

APEX MORTGAGE CAPITAL INC  
Form 10-Q  
November 14, 2003

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

## FORM 10-Q

(mark one)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarter ended: **September 30, 2003**

OR

**TRANSITION REPORT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the transition period from        to

Commission File Number: **001-13637**

## APEX MORTGAGE CAPITAL, INC.

(Exact name of Registrant as specified in its Charter)

**Maryland**

(State or other jurisdiction of incorporation or  
organization)

**865 South Figueroa Street, Suite 1800  
Los Angeles, California**

(Address of principal executive offices)

**95-4650863**

(I.R.S. Employer Identification  
Number)

**90017**

(Zip Code)

Registrant's telephone number, including area code **(213) 244-0000**

Securities registered pursuant to Section 12(b) of the Act:

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Title of Each Class	Name of Exchange Which Registered
Common Stock (\$.01 par value)	American Stock Exchange

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

On November 4, 2003 the number of shares of our common stock outstanding was 29,857,000.

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**APEX MORTGAGE CAPITAL, INC.**

**FORM 10-Q**

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## Apex Mortgage Capital, Inc.

## Balance Sheets

(Unaudited)

	September 30, 2003	December 31, 2002
<b>Assets</b>		
Cash and cash equivalents	\$ 8,708,000	\$ 1,456,000
Fixed income trading securities, at fair value	22,083,000	606,014,000
Fixed income securities available-for-sale, at fair value	1,343,636,000	1,818,893,000
Equity securities available-for-sale, at fair value		4,168,000
Accrued interest receivable	5,444,000	12,012,000
Principal payments receivable	5,335,000	248,000
Other assets	5,080,000	2,587,000
	\$ 1,390,286,000	\$ 2,445,378,000
<b>Liabilities and Stockholders Equity</b>		
<b>Liabilities</b>		
Reverse repurchase agreements	\$ 927,079,000	\$ 2,112,444,000
Payable for unsettled securities	237,750,000	
Accrued interest payable	1,744,000	2,444,000
Dividend payable		13,509,000
Interest rate swaps, at fair value	58,105,000	120,098,000
Accrued expenses and other liabilities	1,512,000	2,224,000
	1,226,190,000	2,250,719,000
Commitments and contingencies (Note 6)		
<b>Stockholders Equity</b>		
Preferred stock, par value \$0.01 per share; 50,000,000 shares authorized; no shares outstanding		
Common stock, par value \$0.01 per share; 100,000,000 shares authorized; 29,857,000 shares outstanding as of September 30, 2003 and December 31, 2002	299,000	299,000
Additional paid-in-capital	331,521,000	331,499,000
Accumulated other comprehensive loss	(55,414,000)	(95,880,000)
Accumulated deficit	(112,310,000)	(41,259,000)
	164,096,000	194,659,000
	\$ 1,390,286,000	\$ 2,445,378,000



See accompanying notes to financial statements

## Apex Mortgage Capital, Inc.

## Statements of Operations

(Unaudited)

	Three Months Ended September 30, 2003	Three Months Ended September 30, 2002	Nine Months Ended September 30, 2003	Nine Months Ended September 30, 2002
<b>Interest Income:</b>				
Fixed income securities	\$ 14,923,000	\$ 53,701,000	\$ 72,520,000	\$ 126,206,000
Cash and cash equivalents	45,000	14,000	92,000	87,000
	14,968,000	53,715,000	72,612,000	126,293,000
<b>Interest Expense</b>	14,927,000	29,237,000	60,629,000	63,331,000
<b>Net Interest Income</b>	41,000	24,478,000	11,983,000	62,962,000
<b>Dividend Income</b>	34,000	106,000	236,000	341,000
<b>Net Interest and Dividend Income</b>	75,000	24,584,000	12,219,000	63,303,000
<b>General and Administrative Expenses:</b>				
Management fee	466,000	539,000	1,570,000	1,360,000
Incentive fee	(1,287,000)	(1,437,000)		
Insurance	164,000	83,000	491,000	250,000
Professional fees	1,025,000	62,000	1,277,000	161,000
Directors fees	30,000	22,000	74,000	66,000
Non-employee stock options	7,000	23,000	22,000	73,000
Other	202,000	151,000	635,000	550,000
	607,000	(557,000)	4,069,000	2,460,000
<b>Net Interest and Dividend Income (Loss) After General and Administrative Expenses</b>	(532,000)	25,141,000	8,150,000	60,843,000
<b>Net Loss from Investment and Derivative Activities</b>	(80,670,000)	(15,645,000)	(66,592,000)	(26,097,000)
<b>Net Income (Loss)</b>	\$ (81,202,000)	\$ 9,496,000	\$ (58,442,000)	\$ 34,746,000
<b>Net Income Per Share:</b>				
Basic	\$ (2.72)	\$ 0.32	\$ (1.96)	\$ 1.39
Diluted	\$ (2.72)	\$ 0.32	\$ (1.96)	\$ 1.38

**Weighted Average Number of Shares Outstanding:**

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Basic	29,857,000	29,857,000	29,857,000	24,976,000			
Diluted	29,857,000	29,992,000	29,857,000	25,105,000			
<b>Dividends Declared Per Share:</b>	\$	\$	0.50	\$	0.42	\$	1.50

See accompanying notes to financial statements

## Apex Mortgage Capital, Inc.

## Statement of Stockholders Equity

(Unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholders Equity	Comprehensive Income / (Loss)
<b>Balance, January 1, 2003</b>	29,857,000	\$ 299,000	\$ 331,499,000	\$ (95,880,000)	\$ (41,259,000)	\$ 194,659,000	
<b>Amortization of non-employees stock options</b>			22,000			22,000	
<b>Net loss</b>					(58,442,000)	(58,442,000)	\$ (58,442,000)
<b>Other comprehensive income (loss):</b>							
Net change in unrealized gain (loss) on available-for-sale securities				(26,130,000)		(26,130,000)	(26,130,000)
Net change in deferred gain (loss) on terminated interest rate swaps				4,603,000		4,603,000	4,603,000
Net change in unrealized gain (loss) on interest rate swaps classified as cash flow hedges				61,993,000		61,993,000	61,993,000
<b>Comprehensive income (loss)</b>							\$ (17,976,000)
<b>Dividends declared</b>					(12,609,000)	(12,609,000)	
<b>Balance, September 30, 2003</b>	29,857,000	\$ 299,000	\$ 331,521,000	\$ (55,414,000)	\$ (112,310,000)	\$ 164,096,000	

The following is a presentation of the changes in accumulated other comprehensive income (loss) for the nine months ended September 30, 2003.

**Nine Months  
Ended  
September 30, 2003**

*Unrealized Gains (Losses) on Available-for-Sale Securities:*

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Change in unrealized gains (losses) during the period	\$	(48,828,000)
Realized (gains) losses on sale of securities during the period		22,698,000
Net change in unrealized gains (losses) on available-for-sale securities	\$	(26,130,000)
<i>Deferred Gain (Loss) on Terminated Interest Rate Swaps:</i>		
Deferred gain (loss) on interest rate swaps terminated during the period	\$	(42,435,000)
Accelerated loss recognition during the period		42,479,000
Reclassification for amortization into interest expense		4,559,000
Net change in deferred gain (loss) on terminated interest rate swaps	\$	4,603,000
<i>Unrealized Gain (Loss) on Interest Rate Swaps Classified as Cash Flow Hedges:</i>		
Change in unrealized gain (loss) during the period	\$	(18,457,000)
Deferred loss on interest rate swaps terminated during the period		42,435,000
Reclassification for adjustments to interest expense		38,015,000
Net change in unrealized gain (loss) on interest rate swaps classified as cash flow hedges	\$	61,993,000

See accompanying notes to financial statements

## Apex Mortgage Capital, Inc.

## Statements of Cash Flows

(Unaudited)

	Nine Months Ended September 30, 2003	Nine Months Ended September 30, 2002
<b>Operating Activities:</b>		
Net (loss) income	\$ (58,442,000)	\$ 34,746,000
Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities:		
Net amortization	19,822,000	669,000
Net loss from investment and derivative activities	66,592,000	26,097,000
Trading activities	532,696,000	(594,929,000)
Change in assets and liabilities:		
Accrued interest receivable	6,568,000	(10,867,000)
Other assets	(2,493,000)	238,000
Accrued interest payable	(700,000)	2,953,000
Accrued expenses and other liabilities	(712,000)	(9,542,000)
Net cash provided by (used in) operating activities	563,331,000	(550,635,000)
<b>Investing Activities:</b>		
Purchase of fixed income securities available-for-sale	(2,303,271,000)	(1,503,945,000)
Proceeds from sales of fixed income securities available-for-sale	2,257,126,000	109,153,000
Proceeds from sales of equity securities	4,299,000	1,937,000
Principal payments on fixed income securities available-for-sale	697,250,000	138,330,000
Net cash provided by (used in) investing activities	655,404,000	(1,254,525,000)
<b>Financing Activities:</b>		
Net change in reverse repurchase agreements	(1,185,365,000)	1,689,237,000
Dividend distributions	(26,118,000)	(40,025,000)
Issuance of common stock		155,819,000
Net cash (used in) provided by financing activities	(1,211,483,000)	1,805,031,000
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>7,252,000</b>	<b>(129,000)</b>
<b>Cash and Cash Equivalents at Beginning of Period</b>	<b>1,456,000</b>	<b>4,330,000</b>
<b>Cash and Cash Equivalents at End of Period</b>	<b>\$ 8,708,000</b>	<b>\$ 4,201,000</b>
<b>Supplemental Disclosure of Cash Flow Information:</b>		
Cash paid for interest	\$ 57,273,000	\$ 61,406,000
Noncash Investing and Financing Activities:		

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Change in accumulated other comprehensive loss	(40,466,000)	(71,874,000)
Change in receivable for unsettled securities		330,567,000
Change in payable for unsettled securities	237,750,000	(384,730,000)
Change in dividends declared, not yet paid	(13,509,000)	2,473,000

See accompanying notes to financial statements

**Apex Mortgage Capital, Inc.**

**Notes to Financial Statements**



**(Unaudited)**



**Note 1 - The Company**

Apex Mortgage Capital, Inc., or the Company, was incorporated in Maryland on September 15, 1997. The Company commenced its operations of acquiring and managing a portfolio of mortgage related assets on December 9, 1997, upon receipt of the net proceeds from the initial public offering of the Company's common stock. The Company uses its equity capital and borrowed funds to seek to generate income based on the difference between the yield on its investments and the cost of its borrowings. The Company is structured for tax purposes as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as amended, or the Code.

The Company entered into a management agreement, or the Management Agreement, as amended, with TCW Investment Management Company, or the Manager, a wholly owned subsidiary of The TCW Group, Inc., pursuant to which the Manager manages the Company's day-to-day operations, subject to the direction and oversight of the Company's Board of Directors. The Management Agreement was initially executed on December 9, 1997.

**Note 2 - Summary of Significant Accounting Policies and Certain Risks**

*Overview*



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Certain information and note disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America, or "GAAP," have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission, or the "SEC," for interim financial statements. The unaudited financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002. The accounting policies used in the preparation of these interim financial statements were consistent with those used in the preparation of the financial statements for the year ended December 31, 2002, unless otherwise noted.

### *Derivatives and Hedging Transactions*





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The Company may enter into interest rate swaps and other financial instruments in order to mitigate the impact of rising interest rates on the cost of its short-term borrowings and market value of its portfolio securities. The Company may also enter into forward contracts to sell U.S. Treasury securities and other financial instruments in order to mitigate the negative impact of rising interest rates on the fair value of its fixed income securities. Such financial instruments are generally referred to as derivatives.

The Company adopted SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, on January 1, 2001. Under SFAS No. 133, all derivatives are recorded at fair value and presented as either assets or liabilities on the Company's balance sheets.

Prior to adopting SFAS No. 133, the Company accounted for changes in fair values of the forward contracts through adjustments to accumulated other comprehensive income (loss). Following adoption of SFAS No. 133, the Company recognizes changes in fair values of forward contracts as a component of net gain (loss) on investment and derivative activities in the statements of operations.

At September 30, 2003 and December 31, 2002, the Company's outstanding interest rate swaps qualify as cash flow hedges and are deemed to be fully effective as hedges under SFAS No. 133. Changes in fair values of such swaps are not reflected in current earnings, but are reflected in other comprehensive income. Currently, fair value of the interest rate swaps is determined by the average of values obtained from two market analytics systems, i.e., The Yield Book and Bloomberg. If the Company were to change current or anticipated borrowings so that they were no longer appropriately matched to the swap agreements, the agreements might no longer qualify for hedge accounting treatment. In that case, changes in their fair values would affect net income.

#### *Stock-based Compensation*

The Company grants stock options to directors and to certain directors, officers and employees of the Manager. Options granted to directors of the Company are accounted for using the intrinsic-value method, and generally no compensation expense is recognized in the statements of operations for such options. Options granted to persons other than directors (i.e., to non-employees) are accounted for using the fair value method; such stock options are measured at their fair value when they are granted and are recognized as general and administrative expense during the periods when the options are vested and the related services are performed. During the nine months ended September 30, 2003 and September 30, 2002, the Company did not issue any stock options. The effects of previously issued and unvested stock options to the Company's directors did not have an impact for either of the periods presented below.

The following table represents the pro forma effects on net income (loss) and net income (loss) per share if compensation costs related to the director stock options were measured using the fair value method as prescribed under SFAS No. 123, *Accounting for Stock-based Compensation*:

	<b>Three Months Ended September 30, 2003</b>	<b>Three Months Ended September 30, 2002</b>	<b>Nine Months Ended September 30, 2003</b>	<b>Nine Months Ended September 30, 2002</b>
Reported net income (loss)	\$ (81,202,000)	\$ 9,496,000	\$ (58,442,000)	\$ 34,746,000
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects				1,000
Pro forma net income (loss)	\$ (81,202,000)	\$ 9,496,000	\$ (58,442,000)	\$ 34,745,000
Earnings (losses) per share:				
Basic - as reported	\$ (2.72)	\$ 0.32	\$ (1.96)	\$ 1.39
Basic - pro forma	\$ (2.72)	\$ 0.32	\$ (1.96)	\$ 1.39
Diluted - as reported	\$ (2.72)	\$ 0.32	\$ (1.96)	\$ 1.38
Diluted - pro forma	\$ (2.72)	\$ 0.32	\$ (1.96)	\$ 1.38

*Recent Accounting Developments*

In April 2003, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* ( SFAS 149 ), which clarifies and amends financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* ( SFAS 133 ). In general, SFAS 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. Implementation of this standard is not expected to have a material effect on the earnings, cash flows or financial position of the Company.

**Note 3 Fixed Income and Equity Securities**

At September 30, 2003, fixed income securities consisted of the following:

(in thousands)	Fixed Income Trading Securities	Fixed Income Securities Available-For-Sale	Equity Securities Available-For-Sale
Principal Amount	\$ 21,710	\$ 1,319,450	
Unamortized (Discount) Premium	(147)	15,918	
Adjusted Cost	21,563	1,335,368	\$
Gross Unrealized Gains	520	14,079	
Gross Unrealized Losses		(5,811)	
Fair Value	\$ 22,083	\$ 1,343,636	\$

At December 31, 2002, fixed income and equity securities consisted of the following:

(in thousands)	Fixed Income Trading Securities	Fixed Income Securities Available-For-Sale	Equity Securities Available-For-Sale
Principal Amount	\$ 585,817	\$ 1,765,448	
Unamortized Premium	12,838	20,371	
Adjusted Cost	598,655	1,785,819	\$ 2,844
Gross Unrealized Gains	7,359	33,225	1,324
Gross Unrealized Losses		(151)	
Fair Value	\$ 606,014	\$ 1,818,893	\$ 4,168

The contractual final maturity of the mortgage loans supporting fixed income mortgage securities is generally between 15 and 30 years at origination. Because of prepayments on the underlying mortgage loans, the actual weighted average maturity is expected to be substantially less.

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Fixed-rate mortgage securities comprised approximately 48.4% and 99.0% of the Company's portfolio of fixed income securities at September 30, 2003 and December 31, 2002, respectively. The shift from fixed-rate mortgage securities to adjustable-rate mortgage securities was made by the Manager to seek to reduce exposure to price volatility and to seek to increase exposure to securities that have more favorable prepayment characteristics. The decrease in fixed income trading securities from December 31, 2002 to September 30, 2003 was primarily due to the sale of \$432,761,000 of fixed income trading securities and \$147,456,000 of principal prepayments on fixed income trading

securities. The expected average remaining maturity of the Company's other fixed income securities as of September 30, 2003 and December 31, 2002 was approximately 27 years and less than one year, respectively.

Adjustable-rate mortgage securities comprised approximately 49.1% and 0.4% of the Company's portfolio of fixed income securities at September 30, 2003 and December 31, 2002, respectively. A portion of the adjustable-rate mortgage securities in the Company's portfolio are backed by loans subject to periodic and lifetime caps that limit the amount the securities' effective interest rates can change during any given period and over the lives of the assets. Both at September 30, 2003 and December 31, 2002, the portion of adjustable-rate mortgage securities subject to periodic caps had an average periodic cap equal to 2.0%. At September 30, 2003 and December 31, 2002, the portion of adjustable-rate mortgage securities subject to lifetime caps had an average lifetime cap equal to 9.5% and 11.3%, respectively.

During the nine months ended September 30, 2003, the Company reported a net loss on investment and derivative activities of \$66,592,000 in the statement of operations. The loss consisted of a loss of \$42,479,000 on terminated swaps, a net loss of \$24,153,000 on the sale of \$2,257,126,000 of fixed income securities available-for-sale, a gain of \$5,424,000 on the sale of \$432,761,000 of fixed income trading securities, a gain of \$1,455,000 on the sale of \$4,299,000 of equity securities available-for-sale, and an unrealized loss of \$6,839,000 on fixed income trading securities.

During the nine months ended September 30, 2002, the Company reported a net loss on investment and derivative activities of \$26,097,000 in the statement of operations. This loss consisted of a net loss of \$55,800,000 on closed forward contracts, a loss of \$229,000 on the sale of \$98,634,000 of fixed income securities available-for-sale, a gain of \$29,907,000 on the sale of \$894,372,000 of fixed income trading securities, a gain of \$594,000 on the sale of \$1,937,000 of equity securities available-for-sale, and an unrealized loss of \$569,000 on fixed income trading securities.

#### **Note 4 - Reverse Repurchase Agreements**

The Company has entered into reverse repurchase agreements to finance certain of its investments. These agreements are secured by a portion of the Company's investments and bear interest rates that have historically moved in close relationship to LIBOR. Reverse repurchase agreements are accounted for as short-term borrowings and recorded as a liability on the balance sheet.

At September 30, 2003, the Company had outstanding \$927,079,000 of reverse repurchase agreements with a weighted average current borrowing rate of 1.11% per annum and a weighted average maturity of one month. The reverse repurchase agreements were collateralized by the Company's securities with an estimated fair value of \$952,656,000.

At December 31, 2002, the Company had outstanding \$2,112,444,000 of reverse repurchase agreements with a weighted average current borrowing rate of 1.40% per annum and a weighted average maturity of one month. The reverse repurchase agreements were collateralized by the Company's securities with an estimated fair value of \$2,199,852,000.

**Note 5 Derivative Financial Instruments and Hedging Activities**

The Company has entered into interest rate swap agreements as summarized below. Under these agreements, the Company receives a floating rate and pays a fixed rate. The swaps qualify as cash flow hedges for accounting purposes, and effectively fix the interest rate paid on \$771,500,000, as of September 30, 2003, of current and anticipated future borrowings under reverse repurchase

agreements. The Company estimates that approximately \$19,325,000 of unrealized and deferred realized losses on interest rate swaps currently included in accumulated other comprehensive loss will be reclassified into interest expense within the next twelve months as net settlements occur. As of September 30, 2003, the maximum length of time over which the Company is hedging its exposure to the variability in future cash flows for current and anticipated future transactions is approximately 8.7 years.

## Interest Rate Swaps at September 30, 2003:

(Dollars in thousands)

<b>Current Notional Amount</b>	<b>Average Fixed Rate</b>	<b>Floating Rate</b>	<b>Par Weighted Average Maturity</b>	<b>Unrealized Losses</b>
\$ 771,500	4.884%	1Month LIBOR	4.7 years	\$ 58,105

## Interest Rate Swaps at December 31, 2002:

(Dollars in thousands)

<b>Current Notional Amount</b>	<b>Average Fixed Rate</b>	<b>Floating Rate</b>	<b>Par Weighted Average Maturity</b>	<b>Unrealized Losses</b>
\$ 1,678,500	4.643%	1Month LIBOR	4.4 years	\$ 120,098

During the fourth quarter of 2002, the Company terminated a portion of the outstanding interest rate swap agreements with a combined notional amount of \$544,500,000, which resulted in a deferred loss of approximately \$13,872,000 with an average term of 1.3 years and an average rate of 3.57% per annum. Also, during the third quarter of 2003, the Company terminated another portion of the outstanding interest rate swap agreements with a combined notional amount of \$907,000,000 which resulted in a deferred loss of approximately \$42,435,000 with an average term of 5.1 years and an average rate of 4.44% per annum.

As a result of declining reverse repurchase agreement balances as of September 30, 2003, the Company accelerated the deferred loss recognition and reclassified \$42,479,000 from accumulated other comprehensive income (loss) to net loss from investment and derivative activities for the nine months ended September 30, 2003. The acceleration of the deferred loss recognition depends on the balance of reverse repurchase agreements maintained by the Company. If the general level of reverse repurchase agreements were to decline further, the Company may be required to accelerate the deferred loss recognition in the future. The remaining deferred loss of \$5,575,000 is being amortized as an adjustment to interest expense over the remaining lives of the original swap agreements.



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During the nine months ended September 30, 2003, interest expense was increased by \$38,015,000 paid to swap counterparties and \$4,559,000 from amortization of deferred losses on terminated swap contracts. During the nine months ended September 30, 2002, interest expense was increased by \$29,342,000 paid to swap counterparties and decreased by \$180,000 from amortization of deferred gains on terminated swap contracts.

**Note 6 Commitments and Contingencies**

There have been no material changes to the matters disclosed in Note 10 - Commitments and Contingencies on the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

**Note 7 - Risks and Uncertainties**

The Company's future results of operations and overall book value involve a number of risks and uncertainties that affect volatility of earnings and book value. Factors that could affect the Company's future operating results and/or book value and cause actual results to vary materially from expectations include, but are not limited to the following: further adverse changes in general economic conditions, further changes in interest rates; and fluctuations in overall market conditions for mortgage-backed securities.

**Note 8 Subsequent Events**

In addition, on July 14, 2003, **the Company** announced that **it** entered into a definitive agreement and plan of merger dated July 12, 2003, with American Home Mortgage Holdings, Inc., or American Home, and American Home Mortgage Investment Corp. (formerly called AHM New Holdco, Inc.), or AHM Investment Corp., a wholly-owned subsidiary of American Home, providing for the acquisition of the Company by American Home pursuant to the merger of the Company with and into AHM Investment Corp., with AHM Investment Corp. surviving the merger. Prior to the merger, American Home will engage in an internal reorganization pursuant to which American Home will merge with and into a wholly-owned subsidiary of AHM Investment Corp. As a result of this reorganization, AHM Investment Corp. will become the new parent company and will own 100% of the capital stock of American Home, and each outstanding share of American Home common stock will be converted into one share of AHM Investment Corp. common stock. In the merger, and subject to the terms and conditions of the agreement and plan of merger, each issued and outstanding share of **the Company**'s common stock will be converted automatically into and become exchangeable for a number of shares of AHM Investment Corp. common stock equal to 107.5% of our book value per share, subject to a collar adjustment, as set forth in the agreement and plan of merger. The completion of the merger is subject to the approval by **the Company**'s stockholders and those of American Home, the receipt of regulatory approvals and other customary conditions. Upon the successful completion of the merger, the Company's Manager has agreed that it will terminate its Management Agreement for a termination fee equal to 40% of the premium over book value received by our stockholders in the merger, not to exceed \$10,000,000, which is less than the amount the Company was originally obligated to pay the Manager under the Management Agreement in the event of a termination without cause by the Company.

**On October 27, 2003, the Company announced that the Registration Statement on Form S-4, Amendment #3, filed by AHM Investment Corp. relating to the proposed acquisition of the Company by American Home was declared effective by the SEC on October 24, 2003.**

## **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion of our financial condition and results of operations should be read in conjunction with the financial statements and the notes to those statements included elsewhere in this Quarterly Report on Form 10-Q and our audited financial statements for the year ended December 31, 2002 included in our Annual Report on Form 10-K previously filed with the SEC.*

### **SAFE HARBOR/FORWARD LOOKING STATEMENTS**

Certain information contained in this Quarterly Report on Form 10-Q constitutes forward-looking statements which can be identified by the use of forward-looking terminology such as may, will, should, anticipate, estimate, intend, continue or believes or the negatives thereof or variations thereon or comparable terminology. Some important factors that would cause actual results to differ materially from those in any forward-looking statements include the following: the possibility that the merger with American Home Mortgage Holdings, Inc. will not be completed; changes in interest rates; a decline in our book value; domestic and foreign business, market, financial or legal conditions; differences in the actual allocation of the assets of the Company from those assumed; and the degree to which assets are hedged and the effectiveness of the hedge, among other factors. In addition, the degree of risk in the Company's investments is increased by the Company's leveraging of its assets. For additional discussion of factors that could cause actual results to differ from those contained in such forward-looking statements, see Principal Risks and Special Considerations, Item 7 Management's Discussion and Analysis of Financial Conditions and Results of Operations and Item 7A Quantitative and Qualitative Disclosures About Market Risk in the Company's Annual Report on Form 10-K for the year ended December 31, 2002. The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

### **GENERAL**

Apex Mortgage Capital, Inc., or the Company, a Maryland corporation, was formed on September 15, 1997, primarily to acquire United States agency and other highly rated, single-family real estate adjustable and fixed rate mortgage related assets. The Company commenced operations on December 9, 1997, following the initial public offering of the Company's common stock. The Company's principal executive offices are located at 865 South Figueroa Street, Suite 1800, Los Angeles, California 90017, and its telephone number is (213) 244-0000.

The Company uses its equity capital and borrowed funds to seek to generate income based on the difference between the yield on its mortgage related assets and the cost of its borrowings. The Company has elected to be taxed as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as amended, or the Code. The Company will not generally be subject to federal taxes on its income to the extent that it distributes its net income to its stockholders and maintains its qualification as a REIT.

The day-to-day operations of the Company are managed by an external management company, TCW Investment Management Company, or the Manager, subject to the direction and oversight of the Company's Board of Directors. A majority of the Board of Directors are unaffiliated with the TCW Group, Inc. (TCW and, together with its subsidiaries and affiliates, the TCW Group), or the Manager. The Manager is a wholly-owned subsidiary of TCW. The Manager was established in 1987, and the TCW Group began operations in 1971 through one of its affiliates. The Company's investment management team are selected members of the TCW Group's Mortgage-Backed Securities Group (the MBS Group), all of whom have over fifteen years of experience in raising and managing mortgage capital. The Company is externally



managed by the Manager. The Manager's key officers have experience in raising and managing mortgage capital, mortgage finance and the purchase and administration of mortgage related assets.

**Website Access to Our Periodic SEC Reports**



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Our internet address is [www.apexreit.com](http://www.apexreit.com). We make our periodic SEC reports (Form 10-Q and Form 10-K) and current reports (Form 8-K) available free of charge through our website as soon as reasonably practicable after they are filed electronically with the SEC. We may from time to time provide important disclosures to investors by posting them in the investor relations section of our website, as allowed by SEC rules.

Materials we file with the SEC may be read and copied at the SEC's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet Website at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding our company that we file electronically with the SEC.

### **RECENT EVENTS**



*Merger Agreement with American Home Mortgage Holdings, Inc.* On July 14, 2003, we announced that we entered into a definitive agreement and plan of merger dated July 12, 2003, with American Home Mortgage Holdings, Inc., or American Home, and American Home Mortgage Investment Corp. (formerly called AHM New Holdco, Inc.), or the AHM Investment Corp., a wholly-owned subsidiary of American Home, providing for the acquisition of the Company by American Home pursuant to the merger of the Company with and into AHM Investment Corp., with AHM Investment Corp. surviving the merger. Prior to the merger, American Home will engage in an internal reorganization pursuant to which American Home will merge with and into a wholly-owned subsidiary of AHM Investment Corp. As a result of this reorganization, AHM Investment Corp. will become the new parent company and will own 100% of the capital stock of American Home, and each outstanding share of American Home common stock will be converted into one share of AHM Investment Corp. common stock. In the merger, and subject to the terms and conditions of the agreement and plan of merger, each issued and outstanding share of our common stock will be converted automatically into and become exchangeable for a number of shares of AHM Investment Corp. common stock equal to 107.5% of our book value per share, subject to a collar adjustment, as set forth in the agreement and plan of merger. The completion of the merger is subject to the approval by our stockholders and those of American Home, the receipt of regulatory approvals and other customary conditions.

*Special stockholders meeting.* As previously announced, our special stockholders meeting to vote on the proposed merger with American Home will be held on November 21, 2003 for our stockholders of record on October 10, 2003.

*Termination of the Management Agreement.* In connection with the proposed merger, we have agreed to terminate the Management Agreement with our Manager, TCW Investment Management Company, at the closing of the proposed merger. Pursuant to the existing terms of the Management Agreement, the Manager is entitled to a fee upon termination of the Management Agreement equal to the fair market value of the Management Agreement. In connection with the agreement and plan of merger with American Home, we have agreed to enter into a third amendment to the Management Agreement at the closing of the merger that provides that we will pay a termination fee to the Manager immediately prior to the closing of the merger, equal to 40% of the premium over net book value received by our stockholders in the merger. This amount is substantially less than the amount the Manager would be entitled to receive from the Company under the existing terms of the Management Agreement, which is less than the amount the Company was originally obligated to pay the Manager under the Management Agreement in the event of a termination without cause by the Company.

By way of example, based on an Apex net book value per share of approximately \$5.50 as of September 30, 2003 and (without giving effect to certain transaction expenses which will be deducted from Apex's actual net book value, including the Manager's termination fee) an American Home average price of \$20.14702 as of October 21, 2003, the termination fee will equal approximately \$4.9 million, which is less than the amount Apex was originally obligated to pay to the Manager under the Management Agreement in the event of a termination without cause by Apex. The actual Apex net book value, American Home average price and termination fee can, and probably will, differ from these figures.

*No declaration of a dividend distribution for the third quarter of 2003.* On September 23, 2003 we announced that, due to costs associated with the anticipated closing of the merger with American Home and the restructuring of our investment portfolio in accordance with the terms of the merger, our board of directors decided not to declare a third quarter 2003 dividend distribution to our stockholders.

*Reporting Period.* Unless otherwise noted, this report describes the Company's operations and developments through the date hereof.

## STRATEGY

Subject to the agreement and plan of merger with American Home, and assuming the contemplated merger is completed, in order to achieve our business objective and generate dividend yields that provide a competitive rate of return for our stockholders, our strategy is to seek to:

purchase primarily single-family real estate adjustable and fixed rate mortgage related assets;

manage the credit risk of our mortgage related assets through, among other activities, the following: (i) carefully selecting mortgage related assets to be acquired; (ii) complying with our investment policy; (iii) actively monitoring the ongoing credit quality and servicing of our mortgage related assets; and (iv) maintaining appropriate capital levels and allowances for possible credit losses;

finance purchases of mortgage related assets with the net proceeds of equity offerings and, to the extent permitted by our leverage policy, to utilize leverage to increase potential returns to stockholders through borrowings (primarily reverse repurchase agreements) with interest rates that will also reflect changes in short-term market interest rates;

structure our borrowings in accordance with our interest rate risk management policy;

utilize interest rate swaps, forward contracts on U.S. Treasury notes, interest rate caps and similar financial instruments to mitigate interest rate risks;

minimize prepayment risk primarily by structuring a diversified portfolio with a variety of prepayment characteristics; and

purchase equity and other securities issued by financial entities on an opportunistic basis.

There can be no assurance that we will be able to generate competitive earnings and dividends while holding primarily high quality mortgage related assets and maintaining a disciplined risk-control profile.

In the event that the merger does not close as contemplated, we may attempt to increase the return to stockholders over time by: (i) raising additional capital in order to increase our ability to invest in additional mortgage related assets; (ii) lowering our effective borrowing costs through direct funding with collateralized

lenders, in addition to using Wall Street intermediaries, and investigating the possibility of using collateralized commercial paper and medium-term note programs; and (iii) improving the efficiency of our balance sheet structure by issuing uncollateralized subordinated debt and other forms of capital.

**THE MANAGEMENT AGREEMENT**



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The Company has renewed its Management Agreement with the Manager for a one-year term ending on December 31, 2003. The Manager is primarily involved in two activities: (i) asset/liability management acquisition, financing, hedging, management and disposition of mortgage related assets, including credit and prepayment risk management; and (ii) capital management oversight of the Company's structuring, analysis, capital raising and investor relations activities. In conducting these activities, the Manager formulates operating strategies for the Company, arranges for the acquisition of mortgage related assets by the Company, arranges for various types of financing for the Company, monitors the performance of the Company's mortgage related assets and provides certain administrative and managerial services in connection with the operation of the Company. The Manager is required to manage the business affairs of the Company in conformity with the policies that are approved and monitored by the Company's board of directors. The Manager is required to prepare regular reports for the Company's board of directors that will review the Company's acquisitions of mortgage related assets, portfolio composition and characteristics, credit quality, performance and compliance with the policies approved by the Company's board of directors.

At all times, the Manager is subject to the direction and oversight of the Company's board of directors and has only such functions and authority as the Company delegates to it. The Manager is responsible for the day-to-day operations of the Company.

In the event that the proposed merger is not completed as contemplated, the Management Agreement may be renewed for additional one-year terms at the discretion of the unaffiliated directors, unless previously terminated by the Company or the Manager upon written notice. Except in the case of a termination or non-renewal by the Company for cause, upon termination or non-renewal of the Management Agreement by the Company, the Company is obligated to pay the Manager a termination or non-renewal fee, which may be significant. The termination or non-renewal fee shall be equal to the fair market value of the Management Agreement without regard to the Company's termination right, as determined by an independent appraisal. The selection of the independent appraiser shall be subject to the approval of the unaffiliated directors. Neither the fair market value of the Management Agreement nor the various factors which the appraiser may find relevant in its determination of the fair market value can be determined at this time.

The fair market value of the Management Agreement will be affected by significant variables, including the following: (i) the historical management fees paid to the Manager; (ii) any projections of future management fees to be paid to the Manager determined by the independent appraiser; and (iii) other factors, all of which may be unrelated to the performance of the Manager.

The Management Agreement may be assigned by the Manager to an affiliate of TCW without the consent of the Company. The Management Agreement may be assigned to a non-affiliate of TCW only with the approval of a majority of the unaffiliated directors.

*Termination of the Management Agreement.* In connection with the proposed merger with American Home, we have agreed to terminate the Management Agreement with our Manager, TCW Investment Management Company, at the closing of the proposed merger. Pursuant to the existing terms of the Management Agreement, the Manager is entitled to a fee upon termination equal to the fair market value of the Management Agreement. In connection with the agreement and plan of merger with American Home, we have agreed to enter into a third amendment to the Management Agreement at the closing of the merger that provides that we will pay a termination fee to the Manager immediately prior to the closing of the merger, equal to 40% of the premium over net book value received by our stockholders in the merger. This amount is



substantially less than the amount the Manager would be entitled to receive from the Company under the existing terms of the Management Agreement.

By way of example, based on an Apex net book value per share of approximately \$5.50 as of September 30, 2003 and (without giving effect to certain transaction expenses which will be deducted from Apex's actual net book value, including the Manager's termination fee) an American Home average price of \$20.14702 as of October 21, 2003, the termination fee will equal approximately \$4.9 million, which is less than the amount Apex was originally obligated to pay to the Manager under the Management Agreement in the event of a termination without cause by Apex. The actual Apex net book value, American Home average price and termination fee can, and probably will, differ from these figures

### **Manager Compensation**

The Manager receives annual base management compensation based on the Average Net Invested Capital of the Company, payable monthly in arrears, equal to 3/4 of 1% of Average Net Invested Capital. The term "Average Net Invested Capital" means the month end sum of (1) the Company's total stockholders' equity computed in accordance with accounting principles generally accepted in the United States of America, plus (2) any unsecured debt that has been approved for inclusion by the unaffiliated directors at issuance, plus or minus (3) an adjustment to exclude the impact of any unrealized gains, losses or other items that do not affect realized net income. Accordingly, incurring collateralized debt to finance specific investment purchases does not ordinarily increase Average Net Invested Capital.

The Manager shall also be entitled to receive as incentive compensation for each fiscal quarter, an amount equal to 30% of the Net Income of the Company, before incentive compensation, in excess of the amount that would produce an annualized Return on Equity equal to the Ten-Year U.S. Treasury Rate plus 1%. The incentive compensation calculation and payment will be made quarterly in arrears. The term "Return on Equity" is calculated for any quarter by dividing the Company's Net Income for the quarter by its Average Net Worth for the quarter. For purposes of calculating the incentive compensation payable, the definition "Return on Equity" is not related to the actual distributions received by stockholders or to an individual investor's actual return on investment. For such calculations, the "Net Income" of the Company means the taxable income of the Company (including net capital gains, if any) before the Manager's incentive compensation, net operating loss deductions arising from losses in prior periods and deductions permitted by the Code in calculating taxable income for a REIT plus the effects of adjustments, if any, necessary to record hedging and interest transactions in accordance with accounting principles generally accepted in the United States of America. A deduction for all of the Company's interest expenses for borrowed funds is taken into account in calculating Net Income. "Average Net Worth" for any period means the arithmetic average of the sum of the gross proceeds from any offering of its equity securities by the Company, before deducting any underwriting discounts and commissions and other expenses and costs relating to the offerings, plus the Company's retained earnings (without taking into account any losses incurred in prior periods) computed by taking the average of such values at the end of each month during such period, minus the cumulative amounts paid by the Company to repurchase its shares.

The ability of the Company to achieve an annualized Return on Equity in excess of the Ten-Year U.S. Treasury Rate plus 1%, and of the Manager to earn the incentive compensation described in the preceding paragraph, is dependent upon the level and volatility of interest rates, the Company's ability to react to changes in interest rates and to utilize successfully the operating strategies described herein, and other factors, many of which are not within the Company's or the Manager's control. The Manager's base compensation shall be calculated by the Manager within 15 days after the end of each month, and such calculation shall be promptly delivered to the Company. The Company is obligated to pay the base compensation within 30 days after the end of each month. The Manager shall compute the quarterly incentive compensation within 45 days after the end of each fiscal quarter, and the Company shall pay the incentive compensation with respect to each fiscal quarter within 15 days following the delivery to the Company of the Manager's written statement setting forth the computation of the incentive compensation for such quarter. Quarterly incentive

compensation is subject to an annual adjustment so that the incentive compensation is based on earnings for the entire year. The Company believes that this compensation arrangement benefits its stockholders because it ties the Manager's compensation to Return on Equity and, in periods of low earnings, the Manager's incentive compensation is reduced or eliminated, thereby lowering the Company's operating expenses.

#### **POLICIES**

The Company's current investment policies are set forth in its Annual Report on Form 10-K for the year ended December 31, 2002.

#### **PRINCIPAL RISKS AND SPECIAL CONSIDERATIONS**



**Leverage Risk.** The Company employs a leveraging strategy of generally borrowing up to 92% of its total assets, less any assets that are funded with committed secured borrowings, plus the market value of any related hedging transactions to finance the acquisition of additional mortgage related assets. The Company's borrowings may, from time to time, exceed 92% of its total assets. In the event borrowing costs exceed the income on its mortgage related assets, the Company will experience negative cash flow and incur losses. Another risk of leverage is the possibility that the value of the collateral securing the borrowings will decline. In such event, additional collateral or repayment of borrowings would be required. The Company could be required to sell mortgage related assets under adverse market conditions in order to maintain liquidity. If these sales were made at prices lower than the carrying value of the mortgage related assets, the Company would experience losses.

**Interest Rate Risk.** There is the possibility that the value of the Company's mortgage related assets may decline since fixed income securities generally decline when interest rates rise. The longer the term of a fixed income instrument, the more sensitive it will be to fluctuations in value from interest rate changes. Changes in interest rates may have a significant effect on the Company's operations, because it may hold mortgage related assets with long terms to maturity. Rising interest rates will negatively impact the Company's borrowings since the value of the collateral securing the borrowing will decline in value, requiring additional collateral or repayments of borrowing. This could reduce the level of borrowings and reduce returns. Also, when interest rates rise, the Company's holdings of mortgage related assets can reduce returns if the owners of the underlying mortgages pay-off their mortgages later than anticipated. This is known as *extension risk*. When interest rates decline, the Company's holdings of the mortgage related assets can reduce returns if the owners of the underlying mortgages pay-off their mortgages sooner than anticipated since the funds prepaid will have to be invested at the then lower prevailing rate. This is known as *prepayment risk*. In addition, when interest rates decline, not only can the value of mortgage related assets decline, but the yield can decline, particularly where the yield on the security is tied to interest rates, such as adjustable mortgages.

**Liquidity Risk.** There is the possibility that the Company may lose money or be prevented from realizing capital gains if it cannot sell a mortgage related asset at a time and price that is most beneficial to the Company. The Company is subject to liquidity risk because it invests in mortgage securities which have experienced periods of illiquidity.

**Credit Risk.** Credit risk is the possibility that the Company could lose money if an issuer is unable to meet its financial obligations, such as the payment of principal and/or interest on an instrument, or goes bankrupt. The Company may invest a portion of its assets in mortgage related assets which are not guaranteed by the U.S. Government or investment grade, which may make the Company subject to substantial credit risk. This is especially true during periods of economic uncertainty or during economic downturns.

**Equity Risk.** Equity risk is the possibility that the Company could lose money if its equity investments decline in value. Such a decline could be caused by a number of factors, including, but not limited to, overall

market conditions, suspension or omission of dividends, bankruptcies and litigation. This is especially true during periods of economic uncertainty or during economic downturns.

***Failure to Maintain REIT Status Risk.*** Failure to maintain REIT status risk refers to the possibility that the Company may become subject to federal income tax as a regular corporation. The Company intends at all times to maintain substantially all of its investments in, and otherwise conduct its business in a manner consistent with, the REIT Provisions of the Code. If the Company fails to qualify as a REIT, it would be treated as a regular corporation for federal tax purposes. This would result in the Company being subject to federal income tax that would further result in a substantial reduction of cash available for distribution to stockholders.

***Failure to Maintain Investment Company Act Exemption Risk.*** The Company intends to conduct its business so as not to become a regulated investment company under the Investment Company Act. As a result, the Company's ownership of certain mortgage related assets may be limited by the Investment Company Act. This could have the effect of harming the Company's operations and returns to stockholders. In addition, if the Company fails to qualify for the exemption from registration as an investment company, its ability to use leverage would be substantially reduced. This could reduce income to the Company and returns to stockholders.

***Risks Relating to Proposed Merger with American Home Mortgage Holdings, Inc.***

**The proposed merger may not be completed, which may significantly harm our stock price.**

Although American Home and the Company have signed the agreement and plan of merger in furtherance of a proposed merger of the Company with and into AHM Investment Corp., the completion of the merger is subject to stockholder and regulatory approvals, and there is no assurance that all of the conditions to closing will be met and that the merger will be completed. In addition, either party may unilaterally terminate the Merger Agreement if the merger is not completed on or before January 12, 2004, or, if the failure to close relates solely to governmental approval or antitrust matters, on or before April 12, 2004. In addition, if the American Home average price is less than \$14.57443 per share, the Company may terminate the agreement and plan of merger, subject to American Home's right to adjust the exchange ratio. Similarly, if American Home's average price is greater than \$24.29071 per share, American Home may terminate the agreement and plan of merger, subject to our right to adjust the exchange ratio.

If the merger is not completed for any reason, the Company may be harmed in a number of ways, including the following:

the price of our common stock may decline to the extent that the current market price of our stock reflects a market assumption that the merger will be completed;

an adverse reaction from our investors and potential investors may reduce future financing opportunities and strategic alternatives;

the pendency of the merger, as well as customary covenants in the merger agreement that limit our ability to take certain actions without American Home's consent, may cause us to defer or potentially lose business opportunities; and

our costs related to the merger, including legal and accounting fees, must be paid even if the merger is not completed.

**If the proposed merger with American Home does not occur, we may incur payment obligations to American Home.**

If the agreement and plan of merger with American Home is terminated under certain circumstances, we may be required to pay American Home a \$12 million break-up fee, plus American Home's expenses incurred in connection with the proposed merger, which may be substantial.

**Stockholders who purchase our common stock after October 10, 2003 will be bound by the outcome of the stockholders' vote in connection with the proposed merger, but will not have the right to vote.**

Our board of directors set a record date of October 10, 2003 in connection with our stockholders' meeting to be held on November 21, 2003 to vote on the merger with American Home. Those stockholders who purchase shares of our common stock after the record date will not have the right to vote on the proposed merger. Nonetheless, if our stockholders entitled to vote at the stockholders' meeting approve the merger with American Home, those stockholders who previously purchased our stock after the record date will be bound by the outcome of the vote.

## **FINANCIAL CONDITION**

### **Fixed Income Securities**



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At September 30, 2003 and December 31, 2002, the Company held \$1,365,719,000 and \$2,424,907,000 of fixed income securities, respectively. The original maturity of a significant portion of the fixed income securities ranges from fifteen to thirty years, however, the actual maturity is subject to change based on the prepayments of the underlying mortgage loans.

The following table is a schedule of fixed income securities held and listed by security type (dollars in thousands):

Fixed Income Securities	September 30, 2003 Carrying Value	Percent of Portfolio	December 31, 2002 Carrying Value	Percent of Portfolio
<b>Mortgage Securities:</b>				
Adjustable Rate (1)	\$ 668,267	48.93%	\$ 9,173	0.38%
Fixed Rate	660,987	48.40%	2,415,484	99.61%
Other Fixed Income Securities	36,465	2.67%	250	0.01%
<b>Totals</b>	<b>\$ 1,365,719</b>	<b>100.00%</b>	<b>\$ 2,424,907</b>	<b>100.00%</b>

(1) At September 30, 2003, the interest rate indices for 36% and 61% of the adjustable rate mortgage securities were based on the one-year U.S. Treasury rate and the London Inter-Bank Offered Rate, respectively.

At December 31, 2002, the interest rate indices for 99% and 1% of the adjustable rate mortgage securities were based on the one-year U.S. Treasury rate and the London Inter-Bank Offered Rate, respectively.

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The following table shows various weighted average characteristics of the fixed income securities held by the Company at September 30, 2003 (dollars in thousands):

Security Type	Par Amount	Par as a Percent of Category	Adjusted Cost Basis	Market Price	Current Coupon	Weighted Average Life (1)
15 Year Agency Pass-throughs	\$ 205,249	15.30%	102.47%	101.73%	4.76%	3.4
30 Year Agency Pass-throughs	439,328	32.76%	100.32%	101.94%	5.73%	3.4
AAA CMOs	4,322	0.32%	98.39%	100.28%	7.25%	1.8
Total Fixed Rate Holdings	648,899	48.38%	100.99%	101.86%	5.43%	3.4
Other Fixed Income Securities	34,000	2.54%	116.34%	107.25%	5.38%	27.4
Adjustable Rate Holdings	658,262	49.08%	100.58%	101.52%	3.93%	0.9
Category Total	\$ 1,341,161	100.00%	101.18%	101.83%	4.69%	2.8

The following table shows various weighted average characteristics of the fixed income securities held by the Company at December 31, 2002 (dollars in thousands):

Security Type	Par Amount	Par as a Percent of Category	Adjusted Cost Basis	Market Price	Current Coupon	Weighted Average Life (1)
30 Year Agency Pass-throughs	\$ 2,327,391	98.98%	101.54%	103.24%	6.07%	2.7
AAA CMOs	12,409	0.53%	97.54%	101.91%	7.10%	1.0
Total Fixed Rate Holdings	2,339,800	99.51%	101.52%	103.23%	6.08%	2.7
Other Fixed Income Securities	2,500	0.11%	16.04%	10.00%	18.28%	0.3
Adjustable Rate Holdings	8,965	0.38%	97.42%	102.32%	5.12%	1.0
Category Total	\$ 2,351,265	100.00%	101.41%	103.13%	6.09%	2.7

(1) The weighted average life of the fixed rate mortgage securities is based upon market prepayment expectations as of the dates shown. The actual weighted average life could be longer or shorter depending on the actual prepayment rates experienced over the life of the securities and is sensitive to changes in both prepayment rates and interest rates. The weighted average life shown for the adjustable rate mortgage assets represents the average time until the next coupon reset date. All averages are shown in years.

**Equity Securities**

The Company held no equity securities at September 30, 2003 and held \$4,168,000 equity securities at December 31, 2002. Equity securities consisted primarily of investment in equities issued by other real estate investment trusts.

At December 31, 2002, equity securities consisted of the following:

(In thousands)	Shares Held	Adjusted Cost	Fair Value
<b><u>Common Stock:</u></b>			
Dynex Capital, Inc.	75	\$ 122	\$ 363
Total Common Stock		122	363
<b><u>Convertible Preferred Stock:</u></b>			
Capstead Mortgage Corporation, Series B	321	2,722	3,805
Total Convertible Preferred Stock		2,722	3,805
Total Equity Securities		\$ 2,844	\$ 4,168

#### Accrued Interest Receivable and Other Assets

The Company had accrued interest receivable and other assets of \$15,859,000 and \$14,847,000 at September 30, 2003 and December 31, 2002, respectively. The increase was primarily due to the increase in receivable for unsettled transactions, which was offset by the decrease in accrued interest receivable at September 30, 2003. Other assets also consist of deferred insurance expense, deferred stockholder rights expense and other prepaid expenses.

#### Stockholders Equity

The Company had stockholders' equity of \$164,096,000 and \$194,659,000 at September 30, 2003 and December 31, 2002, respectively. The decrease in stockholders' equity at September 30, 2003 was primarily due to an increase in accumulated deficit which was partially offset by a decrease in accumulated other comprehensive loss during the nine months ended September 30, 2003. The accumulated deficit included net loss and dividends declared for the nine months ended September 30, 2003. The decrease in accumulated other comprehensive loss included a decrease in unrealized losses on interest rate swaps and a decrease in deferred loss on terminated interest rate swaps, which was offset by a decrease in unrealized gains on available-for-sale securities.

#### **Hedging Instruments**



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There can be no assurance that the Company will enter into hedging activities or that, if entered into, such activities will have the desired beneficial impact on the Company's results of operations or financial condition. Moreover, no hedging activity can completely insulate the Company from the risks associated with changes in interest rates and prepayment rates.

Hedging involves risk and typically involves costs, including transaction costs. Such costs increase dramatically as the period covered by the hedging increases and during periods of rising and volatile interest rates. The Company may increase its hedging activity and, thus, increase its hedging costs during such periods when interest rates are volatile or rising and hedging costs have increased. The Company intends generally to hedge as much of the interest rate risk as the Manager determines is in the best interest of the Company's stockholders given the cost of such hedging transactions and the Company's desire to maintain its



status as a REIT. The Company's policies do not contain specific requirements as to the percentages or amount of interest rate risk that the Manager is required to hedge.

The Company utilizes interest rate swap agreements as a tool to manage interest rate risk. Under the swap agreements, the Company receives a floating rate and pays a fixed rate. The notional amount of each agreement is matched against a like amount of current and anticipated borrowings under reverse repurchase agreements to mitigate the potential effect on cash flows and net interest income of rising interest rates by effectively fixing the rate paid on the matched borrowings over the life of the contract. In the absence of such financial instruments, interest expense on reverse repurchase agreements and similar short-term borrowings, which mature and reprice frequently, can increase faster than the Company can adjust its interest-earning assets and increase interest income, because the Company's mortgage related securities generally have much longer maturities and have fixed rates of interest.

The interest rate swap agreements entered into by the Company are classified as cash flow hedges for accounting purposes and meet the requirements of SFAS No. 133 for such classification. Therefore, changes in the fair value of the agreements are reported in accumulated other comprehensive loss, a component of stockholders' equity, and do not affect net income in the period of the change. Periodic exchanges of cash flows with the counterparties to the agreements are recorded as adjustments to interest expense. If the Company were to terminate the swap agreements prior to their contractual termination dates, or change current or anticipated borrowings so that they were no longer appropriately matched to the swap agreements, the agreements might not qualify for hedge accounting treatment. In that case, changes in their fair values would affect net income.

Borrowings hedged by interest rate swaps are used primarily to acquire and hold fixed income securities available-for-sale. Changes in the fair values of securities available-for-sale are also reported in accumulated other comprehensive income, a component of stockholders' equity. Changes in fair values of the securities only affect periodic earnings when they are sold or if they have an other-than-temporary impairment. Therefore, earnings volatility is reduced by the use of the swap agreements as cash flow hedges and the acquisition of available-for-sale securities with the borrowings hedged by the agreements. Impairment of the available-for-sale securities or decisions to sell the securities prior to their expected maturities could result in unanticipated earnings volatility.

During the fourth quarter of 2002, the Company terminated a portion of its outstanding interest rate swap agreements with a combined notional amount of \$544,500,000, which resulted in a deferred loss of approximately \$13,872,000 with an average term of 1.3 years and an average rate of 3.57%. Also, during the third quarter of 2003, the Company terminated another portion of its outstanding interest rate swap agreements with a combined notional amount of \$907,000,000 which resulted in a deferred loss of approximately \$42,435,000 with an average term of 5.1 years and an average rate of 4.44% per annum.

As a result of declining reverse repurchase agreement balances as of September 30, 2003, the Company accelerated the deferred loss recognition and reclassified \$42,479,000 from accumulated other comprehensive income (loss) to net loss from investment and derivative activities for the nine months ended September 30, 2003. The acceleration of the deferred loss recognition depends on the balance of reverse repurchase agreements maintained by the Company. If the general level of reverse repurchase agreements were to decline further, the Company may be required to accelerate the deferred loss recognition in the future. The remaining deferred losses are being amortized as an adjustment to interest expense over the remaining lives of the original swap agreements.

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At September 30, 2003, the Company had entered into interest rate swap agreements summarized below:

(Dollars in thousands)

Current Notional Amount	Average Fixed Rate	Floating Rate	Par Weighted Average Maturity	Unrealized Losses
\$ 771,500	4.884%	1 Month LIBOR	4.7 years	\$ 58,105

At December 31, 2002, the Company had entered into interest rate swap agreements summarized below:

(Dollars in thousands)

Current Notional Amount	Average Fixed Rate	Floating Rate	Par Weighted Average Maturity	Unrealized Losses
\$ 1,678,500	4.643%	1 Month LIBOR	4.4 years	\$ 120,098

At various times the Company has used forward contracts to sell U.S. Treasury securities as a means to seek to mitigate the effect of rising interest rates on the fair value of its mortgage related securities. The fair values of these forward contracts generally move in the opposite direction of the fair values of the mortgage related securities, and approximately in the same proportion when the maturities and other terms are appropriately matched. When interest rates rise, the fair value of the mortgage related securities declines, but the increasing fair values of the forward contracts help to preserve net asset value relative to the changing fair value of the short-term borrowings used to fund them.

The Company's forward contracts do not meet the criteria for hedge accounting under SFAS No. 133. Therefore, changes in their fair values affect current earnings, as do changes in the fair values of the securities to which they are matched—such securities are classified as trading securities. Although the changes in the fair values of the forward contracts and the trading securities are offsetting, the contracts are not fully effective as hedges and, therefore, there can be volatility in periodic earnings to the extent they are not effective.

At September 30, 2003 and December 31, 2002, the Company had no open forward contracts to sell U.S. Treasury notes.

### Liabilities

The Company has entered into reverse repurchase agreements to finance certain of its mortgage-backed securities. These agreements are secured by a portion of the Company's mortgage-backed securities and bear interest rates that have historically moved in close relationship to LIBOR.

At September 30, 2003, the Company had outstanding \$927,079,000 of reverse repurchase agreements with a weighted average current borrowing rate of 1.11% per annum and a maturity of one month. The reverse repurchase agreements were collateralized by mortgage-backed securities with an estimated fair value of \$952,656,000.

At December 31, 2002, the Company had outstanding \$2,112,444,000 of reverse repurchase agreements with a weighted average current borrowing rate of 1.40% per annum and a maturity of one month. The reverse repurchase agreements were collateralized by mortgage-backed securities with an estimated fair value of \$2,199,852,000.

The Company had interest rate swaps with an unrealized loss of \$58,105,000 and \$120,098,000 at September 30, 2003 and December 31, 2002, respectively. Under the swap agreements, the Company receives a floating rate and pays a fixed rate.

The Company had \$3,256,000 and \$18,177,000 of other liabilities at September 30, 2003 and December 31, 2002, respectively. The decrease in other liabilities at September 30, 2003 was primarily due to the termination of dividend distribution during the quarter ended September 30, 2003. Other liabilities also consist of accrued interest payable and accrued expenses and other liabilities. The Company anticipates settling all other liabilities within one year.

#### **Contractual Obligations**

At September 30, 2003, the Company had contractual obligations summarized below:

Contractual Obligations (dollars in thousands)	Total	Payments due by period			More than 5 years
		Less than 1 year	1 - 3 years	3 - 5 years	
Reverse repurchase principal payable	\$ 927,079	\$ 927,079			
Total	\$ 927,079	\$ 927,079			

**RESULTS OF OPERATIONS**

**Three Months Ended September 30, 2003 Compared To Three Months Ended September 30, 2002**

*Overview*





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For the quarter ended September 30, 2003, the Company's net loss was \$81,202,000, or \$(2.72) per common share on a basic and diluted basis, based on a weighted average of 29,857,000 shares outstanding. This compares to net income of \$9,496,000, or \$0.32 per common share on a basic and diluted basis, based on a weighted average shares outstanding of 29,857,000 and 29,992,000, respectively, for the three months ended September 30, 2002. The weighted average number of shares used to calculate net income per diluted share includes the effect of the assumed exercise of outstanding stock options. The primary reasons for the increase in net loss was due to a decrease in the net interest margin, realized losses on terminated interest rate swaps, and realized losses on the sale of fixed income securities available-for-sale.

### *Net Interest Income*



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Net interest income for the quarter ended September 30, 2003 was \$41,000, consisting of interest income on fixed income securities and cash balances less interest expense on reverse repurchase agreements and interest rate swaps, compared to \$24,478,000 for the quarter ended September 30, 2002, or a decrease of 100%. The decrease in net interest income was primarily due to a decrease in net interest margin, from 2.82%

for the quarter ended September 30, 2002 to (0.44)% for the quarter ended September 30, 2003. Changes in interest income and expense are primarily a function of changes in average effective interest rates on the Company's fixed income securities, reverse repurchase agreements and interest rate swaps, and changes in the average amount of those assets and liabilities outstanding during each year.

The following table reflects the average balances for each category of the Company's interest earning assets as well as the Company's interest bearing liabilities, with the corresponding effective rate of interest annualized:

**AVERAGE BALANCE AND RATE TABLE**

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(Dollars in thousands)

	For the Quarter Ended September 30, 2003		For the Quarter Ended September 30, 2002	
	Average Balance	Effective Rate	Average Balance	Effective Rate
<b>Interest-Earning Assets:</b>				
Fixed Income Securities	\$ 1,544,446	3.86%	\$ 3,372,586	6.37%
Cash and Cash Equivalents	23,229	0.77%	2,185	2.56%
Total Interest-Earning Assets	1,567,675	3.82%	3,374,771	6.37%
<b>Interest-Bearing Liabilities:</b>				
Reverse Repurchase Agreements	1,401,872	4.26%	3,293,219	3.55%
Net Interest-Earning Assets and Spread	\$ 165,803	(0.44)%	\$ 81,552	2.82%

The effective yield data is computed by dividing the annualized net interest income or expense, including the effect on interest expense of hedging transactions as applicable into the average daily balance shown.

The following table reflects the average balances for the Company's equity securities, with the corresponding effective dividend yield annualized:

**AVERAGE BALANCE AND RATE TABLE**

(Dollars in thousands)

	For the Quarter Ended September 30, 2003		For the Quarter Ended September 30, 2002	
	Average Balance	Effective Dividend Yield	Average Balance	Effective Dividend Yield
Equity securities	\$ 1,623	8.38%	\$ 3,931	10.79%

The following table shows the approximate amounts of the change in interest income and expense between 2003 and 2002 that was a function of rate and volume changes, and the amount of the change that cannot be ascribed specifically to either rate or volume changes:

**RATE / VOLUME TABLE**

(Dollars in thousands)

	Three Months Ended September 30, 2003 compared to 2002		
	Total Change	Changes Due to	
		Volume (1)	Rates (1)
<b>Interest-Earning Assets</b>			
Fixed income securities	\$ (38,778)	\$ (29,109)	\$ (9,669)
Cash and cash equivalents	31	135	(104)
<b>Total interest income</b>	<b>(38,747)</b>	<b>(28,974)</b>	<b>(9,773)</b>
<b>Interest-Bearing Liabilities</b>			
Reverse repurchase agreements	(14,310)	(16,791)	2,481
<b>Total interest expense</b>	<b>(14,310)</b>	<b>(16,791)</b>	<b>2,481</b>
<b>Change In Net Interest Income</b>	<b>\$ (24,437)</b>	<b>\$ (12,183)</b>	<b>\$ (12,254)</b>

(1) Changes in interest income/expense not arising from volume or rate variances are allocated proportionately to rate and volume.

A portion of the change in interest expense in the table above is related to the Company's use of interest rate swaps. Periodic settlements of the swap agreements with their counterparties result in adjustments to interest expense associated with the reverse repurchase agreements hedged by the swaps. During the quarter ended September 30, 2003, interest expense was increased by \$10,228,000 due to amounts paid to swap counterparties and \$791,000 from amortization of deferred losses on terminated swap contracts. During the quarter ended September 30, 2002, interest expense was increased by \$14,189,000 due to amounts paid to swap counterparties.

***Dividend Income***



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The Company reported dividend income of \$34,000 from dividends on equity investments for the quarter ended September 30, 2003, compared to \$106,000 for the quarter ended September 30, 2002. The decrease was due to the sale of the equity investments.

### *Net Gain (Loss) from Investment and Derivative Activities*

During the quarter ended September 30, 2003, the Company reported a net loss from investment and derivative activities of \$80,670,000 in the statement of operations. The loss consisted of a loss of 42,479,000 on terminated swaps, a loss of \$39,240,000 on the sale of \$1,509,557,000 of fixed income securities available-for-sale, a gain of \$1,455,000 on the sale of \$4,299,000 equity securities available-for-sale, and an unrealized loss of \$406,000 on fixed income trading securities.

During the quarter ended September 30, 2002, the Company reported a net loss from investment and derivative activities of \$15,645,000 in the statement of operations. This loss consisted of a net loss of \$31,878,000 on closed forward contracts, a gain of \$29,890,000 on the sale of \$887,838,000 of fixed income



trading securities, a gain of \$76,000 on the sale of \$242,000 of equity securities available-for-sale, and an unrealized loss of \$13,733,000 on fixed income trading securities.

*General and Administrative Expenses*



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General and administrative expenses increased to \$607,000 for the quarter ended September 30, 2003 from (\$557,000) for the quarter ended September 30, 2002. The primary reason for the increase was the increase in legal, accounting and other fee expenses associated with the professional services rendered in connection with the Company's pursuit of various strategic alternatives, including our proposed merger with American Home.

In the quarter ended September 30, 2003, the Company reversed the incentive fee recorded as expense year-to-date. Incentive fees are calculated based on year-to-date book earnings adjusted for certain items not subject to tax currently and return on equity relative to certain benchmarks. Because the Company had realized losses on terminated interest rate swap agreements and realized losses on the sale of fixed income securities available-for-sale, distributable income year-to-date through September 30, 2003 did not exceed the benchmark and accordingly the Company was not required to pay the Manager an incentive fee for the quarter ended September 30, 2003.

### **Nine Months Ended September 30, 2003 Compared To Nine Months Ended September 30, 2002**



*Overview*



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For the nine months ended September 30, 2003, the Company's net loss was \$58,442,000, or \$(1.96) per common share on a basic and diluted basis, based on a weighted average of 29,857,000 shares outstanding. This compares to net income of \$34,746,000, or \$1.39 per common share on a basic basis and \$1.38 on a diluted basis, based on a weighted average of 24,976,000 and 25,105,000 shares outstanding, respectively, for the nine months ended September 30, 2002. The weighted average number of shares used to calculate net income per diluted share includes the effect of the assumed exercise of outstanding stock options.

The primary reasons for the change in operating results for the nine months ended September 30, 2003 compared to 2002 are: (1) changes in interest rates and market conditions affecting the fair values of the Company's mortgage related securities and related derivative financial instruments and net interest income; and (2) related changes in investment and hedging strategies.

### *Net Interest Income*





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Net interest income for the nine months ended September 30, 2003 was \$11,983,000, consisting of interest income on fixed income securities and cash balances less interest expense on reverse repurchase agreements and interest rate swaps, compared to \$62,962,000 for the nine months ended September 30, 2002, or a decrease of 81%. The decrease in net interest income was primarily due to a decrease in net interest margin, from 3.04% for the nine months ended September 30, 2002 to 0.37% for the nine months ended September 30, 2003. Changes in interest income and expense are primarily a function of changes in average effective interest rates on the Company's fixed income securities, reverse repurchase agreements and interest rate swaps, and changes in the average amount of those assets and liabilities outstanding during each year.

The following table reflects the average balances for each category of the Company's interest earning assets as well as the Company's interest bearing liabilities, with the corresponding effective rate of interest annualized:

**AVERAGE BALANCE AND RATE TABLE**

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(Dollars in thousands)

	For the Nine Months Ended September 30, 2003		For the Nine Months Ended September 30, 2002	
	Average Balance	Effective Rate	Average Balance	Effective Rate
<b>Interest-Earning Assets:</b>				
Fixed Income Securities	\$ 2,078,309	4.65%	\$ 2,615,606	6.43%
Cash and Cash Equivalents	15,189	0.81%	6,442	1.80%
Total Interest-Earning Assets	2,093,498	4.63%	2,622,048	6.43%
<b>Interest-Bearing Liabilities:</b>				
Reverse Repurchase Agreements	1,898,640	4.26%	2,493,296	3.39%
Net Interest-Earning Assets and Spread	\$ 194,858	0.37%	\$ 128,752	3.04%

The effective yield data is computed by dividing the annualized net interest income or expense, including the effect on interest expense of hedging transactions as applicable into the average daily balance shown.

The following table reflects the average balances for the Company's equity securities, with the corresponding effective dividend yield annualized:

**AVERAGE BALANCE AND RATE TABLE**

(Dollars in thousands)

	For the Nine Months Ended September 30, 2003		For the Nine Months Ended September 30, 2002	
	Average Balance	Effective Dividend Yield	Average Balance	Effective Dividend Yield
Equity securities	\$ 3,068	10.26%	\$ 4,159	10.93%

The following table shows the approximate amounts of the change in interest income and expense between the nine months ended September 30 in 2003 and 2002 that was a function of rate and volume changes, and the amount of the change that cannot be ascribed specifically to either rate or volume changes:

**RATE / VOLUME TABLE**

(Dollars in thousands)

	Nine Months Ended September 30, 2003 compared to 2002		
	Total Change	Volume (1)	Rates (1)
<b>Interest-Earning Assets</b>			
Fixed income securities	\$ (53,686)	\$ (25,925)	\$ (27,761)
Cash and cash equivalents	5	118	(113)
<b>Total interest income</b>	<b>(53,681)</b>	<b>(25,807)</b>	<b>(27,874)</b>
<b>Interest-Bearing Liabilities</b>			
Reverse repurchase agreements	(2,702)	(15,107)	12,405
<b>Total interest expense</b>	<b>(2,702)</b>	<b>(15,107)</b>	<b>12,405</b>
<b>Change In Net Interest Income</b>	<b>\$ (50,979)</b>	<b>\$ (10,700)</b>	<b>\$ (40,279)</b>

(1) Changes in interest income/expense not arising from volume or rate variances are allocated proportionately to rate and volume.

A portion of the change in interest expense in the table above is related to the Company's use of interest rate swaps. Periodic settlements of the swap agreements with their counterparties result in adjustments to interest expense associated with the reverse repurchase agreements hedged by the swaps. During the nine months ended September 30, 2003, interest expense was increased by \$38,015,000 paid to swap counterparties and \$4,559,000 from amortization of deferred losses on terminated swap contracts. During the nine months ended September 30, 2002, interest expense was increased by \$29,342,000 paid to swap counterparties and decreased by \$180,000 from amortization of deferred gains on terminated swap contracts.

**Dividend Income**



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The Company reported dividend income of \$236,000 from dividends on equity investments for the nine months ended September 30, 2003, compared to \$341,000 for the nine months ended September 30, 2002. The decrease in dividend income was due to the sale of our equity investments.

### *Net Gain (Loss) from Investment and Derivative Activities*

During the nine months ended September 30, 2003, the Company reported a net loss on investment and derivative activities of \$66,592,000 in the statement of operations. The loss consisted of a loss of \$42,479,000 on terminated swaps, a net loss of \$24,153,000 on the sale of \$2,257,126,000 of fixed income securities available-for-sale, a gain of \$5,424,000 on the sale of \$432,761,000 of fixed income trading securities, a gain of \$1,455,000 on the sale of \$4,299,000 of equity securities available-for-sale, and an unrealized loss of \$6,839,000 on fixed income trading securities.

During the nine months ended September 30, 2002, the Company reported a net loss on investment and derivative activities of \$26,097,000 in the statement of operations. This loss consisted of a net loss of

\$55,800,000 on closed forward contracts, a loss of \$229,000 on the sale of \$98,634,000 of fixed income securities available-for-sale, a gain of \$29,907,000 on the sale of \$894,372,000 of fixed income trading securities, a gain of \$594,000 on the sale of \$1,937,000 of equity securities available-for-sale, and an unrealized loss of \$569,000 on fixed income trading securities.

*General and Administrative Expenses*





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General and administrative expenses increased to \$4,069,000 for the nine months ended September 30, 2003 from \$2,460,000 for the nine months ended September 30, 2002. The increase was primarily due to an increase in legal, accounting and other fee expenses associated with the professional services rendered in connection with the Company's pursuit of various strategic alternatives, including our proposed merger with American Home.

### LIQUIDITY AND CAPITAL RESOURCES

The Company's primary sources of funds as of September 30, 2003 and December 31, 2002, consisted of reverse repurchase agreements totaling \$927,079,000 and \$2,112,444,000, respectively. The Company expects to continue to borrow funds in the form of reverse repurchase agreements. At September 30, 2003, the Company had borrowing arrangements with approximately twenty different investment banking firms. Increases in short-term interest rates could negatively impact the valuation of the Company's mortgage assets, which could limit the Company's borrowing ability or cause its lenders to initiate margin calls.

For liquidity, the Company will also rely on the cash flow from operations, primarily monthly principal and interest payments to be received on the mortgage assets.

The Company believes that equity capital, combined with the cash flow from operations and the utilization of borrowings, will be sufficient to enable the Company to meet anticipated liquidity requirements. However, an increase in prepayment rates substantially above the Company's expectations could cause a liquidity shortfall. If the Company's cash resources are at any time insufficient to satisfy the Company's liquidity requirements, the Company may be required to liquidate mortgage assets, sell debt or additional equity securities or borrow money to meet its obligations. If required, the sale of mortgage assets at prices lower than the carrying value of such assets would result in losses and reduced income.

The Company may in the future increase its capital resources by making additional offerings of equity and debt securities, including classes of preferred stock, common stock, commercial paper, medium-term notes, collateralized mortgage obligations and senior or subordinated notes. All debt securities, other borrowings, and classes of preferred stock will be senior to the common stock in a liquidation of the Company. The effect of additional equity offerings may be the dilution of stockholders' equity in the Company or the reduction of the price of shares of the common stock, or both. The Company is unable to estimate the amount, timing or nature of any additional offerings as they will depend upon market conditions and other factors.

### INFLATION

Most of the Company's assets and liabilities are financial in nature. As a result, interest rates and other factors drive the Company's performance far more so than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and the Company's dividends are determined by the Company's net income as calculated for tax purposes; in each case, the Company's activities and balance sheet are measured with reference to historical cost and or fair market value without considering inflation.

### **CRITICAL ACCOUNTING POLICIES**

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. The financial information contained within these financial statements is, to a significant extent, financial information that is based on approximate measures of the financial effects of transactions and events that have already occurred. Based on its consideration of accounting policies that involve complex and subjective decisions and assessments, management has identified its most critical accounting policies to be the following:

#### *Classifications of Investment Securities*



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The Company's investment securities are classified as either trading securities or available-for-sale securities, as discussed in Note 3 to the financial statements. Although all of the Company's investment securities are carried on the balance sheets at fair value, the classification of the securities as trading or as available-for-sale determines whether changes in fair value are recorded immediately through current earnings, as they are for trading securities, or as adjustments to accumulated other comprehensive income (loss), which is a component of stockholders' equity, as they are for available-for-sale securities. If available-for-sale securities were classified as trading securities, there could be substantially greater volatility in earnings from period-to-period.

### *Valuations of Investment Securities*



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As noted above, all investment securities are carried on the balance sheets at fair value. Some of the Company's securities, particularly the equity securities, have readily determinable fair values based on quotes provided from recognized securities exchanges. However, most of the Company's fixed income securities have fair values determined by management with reference to price estimates provided by dealers in the securities, independent pricing services, and other sources. Because the price estimates may vary to some degree between sources, management must make certain judgments and assumptions about the appropriate price to use to calculate the fair values for financial reporting purposes. Different judgments and assumptions could result in different presentations of value.

When the fair value of an available-for-sale security is less than amortized cost, management considers whether there is an other-than-temporary impairment in the value of the security (e.g., whether the security will be sold prior to the recovery of fair value). If, in management's judgment, an other-than-temporary impairment exists, the cost basis of the security is written down to the then-current fair value, and the unrealized loss is transferred from accumulated other comprehensive income as an immediate reduction of current earnings (i.e., as if the loss had been realized in the period of impairment).

### *Interest Income and Dividend Recognition*

Interest income on the Company's mortgage securities and other fixed income securities is accrued based on the actual coupon rate and the outstanding principal amount. Premiums and discounts are amortized or accreted into interest income over the lives of the securities using the effective yield method adjusted for the effects of estimated prepayments. In the event that the cost basis of a security has been reduced below par because of an other-than-temporary impairment in value, the difference is treated like a discount in determining the appropriate amount of accretion to recognize as interest income between the date when the cost is adjusted and when the security is ultimately sold. Also, dividends on equity securities are recognized as income on their declaration dates.

*Accounting for Derivative Financial Instruments and Hedging Activities*





In recent periods the Company has used two types of derivative financial instruments, as discussed in Notes 2 and 5 to the financial statements. Both types are used fundamentally for the purpose of hedging the Company's exposure to interest rate risk, and both are carried at fair value on the balance sheets. Forward contracts to sell U.S. Treasury securities are matched against a portion of the Company's fixed income trading securities. These contracts do not qualify for hedge accounting and, therefore, changes in fair values of these instruments are recorded immediately through current earnings. Such changes tend to offset fair value changes in the opposite direction for the fixed income trading securities and help to reduce the volatility of periodic earnings. Interest rate swap agreements are matched against a portion of the Company's current and anticipated reverse repurchase agreements (borrowings), effectively fixing the rate of interest paid on those borrowings for longer durations. These instruments qualify for hedge accounting and are considered to be cash flow hedges. To the extent that periodic changes in fair values of the swap agreements are deemed to be the result of their effectiveness as hedges, such changes are recorded as adjustments to accumulated other comprehensive income, a component of stockholders' equity, rather than to current earnings. If the swaps no longer qualified as cash flow hedges (for example, if the terms of the swaps were not matched appropriately to the terms of the borrowings, or if anticipated borrowings matched to the swaps were not in fact made) all or a portion of the swaps' fair values could become adjustments to current earnings.

*Accounting for Stock Options*



The Company issues stock options to its directors and to certain employees of the Manager. The stock options issued to directors are accounted for using the intrinsic-value method. Because the options were issued with exercise prices no less than the market price of the Common Stock on the dates of grant, and because the stock options key terms are fixed, use of the intrinsic-value method results in the Company not recognizing compensation expense for these stock options. Note 2 to the financial statements discloses the effects on recent earnings if these stock options were accounted for at fair value when granted and if compensation expense were recognized in periodic earnings over the vesting periods of the options. If the terms of the options were to be changed, variable accounting might need to be used, and the Company might then need to begin recognizing compensation expense for these options. Options granted to persons other than directors (i.e., to non-employees) are accounted for using the fair value method; such stock options are measured at their fair value when they are granted and are recognized as general and administrative expense during the periods when the options are vested and the related services are performed.

ITEM 3. **QUANTITATIVE AND QUALITATIVE  
DISCLOSURES ABOUT MARKET RISK**

**MARKET RISK**

The Company's two primary components of market risk are interest rate risk and equity price risk, as discussed below.

**Interest Rate Risk**



*Effect on Net Interest Income.* The Company invests in fixed-rate mortgage assets, among other mortgage assets, that are funded with short-term borrowings. During periods of rising interest rates, the borrowing costs associated with funding such fixed-rate assets are subject to increase while the income earned on such assets may remain substantially unchanged. This would result in a narrowing of the net interest spread between the related assets and borrowings and may even result in losses. The Company may enter into derivative transactions seeking to mitigate the negative impact of a rising interest rate environment. Hedging techniques will be based, in part, on assumed levels of prepayments of the Company's mortgage assets. If prepayments are slower or faster than assumed, the life of the mortgage assets will be longer or shorter which would reduce the effectiveness of the Company's hedging techniques and may result in losses on such

transactions. Hedging techniques involving the use of derivative securities are highly complex and may produce volatile returns. The hedging activity of the Company will also be limited by the asset and sources of income requirements applicable to the Company as a REIT.

*Extension Risk.* Fixed-rate assets are generally acquired with a projected weighted average life based on certain assumptions regarding prepayments. In general, when a fixed-rate mortgage asset is acquired with borrowings, the Company may, but is not required to, enter into an interest rate swap agreement or other hedging instrument that effectively fixes the Company's borrowing costs for a period close to the anticipated average life of the related asset. This strategy is designed to protect the Company from rising interest rates because the borrowing costs are fixed for the duration of the asset. However, if prepayment rates decrease in a rising interest rate environment, the life of the mortgage asset could extend beyond the term of the swap agreement or other hedging instrument. This situation could negatively impact the Company as borrowing costs would no longer be fixed after the end of the hedging instrument while the income earned on the asset would remain fixed. This situation may also cause the market value of the Company's mortgage assets to decline with little or no offsetting gain from the related hedging transactions. In certain situations, the Company may be forced to sell assets and incur losses or borrow money to maintain adequate liquidity.

*Prepayment Risk.* Fixed-rate assets in combination with hedging instruments are also subject to prepayment risk. In falling interest rate scenarios, the fixed-rate mortgage assets may prepay faster such that the average life becomes shorter than its related hedging instrument. If this were to happen, the Company would potentially need to reinvest at rates lower than that of the related hedging instrument. This situation may result in the narrowing of interest rate spreads and may cause losses.

Prepayment rates generally increase when prevailing interest rates fall below the interest rates on existing mortgage assets. In addition, prepayment rates generally increase when the difference between long-term and short-term interest rates declines. Prepayments of mortgage assets could harm the Company's results of operations in several ways. The Company anticipates that a substantial portion of its adjustable-rate mortgage assets may bear initial "teaser" interest rates that are lower than their "fully indexed" rates (the applicable index plus a margin). In the event that such an adjustable-rate mortgage asset is prepaid prior to or soon after the time of adjustment to a fully indexed rate, the Company will have held the mortgage asset while it was less profitable and lost the opportunity to receive interest at the fully indexed rate over the expected life of the adjustable-rate mortgage asset. In addition, the prepayment of any mortgage asset that had been purchased at a premium by the Company would result in the immediate write-off of any remaining capitalized premium amount and consequent reduction of the Company's net interest income by such amount. Finally, in the event that the Company is unable to acquire new mortgage assets to replace the prepaid mortgage assets, its financial condition, cash flow and results of operations could be harmed.

*Forward Contract Risk.* The Company may also enter in forward contracts to sell U.S. Treasury notes in addition to or instead of interest rate swap agreements. These forward contracts are generally expected to mitigate the impact of rising interest rates on the fair value of the Company's fixed income securities. However, if the duration mismatch between mortgage securities and U.S. Treasury notes were to widen, which could occur in both a rising and falling interest rate environment, the fair value of the Company's portfolio would generally be expected to decline. In addition, the use of forward contracts to sell U.S. Treasury notes generally does not directly impact borrowing costs in the same manner as interest rate swap agreements. Therefore, the use of such forward contracts could result in net income volatility during periods of interest rate volatility.

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The Company also invests in adjustable-rate mortgage assets that are typically subject to periodic and lifetime interest rate caps that limit the amount an adjustable-rate mortgage asset's interest rate can change during any given period, as well as the minimum rate payable. The Company's borrowings will not be subject to similar restrictions. Hence, in a period of increasing interest rates, interest rates on its borrowings could increase without limitation by caps, while the interest rates on its mortgage assets are generally limited by caps. This problem will be magnified to the extent the Company acquires mortgage assets that are not fully



indexed. Further, some adjustable-rate mortgage assets may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding. This could result in receipt by the Company of less cash income on its adjustable-rate mortgage assets than is required to pay interest on the related borrowings. These factors could lower the Company's net interest income or cause a net loss during periods of rising interest rates, which would negatively impact the Company's financial condition, cash flows and results of operations.

The Company funds a substantial portion of its acquisitions of adjustable-rate mortgage assets with borrowings that have interest rates based on indices and repricing terms similar to, but of somewhat shorter maturities than, the interest rate indices and repricing terms of the mortgage assets. Thus, the Company anticipates that in most cases the interest rate indices and repricing terms of its mortgage assets and its funding sources will not be identical, thereby creating an interest rate mismatch between assets and liabilities. While the historical spread between relevant short-term interest rate indices has been relatively stable, there have been periods, especially during the 1979-1982 and 1994 interest rate environments, when the spread between such indices was volatile. During periods of changing interest rates, such interest rate mismatches could negatively impact the Company's financial condition, cash flows and results of operations.

*Effect on Fair Value.* Another component of interest rate risk is the effect changes in interest rates will have on the market value of the Company's assets. This is the risk that the market value of the Company's assets will increase or decrease at different rates than that of the Company's liabilities, including its hedging instruments.

The Company primarily assesses its interest rate risk by estimating the duration of its assets and the duration of its liabilities, including all hedging instruments. Duration essentially measures the market price volatility of financial instruments as interest rates change. The Company generally calculates duration using various financial models and empirical data and different models and methodologies can produce different duration numbers for the same securities.

The following sensitivity analysis table shows the estimated impact on the fair value of the Company's interest rate sensitive investments, net of its hedging instruments and reverse repurchase agreement liabilities, assuming rates instantaneously rise and fall one hundred, two hundred, and three hundred basis points. Interest rate sensitive investments currently include fixed income trading and available-for-sale securities. (Dollars are in thousands except per share amounts.)

	Fair Value for Scenario Shown						
	Interest Rates Fall 300 Basis Points	Interest Rates Fall 200 Basis Points	Interest Rates Fall 100 Basis Points	Unchanged	Interest Rates Rise 100 Basis Points	Interest Rates Rise 200 Basis Points	Interest Rates Rise 300 Basis Points
Interest Rate Sensitive Instruments After Hedging Instruments	\$ 317,917	\$ 343,333	\$ 370,477	\$ 380,535	\$ 363,247	\$ 332,887	\$ 297,938
Change in Fair Value	\$ (62,618)	\$ (37,202)	\$ (10,058)		\$ (17,288)	\$ (47,648)	\$ (82,597)
Change as a Percent of Fair	(4.59)%	(2.72)%	(0.74)%		(1.27)%	(3.49)%	(6.05)%

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Value of Interest Rate Sensitive Investments												
Change as a Percent of Stockholders Equity	(38.16)%	(22.67)%	(6.13)%	(10.54)%	(29.04)%	(50.33)%						
Change on a Per Share Basis	\$ (2.10)	\$ (1.25)	\$ (0.34)	\$ (0.58)	\$ (1.60)	\$ (2.77)						

It is important to note that the impact of changing interest rates on fair value can change significantly when interest rates change beyond one hundred basis points from current levels. Therefore, the volatility in fair value for the Company could increase significantly when interest rates change beyond one hundred basis points. In addition, there are other factors that impact the fair value of the Company's interest rate sensitive investments and hedging instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, there may be differences between the fair value changes shown above and actual changes in fair value as interest rates change, and those differences may be material and adverse.

The Company has established an interest rate risk management policy that is intended to mitigate the negative impact of changing interest rates. The Company generally intends to mitigate interest rate risk by targeting the difference between the market weighted average duration on its mortgage related assets funded with secured borrowings to the market weighted average duration of such borrowings to plus or minus one year or less, taking into account all hedging transactions. The Company generally does not intend to have any specific duration target for the portion of its mortgage related assets that are not funded by secured borrowings.

There can be no assurance that the Company will be able to limit such duration differences and there may be periods of time when the duration difference will be greater than one year.

Although there is no direct link between changes in fair value and changes in earnings in many cases, a decline in fair value for the Company may translate into decreased earnings over the remaining life of the investment portfolio.

If the fair market value of the Company's portfolio were to decline significantly, the Company's overall liquidity may be impaired which could result in the Company being required to sell assets at losses.

**The Company's analysis of risks is based on management's experience, estimates, models and assumptions. These analyses rely on models of financial information which utilize estimates of fair value and interest rate sensitivity. Actual economic conditions or implementation of investment decisions by the Manager may produce results that differ significantly from the estimates and assumptions used in the Company's models and the projected results shown in the above tables and in this report. These analyses contain certain forward-looking statements and are subject to the Safe Harbor contained in the Private Securities Litigation Reform Act of 1995.**

ITEM 4.

## **CONTROLS AND PROCEDURES**

As of September 30, 2003, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon the foregoing, our Chief Executive Officer and our Chief Financial Officer concluded that as of September 30, 2003, our disclosure controls and procedures are effective in timely alerting them to material information relating to our Company (including our consolidated subsidiaries) required to be included in our Exchange Act reports. There have been no significant changes in our internal controls or in other factors which could significantly affect internal controls subsequent to the date we carried out our evaluation.

**PART II.**

## **OTHER INFORMATION**



ITEM 1.

# LEGAL PROCEEDINGS





None.

**ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS**

**First Amendment to Shareholder Rights Agreement**

Previously, our board of directors adopted a shareholder rights plan, pursuant to which we issued to holders of our common stock certain preferred stock purchase rights. The terms and conditions of these rights are set forth in a Shareholder Rights Agreement dated as of July 19, 1999, by and between the Company and The Bank of New York, as the Rights Agent. On July 15, 2003, the Company and The Bank of New York executed a First Amendment to our original Rights Agreement. The First Amendment amends the definition of "Exempt Person" as used in the original Rights Agreement to include American Home Mortgage Holdings, Inc. and AHM New Holdco, Inc. and their respective affiliates until such time as the agreement and plan of merger, which we entered into on July 12, 2003 with such parties, is terminated in accordance with its terms. In all other respects, the original Rights Agreement remains in full force and effect and unmodified.

ITEM 3.

## **DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

ITEM 5.

## **OTHER INFORMATION**

None.

ITEM 6.

## **EXHIBITS AND REPORTS ON FORM 8-K**



a) ***Exhibits***

The exhibits listed on the Exhibit List, which appears below following the signature page, are included or incorporated by reference in this Quarterly Report.

b) ***Reports on Form 8-K***



On August 14, 2003, we filed a Current Report on Form 8-K with the SEC, announcing our earnings for the second quarter of 2003.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Apex Mortgage Capital, Inc.  
(Registrant)

Dated: November 14, 2003

/s/ Philip A. Barach  
Philip A. Barach  
President and Chief Executive Officer  
(Principal Executive Officer)

Dated: November 14, 2003

/s/ David S. DeVito  
David S. DeVito  
Chief Financial Officer  
(Principal Accounting Officer)

**EXHIBIT INDEX**

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Pursuant to Item 601 (a)(2) of Regulation S-K, this exhibit index immediately precedes the exhibits.

The following exhibits are part of this Quarterly Report on Form 10-Q and are numbered in accordance with Item 601 of Regulation S-K.

<b>Exhibit No.</b>	<b>Description</b>
2.1	Agreement and Plan of Merger dated as of July 12, 2003, by and among American Home Mortgage Holdings, Inc., American Home Mortgage Investment Corp. (formerly called AHM New Holdco, Inc.), and Apex Mortgage Capital, Inc. (previously filed as Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the Commission on July 15, 2003 and incorporated herein by reference).
3.1	Articles of Amendment and Restatement of the Company, as filed with the State Department of Assessments and Taxation of Maryland on November 25, 1997, (previously filed as Exhibit 3.1 to the Company's Registration Statement on Form S-11 (Commission File No. 333-36069) Amendment No. 3 filed with the Commission on November 21, 1997 and incorporated herein by reference).
3.2	Articles Supplementary relating to the Company's Series A Junior Participating Preferred Stock, as filed with the State Department of Assessments and Taxation of the State of Maryland on July 26, 1999 (previously filed as Exhibit 3.1 to the Company's Current Report on Form 8-K, dated June 30, 1999 and filed with the Commission on July 27, 1999, and incorporated herein by reference).
3.3	Amended and Restated Bylaws of the Company as currently in effect (previously filed as Exhibit 4.4 to the Company's Registration Statement on Form S-2, Commission File No. 333-73448, Amendment No. 1, and filed with the Commission on November 27, 2001 and incorporated herein by reference).
4.1	Form of Share Certificate for Common Stock (previously filed as Exhibit 4.3 to the Company's Current Report on Form 8-K, dated June 30, 1999 and filed with the Commission on July 27, 1999, and incorporated herein by reference).
4.2.1	Shareholder Rights Agreement between the Company and The Bank of New York, as Rights Agent (including as Exhibit B the form of Rights Certificate)(previously filed as Exhibit 4.1 to the Company's Current Report on Form 8-K, dated June 30, 1999 and filed with the Commission on July 27, 1999, and incorporated herein by reference).
4.2.2	First Amendment to Shareholder Rights Agreement dated as of July 15, 2003, by and between Apex Mortgage Capital, Inc. and The Bank of New York (previously filed as Exhibit 4.1 to the Company's Current Report on Form 8-K filed with the Commission on July 15, 2003 and incorporated herein by reference).

- 31.1\* Certification of Philip A. Barach under Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* Certification of David S. DeVito under Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\* Certification of Philip A. Barach under Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2\* Certification of David S. DeVito under Section 906 of the Sarbanes-Oxley Act of 2002.

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\* Filed herewith.