus, a buyout, whether hostile or consensual, could be possible. Downey's shares have tumbled more than 70% in the past year, which makes the company look attractive for buyout. Ford, who sold Golden State Bancorp of San Francisco to Citigroup Inc. in 2002 for \$5.8 billion, acquired nearly 2 million shares of Downey for \$63.4 million.

As previously mentioned, Ken Griffin disclosed a 5% (1,387,817 shares) stake purchase in Downey. Griffin's Citadel Investment Group already held 990,338. With investors eyeing the share purchase in the company, the possibility to a buyout cannot be ruled out. **But the thorny issue is that Downey's loan portfolio is still in the woods. A close look at the company's balance sheet suggests that many serious issues still plague Downey as a significant percentage of the ARMs is expected to reset in the near future. The majority of Downey's \$11 billion in loans are adjustable-rate mortgages and were made to people with mediocre credit history. Thus with the bulk of Downey's option ARMs starting to reset, more turmoil is expected to affect the balance sheet and income statement. The company would have to increase its capital to offset loan defaults. In these circumstances, the buyout could happen presumably at a throwaway price or after the company clears its balance sheet and improve asset quality.**



BEAR CASE

- The global financial system is undergoing turbulent times, and its effect is felt in the real economy as well. The softness in global economy could further accentuate the financial turmoil. These could pose a problem for financial services companies such as DSL, which is at the crux of the problem.
- Experiencing a variety of difficulties, the housing and residential mortgage market is facing a sharp meltdown. If market conditions continue to deteriorate further, they may lead to huge charge offs on loan portfolios and collaterals. The demand supply mismatch has created difficulty in selling homes in markets, which is leading to loss severities on loans and decline in the net realizable value of real estate owned. The housing market, which is expected to further deteriorate, could lead to additional downgrades, triggering larger provisions and charge-offs on loans.
- Geographic concentration in California has created further pressure, as the state's economic conditions continue to worsen. This could result in heightened foreclosures led by an increased number of defaulters. Also, the business could be adversely affected by disruptions such as natural disasters, war or terrorism in the geographic areas where the company operates.
- The types of loans in the company's portfolio have a higher degree of risk, and a downturn in the real estate markets could adversely affect the business. As of December 31, 2007, virtually all of the value of the loan portfolio consisted of loans collateralized by various types of real estate, of which 67% were subject to negative amortization¹. If a loan incurs significant negative amortization, the loan-to-value ratio could increase, raising the Bank's credit-risk exposure and its susceptibility to a downturn in the real estate markets.
- A prolonged period of secondary market illiquidity may reduce the company's loan production volumes and could adversely affect secondary market activities and financial conditions.
- A further deterioration in the housing market may lead to loss severities and further worsening of delinquencies and non-performing assets. Consequently, allowance for credit losses may be inadequate to cover actual losses, and the company may be required to materially increase reserves.
- The private secondary mortgage markets are experiencing disruptions resulting from reduced investor demand for "nonconforming" mortgage loans and mortgage-backed securities, thus demanding increased investor yield requirements for those loans and securities. These conditions may continue or worsen in the future.
- The spread of credit contamination is likely to spill from sub-prime to prime in foreseeable future, due to factors that led to a sub-prime crisis. Lending was at its peak in the last five years and the underwriters and regulators were not paying attention to its repercussion. Currently, when real estate value is falling, the ARMs reset cycle increases, and inventory builds up. In this scenario, it is quietly likely that the company will exhibit continued deteriorating financial results.

¹ A negative amortization loan is one in which accrued interest exceeding the required monthly loan payment is added to loan principal.



- If the U.S. bombs Iraq's nuclear facilities, hundreds of billions of dollars would play havoc with an already depressed domestic economy which could tip the world into recession because of the adverse effect on oil prices, inflation and interest rates. Thus if U.S. goes into a prolong recession, the company's revenues could experience a freefall.
- The company functions in a competitive market where it competes with a variety of financial institutions such as banks, savings and loan associations, mortgage banks, finance companies, brokerage firms, insurance companies, credit unions and other financial intermediaries, whose greater resources may afford them a marketplace advantage. Competition is generally on the basis of interest rates offered on loans and deposits, efforts to obtain loan and deposit customers and a range in quality of products and services provided. If the company is unable to attract new clients and retain existing customers, the company's cash flows and loan growth may be adversely impacted.

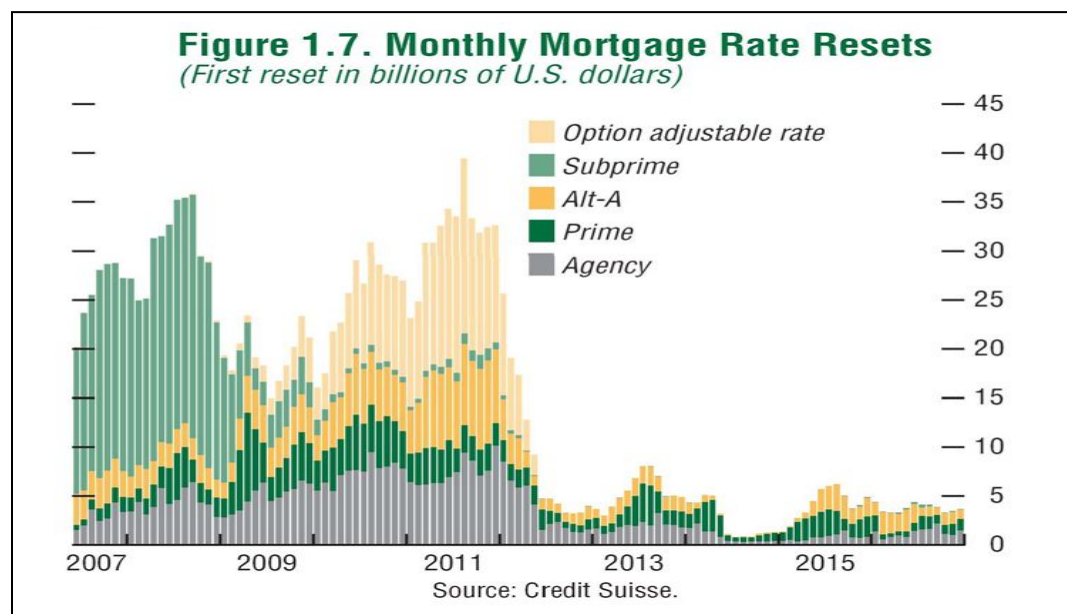


DOWNEY FINANCIAL CORP. – VALUE DRIVERS

Deteriorating economic conditions, slumping housing markets, and defaulting mortgage borrowers are impeding Downey's growth. The company's core lending operations are overshadowed by a significant growth in non-performing assets and reduced loan originations.

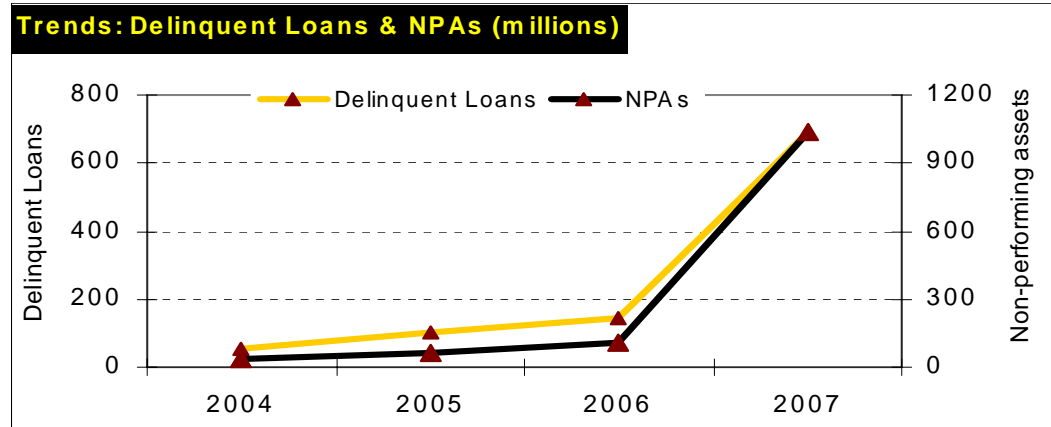
Deteriorating Asset Quality

As the credibility of borrowers weakened, the company's NPAs spiked up. Total non-performing assets have risen from \$110.4 million in 2006 and \$35.2 million in 2005 to \$1.04 billion in 2007, representing nearly 10 times increase in just one-year period. As a percentage of total loans, non-performing assets were 9.4% in 2007, up from 0.80% reported in the year-earlier period. Slowing economic conditions exacerbated by slumping housing markets and increased default rates led to this substantial increase in total NPAs. Recent statistics for the month of January 2008 revealed that non-performing assets to total loans have risen to 11.3%, representing a sequential expansion of 190 bps in NPAs in just one month's time. This also reflects continued weakening of the housing market and its uncertain future, unfavorably impacting the borrowers and the value of their loan collateral, which in turn is leading to higher default rates. A significant increase in 30-59 day class of delinquent loans indicates growing uncertainty in the California housing market.





The report on California housing markets indicate a nearly 21% dip in real-estate prices in California since May 2007. The typical mortgage payment that home buyers committed themselves to paying in January was \$1,743, down from \$1,878 in December 2007 and \$2,155 in January 2006. Foreclosure activity is at record levels. Financing with adjustable-rate mortgages or with multiple mortgages have dropped sharply. As real-estate continues to deteriorate, the DSL's massive rise of delinquent loans and NPAs shows no sign of abating. With mortgage rates being reset at an accelerated pace, going forward this trend is likely to accentuate.



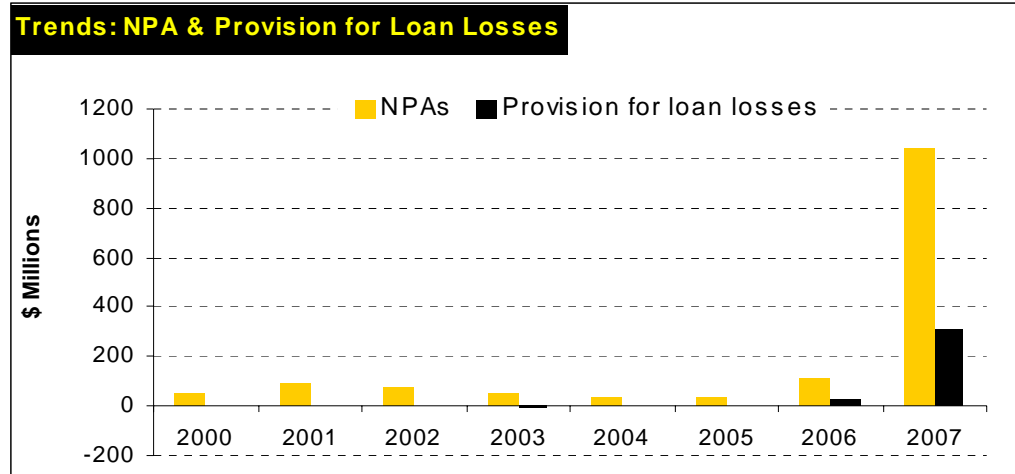
Management is undertaking initiatives to buffer losses from NPAs to some extent by instituting a borrower retention program in the third quarter of 2007. Nevertheless, it should be noted that the interest rates following modification were no less than those offered to new borrowers. These loans have been placed on non-accrual status, as the credibility of borrowers falling under the category is remains a concern.

Rising NPAs & Delinquent loans (2004-2007)				
	2004	2005	2006	2007
30-59 Days	\$ 25.1	\$ 42.6	\$ 57.0	\$ 239.3
60-89 Days	\$ 7.3	\$ 21.1	\$ 24.3	\$ 135.2
90+ Days	\$ 23.9	\$ 37.5	\$ 63.2	\$ 314.2
Total Delinquent Loans	\$ 56.2	\$ 101.2	\$ 144.5	\$ 688.9
As a % of Total Loans	0.4%	0.7%	1.0%	6.1%
Growth		79.9%	42.9%	376.7%
Non-Performing Assets	\$ 35.2	\$ 66.5	\$ 110.4	\$ 1,041.8
As a % of Total Loans	0.2%	0.4%	0.7%	7.8%
Growth		88.9%	65.9%	844.0%



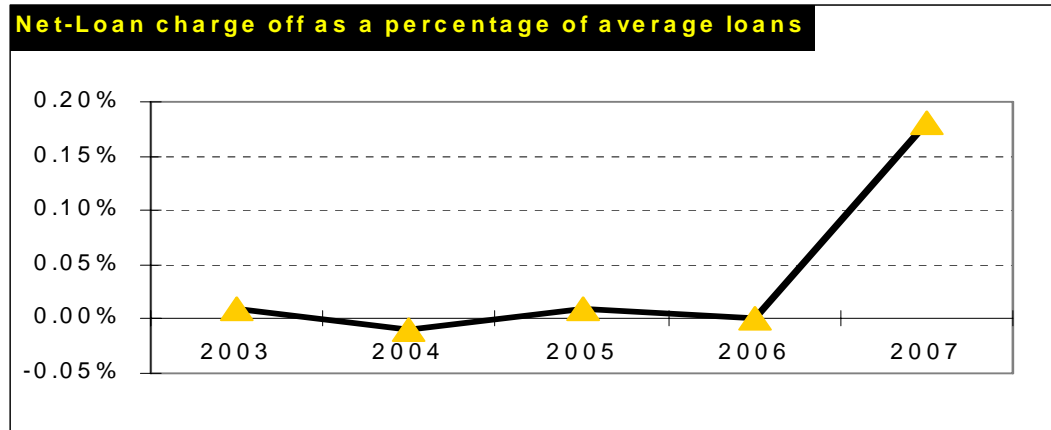
Rising provisions to commensurate spiking NPAs

As a result of increasing NPAs, the company in the fourth quarter of 2007 increased provision for loan losses to \$218.6 million (versus \$0.4 million in the fourth quarter of 2006), bringing total full year provision for loan losses to \$310.3 million (versus \$26.6 million in 2006). Delinquencies of single family loan coupled with losses from foreclosures led to the large increase in allowance for loan losses. Loan reserves to NPAs increased to 29.8% in 2007 from the 24.1% in 2006 and 6.4% in 2005. The increase in provision not only suggests a further anticipated rise in delinquent loans but an expected decline in the value of underlying home collateral due to the continued weakening and uncertainty relative to the housing market. Management believes that this challenging economic environment will continue in 2008. As these delinquencies escalate further in 2008, we can expect a further rise in provisions.



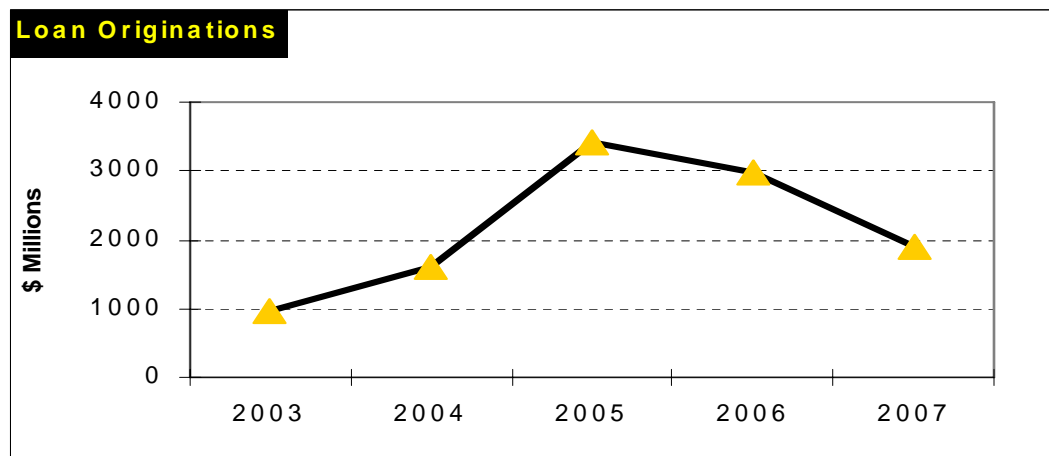
Elevating Charge-Offs

Another concerning factor is the company's escalating charge-offs. In 2007, net loan charge-off totaled \$22.3 million compared to \$0.7 million in the year-earlier period. The increase in net charge-offs are primarily related to residential one-to-four unit loans, with the annualized net charge-off ratio associated with these loans increasing to 0.43% from 0.01% a year ago. In terms of geographic area, regions that exhibited particular weakness include greater Sacramento, Stockton, Modesto and Monterey areas of Northern California, the Inland Empire and San Diego County. We believe charge offs would further escalate on back of increasing delinquency due to ARM's (Adjustable rate mortgage) being reset at higher rates.



Weak Business Environment

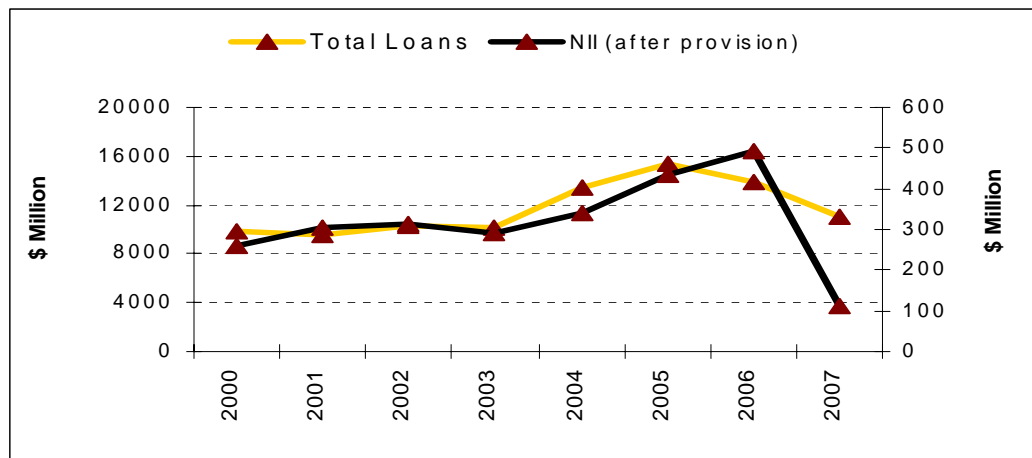
Loans held for investments declined 20.1% year-over-year to \$11.0 billion compared to \$13.8 billion in 2006 as loan-payoffs outpaced originations. Loan originations totaled \$3.8 billion, down 51.7% from \$7.8 billion in the same period a year ago. Loans originated for sale declined \$1.9 billion or 54.8% to \$1.6 billion, while single family loans originated for portfolio declined \$2.0 billion or 48.9% to \$2.1 billion. In addition to single family loans, \$81 million of other loans were originated during 2007, down from \$185 million a year ago. It should be noted that over the last three years, when the economy was experiencing growth at an accelerated pace and a potential housing bubble was forming between 2003 and 2006, the company's loans grew at an impressive double-digit rate, implying its performance directly correlated with the economy. As the US economy is heading for turbulent times the incremental credit growth is likely to taper off.





Shrinking Asset Base

Rising mortgage loan originations drive net interest income for the company. In the present scenario, when the economy is experiencing a slowdown, the company's loan balance is directly impacted and has experienced a straight 20.1% dip in loans held as investments in 2007 from the prior-year period. We believe the recent weakening of the housing market and its uncertain future should continue to impact borrowers and their loan collateral. Therefore, it is quite likely that going forward DSL will experience a further shrinkage in overall asset base, which will ultimately constrain the company's net interest income and spread.





True value of the loan portfolio

	2003	2004	2005	2006	2007	Balance
Loans Subject to NegAm	\$625	\$1,440	\$3,144	\$1,888	\$433	\$7,531
IO Loans	\$125	\$109	\$183	\$1,024	\$1,303	\$2,745
Other	\$214	\$48	\$100	\$78	\$161	\$602
Total	\$964	\$1,597	\$3,428	\$2,991	\$1,897	\$10,877
% of Balance	8.9%	14.7%	31.5%	27.5%	17.4%	100.0%
Reported Loan to Value:						
Loans Subject to NegAm	73%	73%	73%	73%	73%	73%
IO Loans	69%	69%	69%	69%	69%	69%
Other	73%	73%	73%	73%	73%	73%
Implied Home Value:						
Loans Subject to NegAm	\$856	\$1,973	\$4,307	\$2,587	\$593	\$10,316
IO Loans	\$181	\$158	\$266	\$1,485	\$1,889	\$3,978
Other	\$294	\$65	\$137	\$107	\$221	\$824
Total Implied HV	\$1,331	\$2,196	\$4,710	\$4,179	\$2,703	\$15,118
Market Adj to HV						
Home Value Decline	5.0%	15.0%	20.0%	15.0%	7.0%	15.8%
Loans Subject to NegAm	\$813	\$1,677	\$3,446	\$2,199	\$551	\$8,686
IO Loans	\$172	\$134	\$213	\$1,262	\$1,757	\$3,538
Other	\$279	\$55	\$110	\$91	\$205	\$741
Total	\$1,264	\$1,866	\$3,768	\$3,552	\$2,514	\$12,964
"Real" LTV						
Loans Subject to NegAm	76.8%	85.9%	91.3%	85.9%	78.5%	86.7%
IO Loans	72.6%	81.2%	86.3%	81.2%	74.2%	77.6%
Other	76.8%	85.9%	91.3%	85.9%	78.5%	81.2%
Total	76.3%	85.5%	91.0%	84.2%	75.5%	83.9%

The Implied Home Value is based on DSL's reported loan to value figures. DSL has underwritten a substantial part of its mortgages during the heaviest bubble years, with 32% and 27% of its loans underwritten in 2005 and 2006 respectively. Despite the adverse volatility around market prices of homes in DSL's core areas of operations (i.e 89% in California), DSL has ignored the value of the underlying collaterals for calculating the loan to value ratios. If we add the figures of valuation declines in California to the implied home values, it gives the actual market loan to value. DSL's loans are close to 85% of this ratio. The loans underwritten in 2005, which are likely to have the highest loan to value due to the bubble, would comprise the largest percentage of recasts as negative amortization approaches recast thresholds. At 90%+ loans to value, there could be very little incentive for borrowers to recast loans at onerous terms when they have such a small amount of equity in these homes. This situation, we believe, will lead to a rapid rise in foreclosures.

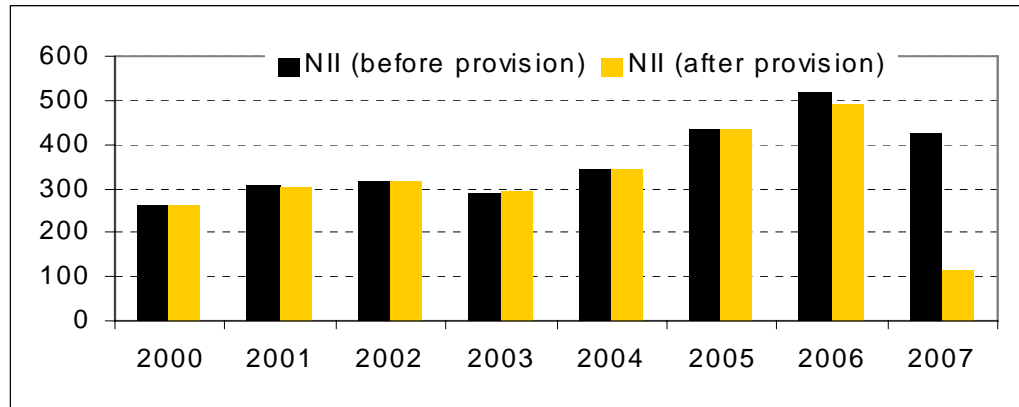
On the other hand, provisions for loan losses makes less than 35% of the total NPA. In the past this has been around 100% of the NPA. Thus, if the company



faces any charge offs over and above the provisions (which is merely \$350 million) it would reduce the company's equity. Further, if the company anticipates any write offs and increases the provisions accordingly, it would have a direct impact on the company's profitability, thereby pushing down the book value. Thus, with increasing NPAs and erosion in home equity, the company's shareholders are expected to suffer, sooner or later.

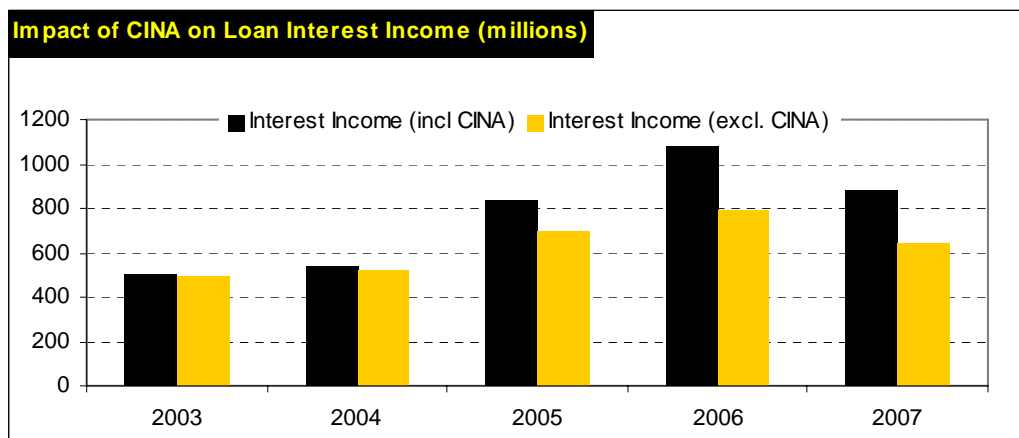
Contracting interest margins

In 2007, net interest income, before provision for loan losses, declined 22.5% year-over-year to \$423.8 million. After incorporating the impact of provision for loan losses, net interest income dropped by a significant 76.7% year-over-year to \$113.7 million while net interest margin contracted 9 basis points to 3.4% (versus 3.6% in 2006). Net spread diminished 25 bps to 2.4%. The decline in the margins is mostly attributable to the shrinking of the total loan asset base, which has fallen by a considerable 20.1% over the prior-year period. The continued weakening of the housing market and its uncertain future have unfavorably impacted the borrowers and the value of their loan collateral. As a result, single family loan delinquencies, as well as losses from foreclosures, rose significantly during 2007 and led to the large increase to the allowance for loan losses.



Eroding Cash Interest Income

The company's loan interest income of \$885.5 million consisted nearly \$245.4 million of non-cash capitalized interest from negative amortization². The lender does not actually receive this interest from negative amortization amount as a payment from the borrower but many capitalize this accrued interest balance and recognize it as an income as long as capitalized interest is considered collectible. Excluding non-cash capitalized interest, net interest income (before provision for loan losses) declined 18.8% year-over-year to \$640.1 million. With loans subject to negative amortization making 68% of DSL's total loans portfolio in 2007, non-cash capitalized interest accounts for a larger percentage of total interest income, therefore making the cash interest component significantly low. We believe capitalized non-cash interest income will trend further in 2008 due to an increase in negative amortization.

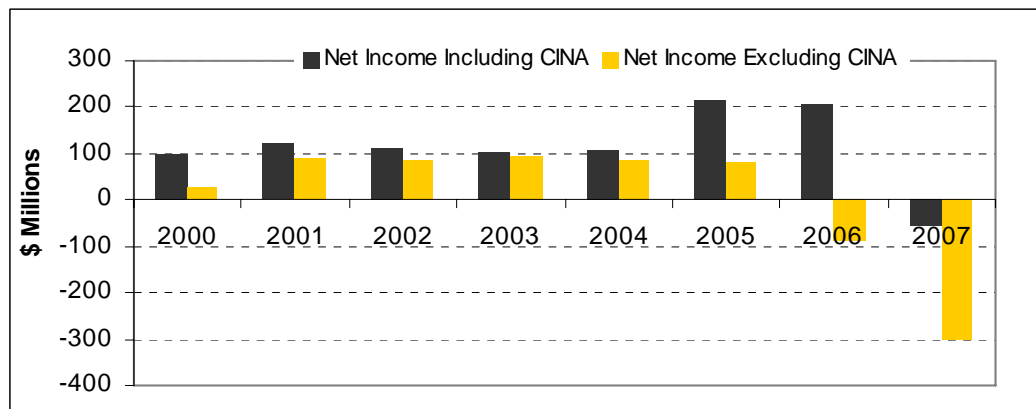


² When the loan payment in any period is less than the interest charged for that period, the lender adds the shorted amount to the total amount owed, thereby increasing the total outstanding loan amount. This process of increasing the loan amount due to the interest shortfall is known as negative amortization. Lenders may record negative amortization as income in the form of capitalized interest.



CINA playing a major component

In 2007, the company reported a net loss of \$56.6 million compared to net income of \$205.2 million reported in the year-earlier period. Included in this net loss is non-cash capitalized interest income of \$245.3 million. Excluding the impact of non-cash capitalized interest income on negative amortization, the net loss amounted to \$302.0 million compared to the net loss of \$87.8 million reported in the prior-year period. This reflects non-cash interest arising from negative amortization is increasingly becoming a main component in driving total loan interest income and bottom-line growth.



To a significant extent, CINA cannot be considered as a core component of earnings, as its cash realization is somewhat questionable. If one knocks off CINA from interest income to arrive at normalized earnings then the picture looks dismal.

Inadequate Loan Verification

It has been noted that at the time of loan discharge, the company made minimal credit history verification for borrowers taking a loan. As of December 31, 2007, approximately 82% of residential one-to-four unit loans held for investment were originated based on income as stated by the borrower and asset verification, while an additional 7% were underwritten with no verification of either borrower income or assets. To the extent borrowers overstated their income or assets, the ability of borrowers to repay their loans may be impaired, which could adversely affect the quality of loan portfolio. Therefore, uncertainty remains about the company's asset quality due to the company's lack of diligence in discharging loans and hence the recoverability of it remains a grave question.



KPMG Accounting Change:

Recently Downey's auditors KPMG, advised the company to make certain accounting changes with respect to TDRs. In the past quarter, the company started a borrower retention program to provide qualified borrowers with the option to adopt less-costly financing alternatives. Citing GAAP rules, the auditors insisted on accounting the loans as troubled debt restructuring (TDRs), as the interest rate were lowered in a loan modification. The modification would not be deemed as TDR, if the modified loan is proved to be at market rates. This forced DSL to account such loans as part of NPAs in the December quarter. **The modifications, which are 40% of the total loans under the program, were led by rising defaults. The performing troubled debt restructuring represents about 3% of the total assets of \$13.5 billion. A substantial portion of company's loan portfolio consists of option ARMs. With reset dates nearing and higher recasts expected, the accounting change can only increase its NPAs. Thus, we believe, restructuring of the asset base would not allow DSL to escape the NPA net.**

Rating Downgrade by Credit Agencies

On January 31, 2008, the credit rating agency Standard & Poor's, lowered its long-term rating on Downey Financial to BBB- (from BBB) and short-term rating to A-2 (from A-3) based on the company's concerning credit performance and profitability. The rating agency believes rising credit costs and challenging operating environment will remain as an impediment to the profitability in near-term. Other rating agencies such as Moody's are also considering cutting their rating on Downey Financials' credit due to the company's higher concentration in the deteriorating housing market of California. The rating agency believes continued deterioration in the California real estate market, which might adversely impact the bank profitability this year.

Bearish California Real-Estate Market

The most recent report on the California real-estate market for the month of January revealed the lowest sales of new and resale house sales statewide since 1988 to 19,145, down 41.0% year-over-year. The median price paid was \$383,000, down from the median price of \$484,000 in March 2007. The typical mortgage payment that home buyers committed themselves to paying last month was \$1,743. That was down from \$1,878 in December, and down from \$2,155 for January a year ago. Adjusted for inflation, mortgage payments are 18.2% below the spring 1989 peak of the prior real estate cycle. The chart below clearly demonstrates declined number of sales in almost all the counties in California.



All Homes	Number Sold 7-Jan	Number Sold 8-Jan	Percent Change	Median Jan-07	Median Jan-08	Percent Change
Alameda	1,279	780	-39.00%	\$570,000	\$487,750	-14.40%
Contra Costa	1,158	667	-42.40%	\$550,000	\$463,000	-15.80%
Marin	195	122	-37.40%	\$830,000	\$845,000	1.80%
Napa	98	44	-55.10%	\$542,500	\$532,500	-1.80%
Santa Clara	1,606	869	-45.90%	\$660,000	\$639,000	-3.20%
San Francisco	402	293	-27.10%	\$750,000	\$744,000	-0.80%
San Mateo	499	295	-40.90%	\$735,000	\$675,000	-8.20%
Solano	468	247	-47.20%	\$430,000	\$347,500	-19.20%
Sonoma	463	269	-41.90%	\$510,000	\$425,000	-16.70%
Bay Area	6,168	3,586	-41.90%	\$601,000	\$550,000	-8.50%

In addition to this, foreclosure activity is at record levels, financing with adjustable-rate mortgages or with multiple mortgages have dropped sharply. As the market remains hamstrung by the credit crunch and uncertainty among buyers, sellers and lenders, price declines worsens, especially in inland markets, which are hit hard by foreclosures. The actual loss of a home to foreclosure totaled 31,676 during the fourth quarter. That is the highest since 1988. Approximately 114% increase in notice for default has been reported. Lending institutions sent homeowners 81,550 default notices during the October-to-December period. That was up by 12.4% from 72,571 the previous quarter, and up 114.6% from 37,994 for fourth-quarter 2006. December quarter's number of defaults was the highest since 1992. The chart below shows state-wide notice of defaults received in the fourth quarter of 2007 compared to the last year.

Concentration Risk

With Downey's operations concentrated basically in California, the company is vulnerable to such downturns in the real estate market. If California real estate prices continue to decline, the value of real estate collateral securing the company's loans will be reduced and provide less security. As a result, management's ability to recover investment on defaulted loans by foreclosing and selling the real estate collateral would then be diminished leading to huge losses.

Fiscal and Monetary Policies

In light of the tough economic environment, the U.S. Federal government has undertaken monetary policies and fiscal policies to stimulate economic growth. On February 13, 2008, Congress enacted a plan to focus on infusing cash to



consumers. The plan also addresses the current lack of liquidity in the mortgage market. The government's plan will temporarily increase the maximum size of mortgage loans (the conforming loan limit) that Fannie Mae and Freddie Mac purchase from the current \$417,000 cap to a maximum of \$729,750. The plan would also permanently raise the cap on the Federal Housing Administration's conforming loan limit from \$362,000 to \$729,750. These changes are intended, among other purposes, to provide more liquidity for originators of larger mortgage loans, make lower interest rates available to homebuyers for such loans and enable homeowners to refinance such loans at lower interest rates. Also Hope Now in October 2007 was instituted which aimed at encouraging mortgage service providers, mortgage counselors, government officials and non-profit groups to coordinate their efforts to help struggling borrowers restructure their mortgage payments and stay in their homes. The plan included coordinating and improving outreach to borrowers, developing best practices for mortgage counselors across the country and ensuring that groups able to help homeowners work out new loan arrangements with lenders have adequate resources to carry out this mission. Despite these initiatives, the company's NPA are increasing. DSL is yet to show some tangible results

Diminishing Shareholders Value

DSL has been a rank underperformer, losing 70% of market value during the last year. If one looks at its book value (unadjusted for asset quality) of \$47.9 it actually looks attractive at sub \$20 level. However, this is only part of the picture. **In a financial entity, financial leverage parties key to understanding share prices. Its Loan value per-share is around \$448.6. Thus, even if 10% of its loan book worsens, then the entire equity could go bankrupt. Given the uncertainty in the entire financial system this is not an incomprehensible scenario. Hence even at these levels we remain bearish on the stock.**



INDUSTRY OUTLOOK

The primary purpose of thrifts is to provide mortgage loans to home owners funded by consumer deposits. Demand for banking services is closely tied to economic activity and the level of interest rates. The profitability of individual banks depends on marketing skills, efficient operations, and competent risk management. Downey has advertised the “good risk management” position and is dealing with multiple layers of risk including: limited verification of borrower income or assets; concentration in California; concentration in housing bubble years; use of mortgage brokers; negatively-amortizing Option-ARM loans. That is the internal position of the bank.

Slowing California economy

As per the Governors budget for 2008 -09, the California and national economies faced considerable headwinds in 2007; a deepening housing slump, a breakdown in mortgage markets, tighter credit, more volatile financial markets, and rising energy prices. Upward resets of sub-prime mortgage rates made payments unaffordable for many borrowers and helped push mortgage defaults and foreclosures to record levels. Uncertainty about how far the problems with these mortgages would spread has increased the financial market volatility and prompted lenders to tighten credit standards. In California, the housing slump has been deeper than the vast majority of other states. Single-family housing permits in the third quarter of 2007 were only about one third of their level in the third quarter of 2005 and existing home sales, about half of their level two years ago.

Growth (%)	Forecast		
	2007	2008	2009
US Real Gross Domestic Product	2.1	1.9	2.9
California Non-farm Employment	0.8	0.7	1.0
California Personal Income	5.6	4.8	5.2
California Consumer Price Index	3.3	2.6	2.7
California New Housing Units	(28.40)	(19.10)	10.1

Department of Finance, California Budget 2007 -2008

The state and national economies will continue to face the same headwinds: a struggling housing sector, problems in mortgage markets, tighter credit, more volatile financial markets, and high energy prices-in 2008 and, to a lesser extent, in 2009, but economic growth should start to pick up in late 2008. The outlook for the national economy is for slower growth in 2008 and improved growth in 2009 and 2010. Real GDP is projected to grow 1.9% in 2008, and 2.9% in 2009 and 2010, as compared to 2.1% in 2007. Non-farm payroll employment is forecast to increase 0.8% in 2008, 1.2% in 2009 and 1.3% in 2010, as compared to 1.3% in 2007.



Slowing job growth

Monthly job gains slowed considerably in the state in the first ten months of 2007, averaging just 5,800. Gains averaged 20,900 in the first ten months of 2006. The state's unemployment rate increased from 4.8% in March 2007 to 5.6% in September and October 2007.

Figure ECO-03
Selected Economic Data for 2007, 2008, and 2009

	2007 (Est.)	2008 (Projected)	2009 (Projected)
Unemployment (thousands)	960.1	1,051.4	1,049.1
(percent change)	10.0	9.5	(0.2)
Unemployment rate (percent)	5.3	5.7	5.6
Nonfarm wage and salary employment (thousands)	15,177.4	15,283.4	15,443.7
(percent change)	0.8	0.7	1.0
Personal income (billions)	1,515.8	1,588.5	1,670.3
(percent change)	5.6	4.8	5.2
Housing units authorized (thousands)	117.0	95.0	104.0
(percent change)	(28.4)	(19.1)	10.1
Corporate profits before taxes (billions)	187.7	188.6	196.2
(percent change)	5.6	0.5	4.0
New auto registrations (thousands)	1,742.0	1,750.5	1,758.0
(percent change)	0.2	0.5	0.4
Total taxable sales (billions)	563.1	582.5	609.1
(percent change)	0.9	3.4	4.6
Consumer price index (1982-84=100)	217.3	223.0	229.0
(percent change)	3.3	2.6	2.7

* CW: Chain Weighted
Note: Percentage changes calculated from unrounded data.

Weak Banking Conditions

As per FDIC's quarterly banking profile, Commercial Banks and Thrifts earned \$105.5 billion in 2007, a decline of \$39.8 billion (27.4%) from the record \$145.2 billion that the industry earned in 2006. Fourth-quarter results, lowest in 16 years translates the weak economic conditions prevailing in the country. Higher provisions for loan losses -- primarily due to weakness in residential mortgage and construction loans -- and sharply lower trading revenue were primarily responsible for the drop in full-year earnings. The bulk of the earnings decline was attributable to a few large institutions, but fewer than half of all insured institutions (49.2 percent) reported increased net income in 2007. In addition, the FDIC reported that fourth-quarter earnings dropped to \$5.8 billion, their lowest level since the fourth quarter of 1991.

Weakness in the housing sector and the credit squeeze in financial markets made it a very challenging time for many institutions. FDIC expects these problems to continue in 2008. Growing asset quality problems are weighing on the bottom line of much thrift. Banking conditions in California was no different, if not

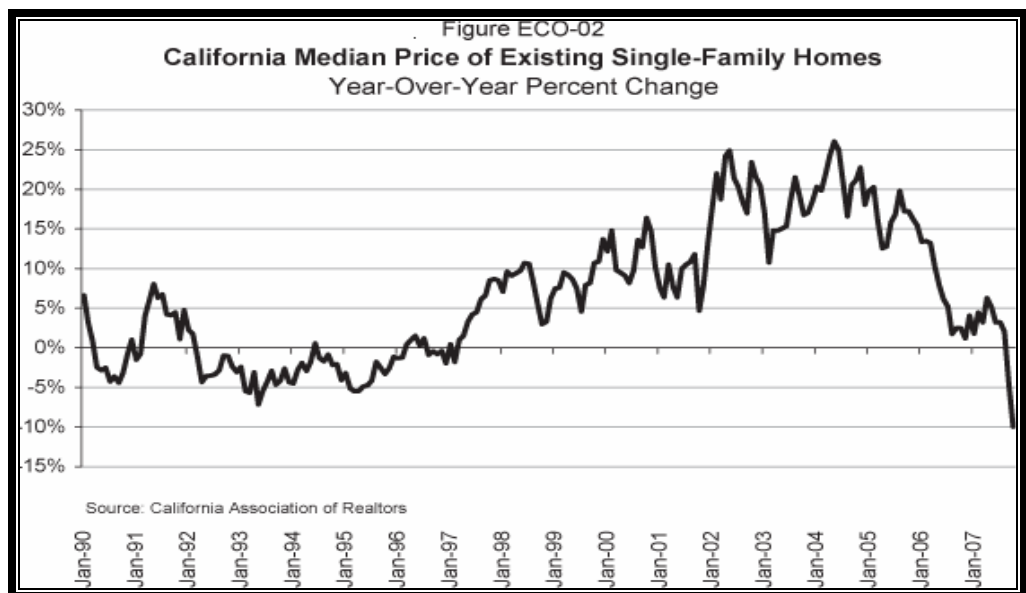


worse, due to sharp fall in housing prices than most of the country. Profitability dropped as return on assets fell to 0.83% in Q3 07 from 1.20%³ in Q3 06.

The number of new institutions also declined in the Q3 07. Cost of funding earning assets increased to 3.12% in Q3 07 from 2.63% in Q3 06 and net interest margin declined to 4.61% from 4.88% in the same period. The quality of assets in the region has also deteriorated considerably. The median ratio of past due and non-accrual loans to total loans increased to 0.54% from 0.27% in the third quarter of 2006, indicating the negative trends for the industry.

Stalled Housing Industry

California home building and residential real estate markets continued to slow in 2007. Single-family residential permits were down 36% from a year ago in the first ten months of 2007, and existing single-family home sales, 25%. In October, the number of unsold homes on the market amounted to 16.3 months of sales at the October sales rate. A year earlier, inventories amounted to 7.2 months of sales. The median price of existing single-family homes sold in October, \$497,000, was 9.9% lower than the median price a year earlier. Real estate loans are the primary forte of Downey and with market conditions on a southward trend, problems at the thrift may be in their intermediate phase.



³ Source: Federal Deposit Insurance Corporation

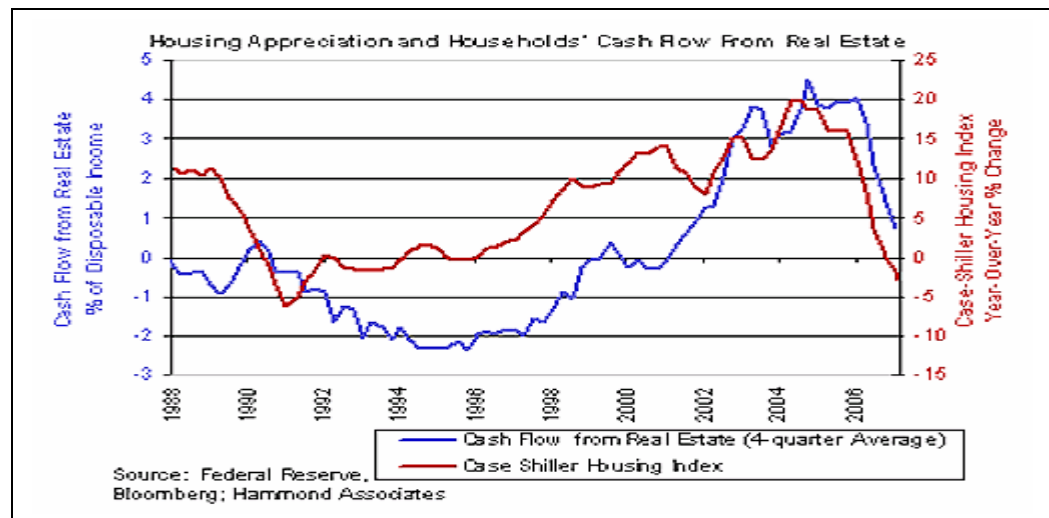


Sub-prime mess: Macro ramifications

Investors and market participants are currently consumed by the financial ramifications of the sub-prime issue. However, we believe the ripple effects emanating from the current crisis could have a greater impact on the overall economy. This spurs the argument of the dreaded possibility of recession.

A major impact stemming from the sub prime meltdown has been the reduction in available funds for lower quality borrowers. This translates into higher interest costs and a higher cost of home ownership. These factors will lead to decrease in the supply of loans to low-quality borrowers, thereby diminishing the pace of growth in home ownership and hurting the housing market. Increased supply due to foreclosures and reduced demand due to an increase in accessibility of funds will depress the already weak housing market further.

The fallout from the sub prime meltdown could also impact economic growth through the housing market. This is because real estate constitutes a large portion of overall economic activity and home equity withdrawals have buoyed consumer spending over recent years.



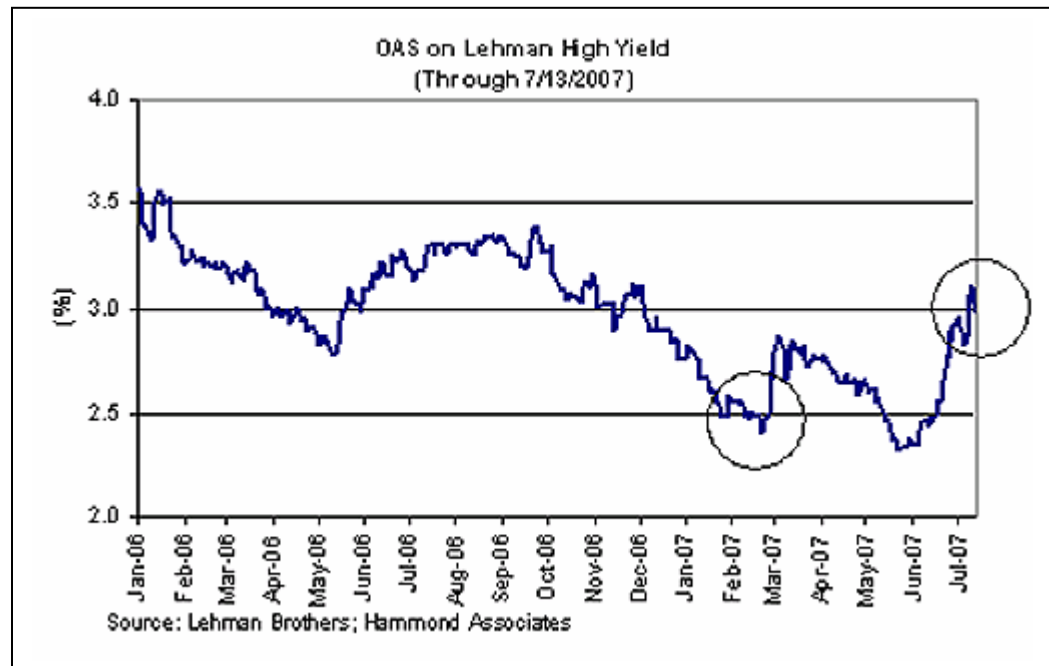
Alan Greenspan and James Kennedy's 2007 study estimates U.S. consumer spending to increase by nearly 3% due to home equity extractions. As housing prices and equity withdrawals tumble, consumer spending - a large portion of economic growth, will be severely impacted. If this occurs, economic growth can easily slow or even decline, creating fears of possible recession.

The effects of the sub prime market meltdown on interest rates and accessibility to home ownership are significant for borrowers and the housing market. However, there has also been an impact on the way investors look at the market,



specifically credit markets. It appears that the sub prime crisis and the resulting high profile business and investment failures, are causing panic in credit markets.

The chart below displays the option adjusted spread (OAS) between Treasury and high-yield bonds. Essentially, this chart indicates how much compensation investors require for taking credit risk. A sharp increase in this premium is evident from the first rumblings that were heard in the sub prime markets in early 2007.



What is really interesting about the sub prime situation is that even though, it has had a minimal direct loss to the economy, the ensuing effects are undeniable. It is amazing to see a \$100 billion in losses (or about 1% of annual GDP) in a \$13 trillion economy lead to the failure of multiple lenders and investment firms and broad correction in credit markets and investor perceptions. To make matters worse, experts have estimated that losses from sub prime issues may reach \$300 billion to \$400 billion i.e. nearly one-third of \$ 1.4 trillion of total US sub prime assets.

Thus, the meltdown in sub prime market would not only hurt investors directly in terms of financial losses but also plague the global economy due to re-pricing of risk. We believe that the Fed intervention of aggressive rate cuts could have a negative ramification in terms of inflation and hence stagflation could emerge as a real concern going forward.



Is the worst over?

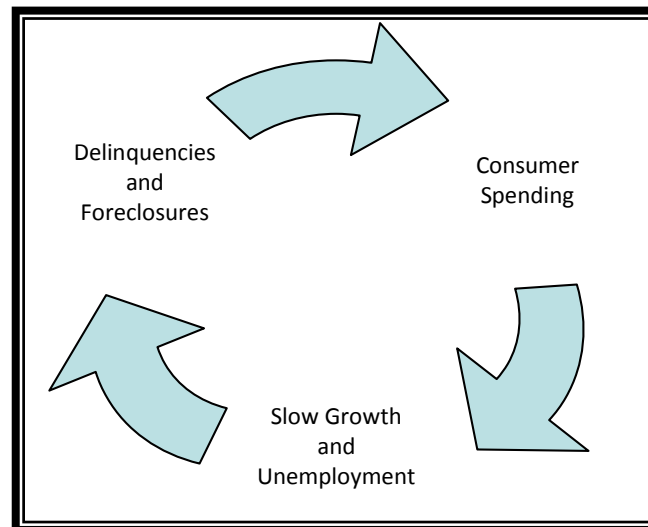
That's the billion dollar question every analyst is grappling with. Let us look at it. We believe we are still some distance away from cleansing the system from what could be termed as the biggest credit bubble given the accelerated pace of ARM resets leading to rising foreclosures have resulted in both price and confidence erosion.

We can divide the current problem into three areas which are interlinked, and the root cause of a potentially disruptive future environment.

Defaults on residential mortgages are leading to liquidity crisis in lending banks and also foreclosures on those properties, which have substantially lost value due to decline in prices.

Consumers having borrowed heavily for consumption and burdened with higher mortgage payments are cutting down on discretionary spending.

Spending cuts and the alarming spike in oil prices have resulted in slow growth and higher unemployment. Job losses in turn are leading to more delinquencies.



The basic problem lies with the increasing delinquencies and foreclosures.



Type of Loan	Percent of loan	Percent of foreclosures started
Prime Fixed	65%	18%
Prime ARM	15%	20%
Subprime Fixed	6%	12%
Subprime ARM	7%	42%
Federal Housing Authority	7%	8%

Source: Mortgage Banks Association (as of Dec, 07)

The foreclosures are not only limited to the subprime loans. The subprime loans constitute only 13% of the total with foreclosure started on more than half the loans. The other aspect is the constant deterioration in Prime loans which comprise 80% of the total loan base. We believe the Fed's action of reducing interest rates cannot mitigate the risks posed by falling housing prices and benign economic environment.

In accordance with the problems stated, we identify two broad areas as the source of further foreclosures. **First, from regions where there were speculative overbuilding of houses, such as California and Florida, which continue to see disproportionate share of foreclosures. These two states comprise 21% of all loans outstanding but account for 30% of foreclosures. They represent 30% of all prime and 22% of subprime adjustable rate mortgages, but account for 47% of prime and 36% of subprime adjustable rate mortgage foreclosures.** The second source of foreclosure is from regions where there is considerable economic adjustment to manufacturing industries. The downsizing of the big three US domestic car manufacturers located around Detroit, Michigan has led to job losses which in turn have led to housing foreclosures. Even in the two reasons the foreclosures from economic restructuring are not significant.

As per Foreclosure Radar, a website that tracks California foreclosure, the number of properties sold at foreclosure auction rose by 55 % in January to a total of 19,821, with a combined loan value of \$8.06 billion. Compared to the same period one year ago, this represents a staggering 454 % increase. Notices of Defaults recorded in January numbered 38,617, up 16.4 percent from 32,948 in December, 2007. This increase follows a 45.1 percent increase from November to December. The recent increases in defaults clearly indicate that auction sales are likely to increase further in the coming months. As per Sean O'Toole, founder of Foreclosure Radar, "The auction sales are a far more accurate indicator of the foreclosure problem." **In January 98% of auction sales went back to the lender after receiving no bids despite the significant discounts now being offered by lenders at auction.** Out of the 19,821 homes that went to auction, 13,950 were



discounted, with an average opening bid discount of 16 percent and about 4,624 had discounts of 30 percent or more. The majority of these discounts are from the amount owed on an 80 percent first mortgage made in the last 2 to 3 years, indicating that many of these properties are being offered at 50 to 70 percent of their prior value. Financial institutions, who have loaned these amounts, will see a lighter balance sheet.

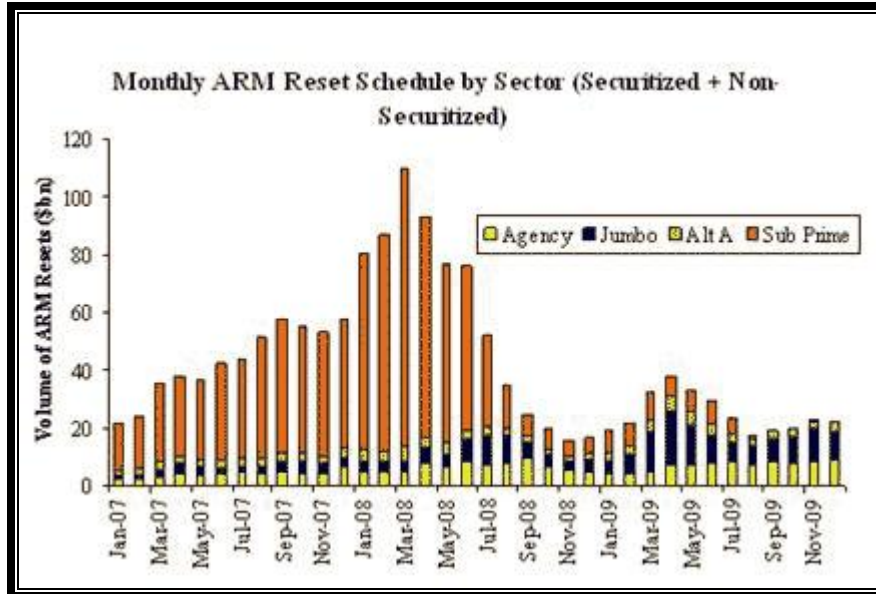
Downey Financial might also see a lighter balance sheet. Most of its residential mortgage loans were originated in the last 2 to 3 years, majority without proper documentation and verification. While defaulters are a drag on its income statement, undervalued collaterals are likely to wipe out a large portion of its balance sheet.

If the study released on March 14, 2008, by David Greenlaw of Morgan Stanley, Jan Hatzius of Goldman Sachs, Anil Kashyap of the University of Chicago, and Hyun Song Shin of Princeton University, is to be believed, the bottom is far below.

According to the report, the economic impact of the mortgage crisis and credit crunch will be huge, and it has barely begun. The report estimates that the credit crunch is expected to push down growth by 1.3 percentage points over the next 12 months. Bank balance sheets were forced to expand in the wake of the mortgage crisis, as off-balance-sheet investments were forced onto their books. The paper estimates that total mortgage credit losses will cost \$400 billion, up from initial estimates in August of \$150 billion. Roughly 50%, or \$200 billion, will be on the books of U.S. banks and securities firms. The study concludes that unless financial markets can quickly recapitalize, banks are likely to cut back their lending to consumers and businesses by nearly \$1 trillion.

Additionally, UBS said in a note published Friday, Feb 29, 2008, that the crisis has cost the global banking sector well in excess of \$100 billion in debt write-downs so far, but losses tied to the credit turmoil will probably exceed \$600 billion, with banks and brokers accounting for more than half of it.

The report also mentioned that a worse-than-expected economic outlook would cause a downward revision to these estimates and a sharp decline in home prices could lead to many U.S. homeowners with negative equity. The deterioration in housing, set off by thousands of sub-prime home loans going bad, has been cushioned somewhat by aggressive rate cuts by the Federal Reserve. While Federal Reserve is doing all it can, the policies do not seem potent enough to address the problem.



The above graph from commonsenseforecaster.com shows a possible reason why fed rate cuts have not been effective. US households are only halfway through the problem of rate resets - 300 basis points upwards - on teaser loans. As per their estimates, it would take until the end of 2009 for rates to normalize.

Albeit, Downey should be less sensitive to these Fed rate cuts because unlike traditional banks that have fixed rate assets and floating rate liabilities, Downey's entire operating strategy is based on matching floating rate assets against floating rate liabilities. While its funding costs will decline, Downey will make much less on its assets which are floating rate. Exacerbating problems, Downey's asset base has shrunk due to weaker loan originations and bad mortgages which have resulted in a declining interest rate spread. This is similar to what was seen in 2007 with an effective interest rate spread of just 2.7%, a decrease from 2006. Downey originated about \$3.7 billion in 2007 compared to \$7.8 billion in 2006, \$15.0 billion in 2005 \$15.4 billion in 2004 and \$ 10.5 billion in 2003.

The mortgage crisis is not limited to banks and securities firms, but spread throughout a large range of investors. The mortgage loans were sliced and repackaged and sold as mortgage-backed bonds, rated by Moody's and Standard & Poor's to investors such as hedge funds. The genesis of the problem lies in excessive leverage and the painful consequences are coming to the fore dueing the current de-leveraging process.

Mr. Eisenbeis, the chief monetary economist for Cumberland Advisers, opines, "It is time to step back and recognize that the current situation isn't a liquidity issue and hasn't been for some time now. Rather, there is uncertainty about the underlying quality of assets -- which is a solvency issue, driven by a breakdown in highly leveraged positions."



Bear Stearns, is an example of what excessive leverage can do when the wheels turn in the reverse direction. On March 16, J P Morgan Chase & Co. announced the acquisition of Bear Stearns for \$2.00 a share highlighting the extent of the credit turmoil. Another potential effect of the de-leveraging will be that it will uncover many other weaknesses in the financial system. This is likely to set off a chain of potential busts. For example, the resulting blow to confidence threatens to further weaken lending, borrowing, spending and investment in the U.S. economy. "Hedge fund blowups have so far been one-off situations. One worry is that we'll cross some line and there'll be a systemic wave of fund failures. It's a reason why the market is so nervous," suggests John Tierney, credit derivatives strategist at Deutsche Bank.

The loss of confidence is also spreading beyond the biggest banks, to regional and small banks. In the fourth quarter, U.S. banks reported their smallest net income, a total of \$5.8 billion, in 16 years, according to the Federal Deposit Insurance Corp. Downey reported a loss \$3.09 per share. Besides the obvious, there are other symptoms of declining confidence. Gold, known to be an effective inflation hedge, is now trading around \$1,000 an ounce.

Thus looking at all the macro and company specific indicators, we believe that the turmoil is set to continue till end of 2009.

A Comparative Study

Downey competes with a wide variety of savings and commercial institutions some of which are as much as triple its size. Competitors include other savings institutions, commercial banks, mortgage banking companies and insurance companies. We estimate the closest competitors for Downey are as listed below:

	Price	Earnings	P/E	Book Value	P/B	ROE (%)	ROA (%)	Dividend Yield	Expected Growth Rate	PEG	Market Cap (Mn)
Downey Financial Corp	20.29	-2.03		47.91	0.42	-4.15	-0.38	2.5%	3.5%	0.0	550.9
Peer Group Median		0.23	5.51	17.95	0.62	1.70	0.09	2.2%	9.0%	23.97	
Peer Group Average		0.67	13.16	20.89	0.76	-0.02	0.00	2.3%	8.7%	128.59	
Peer Group High		6.00	28.72	47.97	1.87	13.67	1.12	5.2%	14.5%	525.50	
Peer Group Low		-2.85	5.26	8.19	0.19	-17.26	-1.55	0.4%	1.0%	0.00	
Bank Atlantic	4.70	-0.38		8.19	0.57	-6.10	-0.47	0.4%	9.3%	0.0	263.5
Bankunited Financial	4.19	0.76	5.51	21.79	0.19	3.66	0.20	0.5%	11.5%	47.9	149.0
Firstfed Fin Cp	31.53	6.00	5.26	47.97	0.66	13.67	1.12	NA	1.0%	525.5	431.0
Sovereign Bancp	10.46	-2.85		14.12	0.74	-17.26	-1.55	3.1%	7.4%	0.0	5040.0
Wash Mutual Inc	12.13	-0.12		24.39	0.50	-0.26	-0.02	5.2%	8.7%	0.0	10710.0
Hudson City Bancp	16.66	0.58	28.72	8.89	1.87	6.20	0.74	2.2%	14.5%	198.1	8640.0

Within the core peer group the price-to-earnings multiple is invalid as many of the peers and Downey itself have negative earnings for the current period. On price to



book basis, Downey trades at a 31% discount to its core peer group median. Given Downey's weak balance sheet, slow loan originations and mounting non-performing assets, we expect this discount to continue in the future. Downey has a more attractive dividend yield compared to its peers, but as the dividends are not in tandem with its earnings, we remain unsure of its sustainability.

	Downey Financial Corp.	BankAtlantic Bancorp A	BankUnited Financial A	Sovereign Bancorp Inc.	Washington Mutual Inc.	Hudson City Bancorp Inc.	FirstFed Financial Corp.
Industry							
Savings & Loans							
Current Share price	19.14	4.48	4.05	9.95	10.59	16.34	28.64
% Off 52-wk High	74.43	62.51	83.44	62.01	76.29	3.48	57.22
% Above 52-wk Low	9.62	55.02	34.55	14.24	6.86	42.71	2.95
Market Value	\$533 mil	\$230 mil	\$142 mil	\$4,794 mil	\$9,346 mil	\$8,470 mil	\$392 mil
Price / Book	0.4	0.5	0.2	0.7	0.4	1.8	0.6
Dividend Yield	2.51%	0.45%	0.49%	3.22%	5.67%	2.20%	0.00%
Long Term Growth Rate	6.00%	9.30%	7.50%	4.90%	8.70%	16.80%	9.00%
Total Return (12 mos)	-69.60%	-58.00%	-80.80%	-59.90%	-69.30%	21.90%	-49.60%
Beta	1.0	0.5	1.3	1.1	0.6	0.8	1.2
Short Interest % of float	21.50%	10.60%	26.50%	2.80%	6.50%	3.20%	12.60%
Profitability & Efficiency							
Revenue	\$1,027 mil	\$535 mil	\$996 mil	\$5,011 mil	\$25,530 mil	\$2,135 mil	\$609 mil
5yr Sales Growth	13.55%	-0.05%	25.89%	17.57%	8.61%	23.16%	24.25%
Net Profit Margin	-5.50%	-2.60%	2.90%	-26.90%	-0.30%	13.90%	15.30%
Dividends	\$0.48	\$0.02	\$0.02	\$0.32	\$0.60	\$0.36	\$0.00
ROE	-4.00%	-4.30%	3.60%	-16.70%	-0.30%	6.30%	13.50%
ROA	-0.40%	-0.30%	0.20%	-1.60%	0.00%	0.70%	1.20%

As a thrift, Downey faces intense competition for consumer deposits. Its primary business activity emphasizes originating first mortgage loans secured by residential properties, mostly adjustable rate single family mortgage loans. It also faces intense competition in making the above mentioned loans. Savings institutions and commercial banks located in the company's core market areas, including many large financial institutions based in other parts of the country or their subsidiaries, make up DSL's most direct competitors. In the closest competitor group, Sovereign Bancorp, Hudson City Bancorp and Washington Mutual are large scale banks with extensive branching in California. Their large scale and brand value gives them an edge in deposit mobilization.

Demand for mortgage services is driven by home sales. When mortgage rates are low, they give rise to refinancing demand. Mortgage applications fell further in February 2008, led by a decline in refinancing. The Mortgage Bankers Association's composite index of applications to buy a home or refinance a loan decreased 22.6 percent in the second week of February on a seasonally adjusted basis from the first week of the month. Leading the decline was a 27.9 percent drop in the index that tracks refinance applications, followed by an 11.5 percent decrease in the purchase-loan index. The housing slump is deepening due to stricter lending rules that make qualifying for a loan more difficult. U.S. mortgage foreclosures rose to an all-time high at the end of 2007, as per Mortgage Bankers Association, as borrowers with adjustable-rate loans gave up their properties to avoid increased payments. While only a small portion of houses that begin



foreclosure proceedings are actually foreclosed, the increased rate hurts the mortgage business.

Additionally, the Senate is considering a bill that would restrict aggressive lending practices by mortgage bankers and brokers. The Senate bill is expected to bar prepayment penalties and yield spread premiums in sub-prime lending. This would restrict another sub-prime crisis but cannot elevate the one, large and looming at present.

The S&P/Case-Shiller index, which tracks home prices in 20 US metropolitan areas, showed a 6.1 percent decline in home prices in October 2007 compared to one year earlier. Experts who produce the index indicate that further home price declines are expected in 2008 in most markets nationwide. High inventories of homes on the market and the increasing difficulty getting a mortgage are exacerbating the decline which in turn is making mortgages difficult. Smaller banks are likely to take the brunt of increasing mortgage rates and lowering home values wiping off their book values and shrinking their income statements. The bubble years of 2004 -2006 led most mortgage bankers to lower their guards and underwrite poor quality mortgages, which now is a dead weight on their financials.



	Downey Financial Corp.	BankAtlantic Bancorp A	BankUnited Financial A	Sovereign Bancorp Inc.	Washington Mutual Inc.	Hudson City Bancorp Inc.	FirstFed Financial Corp.
Financial Strength							
Interest coverage	-1.03	-1.01	-0.98	-1.46	-1.04	-0.93	-0.93
Long Term Debt/Equity	1.05	3.69	8.05	3.84	4.85	5.24	3.41
Total Debt/ Equity	1.05	4.20	8.05	3.84	4.85	5.24	3.41
Long term Debt/Total Capital	0.51	0.79	0.89	0.79	0.81	0.84	0.77
Ownership							
Insiders							
Insiders-% Owned By	4.02	4.6	2.28	1.23	0.43	1.73	14.11
Insiders-Bought Last 90 Days	1480	134879	8917	21818	629268	42517	81990
Insiders-Sold Last 90 Days	0	6684	0	0	441864	87514	41476
Institutional							
Institutional-% Owned By	91	68.4	NA	52.7	94.5	66.9	NA
Institutional-Bought Last 90 Days	12898603	23118435	30071554	83141021	309168137	109701839	11353436
Institutional-Sold Last 90 Days	12330944	20275772	22338370	55681672	373484407	102437413	11943823

While interest coverage ratio is in tandem with the peer group, interest income contains a large percent of capitalized interest on negative amortization (CINA), which might not be realizable given the current business environment. Most of the peer group has some level of capitalized interest on negative amortization in their interest income. **With almost 24% of interest income reported during the fourth quarter being CINA, Downey has the highest negative amortization rates in the group. First Federal follows Downey with 18% of interest income comprising CINA. However, they have significantly higher reserves than Downey.**

	Downey Financial Corp.	BankAtlantic Bancorp A	BankUnited Financial A	Sovereign Bancorp Inc.	Washington Mutual Inc.	Hudson City Bancorp Inc.	FirstFed Financial Corp.
Asset Quality							
Non-performing loans-to- Gross loans	8.21	3.87	3.05	0.53	2.51	0.33	2.72
Non-performing assets-to-Total assets	7.77	4.1	2.99	0.43	2.17	0.19	2.79
Allowance-to-Total Assets	33.54	52.65	30.61	242	421	43.75	71
Allowance-to- Total Loans	3.17	2.04	0.93	1.28	1.05	0.14	1.93

The primary differentiating factor remains the level of non-performing loans. Downey's non-performing loans as a percent of gross loans are significantly higher than its peer group. To put matters into perspective, its allowance coverage is the lowest in its peer group after BankUnited Financial. Combination of these two factors rings alarm bells. Additionally, Downey has the highest negative amortization level in the group. Levels ranged from less than 1.8% for Washington Mutual to as high as 19.1% for DSL in Q3. DSL's negative amortization increased to 23.8% in Q4 2007. DSL is projecting recasts for over \$3 billion, or 30%, of its residential mortgages in 2008. Any further decreases in



real estate values would exacerbate losses, particularly as housing inventories are already high, at the time of foreclosure. We expect that the loans that are recast will either be repaid (the good lot) or will be reset at an interest lower than the current market rate (the bad lot). In either case, the company will be stuck with poor or low interest paying loans.

	9/30/07	10/31/07	11/30/07	12/31/07	1/31/08
Total Assets (\$MM)	\$14,418	\$14,182	\$13,536	\$13,410	\$13,555
% of Total Assets					
TDR	0.67%	1.09%	2.05%	2.99%	3.59%
Other NPA	2.27%	2.77%	3.72%	4.78%	5.55%
Total NPA	2.94%	3.86%	5.77%	7.77%	9.14%
Value (\$MM)					
TDR	\$97	\$155	\$277	\$401	\$487
Other NPA	\$327	\$393	\$504	\$641	\$752
Total NPA	\$424	\$547	\$781	\$1,042	\$1,239
Growth					
TDR		60.03%	79.50%	44.50%	21.37%
Other NPA		20.03%	28.17%	27.30%	17.37%
Total NPA		29.15%	42.67%	33.41%	18.91%

In February 2008, NPAs grew 10.9% as compared to 9.1% in the month of January. TDR growth outpacing normal NPAs could mean that the company is essentially trying to repackage its bad apples as TDRs. We believe, the auditors would force the company to categories such restructured asset as non-performing. Downey's peers are on relatively safer grounds with a smaller percentage of NPAs and higher provisions.

In the above scenario, large institutions, with big economies of scale in operations, can sustain longer periods of economic turmoil than the smaller ones. Most of Downey's peer group comprises large scale banks that are widely diversified; hence the risk is also diversified unlike Downey which has all its assets in California. This will be an advantage given the much more intense decline in California real estate than most other states. We expect Downey's large scale peers to get through the mortgage mess, and also expect consolidation in the industry as smaller companies attempt to survive the crisis. Industry consolidation also makes Downey a probable candidate for acquisition by a large financial institutions looking for exposure in California.



Should WFC (Wells Fargo and Co) be seen in the same light as DSL?

The answer according to us is an emphatic “No”. The comparison would not be justified due to the following reasons:

1. Size

First, DSL and WFC do not make good comparables based on the difference in their sizes. WFC has a market capitalization of \$94.9 billion against \$0.5 billion of DSL. With its extra large scale, WFC has vast economies of scale which are not available to DSL.

2. Diversified, Geographically and Product wise

WFC is well diversified geographically with presence in 23 states; in contrast, 89% of DSL’s real estate loans were concentrated and secured by properties located in California. This makes DSL more vulnerable to changes in California against WFC. Additionally, DSL loan portfolio consists primarily of residential 1-4 mortgage loans. At the end of 2007, residential mortgage loans made more than 96% of DSL’s total loan portfolio. WFC has more diversified loan portfolio, with about 38% in real estate 1-4 mortgage loans.

Table 12: Real Estate 1-4 Family Mortgage Loans by State

(in millions)				31-Dec-07
	Real estate 1-4 family first mortgage	Real estate 1-4 family junior lien mortgage	Total real estate 1-4 family mortgage	% of total loans
California	20,782	28,234	49,016	13%
Minnesota	3,009	4,209	7,218	2%
Arizona	2,986	3,451	6,437	2%
Florida	3,127	2,851	5,978	2%
Colorado	2,612	2,889	5,501	1%
Washington	2,476	2,938	5,414	1%
Texas	3,551	1,805	5,356	1%
New York	2,200	2,275	4,475	1%
Nevada	1,625	1,642	3,267	*
Illinois	1,616	1,444	3,060	*
Other ⁽¹⁾	27431	23,827	51,258	13%

3. Asset Quality

Credit quality in WFC’s real estate-secured lending business has not experienced the level of credit degradation like many subprime, lenders primarily due to their strong underwriting practices. Wells Fargo Financial does not use correspondents or brokers in its U.S. debt consolidation business. Downey has about 82% of its residential one-to-four unit loans underwritten based on borrower stated income and asset verification (which can be overstated) and an additional 7% underwritten with no verification of either borrower income or assets. To put matters into perspective, 44% of these



loans were originated in the last two years. Wells Fargo does not make or purchase any negative amortizing mortgages, including option ARMs, leading to minimal ARM reset risk across the owned loan portfolios. This is a primary differentiating factor between WFC and DSL. As of December 31, 2007, 69% of the total residential 1-4 unit loans (+96% of loan portfolio) of Downey was subject to ⁴negative amortization. If a loan incurs significant negative amortization, the loan-to-value ratio could rise, which increases the Bank's credit risk exposure and its susceptibility to a downturn in the real estate markets in which it lends.

Company	DOWNEY FINANCIAL CORP	WELLS FARGO & CO
Share Info	DSL	WFC
52-wk High	\$74.85	\$37.99
52-wk Low	\$17.26	\$24.38
Dividend	\$0.12	\$0.31
Yield	0.0255	0.0431
Market Cap	524208	94882098
Book Value	1334417	47628000
Key Statistics		
Revenue	1026573	53593000
Long Term Debt	1395545	99393000
Book Value	1334417	47628000
Profitability/Efficiency		
Net Margin	-0.1%	0.2%
Return on Common Equity	-4.0%	17.3%
Return on Invested Capital	-2.0%	5.7%
Return on Assets	-0.4%	1.5%
Asset Turnover	0.07	0.1
Financial Strength		
Interest Coverage	-1.03	-0.68
Long Term Debt/Equity	1.05	2.11
Total Debt/Equity	1.05	3.24
Long-Term Debt/Total Capital	0.51	0.68
Asset Quality		
Non-performing loans-to- Gross loans	8.21	0.7
Non-performing assets-to-Total assets	7.77	
Allowance-to-Total Assets	33.54	
Allowance-to- Total Loans	3.17	1.44

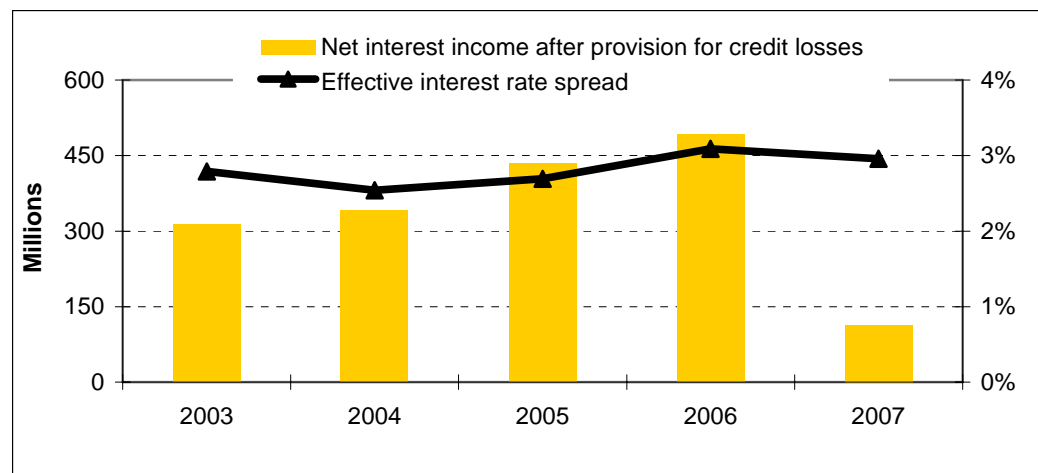
⁴ A negative amortization loan is one in which accrued interest exceeding the required monthly loan payment is added to loan principal.



HISTORICAL PERFORMANCE

Unfavorable trend in operating performance

Downey's income statement and balance sheet growth have diverged since 2006. Total interest income which shows a compounded growth of 16% from 2003 is down a whopping 14% in fiscal 2007. Net interest income has lost traction and is down 18% since 2006. If the robust market conditions in 2003 helped Downey to gain momentum and broaden the revenue base, the recent meltdown in housing demand and sub prime woes have pushed back the company's prospects. The company's increasing provisions for credit losses i.e. \$310 million in 2007, an increase of 10.65 times over 2006, indicates a strong negative trend in operating factors.



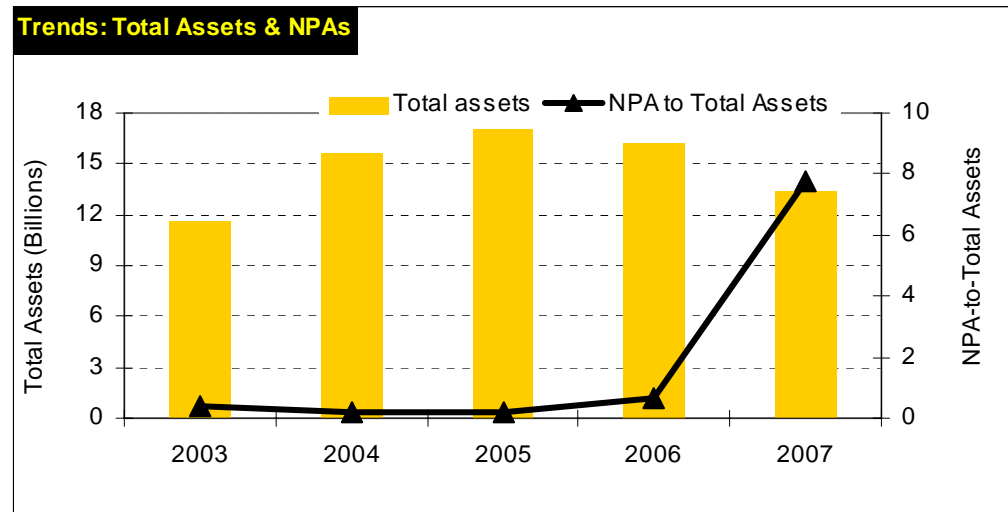
Return on assets increased from 0.89% in 2003 to 1.29% in 2005 due to positive credit lending and improvement in net interest margins.

Originations: Lagging behind

Company operations which have been targeting the real estate market, have benefited from the past housing boom. Loan activity remained strong in the housing boom era of 2003 to 2005. Loans origination remained above \$10 billion levels in which elevated to about \$15 billion in 2004 and 2005. However the housing slump started in 2006, dragging origination activity to below \$4 billion in 2007, down by 23% on CAGR from 2003-2007.



Assets exposed to weakening economy



Total Assets showed good sustenance above the 2003 figures of \$11.6 billion, which reached around \$17 billion in 2005. However the y-o-y reduction of 5.2% and 17.3% in 2006 and 2007, over 2005 and 2006, suggest a meltdown. The situation is vulnerable if we analyze non-performing assets of the bank. NPAs as a percentage of total assets, which were only 0.42% in 2003, fell to 0.21% in 2005. In 2007, the figure touched a high of 4.78%, and the auditors' advice to consider the TDR (troubled debt restructuring) in the NPAs have increased the total NPA to 7.77% of total assets. The weakening housing market led by price mismatches has hurt the company's asset base. The plunge in existing-home sales has been the steepest since 1989, reducing real estate prices, thereby augmenting defaults on loans. Moreover, Downey's early stage delinquency trends should result in sizeable NPA additions through 2008. 30-59 day delinquent loans rose 85% sequentially to \$239.3 million, while 60-89 day delinquencies rose 78% sequentially to \$135.2 million.



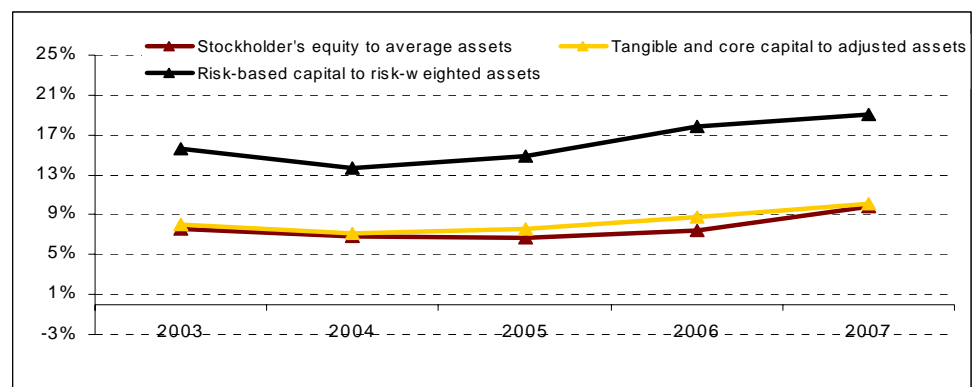
LIQUIDITY AND CAPITALIZATION

The company's major sources of funds include deposits, advances from the FHLB (Federal Home Loan Bank) and other borrowings. Besides, unlocking funds from sale of loans, mortgage-backed securities and real estate payments of loans and mortgage-backed securities also serves as fund flow. Other operations such as sales of loan servicing; and income from other investments helps generate cash.

During 2007, the company's primary sources of funds included \$4.1 billion on loans held for investment and mortgage-backed securities available for sale, \$2.0 billion of U.S. Treasury, GSE (Government Sponsored Entities) and other investment securities available for sale, which was netted by the same amount of purchase in GSE. A net decline of \$260 million in loans held for sale increased funds. Apart from the GSE purchase, \$1.6 billion was utilized in origination and the purchase of loans held for investment. Also, a reduction in borrowings and deposits for \$1.4 billion and \$1.3 billion was absorbed liquidity. The liquidity crunch is evident from the decline in loans origination by about 55%, and absorption of liquidity by borrowings and deposits.

Borrowings

However, Downey's primary source of borrowings, FHLB borrowings totaled \$1.2 billion, representing 8.9% of total assets. While other sources of liquidity are drying up, the company is approved by the FHLB to borrow up to 50% of total assets to the extent it provide qualifying collateral and hold sufficient FHLB stock, which enables the company to borrow an additional \$5.5 billion. While the financial instability assures a future liquidity crunch, the company may be required to utilize the additional capacity from FHLB borrowing arrangement or other sources. Downey also has unused lines of credit of \$307 million and operating leases of \$18 million, which could be useful in a crisis situation. However, the company has liquid assets of \$102 million and can also obtain funds by means of dividends from subsidiaries totaling \$258 million as of December 2007, before sourcing money from external sources.





Capital adequacy is also an important aspect to be covered by the company. The Bank's core and tangible capital ratios were both 10.18% and its risk-based capital ratio was 19.01% at December 31, 2007. The Bank continues to exceed the "well capitalized" standards of 5.00% for core capital and 10.00% for risk-based capital, as defined by regulation. However, the improvement in such ratio is not the effect of improved capital scenario, but reduced asset base.

Liabilities

Company's liabilities of \$12 billion primarily consist of deposits which represents 88% of the total liabilities. The other sources of funds include advances from FHLB and Senior notes.

Preferred Stock

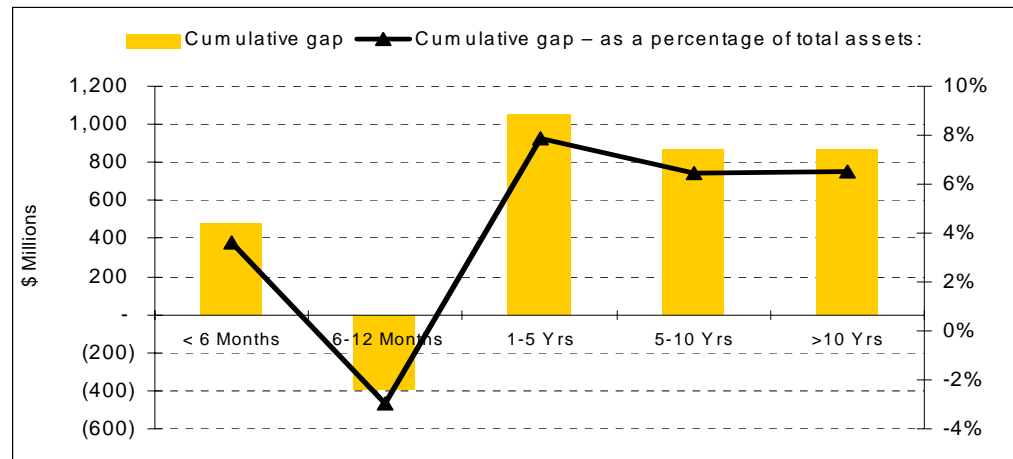
The Company, by its articles of incorporation, is allowed to issue 5 million shares at par value of \$0.01 per share. As of December 31st, 2007, the Company had not issued any shares of its preferred stock.

Common Stock

As of December 31, 2007, the Company had 28,235,022 common shares issued and outstanding with a par value of \$0.01 per share. The Company's paid in capital and additional paid in capital was \$0.3 and \$93.8 million, respectively. The total stockholders equity of \$1.3 billion is largely contributed by the retained earnings of \$1.3 billion among others items.

Asset Liability Management

The Company's interest bearing liabilities consisting of retail deposits and FHLB advances and the interest-earning assets, consist of adjustable rate and fixed rate real estate loans and investment securities are affected by interest rate risk. In the past, company's asset-liability gap has normally been hovering above 7%. However, the company's current asset liability mismatch is quite evident from the chart. Though the company will not face any deficit between its investment and borrowings in the next six months, the cumulative gap clearly suggests the mismatch in the 6 months and 1 year period. Besides, in a scenario of reducing interest rates which give lower incentive to the depositors, the gap could easily widen, thus creating further liquidity issues.



Risk Profile

Downey's business in 2004 and 2005 reflects the housing boom and company's ability to take advantage of the situation. However, the trend also depicts that the company has been largely affected by the housing slump which started in 2006. This has hampered the asset base and loan portfolio, thus decreasing interest income. Lower originations are due to lower demand and reduced capacity to lend. In the scenario of increasing NPAs, **Downey's reducing liquidity has been evident. The company's loan originations in 2007 have been below 20% of the investment portfolio. This figure was more than 45% in 2003.** This indicates the change in the economic situation and also the company's loan portfolio that primarily caters to the loans rather than current loans.



FINANCIAL FORECAST

Assumption in the model: Base Case Scenario

DSL's primary business is loan origination, focusing on residential real estate mortgages in California and mortgage-backed securities ("MBS"). While the Company focuses on first mortgage loan origination secured by residential properties, it also originates multi-family and commercial property loans, home equity loans and home equity lines of credit. DSL also provides construction loan financing for residential and commercial projects. Average loans outstanding at the end of FY 2007 stood at approximately \$12.5 Billion, lower by 20.3% from FY 2006. In the heat of the housing boom, average loans grew by more than 20% in both 2004 and 2005. The decline in loan balance signals that the fallout from the recent years' excesses in real estate and lending could be much more deleterious than expected. Non-traditional mortgages and poor underwriting have significant roles in the housing bubble.

Average Loan balances to decrease by 16.6%

Subdued by the fallout in residential real estate loans, the bank's total outstanding average loan portfolio is likely to decrease by another 16.6% in 2008. We base this assumption on three factors. First, core operations were very weak with originations totaling only \$3.8 billion in 2007, down 51.3% from 2006. Second, DSL is projecting recasts for over \$3B, or 30%, of its residential mortgages in 2008. In 2007, DSL forecasted recasts of \$1.4B of which \$527MM recast while \$552MM were paid off. Assuming payment option will be limited in the current credit crisis scenario; more loans will end up being part of DSL's TDR program. NPAs as of December 2007 were \$1.0B or 7.8% of total assets of which TDR was 2.99% and others 4.78%.



Figures in \$ Million	2005	2006	2007	2008E	2009E	2010E	2011E	2012E
Residential One-to-Four Units		15,173.08	12,044.95	9,997.31	8,797.63	8,445.72	8,276.81	8,194.04
Home Equity Loans and Lines of Credit	279.40	215.59	153.15	137.84	144.73	150.52	156.54	162.80
Residential Five or more Units	70.90	130.19	111.80	98.39	93.47	95.80	98.20	100.65
Commercial Real Estate	137.45	158.91	173.91	177.38	180.93	185.45	190.09	194.84
Non-Mortgage Commercial Loans	4.06	2.75	5.54	4.43	4.65	4.74	4.84	4.94
Consumer	6.82	7.78	6.63	7.30	6.93	6.79	6.66	6.52
Total Average Loan	15,461.68	15,688.30	12,495.98	10,422.64	9,228.34	8,889.04	8,733.13	8,663.80

As TDRs increase, we expect a higher percent of non-performing loans. Third, the residential real estate market has shown greater signs of struggle relative to the commercial market, specifically in markets such as Florida, California, and New York. DSL's banking operations primarily focus on residential real estate mortgages in California. As of December 2007, 89% of the Company's approximate \$10.9 billion residential real estate portfolio was secured by properties located in Southern California, specifically Los Angeles, San Diego, Orange and Santa Clara counties.

Residential real estate lending declines

Our Base Case scenario forecasts the residential real estate loan portfolio growth to slow down by 16.9% in 2008; thereafter slow down is assumed to be in the range of 5-10% until 2010. Similarly, the commercial real estate loan portfolio is expected to grow at 2.5% in 2008, thereafter, we expect this class of assets to grow in the range of 2 - 3% until 2010. Our Base Case scenario forecasts the bank's total average loan portfolio to reduce to approximately \$9.2 billion in 2009. We forecast Downey Financial's residential one-to-four unit loans to decrease from \$12.0 billion in 2007 to approximately \$9.9 billion in 2008 and \$8.4 billion in 2010. Residential one-to-four unit loans comprise more 95% of the loan portfolio. Downey is also focusing on originating non-mortgage commercial loans and other commercial loans, while reducing its exposure to its core mortgage lending operation. Non-mortgage commercial loans increased 101.1% in 2007. Over the last few years, Downey has changed its interest earning assets mix shifting towards investment securities from higher-yielding loans. This also indicates management's anticipation of a possible bubble in the real estate markets. Average loans outstanding as a percentage of total average interest earning assets, decreased from around 95.3% in 2005 to 87.3% in 2007. While loans generate higher yields than investment securities, in times of crisis, the value of loans plummet faster than securities.



A view on interest rates

As per Mortgage-x.com, a website for current and historical mortgage index information, the COFI index is projected to decline to 3.18% in 2008 and to 2.36% by 2010 while the prime lending rate is expected to decline to 5.48% in 2008 and rise back to 6.19% in 2010. In our Base Case, we have tied the interest rates to Federal fund rate, CMT index and COFI index. With the Federal Reserve cutting the bank rate to 3% in January 2008, interest expenses have declined on both sides, lending and borrowing. Since larger rate cuts took place in the current year (2008), 2007 rates don't reflect the fall in rates. Accordingly, yield for the bank's loan portfolio, primarily comprised of residential real estate loans, has been assumed to be in the range of 6-7% for the next three years. We estimate the declining loan portfolio coupled with a lower yield will reduce Downey's interest income significantly. Total interest income from loans is forecasted to decrease from approximately \$885 million in 2007 to just above \$840 million in 2008, and to about \$709 million in 2010.

Deposits to follow the mix

Downey's has traditionally funded its interest earnings assets with a low cost deposit mix, with regular passbook, money market, interest-bearing checking and non-interest bearing checking funds comprising about 67% and the remaining being borrowings, mostly FHLB. During the housing bubble years, Downey has shifted its mix towards a more expensive mix comprising a higher weighting of certificate deposits. As per our Base Case scenario estimate, Downey's average total deposits will decline from about \$11.1 billion in FY 2007 to about \$10.1 billion in FY 2008. We expect deposits to decline up to 2010 after which we are assuming a 3-5% growth till 2012. We do not see a rise in non-interest bearing demand deposits. We expect average non-interest bearing demand deposits to decrease 5.0% over the next two years, declining from \$740 million in 2007 to about \$700 million in 2009. We expect a positive movement in 2010. In addition, we forecast certificate deposits to decrease from \$8.6 billion in 2007 to \$7.4 billion in 2009. The other regular deposits, passbook, money market, interest-bearing checking, are also expected to decline over the next two years as the bank struggles with asset quality issues.

Total average borrowings (advance from FHLB and other interest bearing liabilities) as a percentage of total liabilities were about 23% in 2006 and declined to 14.5% in 2007. We expect Downey to maintain borrowings from FHLB and other interest bearing liabilities at around 14 – 15% of total liabilities. We expect net interest rate on borrowing to increase moderately. Our Base Case scenario assumes that effective interest rates on regular passbook to trend between 95 basis points to 102 basis points in the coming three years and we expect a modestly higher payout on the deposits to retain customers.



Contraction in NIM is there to disappoint investors

We expect the net interest margin will contract in the next two years on a combination of declining loan balances leading to lower interest income and a negative deposit mix that might take time to correct. As per our Base Case scenario, the bank's net interest margin is likely to deteriorate by 40 basis points in 2008 and is expected to remain in the range of 2.2 – 2.5% thereafter.



VALUATION

Our fair value estimate for DSL ranges between \$11.25-\$18.52 based on our Base Case forecast.

We calculated the long term price target for Downey Financial using our discounted cash flow (DCF) analysis⁵. **Our fair value estimate for DSL ranges between \$11.25-\$18.52 based on our Base Case forecast**, long term terminal growth rate of 3%-6% and discount rate of 13.6%. Based on our mid-level target price estimate, the Company's stock is over-priced with a premium over the Company's current market price of \$20.29. We calculated the fair value range for the stock price based on our free cash flow projections using three scenarios – Base Case, Optimistic Case, and Pessimistic Case.

Our fair value estimate for the stock is based on the cash flows forecasted for the Company during our forecast period. Thereafter (beyond 2012), we have used an appropriate growth rate to derive the long-term fair value for the stock. We have used the following assumptions to derive the 12-month fair value of the stock:

Beta: We have used a twelve month beta as a measure of systematic risk prevalent in the company. We believe this beta measure is appropriate to the volatility associated with a company involved in financial services.

Risk-Free Rate: We have used the US 10-year Treasury yield as the benchmark Risk Free Rate. As of the valuation date, the US 10-Year yield stood at 3.40%.

Equity Risk Premium: The equity risk premium represents the expected return of the stockholder over and above the returns from investing in a risk-free asset. We have assumed an equity risk premium of 6.9% in order to calculate the cost of equity applicable to DSL's common stock.

Cost of Equity: Based on our assumptions regarding the beta, risk-free rate and equity risk premium, the *Cost of Equity for DSL is estimated to be 13.6%*.

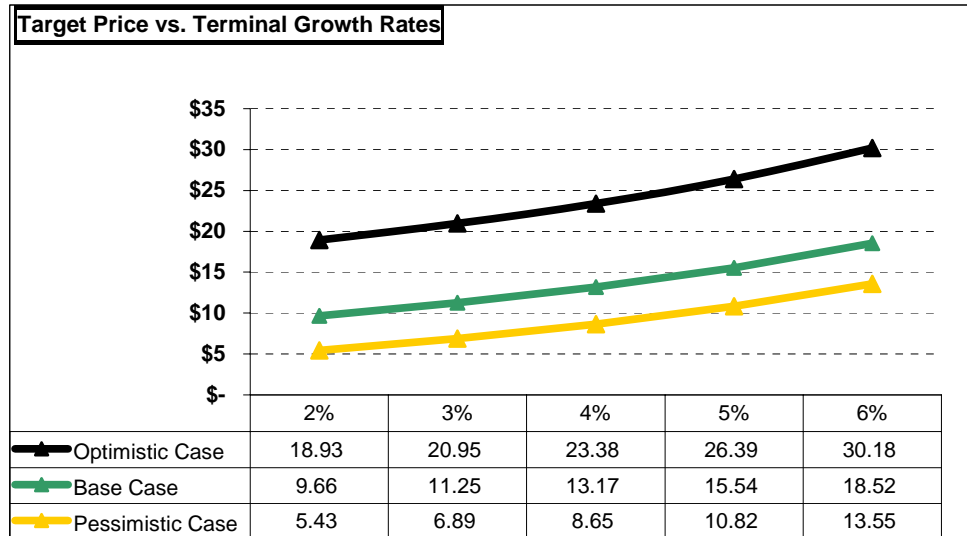
Long-Term Growth Rate: We have developed explicit FCF estimates until the year 2012. After 2012, we have assumed a *nominalized perpetual growth rate of 5.0%*.

The following chart and table describes the target price range for the stock for each scenario for a range of terminal growth rates with the discount rate of 13.6%.

⁵ Refer appendices for a detailed explanation of Discounted Cash Flow Valuation method

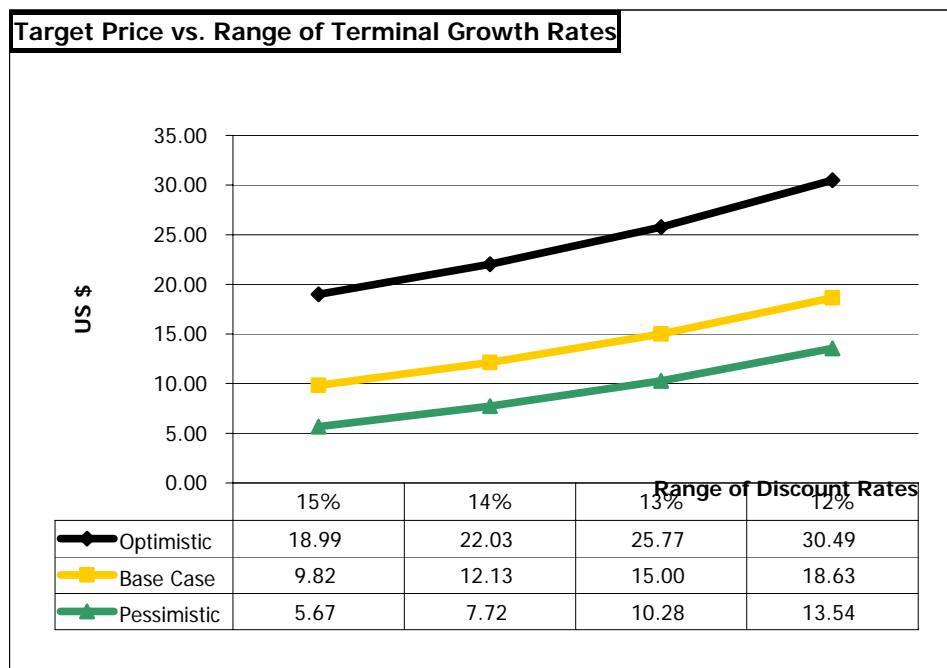


Chart 1: Target Price vs. Long-term Growth Rates



The chart and table describes the target price range for the stock in each scenario for a range of terminal growth rates. This indicates that the target price is very much sensitive to changes in the growth rates.

Chart 2: Target Price vs. Discount Rates





PRICE TO BOOK VALUE

We have derived the share price based on adjusted book value. In view of the scenario analysis, we have based the estimates on three factors – Base Case, Pessimistic Case and Optimistic Case. The adjusted book value accounts for the total loans over and above the NPAs after considering the credit provisions and further estimated write offs. Considering the write offs of 28% in Base Case, 30% in Pessimistic Case and 23% in Optimistic Case, we obtain the value of \$14.74 per share in Base Case, \$8.7 in Pessimistic Case and \$23.6 in Optimistic Case.

Base Case	Dec-07	Dec-08	Pessimistic Case	Dec-07	Dec-08
Total Assets	13,409	12,560	Total Assets	13,409.1	12,752.6
NPA	1,041.77	1,604.39	NPA	1,041.8	1,882.2
Allowance of Loan Losses	33.54%	41.17%	Allowance of Loan Losses	34%	38%
Net NPA	1567.5	2727.3	Net NPA	1,567.5	3,045.4
% of NPA	N/A	28%	% of NPA	N/A	30%
NPA after Write offs	438.9	763.6	NPA after Write offs	470.2	913.6
Equity	1,334.4	1,230.1	Equity	1,334.4	1,189.5
Adjusted BV	895.53	466.44	Adjusted BV	864.2	275.8
No of Shares	27.85	27.85	No of Shares	27.9	27.9
Share Price	32.15	16.75	Share Price	31.0	9.9
Discounted Share Price		14.74	Discounted Share price		8.7

Optimistic Case	Dec-07	Dec-08
Total Assets	13,409.1	13,601.3
NPA	1,041.8	1,187.6
Allowance of Loan Losses	33.5%	48.3%
Net NPA	1,567.5	2,295.0
% of NPA	N/A	23.0%
NPA after write offs	470.2	527.8
Equity	1,334.4	1,275.3
Adjusted BV	864.2	747.5
No of Shares	27.9	27.9
Share Price	31.0	26.8
Discounted Share Price		23.6



CONCLUSION

DSL's operating performance has deteriorated considerably due to the weakness in the housing market and downturn in economy. The uncertainty in operating the environment is well reflected in the company's quality of earnings and asset quality. Given the fact that 82.1% of DSL's net interest income consists of capitalized interest on negative amortization, which is basically an accounting entry and not cash income, the company's financials should fail to attract investor confidence.

Amid the weakening housing market, banks' net margins are falling. The quality of assets is suspect as non performing assets have grown from less than 1% to more than 10% of assets in about a year. Adjustable rate mortgages (ARM) being reset at an accelerated pace in the coming 8 to 12 quarters leading to substantial hike in monthly installment couple with gloomy outlook, in our view, is a recipe for disaster for both the income statement and asset quality of the company.

We expect credit losses to continue to rise on DSL's option ARM portfolio. With high charge offs being projected, we believe DSL will not return to profitability in coming three years. Higher loss provisions, tied with increasing loan settlement expenses will eat away profits. Despite trading at a substantial discount to its US GAAP book value and substantial underperformance in last year, we believe there is still room for downside as news on NPA's are likely to worsen going forward. Hence we believe DSL common stock is a sell/sell short for aggressive investors



FINANCIAL EXHIBITS

DOWNEY FINANCIAL CORPORATION (NYSE: DSL)

SELL

**EXHIBIT 1: Consolidated Income Statement – Base Case**

Figures in \$ Million; except per share data	2003	2004	2005	2006	2007	2008E	2009E	2010E	2011E	2012E
Total Interest Income	522.45	594.08	862.85	1,133.81	980.10	845.02	771.94	709.25	696.97	694.99
Total Interest Expense	233.84	249.82	426.48	615.13	556.26	514.17	497.31	432.78	424.75	396.56
Net Interest Income	288.61	344.25	436.37	518.68	423.84	330.84	274.63	276.47	272.22	298.43
Provision for (recovery from) Loan Losses	(3.72)	2.90	2.26	26.60	310.13	311.19	264.06	205.38	147.88	108.44
Net Interest Income after Provision for Loan Losses	292.33	341.36	434.11	492.07	113.71	19.66	10.57	71.08	124.34	189.99
Non-Interest Income	90.94	65.02	169.93	93.14	46.48	51.60	52.15	47.36	51.34	53.41
Non-Interest Expense	207.07	229.51	233.55	243.21	258.01	224.05	212.51	214.08	217.10	228.27
Income from Continuing Operations	176.20	176.87	370.49	342.01	(97.83)	(152.79)	(149.79)	(95.64)	(41.41)	15.12
Provision for Income Taxes	74.46	69.21	156.01	142.36	(41.23)	(59.59)	(58.42)	(37.30)	(16.15)	5.90
Net Income	101.74	107.66	214.48	199.66	(56.60)	(93.20)	(91.37)	(58.34)	(25.26)	9.22
Diluted EPS	3.64	3.85	7.69	7.16	(2.03)	(3.35)	(3.28)	(2.09)	(0.91)	0.33



EXHIBIT 2: Consolidated Balance Sheet – Base Case

Figures in \$'millions unless specified	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12
Assets								
Cash	190.40	124.87	83.84	932.20	734.93	606.96	799.54	1,140.10
Federal Funds	0.00	0.00	5.90	5.90	5.90	5.90	5.90	5.90
Cash and Cash Equivalents	190.40	124.87	89.74	938.10	740.83	612.86	805.44	1,146.00
Securities available for sale (at fair value)	626.31	1,433.18	1,549.88	1,666.12	1,624.47	1,486.39	1,508.68	1,531.31
Securities held to maturity	0.00	0.00	0.00					
Loans held for sale at fair value	464.49	363.22	103.38	113.72	125.09	137.60	151.36	166.50
Mortgage backed Securities held for sale at fair value	0.28	0.25	0.11	0.10	0.08	0.08	0.08	0.08
Loans Receivable held for Investment	15,357.16	13,807.28	11,033.16	9,202.53	8,834.43	8,509.61	8,360.36	8,293.99
Investment In Real Estate and Joint Ventures	49.34	59.84	68.68	69.37	70.06	70.76	71.47	72.18
Real Estate acquired in Loan settlement	0.91	8.52	115.62	122.56	122.68	61.34	30.67	15.34
Premises and Equipment	109.57	114.05	115.85	112.83	108.42	103.83	99.06	94.10
Federal Home Loan bank stock (at cost)	179.84	152.95	70.96	134.09	125.60	119.62	113.21	113.70
Investment in Downey Financial Capital Trust I	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Mortgage Servicing Rights	20.30	21.20	19.51	19.51	19.51	19.51	19.51	19.51
Other Assets	97.06	122.02	242.16	181.27	190.34	199.85	209.85	220.34
TOTAL ASSETS	17,095.66	16,207.38	13,409.06	12,560.21	11,961.52	11,321.46	11,369.71	11,673.06
Liabilities								
Deposits	11,876.85	11,784.87	10,496.04	9,536.37	9,209.97	8,821.18	8,982.81	9,259.61
Securities sold under agreements to repurchase	0.00	469.97	0.00					
Federal Home Loan Bank advances and other borrowings	3,557.52	2,140.79	1,197.10	1,375.74	1,173.01	953.34	832.78	811.13
Real Estate Notes	0.00	0.00	0.00					
Senior Notes	198.09	198.26	198.45	198.36	198.36	198.36	198.36	198.36
Junior subordinated debentures	0.00	0.00	0.00					
Accounts payable and accrued liabilities	114.53	220.26	183.05	219.66	252.61	290.51	334.08	384.20
Deferred Income Tax	140.47	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total Liabilities	15,887.44	14,814.15	12,074.64	11,330.13	10,833.95	10,263.38	10,348.03	10,653.29
Capital Securities	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Stockholders Equity:								
Common Stock, \$0.01 par value	0.28	0.28	0.28	0.28	0.28	0.28	0.28	0.28
Additional paid-in capital	93.79	93.79	93.79	93.79	93.79	93.79	93.79	93.79
Accumulated and other comprehensive loss	(5.41)	(5.20)	2.77	2.77	2.77	2.77	2.77	2.77
Retained earnings	1,136.35	1,321.16	1,254.37	1,150.02	1,047.51	978.03	941.63	939.72
Treasury Stock, at cost	(16.79)	(16.79)	(16.79)	(16.79)	(16.79)	(16.79)	(16.79)	(16.79)
Total Stockholders equity	1,208.22	1,393.24	1,334.42	1,230.07	1,127.56	1,058.08	1,021.68	1,019.77
Total Liabilities and Stockholders Equity	17,095.66	16,207.38	13,409.06	12,560.21	11,961.52	11,321.46	11,369.71	11,673.06



EXHIBIT 3: Consolidated Cash Flow Statement – Base Case

Figures in \$'millions unless specified	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12
Cash from Operations								
Operating Activities :								
Income from Continuing Operations	214.48	199.66	(56.60)	(93.20)	(91.37)	(58.34)	(25.26)	9.22
Adjustment to reconcile net income								
Provision for losses on loans	(0.03)	26.73	316.58					
Depreciation and Amortization	109.66	131.14	100.10	118.16	122.88	127.80	132.91	138.23
Net gains on sales of loans and mortgage-backed securities	(123.56)	(54.54)	(21.50)					
Gain on sale of subsidiary	0.00	0.00	0.00					
Interest capitalized on loans	(134.73)	(292.95)	(245.40)	(213.90)	(125.88)	(57.79)	(57.12)	(56.51)
Federal Home Loan Bank stock dividends	(10.33)	(9.51)	(6.09)					
Loans originated for sale	(7,715.20)	(3,475.55)	(1,572.42)	(10.34)	(11.37)	(12.51)	(13.76)	(15.14)
Proceeds from sales of loans held for sale	8,443.21	3,560.03	1,811.58					
Proceeds from sales of mortgage servicing rights								
(Increase) decrease in other	(134.34)	(121.15)	(281.20)	97.50	23.89	28.38	33.58	39.62
Net Cash From operating activities	649.2	(36.1)	45.1	(101.8)	(81.9)	27.5	70.3	115.4
Investing Activities								
Purchase of:								
U.S. Treasury securities, agency obligations and other investment	(168.80)	(1,036.22)	(2,019.17)	(116.24)	41.65	138.08	(22.30)	(22.63)
Mortgage-backed securities available for sale			0.00	0.01	0.01	0.00	(0.00)	(0.00)
Loans receivable held for investment	(62.53)	(21.67)	0.00					
Proceeds from sales and maturities of securities available for sale			0.00					
Premises and equipment	(20.14)	(27.82)	(23.57)	(115.14)	(118.47)	(123.21)	(128.14)	(133.27)
Federal Home Loan Bank stock purchase	(17.36)	(0.44)	(6.97)	(63.13)	8.49	5.99	6.40	(0.48)
Originations of loans receivable held for investment (net of refinances of	(6,628.85)	(3,516.35)	(1,552.63)					
Principal payments on loans receivable held for investment and	5,021.69	5,399.58	4,121.35					
Net change in undisbursed loan funds	(48.22)	(62.45)	(41.42)					
Investments in real estate held for investment	(0.27)	(4.05)	(7.01)	(0.69)	(0.69)	(0.70)	(0.71)	(0.71)
Other, net	4.99	10.42	8.28					
Proceeds from sale of:								
Loans held for investment				2,044.52	493.98	382.61	206.37	122.89
Wholly owned real estate and real estate acquired in settlement of loans	14.42	13.52	35.59	(6.94)	(0.12)	61.34	30.67	15.34
Redemption of common securities in Downey Financial Capital Trust I								
Federal Home Loan Bank stock	91.46	36.84	95.05					
Proceeds from maturities of U.S. Treasury securities, agency obligations	29.56	228.95	2,026.80					
U.S. Treasury securities, agency obligations and other			0.00					
Mortgage-backed securities available for sale			0.00					
Net Cash From Investing activities	(1,784.1)	1,020.3	2,635.5	1,742.4	424.9	464.1	92.3	(18.9)
Financing activities								
Net increase in deposits	2,218.87	(91.98)	(1,288.83)	(959.67)	(326.40)	(388.79)	161.63	276.80
Proceeds from Federal Home Loan Bank advances and other borrowings	33,167.68	30,564.99	16,842.54	178.64	0.00	0.00	0.00	0.00
Repayments of Federal Home Loan Bank advances and other borrowings	(34,160.43)	(31,515.32)	(18,267.02)	0.00	(202.73)	(219.67)	(120.55)	(21.65)
Purchase of treasury stock								
Proceeds from exercise of stock Pessions								
Cash dividends	(11.14)	(11.14)	(13.37)	(11.14)	(11.14)	(11.14)	(11.14)	(11.14)
Redemption of junior subordinated debentures	0.00			(0.09)	0.00	0.00	0.00	0.00
Proceeds from the issuance of senior notes								
Other, net	(9.19)	3.74	11.01					
Issuance of common stock								
Minimum withholding tax upon the exercise of stock Pessions								
Net Cash From Investing activities	1,205.8	(1,049.7)	(2,715.7)	(792.3)	(540.3)	(619.6)	29.9	244.0
(decrease) increase in cash and cash equivalents	70.89	(65.53)	(35.13)	848.36	(197.27)	(127.96)	192.58	340.56
cash and cash equivalents at the beginning of the period	119.50	190.40	124.87	89.74	938.10	740.83	612.86	805.44
Cash and cash equivalent at the end of the period	190.40	124.87	89.74	938.10	740.83	612.86	805.44	1,146.00



EXHIBIT 4: DCF Valuation – Base Case

<i>Figures in \$'millions unless specified</i>	2008F	2009F	2010F	2011F	2012F
Net Income available to shareholders	(93.20)	(91.37)	(58.34)	(25.26)	9.22
(sub) Capitalised Interest Negative Amortization	(213.90)	(125.88)	(57.79)	(57.12)	(56.51)
(add) Depreciation	118.16	122.88	127.80	132.91	138.23
Free Cash Flows to Equity	(188.94)	(94.37)	11.67	50.53	90.94

Sensitivity Analysis with Growth Rate	2008F	2008F	2008F	2008F	2008F
Discount Rate	13.6%	13.6%	13.6%	13.6%	13.6%
Terminal Growth	2%	3%	4%	5%	6%
Shares O/S	27.85	27.85	27.85	27.85	27.85
Free Cash Flows to Equity	268.96	313.26	366.77	432.72	515.99
Value Per Share (in \$)	9.66	11.25	13.17	15.54	18.52

Sensitivity Analysis with Discount Rate		<i>(With Terminal growth rate of 3%)</i>							
		PV of Free Cash Flows (in \$'000)				Sum of PV			
Range of Discount Rate		2008F	2009F	2010F	2011F	2012F	Terminal Value	of FC Equity (in	Value per Share (\$)
12%		(168.70)	(75.23)	8.31	32.11	51.60	671	519	18.6
13%		(167.20)	(73.91)	8.09	30.99	49.36	570	418	15.0
14%		(165.74)	(72.62)	7.88	29.92	47.23	491	338	12.1
15%		(164.30)	(71.36)	7.68	28.89	45.21	427	274	9.8

**EXHIBIT 5: Consolidated Income Statement – Optimistic Case**

Figures in \$ Million; except per share data	2003	2004	2005	2006	2007	2008E	2009E	2010E	2011E	2012E
Total Interest Income	522.45	594.08	862.85	1,133.81	980.10	920.32	892.39	883.89	899.61	934.34
Total Interest Expense	233.84	249.82	426.48	615.13	556.26	584.79	568.13	553.14	548.11	521.90
Net Interest Income	288.61	344.25	436.37	518.68	423.84	335.53	324.26	330.75	351.50	412.44
Provision for (recovery from) Loan Losses	(3.72)	2.90	2.26	26.60	310.13	223.66	189.80	142.35	128.11	122.99
Net Interest Income after Provision for Loan Losses	292.33	341.36	434.11	492.07	113.71	111.87	134.47	188.41	223.39	289.45
Non-Interest Income	90.94	65.02	169.93	93.14	46.48	55.10	55.60	53.81	55.91	57.56
Non-Interest Expense	207.07	229.51	233.55	243.21	258.01	245.53	246.72	242.54	254.00	276.52
Income from Continuing Operations	176.20	176.87	370.49	342.01	(97.83)	(78.57)	(56.66)	(0.32)	25.29	70.49
Provision for Income Taxes	74.46	69.21	156.01	142.36	(41.23)	(30.64)	(22.10)	(0.12)	9.86	27.49
Net Income	101.74	107.66	214.48	199.66	(56.60)	(47.93)	(34.56)	(0.19)	15.43	43.00
Diluted EPS	3.64	3.85	7.69	7.16	(2.03)	(1.72)	(1.24)	(0.01)	0.55	1.54



EXHIBIT 6: Consolidated Balance Sheet – Optimistic Case

Figures in \$'millions unless specified	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12
Assets								
Cash	190.40	124.87	83.84	1,201.59	1,179.00	638.02	583.08	402.59
Federal Funds	0.00	0.00	5.90	5.90	5.90	5.90	5.90	5.90
Cash and Cash Equivalents	190.40	124.87	89.74	1,207.49	1,184.90	643.92	588.98	408.49
Securities available for sale (at fair value)	626.31	1,433.18	1,549.88	1,666.12	1,666.12	1,682.78	1,674.37	1,640.88
Securities held to maturity	0.00	0.00	0.00					
Loans held for sale at fair value	464.49	363.22	103.38	113.72	125.09	137.60	151.36	166.50
Mortgage backed Securities held for sale at fair value	0.28	0.25	0.11	0.12	0.11	0.11	0.11	0.11
Loans Receivable held for Investment	15,357.16	13,807.28	11,033.16	9,974.17	9,575.21	9,675.89	9,919.43	10,406.87
Investment In Real Estate and Joint Ventures	49.34	59.84	68.68	69.37	70.06	70.76	71.47	72.18
Real Estate acquired in Loan settlement	0.91	8.52	115.62	122.56	122.68	61.34	30.67	15.34
Premises and Equipment	109.57	114.05	115.85	112.83	110.93	108.94	106.85	104.66
Federal Home Loan bank stock (at cost)	179.84	152.95	70.96	134.09	136.01	132.01	127.33	129.00
Investment in Downey Financial Capital Trust I	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Mortgage Servicing Rights	20.30	21.20	19.51	19.51	19.51	19.51	19.51	19.51
Other Assets	97.06	122.02	242.16	181.27	190.34	199.85	209.85	220.34
TOTAL ASSETS	17,095.66	16,207.38	13,409.06	13,601.26	13,200.97	12,732.72	12,899.93	13,183.87
Liabilities								
Deposits	11,876.85	11,784.87	10,496.04	10,472.29	10,238.88	9,907.17	10,156.75	10,388.36
Securities sold under agreements to repurchase	0.00	469.97	0.00					
Federal Home Loan Bank advances and other borrowings	3,557.52	2,140.79	1,197.10	1,435.60	1,281.47	1,118.37	988.13	958.49
Real Estate Notes	0.00	0.00	0.00					
Senior Notes	198.09	198.26	198.45	198.36	198.36	198.36	198.36	198.36
Junior subordinated debentures	0.00	0.00	0.00					
Accounts payable and accrued liabilities	114.53	220.26	183.05	219.66	252.61	290.51	334.08	384.20
Deferred Income Tax	140.47	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total Liabilities	15,887.44	14,814.15	12,074.64	12,325.91	11,971.32	11,514.41	11,677.32	11,929.41
Capital Securities	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Stockholders Equity:								
Common Stock, \$0.01 par value	0.28	0.28	0.28	0.28	0.28	0.28	0.28	0.28
Additional paid-in capital	93.79	93.79	93.79	93.79	93.79	93.79	93.79	93.79
Accumulated and other comprehensive loss	(5.41)	(5.20)	2.77	2.77	2.77	2.77	2.77	2.77
Retained earnings	1,136.35	1,321.16	1,254.37	1,195.30	1,149.60	1,138.27	1,142.55	1,174.42
Treasury Stock, at cost	(16.79)	(16.79)	(16.79)	(16.79)	(16.79)	(16.79)	(16.79)	(16.79)
Total Stockholders equity	1,208.22	1,393.24	1,334.42	1,275.35	1,229.65	1,218.32	1,222.60	1,254.47
Total Liabilities and Stockholders Equity	17,095.66	16,207.38	13,409.06	13,601.26	13,200.97	12,732.72	12,899.93	13,183.87



EXHIBIT 7: Consolidated Cash Flow Statement – Optimistic Case

Figures in \$'millions unless specified	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12
Cash from Operations								
Operating Activities :								
Income from Continuing Operations	214.48	199.66	(56.60)	(47.93)	(34.56)	(0.19)	15.43	43.00
Adjustment to reconcile net income								
Provision for losses on loans	(0.03)	26.73	316.58					
Depreciation and Amortization	109.66	131.14	100.10	104.60	109.83	115.32	121.09	127.14
Net gains on sales of loans and mortgage-backed securities	(123.56)	(54.54)	(21.50)					
Gain on sale of subsidiary	0.00	0.00	0.00					
Interest capitalized on loans	(134.73)	(292.95)	(245.40)	(198.50)	(119.65)	(55.21)	(54.96)	(54.73)
Federal Home Loan Bank stock dividends	(10.33)	(9.51)	(6.09)					
Loans originated for sale	(7,715.20)	(3,475.55)	(1,572.42)	(10.34)	(11.37)	(12.51)	(13.76)	(15.14)
Proceeds from sales of loans held for sale	8,443.21	3,560.03	1,811.58					
Proceeds from sales of mortgage servicing rights								
(Increase) decrease in other	(134.34)	(121.15)	(281.20)	97.50	23.89	28.38	33.58	39.62
Net Cash From operating activities	649.2	(36.1)	45.1	(54.7)	(31.9)	75.8	101.4	139.9
Investing Activities								
Purchase of:								
U.S. Treasury securities, agency obligations and other investment	(168.80)	(1,036.22)	(2,019.17)	(116.24)	0.00	(16.66)	8.41	33.49
Mortgage-backed securities available for sale			0.00	(0.01)	0.01	0.00	(0.00)	(0.00)
Loans receivable held for investment	(62.53)	(21.67)						
Proceeds from sales and maturities of securities available for sale			0.00					
Premises and equipment	(20.14)	(27.82)	(23.57)	(101.58)	(107.93)	(113.33)	(119.00)	(124.95)
Federal Home Loan Bank stock purchase	(17.36)	(0.44)	(6.97)	(63.13)	(1.92)	4.00	4.68	(1.67)
Originations of loans receivable held for investment (net of refinance:	(6,628.85)	(3,516.35)	(1,552.63)					
Principal payments on loans receivable held for investment and	5,021.69	5,399.58	4,121.35					
Net change in undisbursed loan funds	(48.22)	(62.45)	(41.42)					
Investments in real estate held for investment	(0.27)	(4.05)	(7.81)	(0.69)	(0.69)	(0.70)	(0.71)	(0.71)
Other, net	4.99	10.42	8.28					
Proceeds from sale of:								
Loans held for investment				1,257.49	518.61	(45.47)	(188.58)	(432.72)
Wholly owned real estate and real estate acquired in settlement of Ic	14.42	13.52	35.59	(6.94)	(0.12)	61.34	30.67	15.34
Redemption of common securities in Downey Financial Capital Trust I								
Federal Home Loan Bank stock	91.46	36.84	95.05					
Proceeds from maturities of U.S. Treasury securities, agency obligati	29.56	228.95	2,026.80					
U.S. Treasury securities, agency obligations and other								
Mortgage-backed securities available for sale								
Net Cash From Investing activities	(1,784.1)	1,020.3	2,635.5	968.9	407.9	(110.8)	(264.5)	(511.2)
Financing activities								
Net increase in deposits	2,218.87	(91.98)	(1,288.83)	(23.75)	(233.41)	(331.71)	249.58	231.61
Proceeds from Federal Home Loan Bank advances and other borrowi	33,167.68	30,564.99	16,842.54	238.50	0.00	0.00	0.00	0.00
Repayments of Federal Home Loan Bank advances and other borrow	(34,160.43)	(31,515.32)	(18,267.02)	0.00	(154.13)	(163.10)	(130.24)	(29.64)
Purchase of treasury stock								
Proceeds from exercise of stock Pessions								
Cash dividends	(11.14)	(11.14)	(13.37)	(11.14)	(11.14)	(11.14)	(11.14)	(11.14)
Redemption of junior subordinated debentures	0.00			(0.09)	0.00	0.00	0.00	0.00
Proceeds from the issuance of senior notes								
Other, net	(9.19)	3.74	11.01					
Issuance of common stock								
Minimum withholding tax upon the exercise of stock Pessions								
Net Cash From Investing activities	1,205.8	(1,049.7)	(2,715.7)	203.5	(398.7)	(505.9)	108.2	190.8
(decrease) increase in cash and cash equivalents	70.89	(65.53)	(35.13)	1,117.75	(22.59)	(540.98)	(54.94)	(180.50)
cash and cash equivalents at the beginning of the period	119.50	190.40	124.87	89.74	1,207.49	1,184.90	643.92	588.98
Cash and cash equivalent at the end of the period	190.40	124.87	89.74	1,207.49	1,184.90	643.92	588.98	408.49



EXHIBIT 8: DCF Valuation – Optimistic Case

<i>Figures in \$'millions unless specified</i>	2008F	2009F	2010F	2011F	2012F
Net Income available to shareholders	(47.93)	(34.56)	(0.19)	15.43	43.00
(sub) Capitalised Interest Negative Amortization	(198.50)	(119.65)	(55.21)	(54.96)	(54.73)
(add) Depreciation	104.60	109.83	115.32	121.09	127.14
(less) Change in Risk Weighted Assets 11.0%	0.00	0.00	0.00	0.00	0.00
Free Cash Flows to Equity	(141.83)	(44.38)	59.92	81.56	115.42
PV	(124.84)	(34.38)	40.86	48.95	60.98

Sensitivity Analysis with Growth Rate	2008F	2008F	2008F	2008F	2008F
Discount Rate	13.6%	13.6%	13.6%	13.6%	13.6%
Terminal Growth	2%	3%	4%	5%	6%
Shares O/S	27.85	27.85	27.85	27.85	27.85
Free Cash Flows to Equity	527.20	583.42	651.33	735.03	840.71
Value Per Share (in \$)	18.93	20.95	23.38	26.39	30.18

Sensitivity Analysis with Discount Rate		(With Terminal growth rate of 3%)						
Range of Discount Rate	PV of Free Cash Flows (in \$'000)					Terminal Value	Sum of PV of FC	
	2008F	2009F	2010F	2011F	2012F		Equity (in \$'million)	Value per Share (\$)
12%	(126.63)	(35.38)	42.65	51.83	65.49	851	849	30.5
13%	(125.51)	(34.75)	41.53	50.02	62.64	724	718	25.8
14%	(124.41)	(34.15)	40.44	48.29	59.94	623	614	22.0
15%	(123.33)	(33.55)	39.40	46.63	57.38	543	529	19.0

**EXHIBIT 9: Consolidated Income Statement – Pessimistic Case**

Figures in \$ Million; except per share data	2003	2004	2005	2006	2007	2008E	2009E	2010E	2011E	2012E
Total Interest Income	522.45	594.08	862.85	1,133.81	980.10	787.46	708.95	667.95	667.36	676.91
Total Interest Expense	233.84	249.82	426.48	615.13	556.26	479.30	470.89	489.24	491.69	493.14
Net Interest Income	288.61	344.25	436.37	518.68	423.84	308.16	238.05	178.71	175.66	183.77
Provision for (recovery from) Loan Losses	(3.72)	2.90	2.26	26.60	310.13	369.53	314.21	183.29	128.30	42.77
Net Interest Income after Provision for Loan Losses	292.33	341.36	434.11	492.07	113.71	(61.38)	(76.15)	(4.58)	47.36	141.00
Non-Interest Income	90.94	65.02	169.93	93.14	46.48	54.18	55.79	50.73	50.36	51.79
Non-Interest Expense	207.07	229.51	233.55	243.21	258.01	212.17	193.28	175.41	175.18	180.97
Income from Continuing Operations	176.20	176.87	370.49	342.01	(97.83)	(219.37)	(213.64)	(129.26)	(77.47)	11.82
Provision for Income Taxes	74.46	69.21	156.01	142.36	(41.23)	(85.55)	(83.32)	(50.41)	(30.21)	4.61
Net Income	101.74	107.66	214.48	199.66	(56.60)	(133.82)	(130.32)	(78.85)	(47.25)	7.21
Diluted EPS	3.64	3.85	7.69	7.16	(2.03)	(4.80)	(4.68)	(2.83)	(1.70)	0.26



EXHIBIT 10: Consolidated Balance Sheet – Pessimistic Case

Figures in \$'millions unless specified	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12
Assets								
Cash	190.40	124.87	83.84	1,211.72	1,168.49	1,425.03	1,288.47	1,376.05
Federal Funds	0.00	0.00	5.90	5.90	5.90	5.90	5.90	5.90
Cash and Cash Equivalents	190.40	124.87	89.74	1,217.62	1,174.39	1,430.93	1,294.37	1,381.95
Securities available for sale (at fair value)	626.31	1,433.18	1,549.88	1,666.12	1,666.12	1,691.11	1,716.48	1,742.23
Securities held to maturity	0.00	0.00	0.00					
Loans held for sale at fair value	464.49	363.22	103.38	113.72	125.09	137.60	151.36	166.50
Mortgage backed Securities held for sale at fair value	0.28	0.25	0.11	0.11	0.10	0.10	0.10	0.10
Loans Receivable held for Investment	15,357.16	13,807.28	11,033.16	9,115.37	8,750.76	8,405.35	8,537.04	8,752.07
Investment In Real Estate and Joint Ventures	49.34	59.84	68.68	69.37	70.06	70.76	71.47	72.18
Real Estate acquired in Loan settlement	0.91	8.52	115.62	122.56	122.68	61.34	30.67	15.34
Premises and Equipment	109.57	114.05	115.85	112.83	108.42	103.83	99.06	94.10
Federal Home Loan bank stock (at cost)	179.84	152.95	70.96	134.09	127.53	123.55	122.44	122.52
Investment in Downey Financial Capital Trust I	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Mortgage Servicing Rights	20.30	21.20	19.51	19.51	19.51	19.51	19.51	19.51
Other Assets	97.06	122.02	242.16	181.27	190.34	199.85	209.85	220.34
TOTAL ASSETS	17,095.66	16,207.38	13,409.06	12,752.57	12,355.00	12,243.95	12,252.35	12,586.84
Liabilities								
Deposits	11,876.85	11,784.87	10,496.04	9,745.40	9,603.82	9,709.25	9,830.86	10,103.33
Securities sold under agreements to repurchase	0.00	469.97	0.00					
Federal Home Loan Bank advances and other borrowings	3,557.52	2,140.79	1,197.10	1,399.69	1,252.21	1,087.83	989.43	1,005.26
Real Estate Notes	0.00	0.00	0.00					
Senior Notes	198.09	198.26	198.45	198.36	198.36	198.36	198.36	198.36
Junior subordinated debentures	0.00	0.00	0.00					
Accounts payable and accrued liabilities	114.53	220.26	183.05	219.66	252.61	290.51	334.08	384.20
Deferred Income Tax	140.47	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total Liabilities	15,887.44	14,814.15	12,074.64	11,563.11	11,307.00	11,285.94	11,352.73	11,691.15
Capital Securities	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Stockholders Equity:								
Common Stock, \$0.01 par value	0.28	0.28	0.28	0.28	0.28	0.28	0.28	0.28
Additional paid-in capital	93.79	93.79	93.79	93.79	93.79	93.79	93.79	93.79
Accumulated and other comprehensive loss	(5.41)	(5.20)	2.77	2.77	2.77	2.77	2.77	2.77
Retained earnings	1,136.35	1,321.16	1,254.37	1,109.41	967.95	877.96	819.56	815.64
Treasury Stock, at cost	(16.79)	(16.79)	(16.79)	(16.79)	(16.79)	(16.79)	(16.79)	(16.79)
Total Stockholders equity	1,208.22	1,393.24	1,334.42	1,189.46	1,048.00	958.01	899.61	895.69
Total Liabilities and Stockholders Equity	17,095.66	16,207.38	13,409.06	12,752.57	12,355.00	12,243.95	12,252.35	12,586.84



EXHIBIT 11: Consolidated Cash Flow Statement – Pessimistic Case

Figures in \$'millions unless specified	Dec-05	Dec-06	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12
Cash from Operations								
Operating Activities :								
Income from Continuing Operations	214.48	199.66	(56.60)	(133.82)	(130.32)	(78.85)	(47.25)	7.21
Adjustment to reconcile net income								
Provision for losses on loans	(0.03)	26.73	316.58					
Depreciation and Amortization	109.66	131.14	100.10	104.60	108.78	113.14	117.66	122.37
Net gains on sales of loans and mortgage-backed securities	(123.56)	(54.54)	(21.50)					
Gain on sale of subsidiary	0.00	0.00	0.00					
Interest capitalized on loans	(134.73)	(292.95)	(245.40)	(179.33)	(107.12)	(48.63)	(47.42)	(46.30)
Federal Home Loan Bank stock dividends	(10.33)	(9.51)	(6.09)					
Loans originated for sale	(7,715.20)	(3,475.55)	(1,572.42)	(10.34)	(11.37)	(12.51)	(13.76)	(15.14)
Proceeds from sales of loans held for sale	8,443.21	3,560.03	1,811.58					
Proceeds from sales of mortgage servicing rights								
(Increase) decrease in other	(134.34)	(121.15)	(281.20)	97.50	23.89	28.38	33.58	39.62
Net Cash From operating activities	649.2	(36.1)	45.1	(121.4)	(116.1)	1.5	42.8	107.8
Investing Activities								
Purchase of:								
U.S. Treasury securities, agency obligations and other investment	(168.80)	(1,036.22)	(2,019.17)	(116.24)	0.00	(24.99)	(25.37)	(25.75)
Mortgage-backed securities available for sale			0.00	0.01	0.01	0.00	(0.00)	(0.00)
Loans receivable held for investment	(62.53)	(21.67)						
Proceeds from sales and maturities of securities available for sale			0.00					
Premises and equipment	(20.14)	(27.82)	(23.57)	(101.58)	(104.37)	(108.55)	(112.89)	(117.41)
Federal Home Loan Bank stock purchase	(17.36)	(0.44)	(6.97)	(63.13)	6.56	3.98	1.11	(0.08)
Originations of loans receivable held for investment (net of refinanc	(6,628.85)	(3,516.35)	(1,552.63)					
Principal payments on loans receivable held for investment and	5,021.69	5,399.58	4,121.35					
Net change in undisbursed loan funds	(48.22)	(62.45)	(41.42)					
Investments in real estate held for investment	(0.27)	(4.05)	(7.81)	(0.69)	(0.69)	(0.70)	(0.71)	(0.71)
Other, net	4.99	10.42	8.28					
Proceeds from sale of:								
Loans held for investment				2,097.11	471.74	394.04	(84.27)	(168.73)
Wholly owned real estate and real estate acquired in settlement of	14.42	13.52	35.59	(6.94)	(0.12)	61.34	30.67	15.34
Redemption of common securities in Downey Financial Capital Trust I								
Federal Home Loan Bank stock	91.46	36.84	95.05					
Proceeds from maturities of U.S. Treasury securities, agency obligs	29.56	228.95	2,026.80					
U.S. Treasury securities, agency obligations and other		0.00						
Mortgage-backed securities available for sale		0.00						
Net Cash From Investing activities	(1,784.1)	1,020.3	2,635.5	1,808.5	373.1	325.1	(191.5)	(297.4)
Financing activities								
Net increase in deposits	2,218.87	(91.98)	(1,288.83)	(750.64)	(141.58)	105.43	121.61	272.47
Proceeds from Federal Home Loan Bank advances and other borrow	33,167.68	30,564.99	16,842.54	202.59	0.00	0.00	0.00	15.83
Repayments of Federal Home Loan Bank advances and other borrow	(34,160.43)	(31,515.32)	(18,267.02)	0.00	(147.47)	(164.38)	(98.40)	0.00
Purchase of treasury stock								
Proceeds from exercise of stock Pessions								
Cash dividends	(11.14)	(11.14)	(13.37)	(11.14)	(11.14)	(11.14)	(11.14)	(11.14)
Redemption of junior subordinated debentures	0.00			(0.09)	0.00	0.00	0.00	0.00
Proceeds from the issuance of senior notes								
Other, net	(9.19)	3.74	11.01					
Issuance of common stock								
Minimum withholding tax upon the exercise of stock Pessions								
Net Cash From Investing activities	1,205.8	(1,049.7)	(2,715.7)	(559.3)	(300.2)	(70.1)	12.1	277.2
(decrease) increase in cash and cash equivalents	70.89	(65.53)	(35.13)	1,127.88	(43.23)	256.54	(136.56)	87.58
cash and cash equivalents at the beginning of the period	119.50	190.40	124.87	89.74	1,217.62	1,174.39	1,430.93	1,294.37
Cash and cash equivalent at the end of the period	190.40	124.87	89.74	1,217.62	1,174.39	1,430.93	1,294.37	1,381.95



EXHIBIT 12: DCF Valuation – Pessimistic Case

<i>Figures in \$'millions unless specified</i>	2008F	2009F	2010F	2011F	2012F
Net Income available to shareholders	(133.82)	(130.32)	(78.85)	(47.25)	7.21
(sub) Capitalised Interest Negative Amortization	(179.33)	(107.12)	(48.63)	(47.42)	(46.30)
(add) Depreciation	104.60	108.78	113.14	117.66	122.37
(less) Change in Risk Weighted Assets 11.0%	0.00	0.00	0.00	0.00	0.00
Free Cash Flows to Equity	(208.54)	(128.66)	(14.34)	22.99	83.28
PV	(183.56)	(99.68)	(9.78)	13.80	44.00

Sensitivity Analysis with Growth Rate	2008F	2008F	2008F	2008F	2008F
Discount Rate	13.6%	13.6%	13.6%	13.6%	13.6%
Terminal Growth	2%	3%	4%	5%	6%
Shares O/S	27.85	27.85	27.85	27.85	27.85
Free Cash Flows to Equity	151.28	191.85	240.86	301.25	377.51
Value Per Share (in \$)	5.43	6.89	8.65	10.82	13.55

Sensitivity Analysis with Discount Rate (With Terminal growth rate of 3%)								
Range of Discount Rate	PV of Free Cash Flows (in \$'000)					Terminal Value	Sum of PV of FC Equity (in \$'million)	Value per Share (\$)
	2008F	2009F	2010F	2011F	2012F			
12%	(186.20)	(102.57)	(10.21)	14.61	47.26	614	377	13.5
13%	(184.55)	(100.76)	(9.94)	14.10	45.20	522	286	10.3
14%	(182.93)	(99.00)	(9.68)	13.61	43.26	450	215	7.7
15%	(181.34)	(97.29)	(9.43)	13.14	41.41	391	158	5.7



APPENDICES

DOWNEY FINANCIAL CORPORATION (NYSE: DSL)

SELL

**APPENDIX 1: COMPETITORS**

Description	Market Cap	P/E	ROE %	Div. Yield %	Price to Book
Anchor Bancorp Wisconsin, Inc.	376.01M	11.082	9.952	4.1	1.102
Astoria Financial Corporation	2.38B	18.332	10.286	4.2	1.963
Bank Mutual Corporation	508.81M	33.042	3.549	3.5	1.183
BankAtlantic Bancorp Inc.	250.64M	n.a.	-6.098	0.4	0.546
BankFinancial Corp.	315.87M	41.04	2.319	2	1.085
BankUnited Financial Corporati	142.29M	5.223	3.658	0.5	0.183
Banner Corporation	337.18M	8.457	10.732	3.9	0.77
Berkshire Hills Bancorp Inc.	235.36M	15.522	4.627	2.7	0.72
Brookline Bancorp Inc.	542.28M	31.481	3.221	3.7	1.045
Brooklyn Federal Bancorp Inc.	170.96M	50.787	3.98	2.2	1.996
Centennial Bank Holdings, Inc.	313.07M	n.a.	-27.396	n.a.	0.748
Clifton Savings Bancorp Inc.	255.60M	117	1.221	2.1	1.498
Columbia Banking System Inc.	390.12M	11.389	10.901	3.2	1.142
Dime Community Bancshares Inc.	498.81M	22.054	8.023	3.9	1.855
Essa Bancorp, Inc.	194.09M	n.a.	-3.222	n.a.	0.937
First Financial Holdings Inc.	244.81M	11.345	11.792	4.9	1.307
First Niagara Financial Group	1.13B	13.715	6.137	5	0.832
First Security Group, Inc.	151.48M	13.744	7.765	2.2	1.026
First South Bancorp Inc.	183.03M	11.002	20.632	4.1	2.128
FirstFed Financial Corp.	401.86M	4.913	13.667	n.a.	0.614
Flagstar Bancorp Inc.	361.63M	n.a.	-5.212	3.3	0.522
Flushing Financial Corp.	326.43M	15.069	8.93	3.4	1.397
Home Federal Bancorp Inc.	205.32M	40.169	3.158	1.8	1.007
Horizon Financial Corp.	145.56M	7.651	15.704	4.5	1.142
Hudson City Bancorp Inc.	8.01B	26.638	6.201	2.3	1.738
IndyMac Bancorp Inc.	381.45M	n.a.	-36.464	20.4	0.284
Investors Bancorp Inc.	1.53B	120	1.478	n.a.	1.877
K-Fed Bancorp	142.15M	37.881	3.921	4.4	1.52
Kearny Financial Corp.	717.13M	247.317	0.607	2	1.518
New York Community Bancorp Inc	5.16B	17.759	7.09	6.4	1.233
Northwest Bancorp Inc.	1.28B	26.412	8.066	3.4	2.083
OceanFirst Financial Corp.	197.67M	174.022	0.838	5	1.59
Ocwen Financial Corp.	362.03M	10.722	7.301	n.a.	0.618
People's United Financial Inc.	4.80B	30.911	5.158	3.3	1.08
Provident Financial Services I	719.94M	19.068	3.701	3.7	0.719
Provident New York Bancorp	524.03M	25.439	5.143	1.9	1.303
Prudential Bancorp Inc. Of Pen	141.93M	45.362	3.728	1.6	1.792
Roma Financial Corp.	411.16M	56.55	3.435	1.9	1.847
Southwest Bancorp Inc.	214.07M	10.212	10.3	2.5	0.984
Sovereign Bancorp Inc.	4.93B	n.a.	-17.258	3.1	0.725
Sterling Financial Corp.	705.98M	7.384	9.477	2.9	0.596
United Community Financial Cor	160.48M	21.36	2.658	7	0.588
Washington Federal Inc.	1.91B	14.247	10.275	3.9	1.424
Washington Mutual Inc.	9.31B	n.a.	-0.26	5.1	0.439
Wauwatosa Holdings, Inc.	356.57M	232.857	0.703	n.a.	1.767
Willow Financial Bancorp, Inc.	117.99M	16.638	3.505	5.9	0.572
Wilshire Bancorp Inc.	204.19M	7.67	16.68	3	1.189



APPENDIX 2: MANAGEMENT TEAM

Daniel D. Rosenthal

President and Chief Executive Officer

Daniel D. Rosenthal has been serving Downey Financial Corporation and its subsidiary Downey Savings and Loan Association F.A. as Chief Executive Officer since September 1, 2004. Mr. Rosenthal is also assuming the role of a President of DSL Service Company, the subsidiary of Downey Financial Corporation. He has been a member of the Board of Directors for Downey and the Bank since 1998 and DSL Service Company since 1991. Mr. Rosenthal joined the bank, Downey Savings and Loan Association, in 1975 and served as Senior Vice President and Director of Major Loans. He had served as DSL Service Company's Acting President since 1993. Mr. Rosenthal was named President of DSL Service Company in 1994 and was Senior Vice President and Director of Major Loans of the Bank. During 1998, Mr. Rosenthal served as the Chief Operating Officer of the Bank. He has been Director of Downey Financial Corp. and its subsidiary Downey Savings and Loan Association, F.A since 1998. He has been Vice Chairman of Downey Financial Corp. since December 31, 2007.

Rick McGill

President

Mr. McGill is President of both Downey and the Bank since October 2007. Prior to joining Downey, Mr McGill served Quaker City Bank, a division of Banco Popular North America, for 13 years and held various senior position including President, Chief Executive Officer, and Chief Operating Officer until its sale to Banco Popular in 2004. Prior thereto, Mr. McGill served in senior level positions in several thrifts and banks and has over 30 years experience in the banking and finance industry.

Brian E. Cote

Executive Vice President and Chief Financial Officer

Brian E. Cote is Executive Vice President and Chief Financial Officer of both Downey and the Bank since March 2006. Prior to joining Downey and the Bank, Mr. Cote served as Executive Vice President and Chief Financial Officer of Chinatrust Bank (U.S.A.) from April 2004 through March 2006, and Senior Vice President and Chief Financial Officer of Kinecta Federal Credit Union from May 1999 through April 2004. Prior thereto, Mr. Cote served variety of financial positions at WesCorp, Security Pacific National Bank and American Express International Bank.

Thomas E. Prince

Executive Vice President and Chief Operating Officer

Thomas E. Price is presently assuming the position of Executive Vice President and Chief Operating Officer of both Downey Financial Corporation and the Bank. Prior to March 2006, Mr. Prince served the company as Chief Operating Officer and Chief Financial Officer since September 2006. He joined Downey and the Bank in May 1992 as Executive Vice President and Chief Financial Officer. Prior to joining the Bank as Executive Vice President and Chief Financial Officer in May 1992, Mr. Prince has 24 years of experience at Security Pacific Corporation and Security Pacific National Bank in various financial capacities, the last eight years of which as Senior Vice President and Controller.



Jon A. MacDonald

Executive Vice President, General Counsel and Corporate Secretary

Mr. MacDonald has been appointed as Executive Vice President, General Counsel, and Corporate Secretary of Downey and the Bank since July 2005. Before assuming this role in the company, Mr. MacDonald was working in California based, Crown Realty & Development, Inc. as Executive Vice President & General Counsel. Mr. MacDonald earlier practiced transactional real estate law with the Los Angeles and Orange County offices of Paul, Hastings, Janofsky & Walker LLP.

Robert Suarez

Executive Vice President and Chief Information Officer of the Bank

Mr. Suarez was appointed Executive Vice President and Chief Information Officer in May 2007. Prior to joining the Bank in 2006 as Senior Vice President and Information Technology Chief Demand Officer, Mr. Suarez was a Chief Information Officer at privately held Sigue Corporation from 2004 to 2006, at Indy Mac Bank from 2002 to 2004, and at Fidelity Federal Bank from 1997 to 2004. With over 30 years of Information Technology experience in financial services, Mr. Suarez's previous assignments include Vice President of MIS at Glendale Federal Bank from 1995 to 1997, Assistant Vice President & Program Manager at Great Western Bank from 1988 to 1995, Assistant Vice President & Program Manager at First Interstate Bank from 1981 to 1988, and Operations Manager at Security Pacific Bank from 1975 to 1980.

Lillian E. Gavin

Executive Vice President, Director of Operational and Compliance Risk of the Bank

Lillian E. Gavin is working in the company as Executive Vice President, Director of Operational and Compliance Risk Officer of the Bank since October 2007. She joined Downey Financials in 1997 and has served the company in these years as Director of Regulatory Affairs, Director of Compliance and Risk Management and Chief Credit Officer. Gavin was appointed Executive Vice President in December 1998. Prior to joining the Bank, Ms. Gavin was a senior examiner with the Office of Thrift Supervision and its predecessor, the Federal Home Loan Bank Board, since 1987, and was a bank liquidation specialist with the Federal Deposit Insurance Corporation from 1984 to 1987.

Insiders own 23.9% of outstanding shares of Downey Financial Corporation. Over the past six months insiders were involved a negligible amount of open market activity. Most recent transaction involved a purchase of 500 shares by Jane Wolfe (Director) in November 2007 and 207 shares by Adams Joseph Edward in May 2007.

**APPENDIX 3: FORECAST TABLES AND CHARTS***Tables***Base Case****Downey Financial Average Loans Forecast**

Residential One-to-Four Units	14,963.06	15,173.08	12,044.95	9,997.31	8,797.63	8,445.72	8,276.81	8,194.04
Home Equity Loans and Lines of Credit	279.40	215.59	153.15	137.84	144.73	150.52	156.54	162.80
Residential Five or more Units	70.90	130.19	111.80	98.39	93.47	95.80	98.20	100.65
Commercial Real Estate	137.45	158.91	173.91	177.38	180.93	185.45	190.09	194.84
Non-Mortgage Commercial Loans	4.06	2.75	5.54	4.43	4.65	4.74	4.84	4.94
Consumer	6.82	7.78	6.63	7.30	6.93	6.79	6.66	6.52
Total Average Loan	15,461.68	15,688.30	12,495.98	10,422.64	9,228.34	8,889.04	8,733.13	8,663.80

Downey Financial Average Loans Growth

Residential One-to-Four Units	21.7%	1.4%	-20.6%	-17.0%	-12.0%	-4.0%	-2.0%	-1.0%
Home Equity Loans and Lines of Credit	4.8%	-22.8%	-29.0%	-10.0%	5.0%	4.0%	4.0%	4.0%
Residential Five or more Units	-23.8%	83.6%	-14.1%	-12.0%	-5.0%	2.5%	2.5%	2.5%
Commercial Real Estate	13.4%	15.6%	9.4%	2.0%	2.0%	2.5%	2.5%	2.5%
Non-Mortgage Commercial Loans	-15.7%	-32.2%	101.1%	-20.0%	5.0%	2.0%	2.0%	2.0%
Consumer	-11.4%	13.9%	-14.7%	10.0%	-5.0%	-2.0%	-2.0%	-2.0%
Total Loan	20.9%	1.5%	-20.3%	-16.6%	-4.0%	-3.7%	-1.8%	-0.8%

Downey Financial Average Loan Composition

Residential One-to-Four Units	96.8%	96.7%	96.4%	95.9%	95.3%	95.0%	93.1%	92.2%
Home Equity Loans and Lines of Credit	1.8%	1.4%	1.2%	1.3%	1.6%	1.7%	1.8%	1.8%
Residential Five or more Units	0.5%	0.8%	0.9%	0.9%	1.0%	1.1%	1.1%	1.1%
Commercial Real Estate	0.9%	1.0%	1.4%	1.7%	2.0%	2.1%	2.1%	2.2%
Non-Mortgage Commercial Loans	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%
Consumer	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Total Loan	100%	100%	100%	100%	100%	100%	100%	100%

**Loans as a Percentage of Total Assets (Based on Average Balances)**

Net Loans Receivables	92.9%	91.0%	84.4%	79.4%	76.1%	78.1%	77.5%	77.1%
Total Investment Securities	4.6%	6.5%	12.2%	17.3%	20.6%	18.6%	19.2%	19.6%
Total Interest Earning Assets	97.5%	97.5%	96.7%	96.7%	96.7%	96.7%	96.7%	96.7%
Total Non-Interest Earning Assets	2.5%	2.5%	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%
Total Assets	100%	100%	100%	100%	100%	100%	100%	100%

Downey Financial's Average Deposit Forecast

Interest-bearing Checking	530.11	499.98	478.22	454.31	467.94	444.54	453.44	462.50
Money Market	160.55	156.63	142.81	139.95	146.95	142.54	146.81	151.22
Regular Passbook	2,221.13	1,503.87	1,152.57	1,060.36	1,007.34	906.61	979.14	1,028.09
Certificate of Deposit	7,335.87	9,055.96	8,623.05	7,760.74	7,450.31	7,152.30	7,223.82	7,440.54
Non-Interest Bearing Checking	748.27	746.40	740.75	703.71	700.19	714.19	728.48	743.05
Total Deposits	10,995.93	11,962.83	11,137.39	10,119.07	9,772.73	9,360.19	9,531.69	9,825.40

Downey Financial's Average Deposit Growth

Interest-bearing Checking	-1.3%	-5.7%	-4.4%	-5.0%	3.0%	-5.0%	2.0%	2.0%
Money Market	9.4%	-2.4%	-8.8%	-2.0%	5.0%	-3.0%	3.0%	3.0%
Regular Passbook	-37.0%	-32.3%	-23.4%	-8.0%	-5.0%	-10.0%	8.0%	5.0%
Certificate of Deposit	67.4%	23.4%	-4.8%	-10.0%	-4.0%	-4.0%	1.0%	3.0%
Non-Interest Bearing Checking	48.6%	-0.3%	-0.8%	-5.0%	-0.5%	2.0%	2.0%	2.0%
Total Deposits	20.9%	8.8%	-6.9%	-9.1%	-3.4%	-4.2%	1.8%	3.1%



Deposits as a Percentage of Total Liabilities

Interest-bearing Checking	3.4%	3.1%	3.6%	3.8%	4.1%	4.0%	4.0%	4.0%
Money Market	1.0%	1.0%	1.1%	1.2%	1.3%	1.3%	1.3%	1.3%
Regular Passbook	14.3%	9.4%	8.6%	8.9%	8.8%	8.3%	8.6%	8.8%
Certificate of Deposit	47.2%	56.8%	64.5%	64.8%	65.0%	65.1%	63.6%	63.7%
Non-Interest Bearing Checking	4.8%	4.7%	5.5%	5.9%	6.1%	6.5%	6.4%	6.4%
Total Deposits	70.8%	75.0%	83.4%	84.5%	85.2%	85.3%	83.9%	84.1%
Advances from FHLB	26.3%	21.7%	13.4%	12.7%	11.9%	11.8%	13.2%	13.1%
Other Interest Bearing Liabilities	1.3%	1.2%	1.5%	1.7%	1.7%	1.8%	1.7%	1.7%
Total Borrowings	27.6%	22.9%	14.9%	14.4%	13.7%	13.7%	14.9%	14.8%
Other Non Interest Bearing Liabilities	1.6%	2.0%	1.8%	1.1%	1.1%	1.1%	1.2%	1.2%
Total Liabilities	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Interest on Low Cost Deposits

Interest-bearing Checking	0.36%	0.34%	0.31%	0.31%	0.31%	0.33%	0.37%	0.40%
Money Market	1.05%	1.04%	1.04%	1.04%	1.06%	1.12%	1.25%	1.35%
Regular Passbook	1.07%	1.00%	0.95%	0.95%	0.97%	1.02%	1.14%	1.24%
Total Interest Expense	0.94%	0.85%	0.78%	0.78%	0.79%	0.83%	0.93%	1.01%

Yield on Interest Earning Assets

Total Interest Income from Loans	5.4%	6.9%	7.1%	6.9%	6.9%	6.7%	6.6%	6.5%
Income on tax exempt securities	4.1%	4.9%	9.8%	4.9%	4.9%	5.0%	5.1%	5.3%
Income on taxable investment securities	3.8%	4.8%	5.2%	5.4%	5.4%	5.5%	5.6%	5.9%

Net Interest Margin

Total Interest Income	862.85	1,133.81	980.10	845.02	771.94	709.25	696.97	694.99
Total Interest Expense	426.48	615.13	556.26	514.17	497.31	432.78	424.75	396.56
Net Interest Income	436.37	518.68	423.84	330.84	274.63	276.47	272.22	298.43
Net Interest Margin (%)	2.7%	3.1%	3.0%	2.6%	2.3%	2.5%	2.5%	2.7%

**Profitability Ratios**

Return on Average Assets	1.2%	-0.4%	-0.7%	-0.8%	-0.5%	-0.2%	0.1%
Return on Average Shareholders Equity	15.4%	-3.9%	-7.3%	-7.8%	-5.3%	-2.4%	0.9%
Interest Expense -to- Interest Income	54.3%	56.8%	60.8%	64.4%	61.0%	60.9%	57.1%
Interest Income -to- Average Interest-Earning Assets	6.7%	6.8%	6.7%	6.6%	6.4%	6.4%	6.4%
Interest Expense -to- Average Interest-Bearing Liabilities	3.9%	4.2%	4.3%	4.4%	4.0%	3.8%	3.4%
Net Spread	2.8%	2.6%	2.3%	2.2%	2.5%	2.6%	3.0%
Net Interest Margin	3.1%	3.0%	2.6%	2.3%	2.5%	2.5%	2.7%
Non-Interest Income -to- Operating Profit	18.0%	11.0%	15.6%	19.0%	17.1%	18.9%	17.9%

Liquidity Ratios

Average Net Loans -to- Average Customer Deposits	131.1%	112.2%	103.0%	94.4%	95.0%	91.6%	88.2%
Average Net Loans -to- Average Interest Bearing Liabilities	100.4%	95.2%	88.0%	81.4%	81.9%	77.8%	75.0%
Average Customer Deposits -to- Average Interest Bearing Liability	76.6%	84.9%	85.5%	86.2%	86.2%	84.9%	85.1%
Average Customer Deposits -to- Average Shareholders Equity	925.5%	772.3%	789.2%	829.0%	856.5%	916.6%	962.6%

OPTIMISTIC SCENARIO**Downey Financial Average Loans Forecast**

Residential One-to-Four Units	14,963.06	15,173.08	12,044.95	10,840.45	10,406.84	10,510.90	10,773.68	11,312.36
Home Equity Loans and Lines of Credit	279.40	215.59	153.15	145.50	142.59	145.44	151.25	157.30
Residential Five or more Units	70.90	130.19	111.80	107.33	105.18	107.81	110.51	113.27
Commercial Real Estate	137.45	158.91	173.91	191.30	181.73	186.27	190.93	195.70
Non-Mortgage Commercial Loans	4.06	2.75	5.54	4.98	5.28	5.39	5.50	5.61
Consumer	6.82	7.78	6.63	7.03	6.68	6.54	6.41	6.29
Total Average Loan	15,461.68	15,688.30	12,495.98	11,296.59	10,848.30	10,962.36	11,238.28	11,790.53



Downey Financial Average Loans Growth

Residential One-to-Four Units	21.7%	1.4%	-20.6%	-10.0%	-4.0%	1.0%	2.5%	5.0%
Home Equity Loans and Lines of Credit	4.8%	-22.8%	-29.0%	-5.0%	-2.0%	2.0%	4.0%	4.0%
Residential Five or more Units	-23.8%	83.6%	-14.1%	-4.0%	-2.0%	2.5%	2.5%	2.5%
Commercial Real Estate	13.4%	15.6%	9.4%	10.0%	-5.0%	2.5%	2.5%	2.5%
Non-Mortgage Commercial Loans	-15.7%	-32.2%	101.1%	-10.0%	6.0%	2.0%	2.0%	2.0%
Consumer	-11.4%	13.9%	-14.7%	6.0%	-5.0%	-2.0%	-2.0%	-2.0%
Total Loan	20.9%	1.5%	-20.3%	-9.6%	-4.0%	1.1%	2.5%	4.9%

Downey Financial Average Loan Composition

Residential One-to-Four Units	96.8%	96.7%	96.4%	96.0%	95.9%	95.9%	95.9%	95.9%
Home Equity Loans and Lines of Credit	1.8%	1.4%	1.2%	1.3%	1.3%	1.3%	1.3%	1.3%
Residential Five or more Units	0.5%	0.8%	0.9%	1.0%	1.0%	1.0%	1.0%	1.0%
Commercial Real Estate	0.9%	1.0%	1.4%	1.7%	1.7%	1.7%	1.7%	1.7%
Non-Mortgage Commercial Loans	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Consumer	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Total Loan	100%	100%	100%	100%	100%	100%	100%	100%

Loans as a Percentage of Total Assets (Based on Average Balances)

Net Loans Receivables	92.9%	91.0%	84.4%	82.2%	81.0%	80.6%	81.2%	82.5%
Total Investment Securities	4.6%	6.5%	12.2%	14.5%	15.6%	16.0%	15.4%	14.2%
Total Interest Earning Assets	97.5%	97.5%	96.7%	96.7%	96.7%	96.7%	96.7%	96.7%
Total Non-Interest Earning Assets	2.5%	2.5%	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%
Total Assets	100%	100%	100%	100%	100%	100%	100%	100%

Downey Financial's Average Deposit Forecast

Interest-bearing Checking	530.11	499.98	478.22	454.31	431.60	397.07	405.01	413.11
Money Market	160.55	156.63	142.81	149.95	157.44	152.72	157.30	162.02
Regular Passbook	2,221.13	1,503.87	1,152.57	1,094.94	1,040.19	884.16	954.89	1,002.64
Certificate of Deposit	7,335.87	9,055.96	8,623.05	8,709.28	8,535.09	8,364.39	8,531.68	8,702.31
Non-Interest Bearing Checking	748.27	746.40	740.75	703.71	700.19	714.19	728.48	743.05
Total Deposits	10,995.93	11,962.83	11,137.39	11,112.18	10,864.51	10,512.54	10,777.36	11,023.13



Deposits as a Percentage of Total Liabilities

Interest-bearing Checking	3.4%	3.1%	3.6%	3.4%	3.3%	3.1%	3.2%	3.2%
Money Market	1.0%	1.0%	1.1%	1.1%	1.2%	1.2%	1.2%	1.3%
Regular Passbook	14.3%	9.4%	8.6%	8.1%	8.1%	7.0%	7.5%	7.8%
Certificate of Deposit	47.2%	56.8%	64.5%	64.7%	66.2%	66.3%	67.2%	67.7%
Non-Interest Bearing Checking	4.8%	4.7%	5.5%	5.2%	5.4%	5.7%	5.7%	5.8%
Total Deposits	70.8%	75.0%	83.4%	82.6%	84.3%	83.3%	84.9%	85.7%
Advances from FHLB	26.3%	21.7%	13.4%	14.6%	13.0%	13.9%	12.5%	11.7%
Other Interest Bearing Liabilities	1.3%	1.2%	1.5%	1.5%	1.5%	1.6%	1.6%	1.5%
Total Borrowings	27.6%	22.9%	14.9%	16.1%	14.5%	15.5%	14.0%	13.2%
Other Non Interest Bearing Liabilities	1.6%	2.0%	1.8%	1.3%	1.2%	1.2%	1.1%	1.1%
Total Liabilities	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Yield on Interest Earning Assets

Total Interest Income from Loans	5.4%	6.9%	7.1%	7.2%	7.2%	7.0%	6.9%	6.9%
Income on tax exempt securities	4.1%	4.9%	9.8%	4.9%	4.9%	5.0%	5.1%	5.3%
Income on taxable investment securities	3.8%	4.8%	5.2%	5.4%	5.4%	5.5%	5.6%	5.9%

Net Interest Margin

Total Interest Income	862.85	1,133.81	980.10	920.32	892.39	883.89	899.61	934.34
Total Interest Expense	426.48	615.13	556.26	584.79	568.13	553.14	548.11	521.90
Net Interest Income	436.37	518.68	423.84	335.53	324.26	330.75	351.50	412.44
Net Interest Margin (%)	2.7%	3.1%	3.0%	2.5%	2.5%	2.5%	2.6%	3.0%

**PESSIMISTIC SCENARIO****Downey Financial Average Loans Forecast**

Residential One-to-Four Units	14,963.06	15,173.08	12,044.95	9,876.86	8,691.63	8,343.97	8,469.13	8,680.86
Home Equity Loans and Lines of Credit	279.40	215.59	153.15	140.90	133.86	128.50	133.64	138.99
Residential Five or more Units	70.90	130.19	111.80	106.21	100.90	98.38	100.84	103.36
Commercial Real Estate	137.45	158.91	173.91	187.82	191.57	186.79	191.45	196.24
Non-Mortgage Commercial Loans	4.06	2.75	5.54	4.71	4.94	5.04	5.14	5.24
Consumer	6.82	7.78	6.63	7.43	7.06	6.92	6.78	6.64
Total Average Loan	15,461.68	15,688.30	12,495.98	10,323.92	9,129.96	8,769.59	8,906.98	9,131.33

Downey Financial Average Loans Growth

Residential One-to-Four Units	21.7%	1.4%	-20.6%	-18.0%	-12.0%	-4.0%	1.5%	2.5%
Home Equity Loans and Lines of Credit	4.8%	-22.8%	-29.0%	-8.0%	-5.0%	-4.0%	4.0%	4.0%
Residential Five or more Units	-23.8%	83.6%	-14.1%	-5.0%	-5.0%	-2.5%	2.5%	2.5%
Commercial Real Estate	13.4%	15.6%	9.4%	8.0%	2.0%	-2.5%	2.5%	2.5%
Non-Mortgage Commercial Loans	-15.7%	-32.2%	101.1%	-15.0%	5.0%	2.0%	2.0%	2.0%
Consumer	-11.4%	13.9%	-14.7%	12.0%	-5.0%	-2.0%	-2.0%	-2.0%
Total Loan	20.9%	1.5%	-20.3%	-17.4%	-4.0%	-3.9%	1.6%	2.5%

Downey Financial Average Loan Composition

Residential One-to-Four Units	96.8%	96.7%	96.4%	95.7%	95.2%	95.1%	95.1%	95.1%
Home Equity Loans and Lines of Credit	1.8%	1.4%	1.2%	1.4%	1.5%	1.5%	1.5%	1.5%
Residential Five or more Units	0.5%	0.8%	0.9%	1.0%	1.1%	1.1%	1.1%	1.1%
Commercial Real Estate	0.9%	1.0%	1.4%	1.8%	2.1%	2.1%	2.1%	2.1%
Non-Mortgage Commercial Loans	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%
Consumer	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Total Loan	100%	100%	100%	100%	100%	100%	100%	100%

**Loans as a Percentage of Total Assets (Based on Average Balances)**

Net Loans Receivables	92.9%	91.0%	84.4%	79.8%	77.3%	75.9%	75.8%	75.9%
Total Investment Securities	4.6%	6.5%	12.2%	16.8%	19.3%	20.8%	20.8%	20.7%
Total Interest Earning Assets	97.5%	97.5%	96.7%	96.7%	96.7%	96.7%	96.7%	96.7%
Total Non-Interest Earning Assets	2.5%	2.5%	3.3%	3.3%	3.3%	3.3%	3.3%	3.3%
Total Assets	100%	100%	100%	100%	100%	100%	100%	100%

Downey Financial's Average Deposit Forecast

Interest-bearing Checking	530.11	499.98	478.22	468.66	454.60	431.87	440.51	449.32
Money Market	160.55	156.63	142.81	139.95	137.15	133.04	137.03	141.14
Regular Passbook	2,221.13	1,503.87	1,152.57	1,267.82	1,293.18	1,189.72	1,213.52	1,237.79
Certificate of Deposit	7,335.87	9,055.96	8,623.05	7,760.74	7,605.53	7,833.69	7,912.03	8,149.39
Non-Interest Bearing Checking	748.27	746.40	740.75	703.71	700.19	714.19	728.48	743.05
Total Deposits	10,995.93	11,962.83	11,137.39	10,340.88	10,190.65	10,302.52	10,431.56	10,720.68

Deposits as a Percentage of Total Liabilities

Interest-bearing Checking	3.4%	3.1%	3.6%	3.8%	3.7%	3.5%	3.5%	3.5%
Money Market	1.0%	1.0%	1.1%	1.1%	1.1%	1.1%	1.1%	1.1%
Regular Passbook	14.3%	9.4%	8.6%	10.2%	10.5%	9.6%	9.6%	9.5%
Certificate of Deposit	47.2%	56.8%	64.5%	62.6%	62.0%	63.1%	62.6%	62.6%
Non-Interest Bearing Checking	4.8%	4.7%	5.5%	5.7%	5.7%	5.8%	5.8%	5.7%
Total Deposits	70.8%	75.0%	83.4%	83.5%	83.1%	83.0%	82.6%	82.3%
Advances from FHLB	26.3%	21.7%	13.4%	13.7%	14.0%	14.1%	14.6%	14.8%
Other Interest Bearing Liabilities	1.3%	1.2%	1.5%	1.6%	1.6%	1.6%	1.6%	1.5%
Total Borrowings	27.6%	22.9%	14.9%	15.3%	15.6%	15.7%	16.1%	16.4%
Other Non Interest Bearing Liabilities	1.6%	2.0%	1.8%	1.2%	1.3%	1.3%	1.3%	1.3%
Total Liabilities	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Yield on Interest Earning Assets

Total Interest Income from Loans	5.4%	6.9%	7.1%	6.5%	6.4%	6.1%	6.0%	5.8%
Income on tax exempt securities	4.1%	4.9%	9.8%	4.8%	4.8%	4.9%	5.0%	5.2%
Income on taxable investment securities	3.8%	4.8%	5.2%	5.3%	5.3%	5.4%	5.5%	5.7%



Net Interest Margin

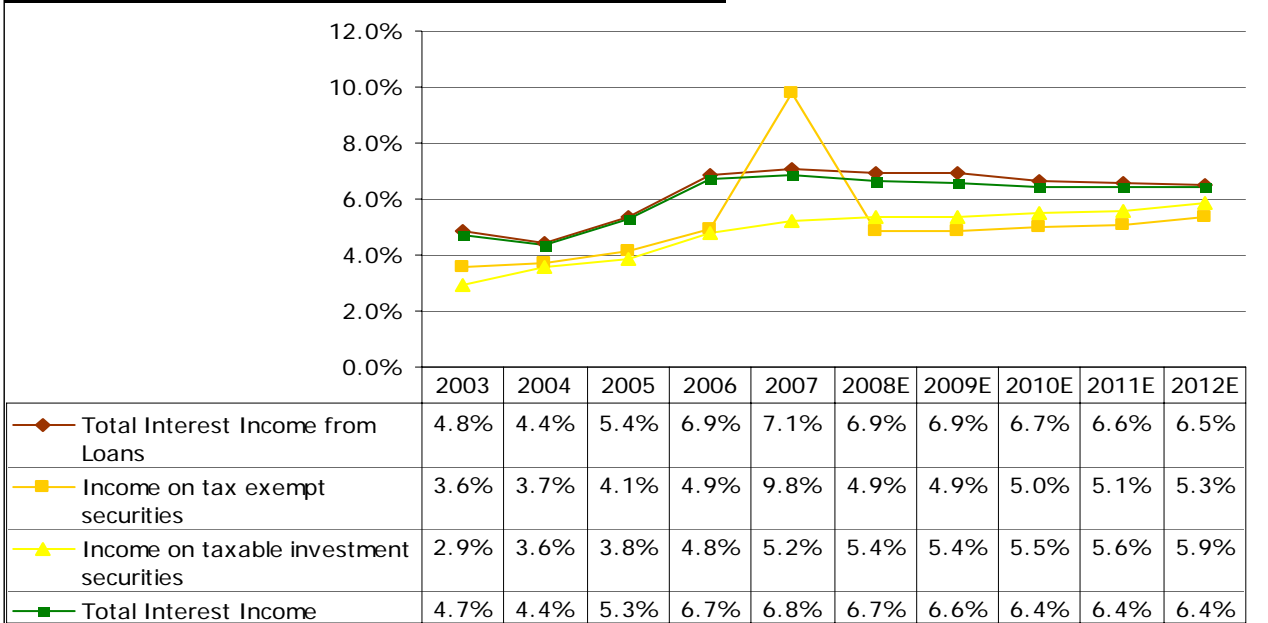
Net Interest Margin								
Total Interest Income	862.85	1,133.81	980.10	787.46	708.95	667.95	667.36	676.91
Total Interest Expense	426.48	615.13	556.26	479.30	470.89	489.24	491.69	493.14
Net Interest Income	436.37	518.68	423.84	308.16	238.05	178.71	175.66	183.77
Net Interest Margin (%)	2.7%	3.1%	3.0%	2.5%	2.1%	1.6%	1.5%	1.6%



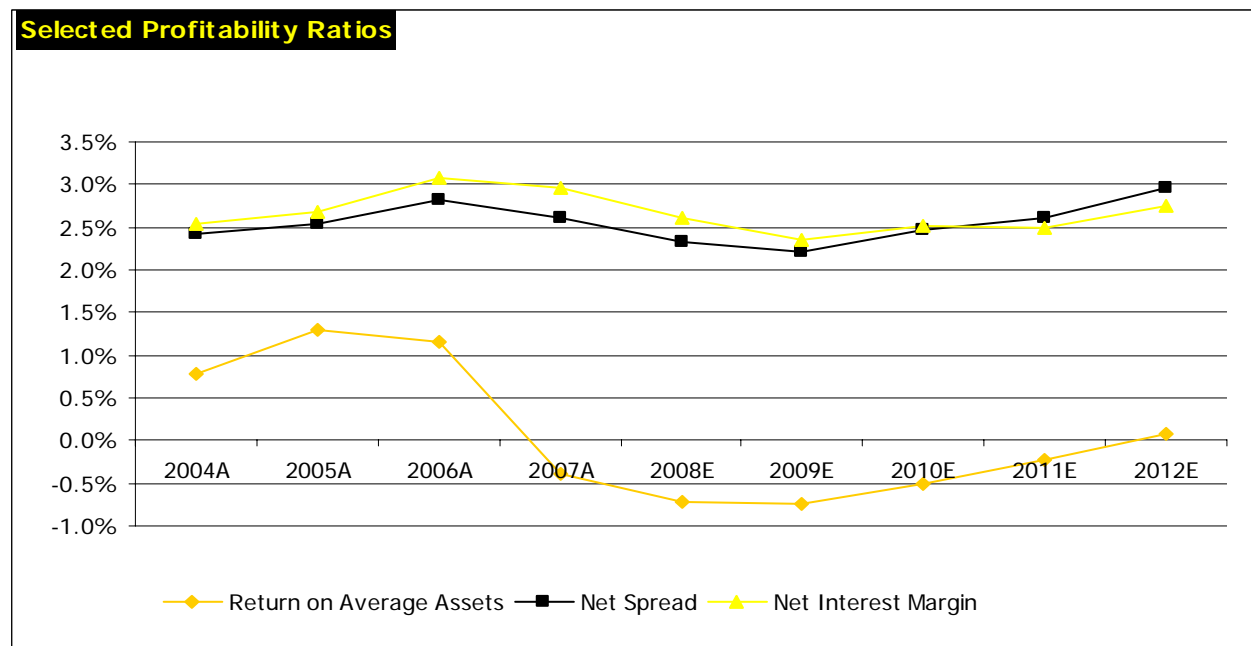
Charts

Base Case Scenario

Downey Financial's Yield on Interest Earning Assets

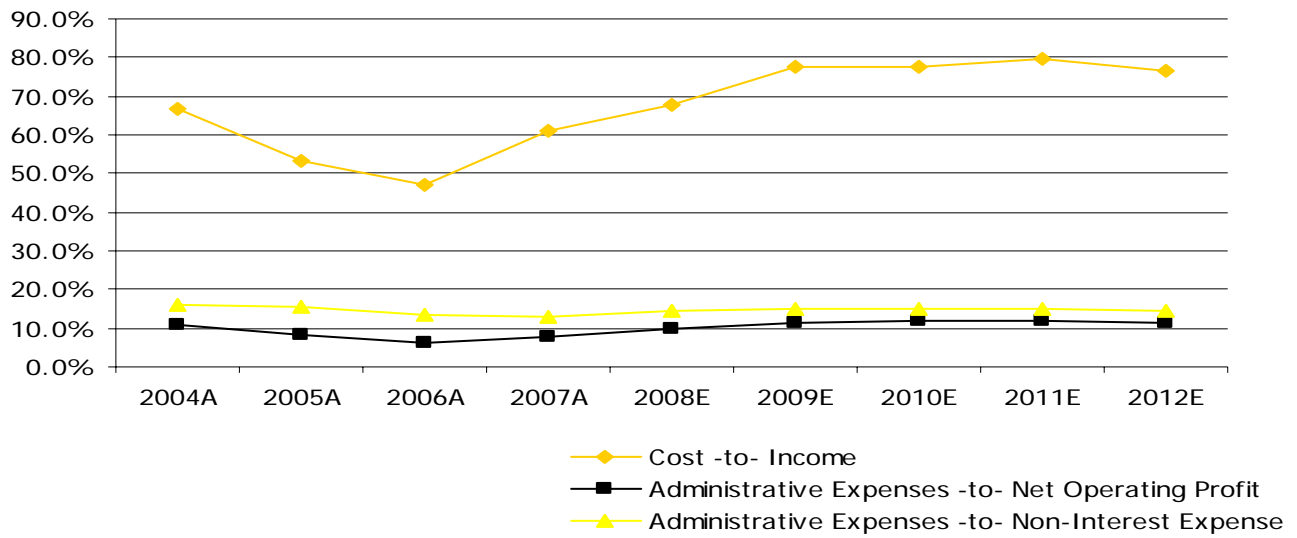


Selected Profitability Ratios

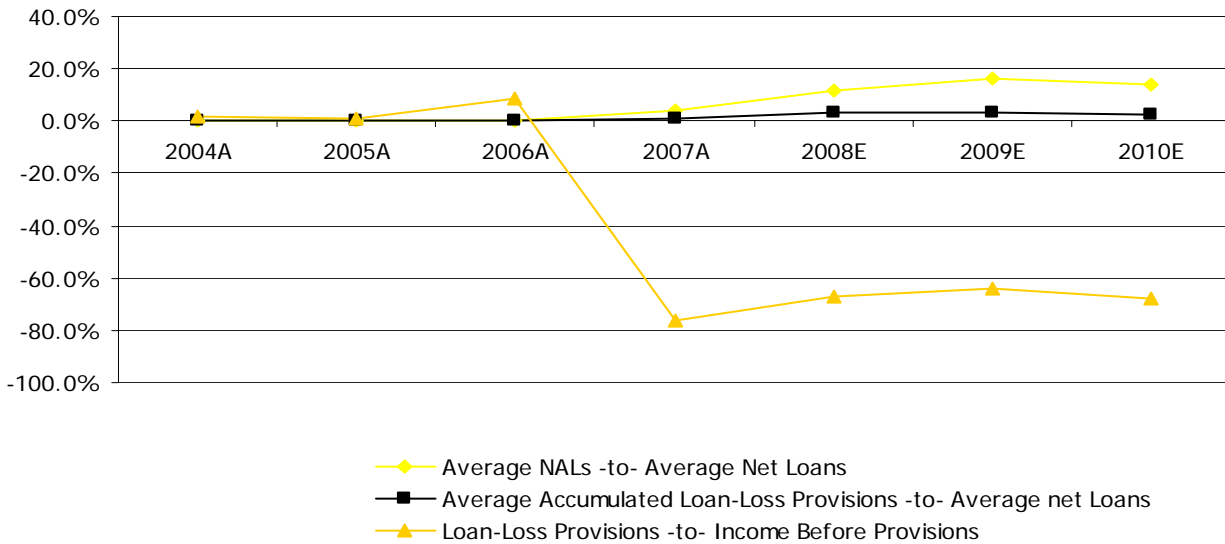




Selected Efficiency Ratios

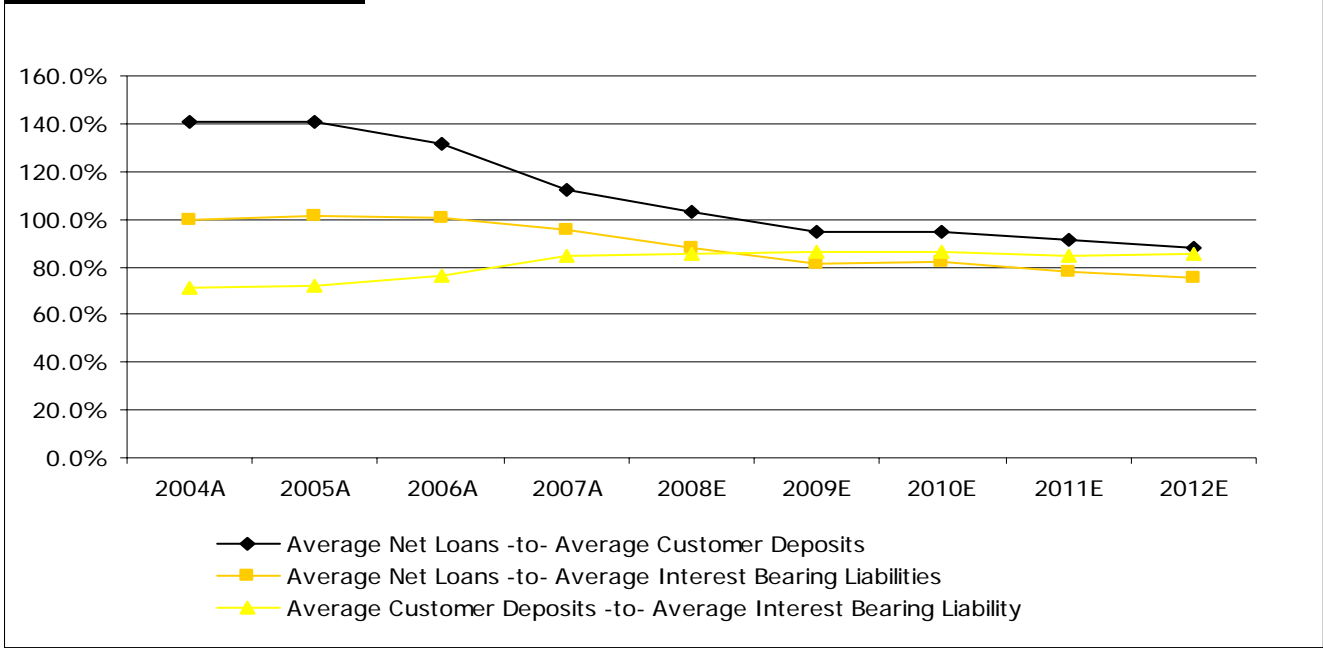


Selected Asset Quality Ratios



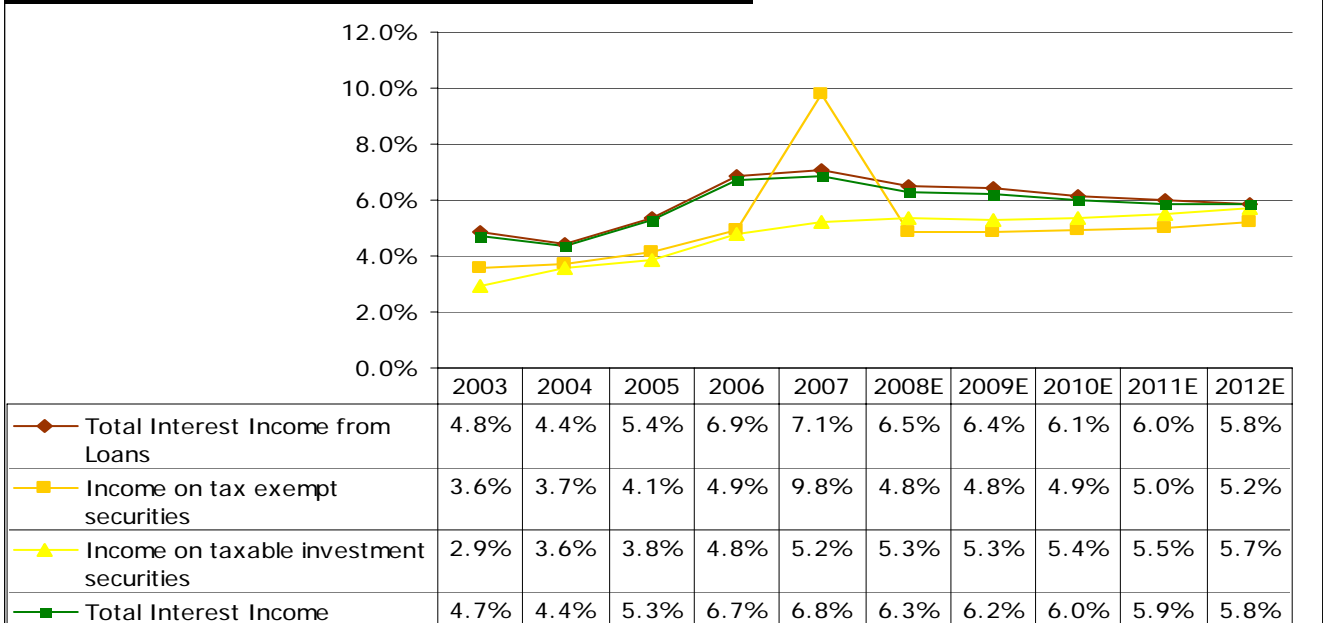


Selected Liquidity Ratios



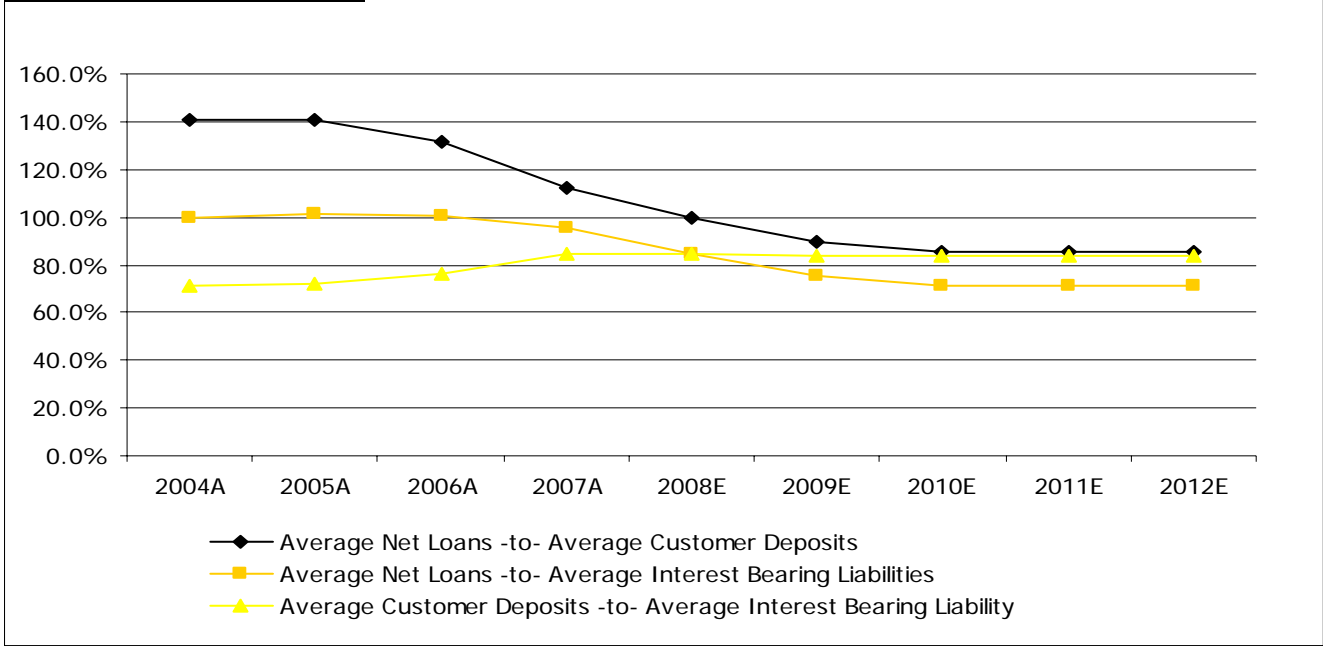
PESSIMISTIC SCENARIO

Downey Financial's Yield on Interest Earning Assets

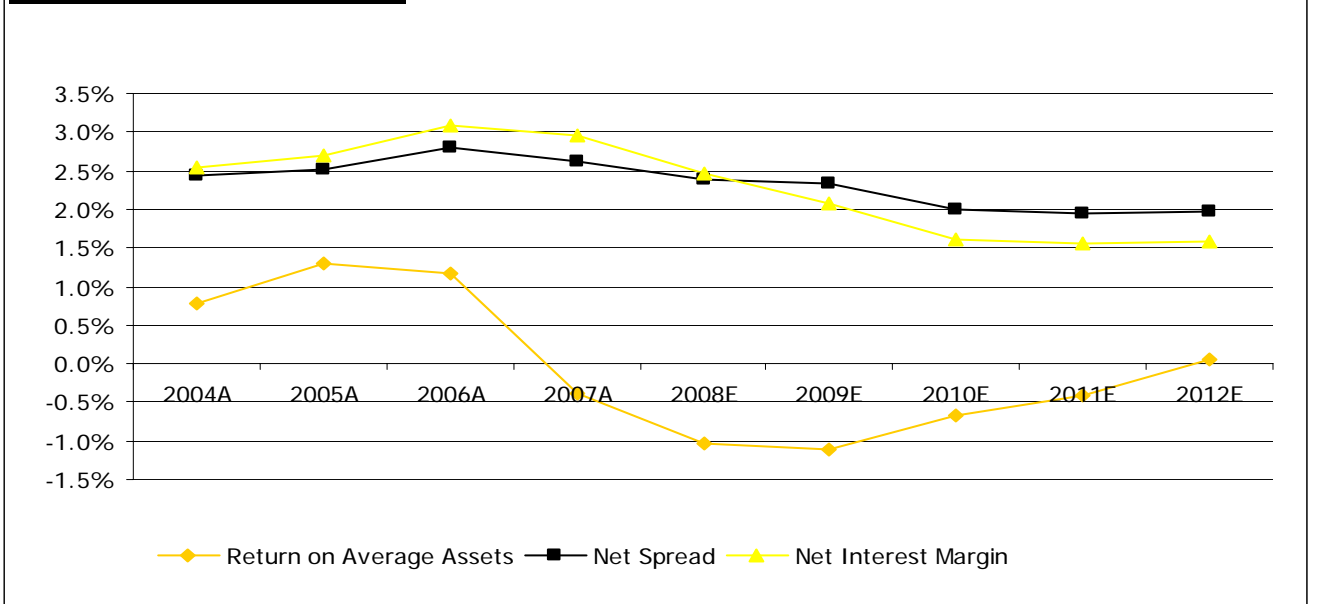




Selected Liquidity Ratios

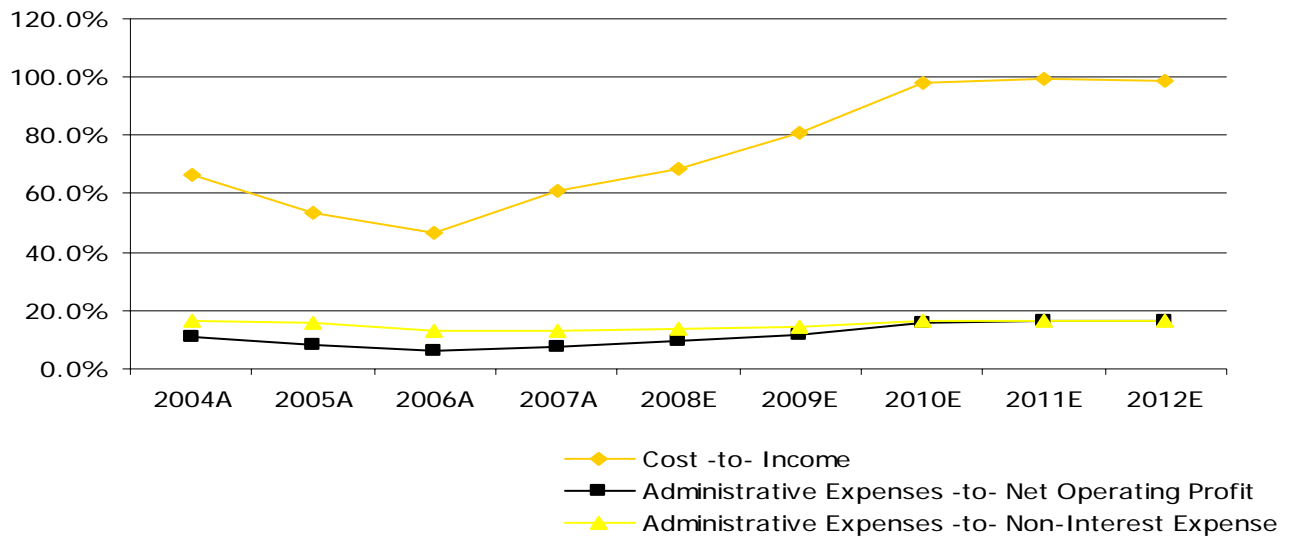


Selected Profitability Ratios

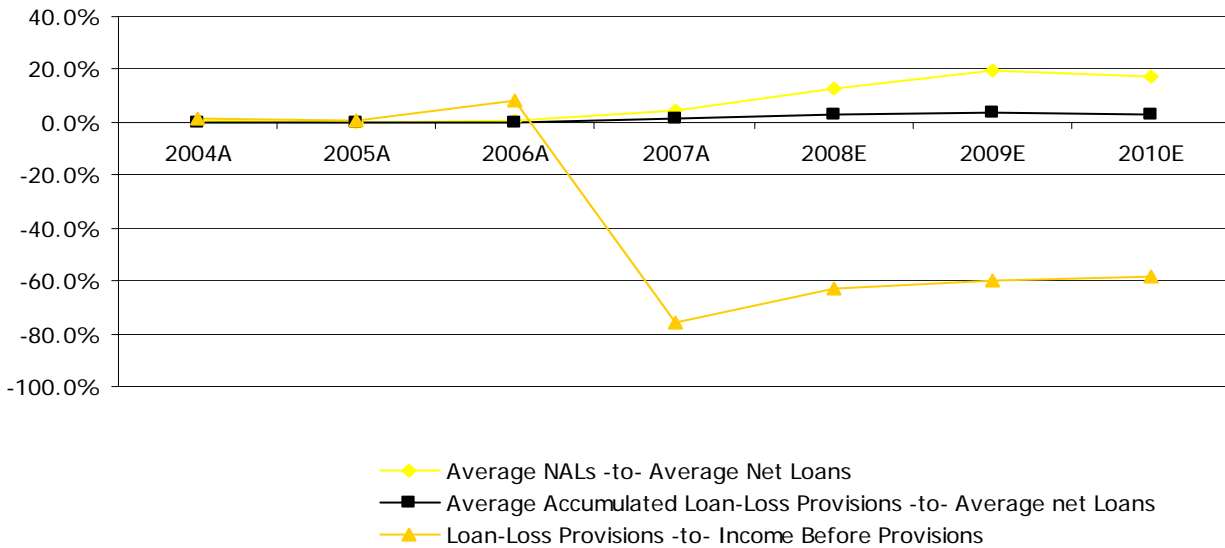




Selected Efficiency Ratios



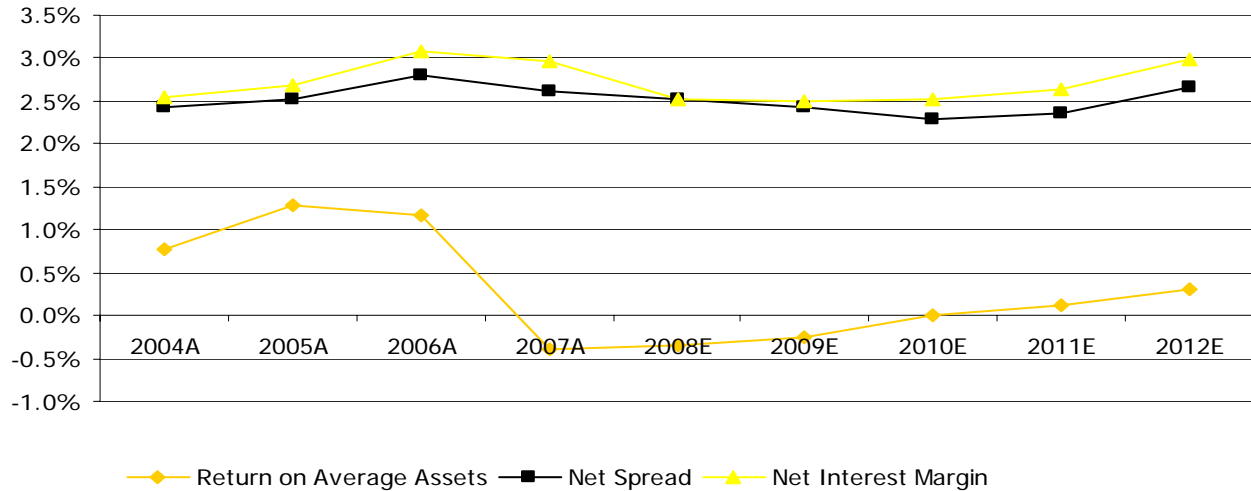
Selected Asset Quality Ratios



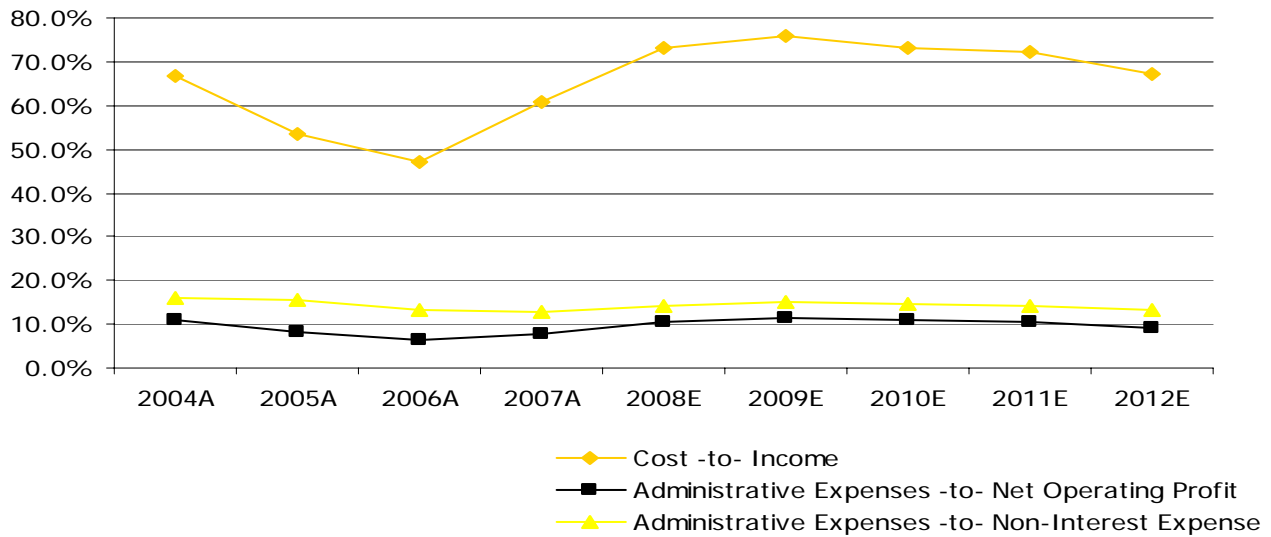


OPTIMISTIC SCENARIO

Selected Profitability Ratios

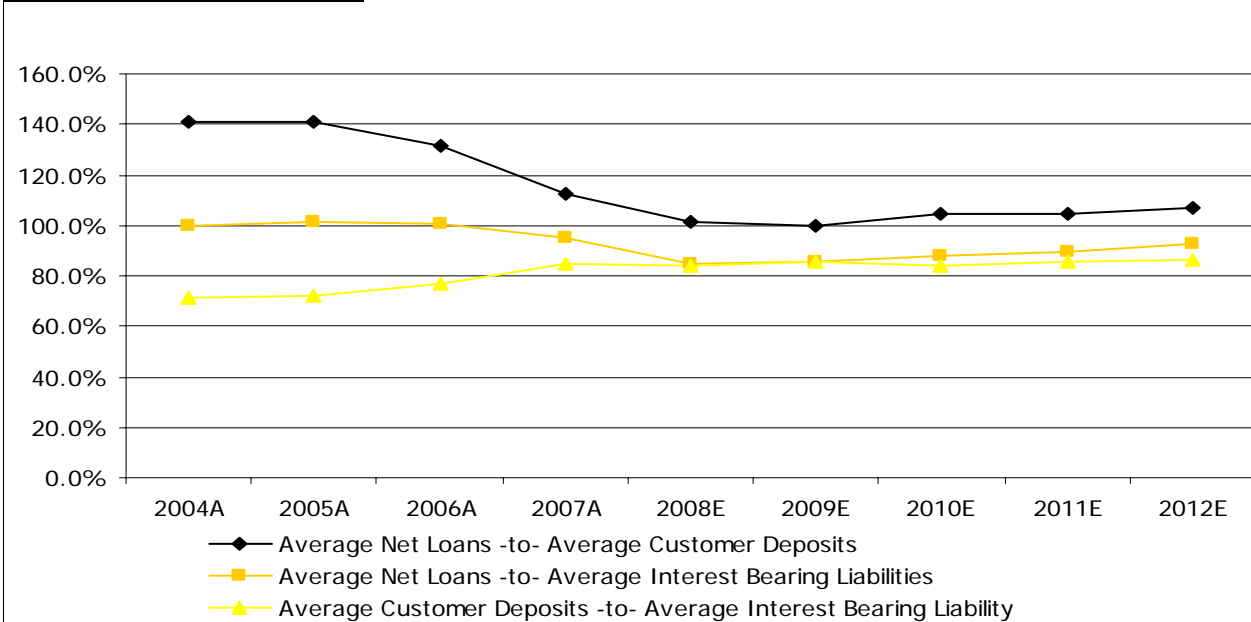


Selected Efficiency Ratios

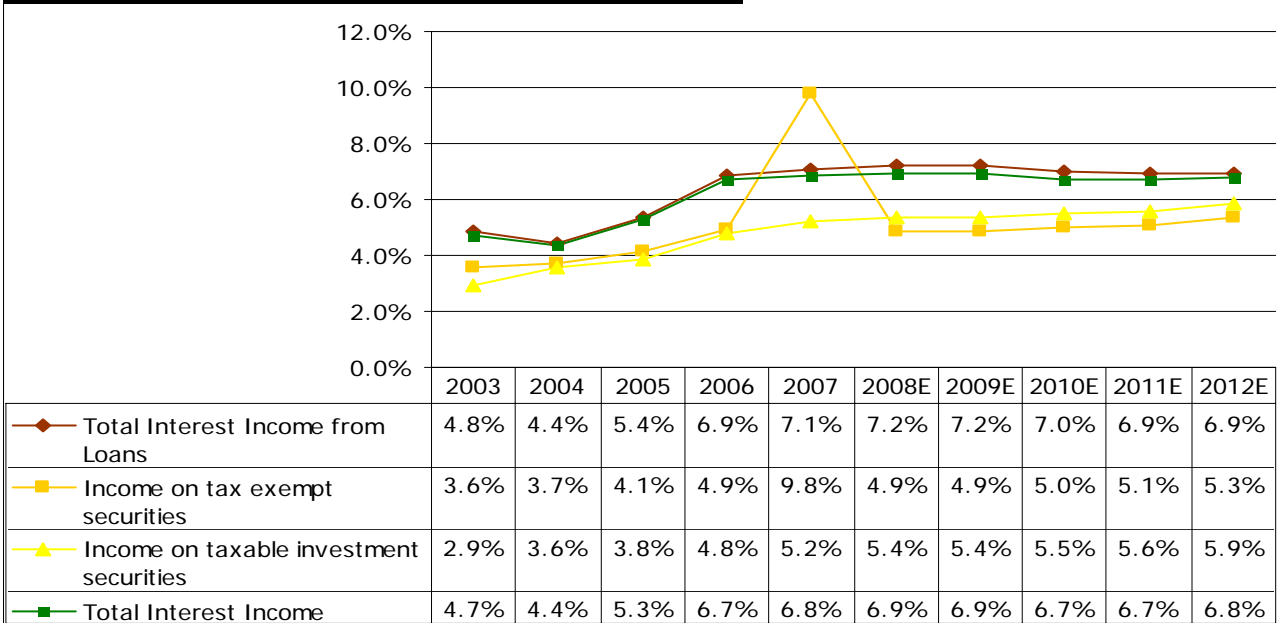




Selected Liquidity Ratios



Downey Financial's Yield on Interest Earning Assets





APPENDIX 4: DISCOUNTED CASH FLOW EXPLANATION

Discounted Cash Flow Analysis (DCF) values a company today, based on projections of how much cash will be generated from a company in the future. A DCF analysis assumes that a company is worth all of the cash that it can make available to investors in the future. It is called a "discounted" cash flow because cash in the future is worth less than cash today, and therefore must be discounted to today.

For example, suppose someone asked an investor to choose between receiving \$100

today and receiving \$100 in a year. Chances are the investor will take the money today, knowing that he can invest that \$100 now and have more than \$100 in a year's time. In simple terms, the amount that the investor would have in one year is worth \$100 dollars today - or the discounted value is \$100. We make the same calculation for all the cash expected to be generated by a company in the future to get a valid measure of the company's value today. As seen in the table below, the present Value of \$100 reduces as the number of years forecasted increase.

Table 1: Present value of \$100

Amount (\$)	Discount Rate (r)	Year (n)	PV (Amt/(1+r)^n)
100	10%	1	90.91
100	10%	2	82.64
100	10%	3	75.13
100	10%	4	68.30
100	10%	5	62.09
100	10%	6	56.45
100	10%	7	51.32
100	10%	8	46.65
100	10%	9	42.41
100	10%	10	38.55

We use a Discounted Cash Flow Analysis (DCF) to forecast future cash flows to determine a fair value range for a given stock price.

We normally forecast cash flows during a five-year period from the Income Statement, which



requires additional forecasting inputs. We focus on the Present Value of Future Cash Flows to compute a target price. The **Cash Flow Statement** is as an accounting statement that shows the amount of cash generated and used by a company in a given period, calculated by adding non-cash charges (such as depreciation) to net income after taxes. Cash flow can be attributed to a specific project, or to a business as a whole.

Free Cash Flow (FCF) represents the cash that a company is able to generate after spending the money required to maintain/expand its asset base. Free cash flow is important because it allows a company to pursue opportunities that enhance shareholder value. Without cash, it is difficult to develop new products, make acquisitions, pay dividends and reduce debt.

Free Cash Flows Computation

Net Cash From Operations	xx
Less/add: (increase)/decrease in working capital	xx
Less: Capital Expenditure	(xx)
<i>Free Cash Flows</i>	xx

The table below demonstrates how we calculate FCF for a company.

Table 2: Free Cash Flow Calculation of XYZ Company

<i>Figures in \$'000 unless specified</i>	Y 0	Y+1	Y+2	Y+3	Y+4	Y+5
Net Cash from Operations	2.07	20.37	55.42	129.01	241.43	397.98
CAPEX	(24.00)	(77.00)	(169.40)	(372.68)	(614.92)	(901.89)
Net Debt Additions	19.20	61.60	134.90	278.94	430.34	585.99
Free Cash Flows Equity	(2.73)	4.97	20.93	35.28	56.84	82.08

The theory behind the DCF model is that investors are willing to pay for a stream of future cash flows. Future cash flows are

discounted with a present value formulation to determine a fair stock price today, given what we know and how we forecast the future.



Present Value (PV) is the value in today's dollars assigned to an amount of money in the future, based on our estimate of rate-of-return over the long-term. In this analysis, rate-of-return is calculated based on annual

compounding. A given amount of money is always more valuable sooner than later since this enables one to take advantage of investment opportunities. Because of this, present values are less than corresponding future values.

$$\text{Value of Firm} = \sum_{t=1}^{t=n} \frac{\text{CF to Firm}_t}{(1+WACC)^t}$$

Our key input is the rate used to discount future cash flows to their present values. Most firms have a well-defined policy regarding their capital structure. Therefore, the Weighted Average Cost of Capital (WACC) (after tax) is appropriate for use with all projects. Present value is additive. The present value of a quantity of cash flows is the sum of each one's present value.

There are three main steps to calculating a DCF

1. First, we calculate the stream of cash flows in the five-year forecast period. Then we discount these cash flows back to the beginning of the first forecasted fiscal year. The method we use to discount back to the present is the **Present Value**

Method where we discount the free cash flows of the company by the **WACC**.

2. The second step is to determine the company's value at the end of the forecast period. This is the **Terminal Value**. The Terminal Value is then discounted back to the beginning of the first forecasted fiscal year. The method we use to discount back to the present is the **Perpetuity Growth Model**. The Perpetuity Growth Model accounts for the value of free cash flows that continues into perpetuity in the future, growing at an assumed constant rate. To determine the present value of the terminal value, one must discount the Terminal



Value by a factor equal to the number of years included in the initial projection period. If N is the fifth and final year in this period, then the Terminal Value is divided by $(1 + r)^5$.

3. The final step is adding these two to determine a fair value today based on what we know about the future.

An important decision in using Present Value models is deciding what cash flow or earnings stream will be forecasted and eventually discounted to compute an evaluation. We forecast Free Cash Flow which requires more input than simply using EBITDA (Earnings before Interest, Tax, Depreciation and Amortization).

A simpler method for discounting cash flow forecasts is using EBITDA (not a GAAP reporting required item). EBITDA can be defined as gross cash flow. This method of discounting is appropriate when EBITDA forms the basis of evaluation for the company. This method works well with small companies that have yet to post positive earnings. For all other companies, it is a good idea to examine at how the valuation methodology is applied.

DCF is a more involved forecasting method because it calculates the forecasted Free Cash Flow. The method requires forecasting of items such as the Operating Margins, tax rates, capital expenditures and changes in working capital. In addition, Debt is not subtracted from the discounted Free Cash Flow since Free Cash Flow is, by definition, net of the debt payments.

For the most part, free cash flow is a trustworthy measure that cuts through much of the arbitrary "guesstimates" involved in reported earnings. Regardless of whether a cash outlay is counted as an expense or turned into an asset on the balance sheet, free cash flow tracks the money left over for investors.

DCF analysis treats a company as a business rather than as a ticker symbol and a stock price. It requires us to think through all the factors that will affect the company's performance. DCF analysis really gives the investor an appreciation for what drives stock values.

Five years of forecasting in the Income Statement must be forecasted for the complete 5 year forecast timeframe. We analyze prior year's data to aid in making better forecasts.



Terminal Value

Since we cannot estimate cash flows forever, we generally impose closure in discounted cash

flow valuation by stopping our estimates of cash flows five years (Y+5) in the future and then computing a terminal value that reflects the value of the firm at that point.

$$\text{Value of a Firm} = \sum_{t=1}^{t=n} \frac{CF_t}{(1+k_c)^t} + \frac{\text{Terminal Value}_n}{(1+k_c)^n}$$

The Terminal Value is the forecasted value of the stream of cash flows the company will have at the end of the forecast period. We base this on the company's prospects at that time. We assume that the cash flow in year five (Y+5) will continue at a stable growth for five more

years. Since this is too far in the future to accurately forecast, we do not attempt to forecast the individual line items that compute cash flow. We use the **Long Term Sustainable Growth Rate** as the primary determinant of the Terminal Value.

$$\text{Terminal Value}_t = \frac{\text{Cash Flow}_{t+1}}{r - g_{\text{stable}}}$$

Therefore, our DCF computes a value for the company in year five. We have found that calculating the terminal value using the stable growth method provides more accuracy because of the multiple or sum of years method we employ.

The Terminal Multiple is an important component of equity valuation. This is the value one expects will be the growth rate at the

end of the forecast time period, Y+5. Since it is difficult to accurately forecast this, it is common to use the Long Term Growth Rate as the proxy for the Y+5 growth rate. As analysts, we can experiment with Terminal Multiples that are appropriate for the company in which we are analyzing. We normally forecast a long term growth rate in the middle of this range. Our output graphs then describe the range of target prices based on a range of assumed growth



rates. When studying the target price output, one quickly sees the target price sensitivity to the terminal multiple. Our sensitivity index is defined as “A technique for determining the outcome of a decision if a key variable (discount rate) differs from projected one.” This makes empirical sense. When the perception of growth prospects changes for a company, the stock typically reacts strongly. These graphs objectively quantify such a strong potential reaction to the upside or downside.

We use the **Gordon Growth Model** to determine Terminal Value.

This method assumes that the company is a perpetual entity and will continue to generate positive cash flows throughout its life. However, on reaching maturity, the growth rate of the company slows down. Hence, we assume that the company will grow at an average constant rate for the rest of its life. The terminal value is calculated using the following formula

$$\text{Terminal Value} = \frac{\text{Final Projected Year Cash Flow} * (1 + \text{Long-Term Cash Flow Growth Rate})}{(\text{Discount Rate} - \text{Long-Term Cash Flow Growth Rate})}$$

The formula simplifies the practical problem of projecting cash flows far into the future. However, it rests on the significant assumption that the cash flow of the last projected year will stabilize and continue at the same rate forever. This is an average of the future growth rates, not a single rate expected to occur every year into perpetuity. Some growth will be higher or

lower, but the expectation is that future growth will average the long-term growth assumption. This formula uses the final year’s projected cash flows (Y+5), and multiplies it by a long-term nominal growth rate. This is further discounted by the difference between the discount rate used for Present value calculation (WACC) and the assumed long term growth rate.

**Table 3: DCF Analysis with Terminal Growth Rates**

<i>Figures in \$'000 unless specified</i>	Y-0	Y-1	Y-2	Y-3	Y-4	Y-5	Terminal Value		
Net Cash from Operations	2	20	55	129	241	398			
CAPEX	(24)	(77)	(169)	(373)	(615)	(902)	Range of Terminal Growth Rate		
Net Debt Additions	19	62	135	279	430	586	3%	4%	5%
Free Cash Flows Equity	(3)	5	21	35	57	82	592	630	672
PV	(3)	4	13	18	23	28	71	76	81

Discount Rate

The Discount rate is an important determinant in using PV calculations for equity valuation. We display the assumed discount rates used in the valuation output tables and charts. We can use two different discount rates; one for the five year forecast period and another for the terminal value. Normally we use the same discount rate throughout the valuation model.

To better understand the discount rate, let us compare the Present Valuation formulation to financing a house. The interest rate on the mortgage is analogous to the discount rate, whereas the monthly mortgage payments are analogous to the cash flows. The PV of the Cash Flows is analogous to the face value of the mortgage. To analyze a company we first forecast the cash flows (mortgage payments) with the income statement. To determine the current value of these future cash flows, (face value of the mortgage), we use a discount rate

(interest rate). In setting up a mortgage payment, the interest rate is the starting point to compute the mortgage payment. For a stock valuation, we forecast the future cash flows and need to apply an appropriate discount rate to equate a current value.

There are methods to calculate Discount Rates.

Cost of Equity or the Required Rate of Return for Equity Holders

Unlike debt, which the company must pay at a set rate of interest, equity does not have a concrete price that the company must pay. However, that does not mean that there is no cost of equity. Equity shareholders expect to obtain a certain return on their equity investment in a company. From the company's perspective, the equity holders' required rate of return is a cost, because if the company does not deliver this expected return, shareholders will



simply sell their shares, causing the price to drop.

Therefore, the cost of equity is what it costs the company to maintain a share price that is

satisfactory (at least in theory) to investors. The most commonly accepted method for calculating cost of equity comes from the Nobel Prize-winning capital asset pricing model (CAPM), where:

$$\text{Cost of Equity (Re)} = R_f + \beta(R_m - R_f)$$

R_f - Risk-Free Rate - This is the rate obtained from investing in securities considered free from credit risk, such as government bonds from developed countries. The interest rate of 10-year U.S. Treasury bills or the long-term bond rate is used frequently as a proxy for the risk-free rate. If the Risk Free Rate is assumed to be higher in a DCF calculation, the projected share price will be lower, all other metrics being assumed as equal.

β - Beta - The Beta measures how much a company's share price moves against the market as a whole. A Beta of one, for example, indicates that the company moves in line with the market. If the Beta is in excess of one, the stock price is more volatile than the market's movement; less than one means the share is more stable. Occasionally, a company may have a negative Beta (e.g. a gold mining company), which means the share price moves in the

opposite direction to the broader market. If the Beta is assumed to be higher in a DCF calculation, the projected share price will be lower, all other metrics being assumed as equal.

$(R_m - R_f) = \text{Equity Market Risk Premium}$ - The equity market risk premium (EMRP) represents the returns investors expect, over and above the risk-free rate, to compensate them for taking extra risk by investing in the stock market. In other words, it is the difference between the risk-free rate and the market rate. It is a highly contentious figure. Many analysts argue that this metric rises due to the concept that holding shares has become a riskier proposition. If the Equity Market Risk Premium is assumed to be higher in a DCF calculation, the projected share price will be lower, all other metrics being assumed as equal.



Weighted Average Cost of Capital (WACC)

The WACC is the weighted average of the cost of equity and the cost of debt based on the percentage of debt and equity in the company's capital structure. The percentage of debt is represented by **Debt/Value**, a ratio comparing

the company's debt to the company's **Total Value (equity + debt)**. The percentage of equity is represented by **Equity/Value**, a ratio comparing the company's equity to the company's total value. We calculate the WACC by using the following formula:

$$\text{WACC} = \text{Cost of Equity} * [\text{Equity}/(\text{Debt} + \text{Equity})] + \text{After Tax Cost of Debt} * \text{Debt}/(\text{Debt} + \text{Equity})$$

A company's WACC is a function of the mix between debt and equity and the cost of that debt and equity. On one hand, in the past few years, falling interest rates have reduced the WACC of companies. On the other hand, corporate disasters such as those at Enron and WorldCom have increased the perceived risk of equity investments.

An appropriate discount rate is computed quantitatively using historical rates to assume and to equate the time value of money of future flows. For a stock, we compute a rate adjusted

for the shares outstanding to compute a stock price. It is important for the analyst to be comfortable with the discount rate used. Important parameters to consider are

- 1) Is the cost of equity greater than the cost of debt?
- 2) Is the equity risk premium today different from the long term average?
- 3) Is the historically based Beta indicative of the future volatility in the stock price?
- 4) Does the discount rate accurately reflect the required rate of return for the stock?



Table 4: Example of WACC Method

WACC	
Cost of Equity	
Risk free rate	5.25%
Risk premium	7%
Beta	1.0
Cost of Equity [A]	12.25%
Weight of Equity [B]	80%
-	
Cost of Debt	
Cost of Debt [C]	7.87%
Weight of Debt [D]	20%
WACC $\{(A*B)+(C*D)\}$	11.37%

What If Analyses

As analysts, we can change the quarterly estimated data for future quarters depending on a company's prospects. A company may have revenue targets or margin guidance that can be used. If management is adopting a different growth strategy, changes to capital expenditures and working capital may be appropriate. We can change the discount rate to analyze the sensitivity to it.

Any changes in margins, revenues, tax rate, depreciation, including tax rate, CAPEX and working capital inputs will be reflected in the our valuation charts. This occurs because our analysis is sensitive to changes in any of these parameters. Such changes in our inputs allow us to select an appropriate range of terminal multiples.

**Table 5: Sensitivity Analysis with Discount Rate**

Range of Discount Rates	PV of Free Cash Flows						Terminal Value
		Y-0	Y-1	Y-2	Y-3	Y-4	
20%	(2.57)	3.90	13.68	19.22	25.81	31.06	102.17
22%	(2.55)	3.82	13.17	18.19	24.03	28.44	86.13
24%	(2.54)	3.73	12.68	17.23	22.40	26.08	72.82
26%	(2.53)	3.66	12.21	16.34	20.90	23.95	61.72

Table 6: Sensitivity Analysis with Growth Rate

Discount Rate	23%	23%	23%	23%	23%
Terminal Growth	3%	4%	5%	6%	7%
Shares O/S	24.69	24.69	24.69	24.69	24.69
Sum PV of FCFE	210.31	214.84	219.88	225.52	231.88
Add: Cash	21.81	21.81	21.81	21.81	21.81
Equity Value	232.12	236.65	241.69	247.33	253.69
Value Per Share (in \$)	9.40	9.59	9.79	10.02	10.28



Optimistic Case, Base Case, Pessimistic Case

As analysts, we form our own estimates about the company's financials based on certain information provided by the management and our own understanding of the company's business model. We generally create three scenarios, the Optimistic Case Scenario, the Base Case Scenario, and the Pessimistic Case Scenario.

The Optimistic Case is a bullish outlook of the company's value while the Pessimistic case is a conservative view. The Base case scenario illustrates our expectation of the Company's value under normal circumstances.

This analysis allows us to create a wide range of forecasts and compare implied target prices. We always need to adjust our forecasts as a company grows.

For the Optimistic Case, Revenues and Margins may be stronger, along with the same or higher CAPEX and Depreciation. For the Pessimistic Case, Revenues and Margins will normally be weaker, Debt may increase, CAPEX and Depreciation may decline.

If we wish to make changes to the Base Case, we can go back to the forecasting of the Income Statement.



Net Cash Flow from Operations (NCFO)

Top-Down Cash Flow

Net Cash Flow from Operations (NCFO) analyzes the flow of cash through the enterprise, using income statement and balance sheet data items to reconstruct how cash is generated and used. We start with revenues, adjusting for the change in receivables to determine Gross Cash Collections. Cost of goods sold, net of depreciation and SG&A expenses, are aggregated to determine Total Operating Expenses. We then look at the changes in the working capital accounts that represent operating activity, to determine how much cash was used or generated while managing operations (current assets and liabilities). Receivables are excluded here since they have already been used in calculating gross cash collections, and cash is excluded here since cash is our resultant. Change in working capital accounts is calculated as an expense item such that a negative value is a generation of cash. We derive the NCFO by adding the working capital cash requirements/generation with operating expenses and then subtracting from Gross Cash Collections.

Since the NCFO is the actual cash generated from the core business, it is a very good

barometer of the health of the business. It is a report card on how well it is managed. NCFO interest coverage and NCFO interest and capital expenditure coverage indicates how well interest payments and capital expenditures can be covered by ongoing business operations. One negative value after a string of positive values does not necessarily mean that debt or lines of credit need to be used. Prior cash balances may cover outflows. Trends and values are important. The reasons for a change in the trend may be apparent from examining the line items in our NCFO calculations, especially in working capital accounts.

Traditional Bottom-Up Cash Flow

The financial community primarily uses the traditional method for calculating cash flow. Beginning with net income, non-cash charges are added back. This typically includes depreciation, amortization and changes in deferred charges. Trends and values are important when analyzing net cash flow and free cash flow. We define net cash flow as the amounts of cash being received and spent by a business during a defined period of time. It includes cash flows from different streams such



as operating activities, investing activities and financing activities.

- **Operational cash flows:** Cash received or expended as a result of the companies core business activities.
- **Investment cash flows:** Cash received or expended by making capital expenditures (i.e. the purchase of new

machinery), the making of investments or acquisitions.

- **Financing cash flows:** Cash received or expended as a result of financial activities such as receiving or paying loans, issuing stock, and paying dividends.



Table 7: Comparing NCF0 to Traditional Bottom up Cash Flow

Bottom-Up Cash Flow	Net Cash Flows From Operations
Operating Activities, Cash Flows Provided By or Used In	
Net Income	Revenues
Adjustments To Net Income	plus decrease (-increase) in AR
Depreciation	Gross Cash Collections from Operations
Changes in Account Receivables	
Changes In Liabilities	Operating Expenses
Changes In Inventories	COGS, less Depreciation & Amort
Changes In Other Operating Activities	SGA
Total Cash Flow From Operating Activities	R&D
	Total Operating Expenses
Investing Activities, Cash Flows Provided By or Used In	
Capital Expenditures	Working Capital Changes
Investments	Increase in Inventories
Other Cashflows from Investing Activities	Increase in Notes Receivable
Total Cash Flows From Investing Activities	Increase in Deferred Charges
	Increase in Other Current Assets
Financing Activities, Cash Flows Provided By or Used In	Decrease (inc) in Accounts Payable
Dividends Paid	Decrease (inc) in Notes Payable
Treasury stock acquired Paid	Decrease (inc) in Current LTD
Issuance of long-term debt	Decrease (inc) in Current Cap Leases
Payments and redemptions of long-term debt	Decrease (inc) in Accrued Expenses
Change in deposits	Decrease (inc) in Income Tax Payable
Contractholder fund deposits	Decrease (inc) in Other Current Liab
Contractholder fund withdrawals	Total Changes in Working Capital
	Total Cash Outflows for Op (Op Exp+Chg WC)
Cash flows from financing activities of continuing operations	Net Cash Flow from Operations (NCF0)
Effect of exchange rate changes on cash and cash equivalents	STATEMENT OF CHANGES IN CASH
	Cash from Operating Activities
Change in cash and due from banks	Net Income (\$mil)
	Depreciation (\$mil)
	Cash from Discontinued Oper (\$mil)
	Net Other Adjustments (\$mil)
	Net Ch in Oper Assets and Liabilities
	Net Cash from Oper Activities \$mil



Free Cash Flow to Assets

A very useful analysis is to compare the free cash flow back to the asset base that generates the cash. The value of this ratio is related to the type of business.

A trend analysis is a very good indicator of whether the company is creating value or not. When FCF/Assets are increasing, management is receiving higher returns for every dollar invested. If this metric is decreasing, the company is receiving lower returns on their investments. Quarterly data can fluctuate and be seasonal, so the trend of the LTM data series is more important. When a company is going through a peak or trough in its business cycle, the trend of the quarterly data is typically volatile. Such inflection points are a sign of

change. A change in the LTM data is more descriptive of changing fortunes, but it can also fluctuate towards the end of a business cycle change (trough of peak). If a company's assets do not generate adequate free cash flow over time, that company might very well be a short sale candidate or at worst, a bankruptcy candidate. This would indicate that the company might be in the wrong business.

We find that the trend in the FCF/A is highly correlated to the movement in the stock price for many different companies over time. That is, when increasing, the stock will tend to rise and vice versa. This presumes the stock price is not ahead of itself. Another caveat is that the FCA/A needs to be consistently positive (negative) over an extended period of time as related to share prices.



Glossary of Terms

1. **Net Cash from Operations (NCFO):** The NCFO method traces the flow of cash through the company in the manner that cash actually is generated and used
2. **CAPEX:** Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment. This type of outlay is made by companies to maintain or increase the scope of their operation. These expenditures can include everything from repairing a roof to building a brand new factory. These expenses are deducted from the cash flows while calculating the DCF
3. **Working Capital:** A measure of both a company's efficiency and its short-term financial health. WC is calculated by subtracting current liabilities from current assets. Positive working capital means that the company is able to pay off its short-term liabilities. Negative working capital means that a company currently is unable to meet its short-term liabilities with its current assets (cash, accounts receivable, inventory).
4. **DCF:** A valuation method used to estimate the attractiveness of an investment opportunity. Discounted cash flow (DCF) analysis uses future free cash flow projections and discounts them (most often using the weighted average cost of capital) to arrive at a present value, which is used to evaluate the potential for investment.
5. **FCF:** A measure of financial performance calculated as operating cash flow, minus capital expenditures. Free Cash Flow (FCF) represents the cash that a company is able to generate after laying out the money required to maintain/expand its asset base. Free cash flow is important because it allows a company to pursue opportunities that enhance shareholder value.
6. **Terminal Value:** The value of an investment at the end of a period, taking into account a specified discount rate.



7. **WACC:** A calculation of a firm's cost of capital in which each category of capital is proportionately weighted. All capital sources - common stock, preferred stock, bonds and any other long-term debt - are Included in a WACC calculation. This is generally used to discount the cash flows in a DCF calculation.

8. **Discount Rate:** Discounting is the process of finding the present value of an amount of cash at some future date. The rate (usually WACC) used in determining the present value of future cash flows is known as the discount rate.

9. **Present Value:** The amount that a future sum of money is worth today given a specified rate of return.

10. **Sensitivity Analysis:** A technique for determining the outcome of a decision if a key prediction turns out to be wrong.

11. **Optimistic Case, Base Case, and Pessimistic Case:** The Optimistic Case is a bullish outlook of the company's value while the Pessimistic case is a conservative view. The Base Case Scenario illustrates our expectation of the Company's value under normal circumstances.



Glossary of Banking and Financial Terms

1. **Net Interest Income (NII):** Net interest income is the amount of money the bank receives from interest on assets (commercial loans, personal mortgages, etc) minus the amount of money the bank pays out for interest on liabilities (personal bank accounts, etc).
2. **Net Interest Margin (NIM):** Net Interest Margin is a measure of the difference between interest income generated by banks or other financial institutions by their lending activities and interest paid on borrowings. NIM is expressed as net interest Income (i.e. interest income – income expenditure) as a percentage of earning assets (i.e., loans). It is a performance metric that examines how successful a firm's investment decisions are compared to its debt situation. A negative value denotes that the firm did not make an optimal decision, because interest expenses were greater than the amount of returns generated by investments.
3. **Spread:** Nominal average difference between borrowing and lending rates. Net interest spread is generally higher than net interest margin, as banks may need to keep a certain amount of assets in non-interest bearing assets.
4. **Non-Performing Assets (NPAs):** Non-performing assets, also called non-performing loans, are loans made by banks, on which repayments or interest payments are not being made on time. If payments are late for more than 90 days, a loan is classified as past due. Once a payment becomes very late (usually 90 days) the loan classified as non-performing.
5. **Charge-offs:** Loans written off as uncollectible bad debt are known as charge-offs. When full repayment is considered unlikely, loans are removed from the lender's balance sheet and charged against the Loan Loss Reserves account for bad debt.
6. **Negative Amortization:** Negative amortization occurs when the borrower makes a payment at an interest rate that is lower than the accrual rate; therefore, the monthly payment is insufficient to cover the interest expense, and the difference is added to the principal amount. For example: if the periodic interest payment on a loan is \$500 and a \$400 payment may contractually be made, \$100 is added to the principal balance of the loan.
7. **Capitalized Interest from Negative Amortization:** Lenders may record negative amortization as income in the form of capitalized interest. The lender does not actually receive the negative amortization amount as a payment from the borrower. Under generally accepted accounting principles (GAAP) the lender may capitalize (add to the loan balance) the accrued but unpaid



interest amount and recognizes it as income as long as the capitalized interest is considered collectible.

8. **Provision for Loan losses:** An expense set aside as an allowance for bad loans.
9. **Charge-off ratio:** The ratio of the total amount of loans written off during a period to total outstanding amount of loans at the end of that period. This ratio measures the gross credit loss of a loan portfolio over a specified period of time.
10. **Loan-to-value ratio:** A lending risk assessment ratio that financial institutions and others lenders examine before approving a mortgage. Typically, assessments with high LTV ratios are generally seen as higher risk and, therefore, if the mortgage is accepted, the loan will generally cost the borrower more to borrow or he or she will need to purchase mortgage insurance. It is expressed as Mortgage amount as a percentage of appraised value of the property. For example if Jim needs to borrow \$92,500 to purchase a \$100,000 property. The LTV ratio yields a value of about 92.5%.
11. **Sensitivity Analysis:** A technique for determining the outcome of a decision if a key prediction turns out to be wrong.
12. **Optimistic Case, Base Case, and Pessimistic Case:** The Optimistic Case is a bullish outlook of the company's value while the Pessimistic case is a conservative view. The Base Case Scenario illustrates our expectation of the Company's value under normal circumstances.
13. **Mortgage-backed security (MBS):** Mortgage securities represent an ownership interest in mortgage loans made by financial institutions (savings and loans, commercial banks or mortgage companies) to finance the borrower's purchase of a home or other real estate. Mortgage securities are created when these loans are packaged, or pooled, by issuers or service providers for sale to investors. As the underlying mortgage loans are paid off by the homeowners, the investors receive payments of interest and principal.
14. **Adjustable Rate Mortgage (ARMs):** A type of mortgage in which the interest rate paid on the outstanding balance varies according to a specific benchmark. The initial interest rate is normally fixed for a period of time after which it is reset periodically, often every month. The interest rate paid by the borrower will be based on a benchmark plus an additional spread, called an ARM margin.



15. **Delinquent Loans:** When a borrower fails to make required payments on a loan and does not cure the delinquency within 60 days, the loan is recorded as delinquent loan. If the borrower can not bring the payments current within a certain time period, the lender may initialize foreclosure proceedings.
16. **Foreclosure:** A situation in which a homeowner is unable to make principal and/or interest payments on his or her mortgage, so the lender, here bank, can seize and sell the property as stipulated in the terms of the mortgage contract.
17. **Fiscal policy:** Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.
18. **Monetary policy:** The actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.
19. **Fannie Mae (Federal National Mortgage Association):** A government-sponsored enterprise (GSE) that was created in 1938 to expand the flow of mortgage money by creating a secondary mortgage market. Fannie Mae is a publicly traded company which operates under a congressional charter that directs Fannie Mae to channel its efforts into increasing the availability and affordability of homeownership for low-, moderate-, and middle-income Americans. In order to promote homeownership, Fannie Mae also holds a large portfolio of its own and other institution's MBSs, known as its retained portfolio.
20. **Freddie Mac (Federal Home Loan Mortgage Corporation):** A stockholder-owned government-sponsored enterprise (GSE) chartered by Congress in 1970 to keep money flowing to mortgage lenders in support of home ownership and rental housing for middle income Americans. Freddie Mac purchases, guarantees and securitizes mortgages to form mortgage-backed securities. The mortgage-backed securities that it issues tend to be very liquid and carry a credit rating close to that of U.S. Treasuries.
21. **Book Value per share (BVPS):** A financial measure that represents a per share assessment of the minimum value of a company's equity. Book value of equity per share is one factor that investors can be used to determine if a stock is undervalued.
22. **Loan value per share (LVPS):** Loan value divided by the number of outstanding shares.



23. **Recession:** Recession is a decline in a country's gross domestic product (GDP), or negative real economic growth, for two or more successive quarters of a year.
24. **Real GDP:** Real GDP is a macroeconomic measure of the size of an economy adjusted for price changes and inflation. Real GDP measures the output of final goods and services produced and incomes earned at constant prices.
25. **GDP:** GDP is defined as the total market value of all final goods and services produced within a given country in a given period of time. The most common method of measuring GDP is the expenditure method, wherein GDP is calculated as a sum of consumption, gross investment, government spending, and net exports (i.e., exports – imports)
26. **Multi-family and Commercial Property Loans:** Loan in which the borrower borrows the loan money from a financing institution by keeping the property as collateral against it
27. **Home Equity Loans:** A home equity loan is the one in which the borrower borrows the loan money from a financing institution by keeping his home as collateral against it.
28. **Home Equity Lines of Credit:** A method of borrowing in which a homeowner may borrow against home equity as needed using a checkbook or credit card. It differs from a standard loan in that the borrowing may be done over a period of time, preventing excess borrowing and limiting interest costs.
29. **Prime Lending Rate:** The prime loan interest rate is the rate that commercial banks charge to its most creditworthy customers. It is a term applied in many countries to a reference interest rate used by banks.
30. **Federal Fund Rate:** The interest rate at which a depository institution lends immediately available funds (balances at the Federal Reserve) to another depository institution overnight.
31. **Money Market:** Money market is the global financial market for short-term borrowing and lending. It provides short-term liquid funding for the global financial market, typically for 13 months. The money market consists of financial institutions and dealers in money or credit who wish to either borrow or lend. Core money market consists of banks borrowing and lending using commercial paper and repo at benchmarked market rate
32. **Interest-Bearing Checking:** non-interest bearing checking funds



33. **Federal Home Loan Bank (FHLB):** It is a cooperatively owned wholesale bank that supports housing and economic development in the communities served by member institutions in Arkansas, Louisiana, Mississippi, New Mexico, and Texas
34. **Certificate of Deposit (CD):** Certificate of deposit is a time deposit which is commonly offered by banks, thrift institutions and credit unions. These are similar to savings accounts in that they are insured and thus virtually risk-free.
35. **Thriffs:** An organization formed for the purpose of holding deposits for individuals; examples include savings banks and savings and loans.
36. **Capital Adequacy Ratio (CAR):** Capital adequacy ratio is the ratio which determines the capacity of the bank in terms of meeting the time liabilities and other risk such as credit risk, operational risk, etc. In the simplest formulation, a bank's capital is the "cushion" for potential losses, which protect the bank's depositors or other lenders.
37. **Default Risk:** The risk that companies or individuals will be unable to pay the contractual interest or principal on their debt obligations.
38. **Interest Rate Risk:** The risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in any other interest rate relationship. Interest rate risk affects the value of bonds more directly than stocks, and it is a major risk to all bondholders. As interest rates rise, bond prices fall and vice versa.
39. **Prepayments:** An early payment of a loan by the borrower.
40. **Refinancing:** Refinancing refers to the replacement of an existing debt obligation with a debt obligation bearing different terms. Refinancing may be undertaken to reduce interest costs (by refinancing at a lower rate), to extend the repayment time, to pay off other debts, to reduce one's periodic payment obligations (sometimes by taking a longer-term loan), to reduce or alter risk (such as by refinancing from a variable-rate to a fixed-rate loan), and/or to raise cash for investment, consumption, or the payment of a dividend.
41. **Credit Risk:** Credit risk is risk due to uncertainty in a counter party's (also called an obligor's or credit's) ability to meet its obligations.
42. **Government Sponsored Entities (GSE):** These are privately held corporations with public purposes created by the U.S. Congress to reduce the cost of capital for certain borrowing sectors of the economy. Members of these sectors include students, farmers and homeowners. GSEs



carry the implicit backing of the U.S. Government, but they are not direct obligations of the U.S. Government. For this reason, these securities will offer a yield premium over Treasuries. Some consider GSEs to be stealth recipients of corporate welfare. Examples of GSEs include: Federal Home Loan Bank, Federal Home Loan Mortgage Corporation (Freddie Mac), Federal Farm Credit Bank and the Resolution Funding Corporation.

43. **Casualty Insurance:** Casualty insurance policies are written to cover loss that is the direct result of accident.
44. **High Net Worth Individuals:** In private banking, a high-net-worth individual (HNWI) is a person with a high net worth. Typically these individuals are defined as having investable assets (financial assets not including primary residence) in excess of US\$1 million.
45. **Net-worth:** Total Assets minus total liabilities. Net worth is an important determinant of the value of a company, considering it is composed primarily of all the money that has been invested since its inception, as well as the retained earnings for the duration of its operation.
46. **Sub-prime Loan:** A type of loan that is offered at a rate above prime to individuals who do not qualify for prime rate loans. Quite often, subprime borrowers are often turned away from traditional lenders because of their low credit ratings or other factors that suggest that they have a reasonable chance of defaulting on the debt repayment. Subprime loans tend to have a higher interest rate than the prime rate offered on traditional loans.
47. **Tangible Capital Ratio:** Tangible capital is outstanding stock plus retained earnings. In 1989, Office of Thrift Supervision (OTS) set the minimum tangible capital requirement for savings institutions at 1.5 percent of assets.
48. **Core Capital Ratio:** The capital any thrift is required to have in order to comply with the Federal Home Loan Bank's rules. This is one of three capital standards established for savings institutions in 1989. The minimum amount of core capital for the soundest institutions is 3% of assets.
49. **Risk-based Capital:** This is one of three capital standards adopted for savings institutions in 1989. The standard is designed to require savings institutions to hold more capital for higher-risk assets. The value of each asset is weighted according to its risk and then capital is calculated at a fixed percent of each risk-weighted asset.



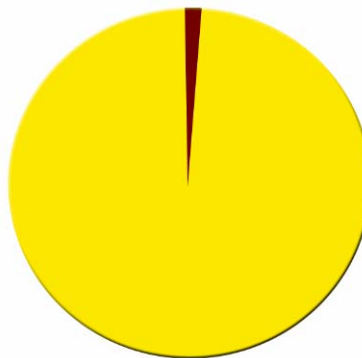
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