



# Newtek Business Services, Inc.

## (NKBS-\$3.78)

**STRONG BUY**

**FINANCIAL SERVICES**

**JULY 9, 2004**

**INITIATING COVERAGE**

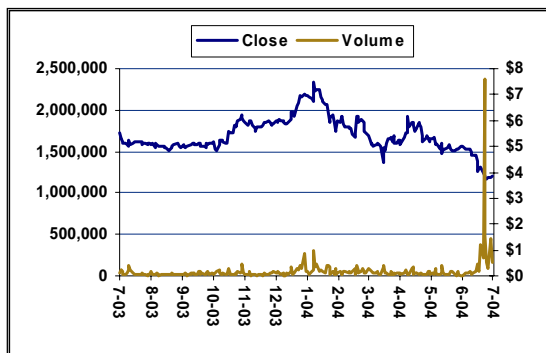
### What a long strange trip it's been...

Earnings Per Share (\$)		
FY End: Dec		Price/Earnings
2003A	\$0.36	10.5x
2004E	\$0.32	11.8x
2005E	\$0.40	9.5x

Revenues (\$millions)		
FY End: Dec		Price/Revenue
2003A	\$60.5	2.1x
2004E	\$71.2	1.8x
2005E	\$99.1	1.3x

Market Data	
Price 07/08/04	\$3.78
52-Week Range	\$3.64 - \$7.95
Est. 3-Yr. EPS Growth	25%
Market Cap. (\$MM)	\$126.3
Shares Out (MM)	33.4
Float (MM)	18.5
Avg. Daily Volume	103,577
S&P 500	1,109.1

Capitalization Data	
L/T Debt (MM)	\$62.9
Equity (MM)	\$40.7
Debt/Equity	154.6%
Book Value/Share	\$1.53
Cash/Share	\$1.70



Disclosure(s): a, b, i

- We believe fragmentation in the small to medium-sized business (SMB) market creates a significant opportunity for a "one-stop shop" that can deliver a variety of products crucial to the success of SMBs
- In our estimation, Newtek Business Services has emerged as just such a provider
- We are projecting that Newtek can advance EPS at approximately 25% per year, on average, over much of the next 3 to 5 years, or 2.5x the long-term consensus for the S&P 500
- Despite the potential for above-average growth, NKBS shares trade at less than 10x our estimate of 2005 EPS
- We attribute this anomaly to Newtek's original financing vehicles--capcos--which are difficult to understand and generate non-cash GAAP revenue and income long after the economic value associated with them has been created in our opinion
- Even ignoring this income and assigning a value to each of NKBS' component businesses, which all have publicly traded peers, we arrive at an overall estimate of fair value of just over \$6.00 (Table 5)
- A discounted cash flow analysis yields a remarkably similar result (Table 6); thus, we have a 12-month price target of \$6.00
- At that value there is a potential return of 59% from the levels at which NKBS now trades
- We have identified a number of catalysts for these shares; when considered with the 59% upside potential, we are initiating coverage with a Strong Buy rating

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## INVESTMENT THESIS

The SMB, or small to medium-sized business, market is considered by many to be the engine of the U.S. economy. According to the U.S. Small Business Administration (SBA), there were approximately 22.9 million small businesses in the U.S. in 2002, representing 99.7% of all employers. These businesses accounted for more than 50% of private sector employment and nonfarm private gross domestic product<sup>1</sup>. Small businesses also represented 97% of U.S. exporters<sup>2</sup>. Most significant, in our estimation, is that small businesses provide approximately 75% of net new jobs added to the economy<sup>3</sup>.

The vendors serving the SMB market, mostly small businesses themselves, tend to be local and monoline (providing a single product or group of products). We believe this fragmentation creates a significant opportunity for a “one-stop shop” that can cost-effectively distribute a set of value-added small business solutions nationally and deliver them locally. Newtek Business Services has, in our opinion, emerged as just such a provider. Pending the acquisition of CrystalTech Web Hosting, Inc., one of the largest Microsoft® Windows-based web hosting companies in the world<sup>4</sup>, Newtek will be able to offer small businesses a unique set of products and services we deem critical not only for their success, but often their very survival. In addition to web hosting, these include SBA loans and electronic payment processing.

The only real competitor in the national SMB arena is American Express’ OPEN: The Small Business Network™, which provides financing tools, such as charge and credit cards, lines of credit, and business loans. American Express, however, does not offer other essential business services like business insurance or IT solutions. We know of no other large provider of financial and business services that attempts to deliver a complete array of high quality products affordably to the SMB market nationwide. Most of these organizations appear to gear their marketing strategies toward the Fortune 1000 or other large companies. Many seem to have concluded that there is no cost-effective way to market to and serve small businesses on a nationwide basis. Although we do not perceive the SMB market to be underserved—there is no shortage of suppliers—we do feel there is a natural opening for firms like Newtek that can provide a range of essential small business products and services through one commissioned salesperson.

Given these opportunities—and the acquisitions the company is likely to make—we believe Newtek Business Services can increase its earnings at an average annual rate of 25% a year for much of the foreseeable future, which is 2.5x the 10% per annum earnings growth expected of the S&P 500 (which we use as a proxy for the overall market) over the next five years<sup>5</sup>. Our 2004 and 2005 EPS estimates of \$0.32 and \$0.40 are consistent with that belief. The company’s above-average earnings growth potential notwithstanding, NKBS shares trade at less than 10x our estimate of 2005 EPS. Weighing on the valuation of the company’s shares, in our estimation, are the firm’s narrow float, thin trading volumes and, until a recently completed follow-on offering of common stock, lack of institutional ownership. Additionally, we do not believe the market is giving the company any credit for its non-cash income from realization of tax credits. This revenue item—as well as the accompanying interest and insurance expense—can be traced to Newtek’s use of capital companies or “capcos” to provide seed money for some of its component businesses during the first few years of its history (see Capcos and Background). Although we feel that most of the economic value arising from the use of a capco is created upon its inception—which is also when most of the cash flows associated with the transaction take place—GAAP requires that the related revenue and expense be recognized over time as the tax credits allocated by the sponsoring state are “earned” and delivered to insurance company investors.

In our view, this treatment not only gives rise to a timing mismatch between the value-added activity and reported earnings, but also obscures the performance of Newtek’s operating businesses, which can be assigned a value because there are comparable publicly traded peers. Using the “sum-of-the-parts” approach summarized in Table 5—which excludes the projected contribution of the capcos to reported earnings in 2005—we arrive at an estimate of fair value of NKBS of slightly more than \$6.00. This estimate of fair value does, however, take into consideration the \$20 million, net, we anticipate the company will be able to raise

<sup>1</sup> U.S. Small Business Administration, U.S. Bureau of the Census, Advocacy-funded research by Joel Popkin and Company (Research Summary #211), Advocacy-funded research by CHI Research, Inc (Research Summary #225), Bureau of Labor Statistics, Current Population Survey, U.S. Department of Commerce, and International Trade Association.

<sup>2</sup> Ibid.

<sup>3</sup> Ibid.

<sup>4</sup> Netcraft, a prominent independent Internet consulting firm in the United Kingdom.

<sup>5</sup> Bloomberg.

through the formation of two new capcos in Washington, D.C. and Texas. Assuming the capital can be deployed at rates of return similar to those of Newtek's operating businesses, the money raised in organizing a capco is no less a driver of future earnings growth than the earnings retained from those businesses.

To validate our estimate of fair value, we performed a discounted cash flow analysis (see Table 6), producing a remarkably similar result (Table 6). We have, therefore, established \$6.00 as our 12-month price target. At that valuation, NKBS would provide a return of nearly 60% to those investors buying in at current prices.

As implied by our price target and the potential return it provides, we believe there is significant opportunity for new investors. Assuming the proposed acquisition of CrystalTech is completed as contemplated, the company will sport a unique set of products and services tied together by a single strategic theme—that of providing what we consider the services needed for the success of most small businesses at an affordable cost. We believe this theme will become clearer as the Newtek's operating businesses gain more visibility. If our projections are accurate, capco revenue will decline to 51% of the total this year and 39% next year, down from 95% in 2002 and 77% in 2003. Similarly, we expect the capcos' contribution to pretax income to fall to 61% in 2004 and 41% in 2005; the comparable figures for 2002 and 2003 were 118% and 101%, respectively. Because the company plans to reduce its reliance on the capcos for both capital and revenue, we believe their contribution to both revenue and earnings will fall off even more sharply in 2006 and beyond. We believe that as Newtek completes the transformation from "investor" to "operator" and its component businesses become more visible, many market participants will use an approach similar to our own because there are publicly traded peers. Finally, the recently completed secondary offering provided NKBS with much needed institutional sponsorship. Although institutions will still hold only about 25% of the shares outstanding by our estimates, that is up considerably from 13.5% before the offering. Also, many of the company's existing institutional investors were passive investors—indexers or custodians holding a broad basket of stocks that mimicked the performance of the major market indices. We believe the company's new investors are considerably more active and active investors may come to represent the bulk of Newtek's institutional ownership. Although not confirmed, we believe the company was dropped from the Russell 3000, based on data provided by Russell. In light of this deletion from the index, many of the company's existing institutional holders may trim or liquidate their position in NKBS. We actually regard the deletion as a positive event. If Newtek meets or exceeds our expectations, we believe the company and its shares can only benefit from active institutional ownership. In our opinion, any one or a combination of these developments—acquisition of CrystalTech, increasing visibility of the operating businesses, diminishing dependence on the capcos, increasing institutional sponsorship, and meeting/exceeding both internal goals and investor expectations—could serve as a catalyst for NKBS shares. When taken into consideration with the 59% return implied by our price target, we are initiating coverage of NKBS shares with a Strong Buy rating.

## RECENT EVENTS

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**June 29, 2004.** Newtek announced it had priced 6,000,000 shares of common stock at \$3.60 a share, raising gross proceeds of approximately \$21.6 million for the company. The company granted the underwriters an option to purchase up to 900,000 additional shares to cover overallotments, one-half of which would be sold by the company and the balance by certain selling shareholders. If exercised, the overallotment option would generate another \$1.6 million in gross proceeds for Newtek.

**June 28, 2004.** The company reported that its Newtek Small Business Finance unit had extended its warehouse line of credit by one year to June 30, 2005. The company and its lender also agreed to a possible increase of up to \$25 million, bringing the total facility to \$100 million, under certain conditions. The amended warehouse line of credit agreement also contained adjustments to the terms of the advances and required reserves, additional financial and non-financial covenants and a commitment from Newtek Small Business Finance to obtain an additional \$10 million in financing from other sources by August 2, 2004. Absent such financing, Newtek would be required to make a debt or equity infusion of at least \$10 million to support the lending activities of the small business finance unit. If the company fails to arrange third party financing or provide an infusion of \$10 million into Newtek Small Business Finance, it could be considered in default of the terms of the new warehouse facility.

**May 5, 2004.** Newtek reported a net loss of \$0.06 a share for the first three months of 2004, \$0.03 ahead of the one estimate posted to Thomson's First Call. In the comparable quarter of 2003, the company reported a

net profit of \$0.07 a share. The loss and unfavorable comparison to first quarter 2003 results was attributable to the revenue recognized upon earning tax credits in Newtek's capcos, which can exhibit a high degree of variation. In the press release announcing first quarter earnings, however, company officials did indicate that they were anticipating profitability for the remainder of the year.

**April 28, 2004.** The company announced that it had signed an agreement to acquire CrystalTech Web Hosting, Inc. At the time of the announcement, CrystalTech had approximately 26,000 clients, 80% of which were small to medium-sized businesses. The acquisition would greatly enhance Newtek's ability to cross-market its growing menu of business and financial services to a large, pre-existing customer base. Under terms of the agreement, Newtek would pay CrystalTech's owners and investors up to \$13.5 million, including \$10 million in cash upon closing. Among a number of other conditions, completion of the transaction was subject to the condition that Newtek obtain financing of at least \$12 million, \$10 million of which would be used to satisfy the upfront cash portion of the purchase price.

## CAPCOS

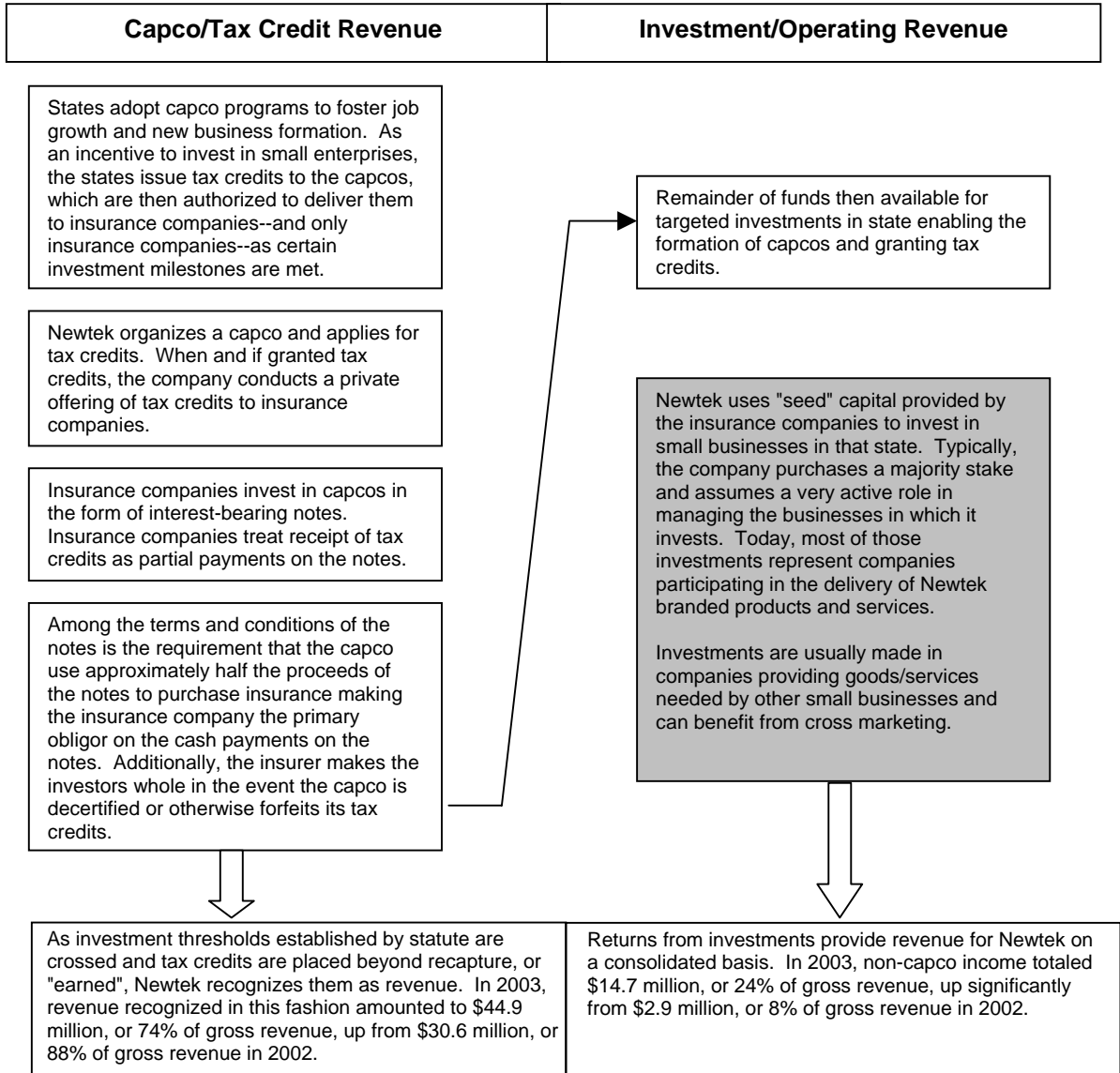
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A certified capital company, or capco, is either a corporation or limited liability company organized and chartered in one of nine states that currently have enabling legislation: Alabama, Colorado, District of Columbia, Florida, Louisiana, Missouri, New York, Texas and Wisconsin. In some respects, capcos can be viewed as a government-sponsored enterprise—similar to Fannie Mae, Freddie Mac, Sallie Mae, Farmer Mac—in that the state governments are using the structures to funnel private investment into projects that advance public policy objectives. In this particular case, the states sponsoring the capcos are attempting to promote job growth and the formation of new businesses by providing tax credits to insurance companies writing premiums in those states. It should be remembered that only insurance companies can utilize the tax credits allocated to the capcos.

In general, the process is as follows. State governments issue tax credits to the capcos, which, in turn, issue equity and debt instruments to insurance companies. In addition to interest earned on the debt instruments and, hopefully, increases in the market value of their equity stakes, the insurance companies receive credits that can be applied to the taxes on premiums written in those states sponsoring capco programs. In most cases, the tax credits provided by the states are equal in dollar amount to the size of the investment(s) made by the insurance companies. Before the tax credits can be delivered to the insurance companies, the capcos must achieve certain investment milestones. In New York, for instance, a capco must invest at least 25% of its certified capital within 24 months of the initial investment date, 40% within 36 months and 50% within 48 months. The minimum requirements are calculated on a cumulative basis and the capcos may re-invest any returns they earn on their investments in the intervening months and years. Re-invested returns count toward meeting the minimum investment requirements and receive the same credit as funds originally provided by the insurance companies. In addition to meeting investment thresholds within well-defined timeframes, capcos must make their investments in qualifying organizations, the attributes of which—like the milestones themselves—will vary from state to state. These requirements will include restrictions on the initial size of the organizations financed, the number of employees, the location in the state of the organization's principal place of business, the organization's commitment to remaining therein for a specified period of time, the types of business conducted, and the terms of the investments in the organizations. As the companies organizing the capcos "earn" tax credits by crossing the various investment thresholds, they recognize the dollar amount of those credits as income and the tax credits become deliverable to the insurance companies, typically at some date in the future. The insurance companies can utilize the tax credits over no less than ten years, or 10% per year. The firms organizing the capcos typically try to reach their investment milestones as quickly as possible, thereby earning a large percentage of the tax credits early in the life of the capco and delivering the credits in later years. Failing to reach the investment thresholds in the required timeframe or meet the other statutory requirements may result in decertification of the capco, which could result in the loss or recapture of some or all of the tax credits previously earned and passed on to capco investors. We observe that in all of the states in which Newtek has organized capcos, once the capco has crossed the 50% threshold, 100% of the tax credits can be put beyond recapture—unless, of course, the firm fails to meet some of the other requirements of capco investing in those states. We also note that Newtek recognizes as income only those tax credits placed beyond forfeiture.

EXHIBIT I

NEWTEK REVENUE GENERATION



Source: Company reports.

A diagram of the process, as it pertains to Newtek, can be found in Exhibit I. Although the process illustrated is very similar to the one described above, there is the additional step of obtaining insurance on the capcos making the insurer the primary obligor of the cash payments required on the notes issued by the company in forming the capco. Essentially, the company uses approximately half the proceeds from the notes, along with some of its own capital, to create a sinking fund that will be used to retire the notes in their entirety upon maturity. Assuming the notes are outstanding for ten years, the insurance company need only generate a return on the sinking fund that compounds at just under 7% per annum to meet that obligation. The insurance company also indemnifies Newtek—or, more accurately, the capco note holders—against any future loss of tax credits. Under the terms of the notes, Newtek can satisfy the interest requirements of the notes by earning and delivering tax credits. Thus, after obtaining insurance, Newtek has no cash obligations to either the insurer or the note holder and approximately half the proceeds from the note issuance to make targeted investments in that state. Also, as noted above, Newtek can use returns from early investments to fund subsequent investments and meet its minimum investment requirements within the specified timeframes. If the minimum investment thresholds are crossed before the time period specified in the enabling statutes have

elapsed—and before the state is required to deliver the tax credits—the present value of the tax credit earned is recorded as both income and a receivable, “Credits in Lieu of Cash”. The discount used to capitalize that asset is accreted until the tax credits become utilizable by the capcos’ insurance company investors. Thus, the revenue reported as income from tax credits includes newly earned tax credits and the accretion of the discount used to capitalize existing balances of Credits in Lieu of Cash. When the tax credits become available to Newtek’s note holders, the balances of Credits in Lieu of Cash are credited with a corresponding debit made to Notes Payable in Credits in Lieu of Cash. It should be emphasized here that none of these entries—recognition of income or changes in the individual asset and liability accounts—involve the receipt or disbursement of cash. In our opinion, these entries are the GAAP legacy of organizing the capcos, which served as a very cost-efficient means of financing Newtek’s component businesses. We believe the true economic value of these vehicles is created upon their formation, which is also when substantially all of the cash flows associated with the transaction occur.

Newtek’s policy is to deploy the capital raised via the capcos as quickly as possible. Currently, investments are made in businesses already delivering Newtek-branded products and services. Thus, the capco formed in Alabama in January 2004 will probably invest in one or more of the following businesses: a SBA loan production office, a merchant card services sales and marketing organization, a small business insurance agency, and a small business tax service. Newtek’s experience with these businesses and the ability to just “plug” them into a larger network of small business service providers, many of them sharing the same technology and administrative infrastructure, helps accelerate the investment process. As of March 31, 2004, all of the company’s capcos were in compliance with their respective states’ investment requirements. Seven of the eleven capcos have surpassed the 50% minimum investment milestone, placing 100% of the tax credits allocated to them beyond recapture—barring a failure to meet one or more of the qualitative requirements (the risks the company deems to be immaterial). This represents approximately \$121.2 million in tax credits, or about 73% of the total tax credits associated with Newtek’s capcos.

## BACKGROUND

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### Company history

The origins of Newtek Business Services date back to 1998, when its principals began forming capcos (see discussion above) to fund the acquisition and development of early-stage, high growth technology-oriented businesses, particularly those focused on Internet-related commerce, or “e-commerce.” In many respects, the nascent organization resembled a capco-funded CMGI, Inc., Internet Capital Group or Safeguard Scientific. These businesses were consolidated under BJB Holdings, Inc. In mid-1999, Newtek Capital, Inc., or, more accurately, a predecessor organization, TWG, Inc., was formed to combine the businesses owned and operated by BJB Holdings and REXX Environmental Corporation, a publicly traded company listed on the American Stock Exchange (ASE). The latter organization, through its sole operating subsidiary, Watkins Contracting, Inc., was engaged in environmental remediation, which included among other activities, asbestos abatement. TWG, Inc. changed its name to Newtek Capital in January 2000 and the transaction, structured as a reverse merger, was consummated in September of that year. In the process, REXX sold Watkins Contracting back to its managers, from whom REXX acquired the business in October 1997. And, most significantly, Newtek became a publicly traded company trading under the ticker symbol NKC on the ASE.

The capco programs in which the company participated were utilized to help fulfill Newtek’s initial long-term strategic objective of developing and holding a majority position or control of early-stage companies principally focused on technology, especially the Internet and e-commerce. Referred to as “partner companies”, Newtek’s investments were selected on the basis of two criteria: 1) those companies integrating technology into organizations that had not yet meaningfully benefited from the technological revolution that characterized much of the 1990s (e.g., small businesses); and 2) those companies capable of providing goods and/or services required for the success of other firms in the existing partner network. Newtek took a “hands off” approach to managing the partner network, acting more like a passive investor than an active operator.

Almost immediately, however, the “incubator” strategy came under pressure and Newtek’s long-term goals began to evolve. The impetus for change came from two sources. The first was a significant reversal in the fortunes of many technology and Internet-related firms and, accompanying that reversal, a sharp decline in the value investors—both public and private—were willing to assign to such ventures. The other strategic

imperative came from structural issues within the capco programs themselves. Originally conceived as venture capital funds, it became very clear to both Newtek and state governments sponsoring the capcos, that the financing provided by these programs was only one of many resources needed for successful strategic execution by new and growing small businesses. Small to medium-sized businesses also require administrative, managerial, technical, legal and financial management support. After its first year of operations, Newtek determined that it would take a “hands-on” approach to its investments and provide these other elements necessary for the businesses to survive and succeed. This led to a very active role in the management of these enterprises.

In our estimation, 2002 was a watershed year for Newtek. In that year Newtek’s current strategy of providing high quality business and financial services to small and medium-sized businesses at an affordable cost began to emerge. In January 2002, the company signed a letter of intent to acquire Comcap Holdings. Comcap’s principal operating subsidiary, Commercial Capital Corporation (CCC), was—and still is—one of 14 lenders licensed to make U.S. Small Business Administration (SBA)-guaranteed loans in all 50 states. Although a definitive agreement was not signed until August 2002 and the acquisition did not close until December of that year, the commitment to purchase CCC clearly signaled to us the start of the company’s transition from investor in to operator of small business service providers.

In April 2002, Newtek rolled out the first of its branded service offerings, Newtek Merchant Solutions (NMS), to market credit card, debit card, gift card, check card, and check approval solutions to high-volume retailers and restaurants. The company had already established itself in the merchant card processing business by acquiring equity interests in a number of sales and marketing offices in New York, Louisiana, and Wisconsin. The creation of NMS was really just the application of the Newtek brand to the three sales and marketing organizations, the first step in coordinating the efforts of the company’s network of small business service providers. Most of the businesses in which Newtek’s family of companies compete are highly fragmented with no dominant provider(s). We believe that by offering a suite of branded business services at a reasonable cost, the company can gain a powerful competitive advantage among small business owners, many of them new to the administrative, legal, tax, and technical requirements of running one’s own business. NMS was followed by Newtek IT Services (technology solutions), Newtek Financial Information Systems (outsourced financial administration solutions), Newtek Strategies (strategic planning and consulting), New Client Services (customer service and cross-selling for all of the aforementioned products), and Newtek Business Exchange (business brokerage).

Although there have been additional refinements to Newtek’s strategy in the last year and a half, the company’s transformation was essentially complete by the end of 2002. In November of that year, Newtek’s board of directors approved the change of the company’s name to Newtek Business Services, more closely aligning the firm’s identity with its mission and strategy. In the following month, the Small Business Administration approved the transfer of CCC’s license to make SBA-guaranteed loans in all jurisdictions nationwide to a subsidiary of Newtek. The acquisition of CCC was completed shortly thereafter. Subsequent to the acquisition CCC was renamed Newtek Small Business Finance (NSBF). Prior to its acquisition and recapitalization, NSBF had been poorly managed and plagued by problem loans. As part of a detailed reorganization program worked out in the months before the acquisition, Newtek helped arrange for a strategic investment of \$2,000,000 by an affiliate of Credit Suisse First Boston (CSFB) which took the form of a preferred stock issue representing a 20% equity interest in NSBF. The arrangement also included a referral agreement, under which NSBF and another affiliate of CSFB would be permitted to refer loan prospects to each other.

The present Newtek business model became fully visible in 2003. The company originated \$25.1 million in new SBA loans in 2003 and finished the year with balances of \$52.1 million in SBA loans held for investment (and another \$3.6 million in loans held for sale). Newtek also serviced for others loans with a total unpaid principal balance of \$123.8 million. SBA lending activities accounted for 12% of gross revenue in 2003 and 5% of pretax income. None of Newtek’s revenue or income before taxes was derived from these activities in 2002. Similarly, Newtek Merchant Solutions accounted for 10% of total revenue in 2003. Although the company had been in the merchant card processing business since 2001 with the formation of Universal Processing Services—New York, LLC, Universal Processing Services—Louisiana, LLC, and Universal Processing Services—Wisconsin, LLC, these organizations did not contribute meaningfully to revenue until 2003. Undoubtedly helping boost the contribution of NMS to total revenue in 2003 was the acquisition of Automated Merchant Services (AMS) in August of that year. In that transaction, Newtek

acquired 2,100 existing clients and 10 customer representatives in the South Florida market. Because of the fixed cost overhead associated with this business, merchant card services has experienced operating losses in each of the last three years. That segment, however, reported a small profit in the first quarter of this year and we expect the operating leverage inherent in the business to start working in favor of Newtek Merchant Solutions in 2004 and 2005. At the same time, capco income—the non-cash revenue recognized when tax credits are placed beyond recapture—fell to 77% of total revenue from 95% in 2002 and 99% in 2001. And, even though passive capco investment business represented 100% of GAAP pretax income in 2003, we anticipate further declines in the capcos' contribution to reported revenue and, more important, a diminishing role in reported earnings. In December 2003, the company moved the listing of its common stock from the American Stock Exchange to the Nasdaq National Market and began trading under its current ticket symbol, NKBS.

In 2004, Newtek honed its business model even further, making the decision to build its suite of service offerings to small business owners around three core products: 1) SBA loans; 2) merchant card processing services; and 3) web hosting (assuming closure of the CrystalTech acquisition as planned). Having already established a beachhead in the SBA market the previous year, Newtek expanded its commitment to SBA lending business by negotiating an extension of existing warehouse line of credit with Deutsche Bank and signing a letter of intent to replace that line with a permanent \$100 million financing facility. The facility should ease the process of selling or securitizing the loans. Additionally, Newtek entered into arrangements permitting NSBF to market its loans to clients and members of Merrill Lynch's Financial Services, Inc., the Community Bankers of Wisconsin's CBW Financial Services, Inc. and the Navy Federal Credit Union.

Long a mainstay of its operating businesses, sales in the electronic payments unit have begun to ramp up rapidly, growing at 9% per month sequentially over the last twelve months. Newtek Merchant Solutions had 5,000 customers at year-end 2003 and has been adding approximately 300 new clients per month in 2004. We are projecting that NMS' revenue will nearly triple in 2004, growing to \$17.6 million from \$6.3 million in 2003. Furthermore, if our other estimates and assumptions are reasonably accurate, merchant card revenue will constitute 25% of the company's total revenue this year and 32% next year. Driving the actual and prospective increases in NMS's revenue and customer base, we believe, is the unit's 100 commissioned sales representatives. These "feet on the street" serve as the contact points for not only merchant card services, but also many of the company's other products and services.

Finally, Newtek proposes to enter the web hosting business with the acquisition of CrystalTech Web Hosting, Inc., which was financed by the company's recent follow-on offering of common stock. Headquartered in Phoenix, AZ, Crystal Tech provides a variety of secure and reliable web hosting options to approximately 26,000 clients, most of them small and medium-sized businesses. Like Newtek's other operating businesses, CrystalTech has been growing rapidly. CrystalTech added approximately 9,600 net new customers in 2003, up sharply from about 3,900 just two years earlier. Gross revenue increased by almost 90% in each of the years 2000-2002 and 45% in 2003. Net income grew by a factor of 10x to \$2.2 million in 2003 from just over \$0.2 million in 2002. In the first quarter of 2004, net income more than doubled to \$1.0 million from \$0.4 million in the first period of 2003. We believe the addition of 26,000 customers—to which Newtek can market its other products and services—was as important a consideration to the company's management as the opportunity to participate in a rapidly growing and highly profitable business. Another important consideration is the relatively small incremental effort in marketing CrystalTech's web hosting services to new customers. Newtek's sales reps are already marketing the company's loan, merchant card, insurance, tax and other services to those prospective clients. First announced in April of this year, the company expects to complete the acquisition of CrystalTech within the next several weeks.

## **Management**

**Barry Sloane**, Chairman of the Board, Chief Executive Officer and Secretary since inception in 1999. From July 1995 to January 1999, Mr. Sloane was the founder and principal of The Sloane Organization, LLC, engaged in financial consulting and investment banking. From September 1993 through July 1995, Mr. Sloane was a Managing Director of Smith Barney, Inc. where he directed the Commercial and Residential Real Estate Securitization Unit and, prior to that, he was national sales manager for institutional mortgage and asset backed securities sales. From April 1991 through September 1993, he was founder and President of Aegis Capital Markets, a consumer loan origination and securitization business which was eventually taken public with the name of "Aegis Consumer Funding." From October 1988 through March 1991, Mr. Sloane

was Senior Vice President of Donaldson, Lufkin and Jenrette, where he was responsible for directing sales of mortgage-backed securities.

**Jeffrey G. Rubin**, President and a Director since February 1999. In June 1994, Mr. Rubin founded, financed and participated in the day-to-day management of Optical Dynamics Corporation, formally known as Fastcast Corporation, an early stage technology company. Mr. Rubin served as an officer of that company and a member of the board of directors until December 1997. From January 1992 through January 1998, Mr. Rubin served as a private venture capitalist. From September 1989 through January 1994, Mr. Rubin served as Vice President of American European Corporation, an import/export company, and participated in management in various capacities. Mr. Rubin also has served as a director of BRT Realty Trust, a New York Stock Exchange listed company, since March 2004.

**Brian A. Wasserman** has been our Chief Financial Officer, Treasurer and a Director since 1999. From December 1997 until December 1999, Mr. Wasserman was the general partner of two private venture capital limited partnerships with diverse public and private investments. From December 1997 until November 1999, Mr. Wasserman was a director of Heuristic Development Group (subsequently, Virtual Communities, Inc.), a publicly traded company engaged in the development, marketing, sale and licensing of the Intellifit System, a computerized system which generates personalized exercise prescriptions. From 1997 to November 1999 Mr. Wasserman was a director of REXX Environmental Corporation, a publicly traded holding company in the environmental remediation business which, following the sale of its entire business to third parties, merged with Newtek Business Services in 2000. Previously, Mr. Wasserman was an audit and tax manager with Coopers & Lybrand, LLP. Mr. Wasserman is a member of the American Institute of Certified Public Accountants and the New York State Society of Certified Public Accountants.

## MISSION & STRATEGY

Newtek's mission is to become the premier provider of high value and cost efficient services to small to medium-sized businesses. To fulfill this mission, the company intends to offer the SMB market a growing and increasingly diverse line of products necessary for small business survival and success. As noted above, Newtek has built its suite of service offerings to small and medium-sized business owners around three core products: 1) SBA loans; 2) merchant card processing services; and 3) web hosting. The value of these products is that they serve as anchors, particularly loans. The products are "sticky" (the cost of switching providers is high, creating certain barriers to exit) and long lasting in nature, creating ample opportunities for cross-selling other products and services. The company feels that loans represent one of the easiest ways of penetrating a new customer's business. Almost all businesses—large and small—require access to credit. Whether the credit takes the form of a commercial mortgage, an equipment lease, a working capital line of credit, or some other type of loan, virtually all businesses will need to borrow at some point in their life cycle. Many SBA loans are secured by the property housing the borrower's principal place of business. In addition to functioning as a core or anchor product, loans—or, more accurately, the data gathered and stored during the loan application process—can serve as a powerful marketing tool, providing substantial aid to the company and its sales representatives in future cross-selling efforts.

We believe that electronic payment processing, or merchant card services, can serve as another important anchor. The Federal Reserve reports that the use of electronic payments (credit card, debit card, stored value cards, electronic funds transfer, etc.) increased by a factor of 5x from 1979 to 2000. Concomitantly, the number of paper checks in circulation has dropped sharply. According to the Nilson Report, the number of paper checks in circulation fell by 10 billion between 1995 and 2002. The Nilson Report also projects that the number of credit, debit and stored value card transactions will surpass cash and check transactions by 2009. It is our opinion that the explosive growth of credit and debit cards will make their acceptance for payment a necessity for small and large businesses alike. Intensifying the pressure on small businesses to make electronic payments available are declining costs and the opportunity to serve a broader universe of customers.

To meet the twin goals of growing its businesses profitably and providing high quality services to the small business community at a reasonable cost, Newtek will rely on its "hub-and-spoke" system of delivery and cross-selling. The company's small business loans, for instance, can be processed centrally using data gathered from Newtek's web-based application system, eliminating the need for paper forms and face-to-face

meetings between clients and loan officers. The loans can be administered centrally as well. There is not a necessity to have a branch in every locality served by NSBF. Similarly, because of the electronic nature of the products, card transaction processing services and website development/hosting can also be carried out centrally with customer service and follow-on marketing conducted over the telephone or via e-mail. For many of Newtek's clients, the initial point of contact will be one of NMS' 100 commission-only sales representatives, the company's "feet on the street". These representatives will then enter client—or potential client—data into the firm's proprietary, web-based referral system for follow-up by the firm's financial specialists (NSBF) or personnel from one of Newtek's other businesses. Other leads will enter the referral system via an alliance partner (see below).

Cross-selling, in our estimation, will be key to the company's long-term success in delivering high quality services to small to medium-sized businesses at an affordable price. It is far more cost-effective to market to an existing customer than to acquire a new one. The incremental cost of issuing a property and casualty insurance policy to an existing SBA loan customer, for instance, is very small compared to the cost of marketing the product to a large number of prospective clients in the hope that one will purchase it. Management understands the critical nature of cross-selling in executing its strategy, having already committed the necessary resources to the development of a proprietary web-based referral system, capable of tracking leads across all of Newtek's organizations as well as those of its alliance partners. The company also appears to understand the necessity of having a system of incentives in place to ensure cooperation among employees of Newtek's various business units, having documented that requirement in the prospectus accompanying the company's recently closed secondary offering. Including targets for total unique customers by year-end also attests to the importance attached to cross-selling. Company officials anticipate that Newtek will have 40,000 total small to medium-sized business clients by the end of 2004 (assuming the completion of the pending CrystalTech transaction, which would bring the company 26,000 new accounts in and of itself).

Another important element of Newtek's strategy is the addition of new products and services. Combined with the company's customer acquisition and cross-selling efforts, the arithmetic of introducing new products and services is very powerful. For example, the introduction of a new product at the end of 2004, assuming the company meets its customer relationship goal, provides the company the potential for 40,000 additional sales. And that is before new relationships are considered.

We expect that Newtek will use opportunistic acquisitions to add complementary services and products to its suite of service offerings. Although the degree to which the potential target's products fit into the company's existing array of offerings and caters to the small to medium-sized business market to which Newtek has committed itself, will undoubtedly serve as two of the most important criteria in any acquisition, we feel that—just as in the proposed CrystalTech transaction—the number of customer relationships the target can add will receive as much, if not more, weight in the company's decision. One of the company's stated goals is to build a large unified database of small and medium-sized business client accounts.

We believe the company will fund most of these additional acquisitions with internally generated cash flows or new debt/equity financing. Another objective of the company is to reduce its dependence on capco programs as a source of funding and revenue. That being said, however, we do not expect Newtek to eschew these programs entirely. We believe the company will continue to use the capco programs as opportunities arise to fund acquisitions or expansion of its current business lines at relatively low cost. As discussed earlier, many of the funds raised via the capco programs recently are being invested in Newtek's own businesses.

One other significant initiative underway at the company is Newtek's effort to develop brand awareness. In addition to permitting majority-owned companies to use the "Newtek" name without charge, the company has struck several strategic marketing alliances with nationally recognized businesses, trade organizations and affinity groups. These include Merrill Lynch, Cendant Corporation, the Credit Union National Association, the Revelation Corporation of America, the Navy Federal Credit Union, and the Veterans' Corporation of America. In addition to the opportunity to market to a much wider audience under these arrangements, the company hopes to build much greater recognition of the "Newtek" brand among the millions of customers, members and participants of these organizations. Company officials intend to court other strategic partners and negotiate new marketing alliances in an effort to further develop the "Newtek" brand.

## FINANCIAL ANALYSIS

**Recent performance.** In the first quarter of this year, Newtek reported a net loss of \$1.7 million, or \$0.06 a share, compared to net income of \$1.9 million, or \$0.07 a share. The year-over-year decline in net income is entirely due to the income recognized from tax credits, which fell by \$8.4 million from \$10.4 million in Q103 to \$2.0 million in Q104. As discussed above in the section describing capcos, the company “earns” tax credits for its insurance company investors by deploying capital raised in the formation of the capcos by certain deadlines. As the company reaches the required investment milestones and places the tax credits beyond recapture by the states sponsoring the capcos, it recognizes the dollar amount of those credits as income and the tax credits become deliverable to the insurance companies, typically at some date in the future (actually, it is the present value of the tax credits that are recognized as income and placed on the balance sheet as Credits In Lieu of Cash). Because of the differing dollar amounts raised under Newtek’s 11 capco programs (including the recently formed Wilshire Alabama Partners), the differing dates of organization, differing investment requirements—in terms of the percentage of the capital that must be invested and the time frame in which it must be invested—and the differing speeds at which Newtek has met these targets, this revenue item is subject to a great deal of variation. Although the company plans to reduce its dependence on capcos as both a source of funding and a source of revenue, we still expect quarterly income and earnings to exhibit some volatility over much of the next year and a half.

Partially offsetting the unfavorable impact of the \$8.4 million decrease in income from tax credits were: 1) a decline of \$1.7 million in investment writedowns; 2) an increase of \$0.6 million in the pretax contribution of SBA lending (NBSF); and 3) an improvement of \$0.4 million in the pretax contribution of electronic payment processing (NMS). In the March 2003 quarter, Newtek determined that there was an other than temporary decline in the value of three of its investments totaling \$1.7 million, which was subsequently recognized as an expense item on the company’s income statement. There were no such valuation adjustments in the first quarter of this year. Additionally, as of March 31, 2004, unconsolidated investments—those accounted for under the equity or cost method—amounted to only \$1.6 million. Additionally, those investments accounted for under the cost method consist of debt instruments classified as held to maturity. As long as the company can demonstrate the intent and the ability to hold these assets to maturity, Newtek is not required to reflect changes in the market value of these investments in either its income statement or balance sheet (the accumulated other comprehensive income account of shareholders’ equity). Thus, in our opinion, the exposure to further downward adjustments in the value of the company’s investments is small.

The largest component of the improvement in the contribution to pretax income from SBA lending was an estimated \$0.9 million increase in the gain from the sale of SBA loans. In the first quarter of 2004, NSBF originated \$11.3 million in new SBA loans and sold \$8.1 million. The small business finance subsidiary neither made nor sold any loans in the first quarter of the previous year. NBSF, which had just been acquired in December 2002, did not resume lending and secondary market activities until the third quarter of 2003.

The company’s electronic payment processing business essentially broke even in the quarter ended March 31, 2004, compared to a loss of \$0.4 million in the same period last year. We believe that NMS is just now attaining the scale necessary to exploit the operating leverage inherent in that business. Therefore, we would expect the pretax contribution from NMS to ramp up significantly in 2005 and beyond.

**Financial condition.** As of March 31, 2004, Newtek Business Services reported total assets of \$200.7 million, total liabilities (including minority interest) of \$160.1 million, and total shareholders’ equity of \$40.7 million; these are comparable to the \$192.2 million, \$151.9 million and \$40.2 million reported at the end of December 2003.

Most of the small quarter-over-quarter increase in total assets, 4.4%, resides in the cash accounts, the balances of which rose by \$9.6 million to \$45.2 million. We believe that the increase can be traced to the formation of the Wilshire Alabama Partners capco in Q104, which raised \$11.1 million in new capital, much of which is earmarked for investment in qualifying organizations in the state of Alabama. As a result of the increase, cash, as percentage of total assets, rose to 23% from 18% at the end of the prior quarter. Most of the remaining balances of cash consist of cash and cash equivalents held at various consolidated operating entities.

Together with credits in lieu of cash (discussed above under Capcos) and SBA loans, cash and cash equivalents made up 84% of total assets at the end of March 2004, compared to 85% at the end of December 2003. Credits in lieu of cash declined by \$2.8 million to \$68.5 million in the first quarter. The company only recognized \$2.0 million in tax credits while \$4.8 million in credits became deliverable. Once again, we feel obligated to point out that none of these entries involves the receipt or disbursement of cash. At the end of Q104, this account represented 34% of total assets, down from 37% at the end of December 2003. Total balances of SBA loans also fell in the quarter—to \$54.8 million at March 31, 2004 from \$55.7 at the end of the previous quarter. Loans held for investment increased by \$0.5 million to \$52.5 million in the March 2004 quarter. The \$3.1 million in new loans originated for investment easily eclipsed the normal runoff in the portfolio. Loans held for sale, however, decreased by \$1.3 million to \$2.3 million in the quarter as the balances of loans sold exceeded the volume of loans originated for sale by that amount. As a result, total loans constituted just 27% of total assets at the end of Q104 compared to 29% at the end of Q404.

Changes in the balances of bank notes payable and notes payable in credits in lieu of cash account for most of the \$8.5 million, or 5.9%, increase in total liabilities. These two accounts made up 79% of all liabilities and minority interest at the end of the first quarter of 2004, up from 77% the quarter before. The balances of bank notes payable rose to \$55.6 million in the first quarter from \$52.0 million at the end of the December 2003 quarter. The additional notes were used to support new loans originated in the quarter pending the settlement of loans sold. The increase lifted the ratio of bank notes payable/total liabilities and minority interest to 35% from 34% the prior quarter. Notes payable in credits in lieu of cash (also discussed under Capcos) stood at \$69.7 million at the end of March 2004, up \$4.1 million from the \$65.7 million reported at the end of 2003. The increase was most likely the result of the obligation to deliver tax credits created when Wilshire Alabama Partners was established. This increase was partially offset by \$4.8 million in tax credits that became deliverable in Q104. Notes payable in credits in lieu of cash represented 44% to total liabilities and minority interest at the end of the first quarter, up from 43% the previous quarter.

Despite a net loss of \$1.7 million in the first quarter, shareholders' equity grew by \$0.5 million. Eclipsing the net loss were new common stock issuances, most them private or connected to the exercise of options, resulting in the addition of \$1.9 million in equity capital and a decline of \$0.3 million in unearned compensation. Unearned compensation consists of restricted stock award units that have yet to vest. As the restricted stock awards vest, the employee granted the award receives one share of common stock for each unit vested (in essence, that employee "earns" the award). The awards are classified as an offset to equity for accounting purposes (a contra equity account). As the awards are "earned" the unearned compensation account is credited (reducing the balance of the account) and employee compensation expense is debited. Three hundred thousand of such expense was recognized in the first quarter of 2004.

At the end of the March 2004 quarter, there were 26.7 million shares outstanding, up from 26.2 million at the end of December 2003. Approximately 200,000 shares were sold in private transactions. Another 154,000 were issued as a result of option exercises. 85,500 shares were issued in connection with the funding of the Wilshire Alabama capco. These transactions accounted for the vast majority of the increase in share count.

**Earnings estimates.** We have established EPS estimates of \$0.32 and \$0.40 for 2004 and 2005 respectively. Estimates for the second half of 2004 and 2005 take into consideration the 6.45 million shares issued in a secondary offering late last month (assuming the overallotment option is exercised in full, permitting existing stakeholders to sell approximately 450,000 shares). Thus, we are using a weighted average fully diluted share count of 30.0 million in our 2004 EPS estimate and a weighted average fully diluted share count of 35.0 million in our 2005 EPS estimate.

Second half 2004 and full 2005 estimates also have embedded in them the assumption that the Crystal Tech acquisition is completed by the contractual closing date, which has been extended twice now, of July 19, 2004. In the event the transaction does not close by that date or a new extension is not negotiated, Newtek would forfeit the \$200,000 on deposit as consideration for the current extensions. If the acquisition is completed by the July 19 deadline, the deposits would merely be credited to the purchase price payable to the seller at closing.

In any event, we have broken out our projections by line of business. We believe the valuation eventually awarded NKBS shares will depend on the growth and the franchise established by the company's operating businesses (see Valuation). Additionally, there are observable market values for other companies

participating in those businesses. Many of those participants are publicly traded and the valuations accorded their shares can serve as a benchmark when arriving at an estimate of the fair value of Newtek's individual businesses. Therefore, we have attempted to assign estimated revenues and expenses to the appropriate business segment and make reasonable assumptions about those line items that cannot be readily assigned (see projected financial statements at the end of this report). A brief discussion of those estimates and assumptions follow.

**SBA Lending (NSBF).** We have forecasted NSBF's contribution to pretax profit at \$4.2 million in 2004 and \$7.7 million in 2005. The major assumptions underlying these projections are contained in a table following our projected financial statements. We believe the company can originate \$100 million in new SBA loans this year and \$150 million next year. Although these figures represent increases of 300% and 50%, respectively, we feel comfortable with the estimates. The company has turned around the NSBF franchise and recently entered into strategic marketing alliances with large, well-known business and trade organizations such as Merrill Lynch, the Community Bankers of Wisconsin and the Navy Federal Credit Union. A key feature of these agreements is the ability of the company to access data on customers and members of its marketing partners. Perhaps providing the most confidence in our estimates is the proposed Crystal Tech acquisition, which will bring Newtek an additional 26,000 customers to which the company can market its loan products. And, it should be noted, Crystal Tech has been adding about 1,000 new customers a month.

We have assumed the company will sell the guaranteed portion of the loans and retain the remaining balances for investment. Although the guarantee covers 75% of the loan, because sales typically lag originations by one to two months, we assume only 70% of total originations are sold in any one quarter. The remaining balances, even those loans held for sale, stay on the balance sheet in our modeled results. Those that are funded by the Deutsche Bank credit facility should earn a spread of 325 bp (less the amortization of deferred origination expenses and finance facility charges). The coupon rate of interest on SBA loans is Prime + 275 bp; the line of credit from Deutsche Bank financing those loans bears interest at Prime – 50 bp. We assume an advance rate of only 75% from Deutsche Bank, which implies that the other 25% of loans held for sale and loans held for investment will be funded by equity. Thus, the net interest margin (net interest income/average earning assets) would be much higher than the 325 bp calculated above. We estimate this to be closer to 360 bp holding all other assumptions the same. We have projected a loan loss provision of \$0.5 million for 2004 and \$0.7 million for 2005 based on the belief that the annualized provision, as a percentage of average loans, of 80 bp made in the first quarter of 2004 will be adequate to cover all known and inherent losses in the loan portfolio throughout our forecast horizon.

Although we are aware of instances in which SBA loans have fetched a 15-20% premium over par when sold, we are assuming a more reasonable 10%, 300 bp of which represent capitalized servicing rights. The gain from the sale of these loans represents the single largest component of net revenue for the SBA lending unit. Servicing, however, becomes an increasingly important element of net revenue in our projections. If those projections are accurate, servicing revenue will exceed net interest income after loan loss provisions in 2005. We are forecasting that the average balances of loans serviced for others will total \$138.2 million in 2004 and \$229.0 million in 2005. Although the company reports that the average servicing spread (fee as a percentage of unpaid principal balances) for new loans is 200 bp, we believe the average fee on existing loans is much smaller. Therefore, we used a blended rate in our earnings model, arriving at a weighted average fee of 159 bp in 2004 and 185 bp in 2005 as newer loans represent a larger part of the servicing portfolio. Netted against this fee in our calculations is the amortization of the capitalized servicing rights. We assume that the loans underlying these servicing rights amortize—and this includes both scheduled amortization and early repayments—at an annual rate of 26%, in line with the company's recent experience.

Our projections of operating expenses, \$6.6 million and \$8.5 million in 2004 and 2005, respectively, imply annual increases of 162% and 22%. The somewhat outsized increase in 2004 reflects the infrastructure and other investments we believe necessary to quadruple loan production as we have projected. As a result, the operating expenses associated with SBA lending in our earnings model represent 20% of the total operating expenses we anticipate in 2004, up sharply from the 12% reported by the company in 2003. Because we expect these investments to be largely behind the company by the end of 2004, we have modeled an increase in operating expenses of only 22%. Consequently, forecasted SBA lending expenses drop to 16% of the total we have projected for 2005. Given these assumptions and our expectation that net revenues will grow at 116% and 58% in 2004 and 2005, respectively, we calculate the SBA lending's net operating margin (before

minority interest) will narrow to 39% in 2004 from 47% in 2003 before expanding once again to 50% in 2005. We do not expect NSBF to record any expense for minority interest in 2004. Given the investments alluded to above, NSBF will probably not hit the profitability triggers necessary for the recognition of such interest. We do, however, anticipate a resumption of those entries, totaling \$0.9 million, in 2005.

**Electronic payment processing (NMS).** Although we expect only breakeven performance for the merchant card services unit in 2004, we have projected a positive contribution of \$4.5 million in 2005. These figures compare to losses of \$1.3 million in 2002 and \$0.9 million in 2003. Traditionally a low-margin business, we believe NMS has finally achieved the scale economies required for profitability in payment processing. According to our projections, the card-processing unit will nearly triple its revenue this year—increasing from \$6.3 million in 2003 to \$17.6 million in 2004—and then nearly double that in 2005 advancing to \$32.0 million. NMS has exhibited sequential monthly sales growth of 9%, on average, over the last twelve months. In the first six months of this year, the unit has been adding approximately 300 new clients per month. The company expects about 9,000 clients by year-end 2004, up 80% from the 5,000 reported at year-end 2003. And that is before the Crystal Tech acquisition—and the 26,000+ accounts to which NMS' 100 sales reps can cross-market the service—is considered.

Our estimate of 2004 operating expenses, \$17.4 million, represents an increase of 141% over those incurred in 2003. At this level, NMS would report a small pretax profit of \$0.2 million, or just over 1% of unit revenue. The 58% increase in operating expenses we are anticipating in 2005, or \$27.5 million, would result in a pretax margin of \$4.5 million, or 14% of projected revenue. These estimates reflect the belief that the merchant card services business needs approximately \$17.5 million in revenue to breakeven and, above that level, the unit can start to reap the benefits of the operating leverage inherent in the business. And, despite the sharp increase in pretax profit we are expecting in 2005, we do not believe NMS will ever exhibit the operating margins already being observed at the SBA lending and web hosting segments.

**Web hosting.** We have modeled contributions to pretax income of \$2.1 million and \$2.0 million from the web-hosting segment in 2004 and 2005, respectively. Crystal Tech's net income grew by a factor of nearly 10x in 2003 on a 46% increase in net revenue to \$5.5 million. In the first quarter of 2004, the company earned \$1.0 million on net revenue of \$1.8 million, an increase of 153% over the \$0.4 million earned in Q103. Although we are projecting pretax income of approximately \$1.0 million a quarter in the second half of 2004, we are assuming contributions of half that level in 2005 based on the expectation that Newtek will spend very heavily on marketing next year, bringing total operating expenses to \$6.0 million from the annualized \$3.8 million we are anticipating in 2004. We have also assumed that 2005 net revenues will be flat with the annualized \$8.0 million we are expecting in 2004. We have kept our assumptions and estimates for this segment conservative given the fact that the Crystal Tech acquisition has not yet been completed and ever-present risk that that company will not be integrated as seamlessly as contemplated in Newtek's strategic plans. Once again, assuming the Crystal Tech acquisition is completed by the contractual deadline of July 19, 2004 and the company's operations are merged smoothly into those of Newtek, we believe the web-hosting segment may offer the most upside to our overall estimates.

**Capcos.** Although we expect the operating businesses discussed above to account for the vast majority of Newtek's reported earnings and assets over time, the capco programs will dominate GAAP financial statements for much of the next two years according to our calculations. We estimate that the capcos will generate \$10.0 in pretax income in 2004 and \$9.7 million in 2005; these would contributions would constitute 61% and 41% of total projected pretax income in 2004 and 2005, respectively.

Using details on the capco programs contained in the company's SEC filings—specifically, the total tax credits allocated, the total tax credits earned, the total remaining to be earned and the investment benchmark (milestone) dates—as well as publicly issued guidance from the company, we have calculated income from tax credits of \$33.5 million in 2004 and \$35.0 million in 2005. The total capco income we have projected, \$36.4 million in 2004 and \$39.0 million in 2005, would still represent 51% and 39% of the total revenue we are expecting in 2004 and 2005, respectively.

These estimates assume that Newtek will be able to recognize as income over 75% of the \$11.1 million in tax credits allocated to Wilshire Alabama Partners earlier this year in 2004 and 2005, with the bulk of that amount realized in the current year. Furthermore, we assume that new capcos are formed in Washington, D.C. and Texas next year and that a total of \$40.0 million in tax credits are allocated to the two capcos.

Similar to our beliefs about the Alabama capco, we are confident the company can deploy the capital raised in the formation of the two new capcos quickly. The company's current strategy of investing in its own businesses, with which it has some experience, should enable Newtek to place most of the tax credits allocated in the formation of new capcos beyond recapture within the first year. Therefore, we expect that the company will be able to recognize as income \$26.0 million of the \$40.0 million in total tax credits we assume will be allocated to the new capcos in 2005.

Estimates of other income and expenses in the capco segment merely assume continuation of recently observed trends. The sole exceptions are interest expense and insurance expense, both non-cash items, which we have adjusted for the formation of Wilshire Alabama Partners and the expectation that the company will form two more capcos in 2005. As a result of this expectation, we have projected interest expense of \$12.9 million in 2004 and \$15.0 million in 2005. The comparable figures for 2002 and 2003 are \$10.7 million and \$11.6 million. Similarly, we have forecasted insurance expense at \$3.0 million in 2004 and \$3.5 million in 2005, up from \$2.0 million in 2002 and \$2.5 million in 2003.

Assuming that the company continues to withdraw its resources from some of its smaller investments made earlier in the life cycle of the capcos, effectively unwinding its involvement in those enterprises, we expect that the minority interest expense associated with those businesses will diminish over time. That expectation is reflected in the modeled capco results. In fact, we believe that, after 2004, the remaining investments will, in the aggregate, generate net losses, resulting in a negative entry in the minority interest line item.

**Other businesses.** We do not believe Newtek's emerging businesses—financial information systems, tax services, and business insurance—will make any material contribution to reported revenue or earnings over our forecast horizon. Therefore, we have not considered them in our 2004 and 2005 estimates.

## VALUATION

Newtek Business Services is rather unique in our universe. Although unified by a single strategic theme—that of providing what we deem services critical to the success of a small business at an affordable cost—the company operates in a number of disparate arenas. However, each of the component businesses has comparable publicly traded peers. We believe the valuations accorded the shares of these peers can serve as reliable benchmarks in arriving at a fair value of each of Newtek's individual businesses.

On Table 1, we have summarized the contribution of each of the company's business units to our estimates of 2004 and 2005 EPS. We have assumed the company's effective tax rate of 41% applies to all the units and divide the net income thus derived by the 35 million average fully diluted shares we have projected for the entire company next year.

Table 2 contains the trailing twelve-month (TTM), current year and forward P/E multiples for all publicly traded U.S. banks with less than \$500 million in assets and for which there are estimates posted to Thomson's First Call. We feel the multiples awarded these institutions can serve as a useful benchmark in valuing Newtek's small business lending unit, NSBF. Like NSBF, all of these companies are lenders; and many have well-established small business lending programs in place themselves. Applying the median forward P/E to our estimate of NSBF's 2005 EPS of \$0.13 yields a value of \$1.86. Similarly, we apply the median forward P/E of what we perceive to be a comparable group of transaction-processing peers (Table 3) to our estimate of NMS' 2005 EPS, which produces a value of \$1.35. Next we multiply our estimate of Crystal Tech's 2005 EPS by the P/E awarded the median Internet enterprise on Table 5, resulting in a value of \$1.19. Although the companies appearing on Table 4 operate in very different segments of the Internet and Internet technology sector, we believe the median multiple of 35.3x is appropriate for an organization like Crystal Tech, which advanced net income by a factor of nearly 10x in its most recent fiscal year and 2.5x in the most recently

	<b>2004E</b>	<b>2005E</b>
SBA Lending (NSBF)	\$0.08	\$0.13
Electronic payment processing (NMS)	0.00	0.08
Web hosting (CrystalTech)	0.04	0.03
Capcos	0.20	0.16
Total	\$0.32	\$0.40

*Source: Company reports, RCP estimates*

reported quarter. Additionally, Crystal Tech has consistently grown its customer base and has added approximately 1,000 new clients in each month of 2004.

**Table 2. Valuations of small, publicly traded U.S. banks**  
(Assets < \$500 million, MRQ and at least one estimate posted to Thomson's First Call)

Company	Ticker	Closing Price 7/8/04	Price/TTM EPS	Price/Est 2004 EPS	Price/Est 2005 EPS
Coast Financial Holdings, Inc.	CFHI	\$14.08	na	234.67x	50.29x
Bancshares of Florida, Inc.	BOFL	13.20	-19.13x	132.00x	17.60x
Gateway Financial Holdings, Inc.	GBTS	13.16	34.63x	30.60x	19.35x
Bridge Street Financial, Inc.	OCNB	13.78	47.52x	30.62x	21.20x
Ohio Legacy Corp	OLCB	11.00	34.38x	22.00x	13.75x
Tower Financial Corporation	TOFC	14.11	26.62x	20.16x	na
James Monroe Bancorp, Inc.	JMBI	18.64	26.25x	25.19x	19.22x
SVB Financial Services, Inc.	SVBF	18.85	23.86x	22.44x	20.94x
Community Bancorp of New Jersey	CBNJ	17.80	29.18x	20.94x	na
Community Central Bank Corporation	CCBD	12.99	16.87x	15.10x	13.67x
Summit Bank Corporation	SBGA	16.57	18.62x	16.91x	14.54x
United Bancorp, Inc.	UBCP	14.25	13.57x	13.70x	12.95x
Pacific Continental Corporation	PCBK	15.56	14.96x	14.28x	12.35x
Abigail Adams National Bancorp, Inc.	AANB	15.06	14.76x	13.10x	12.05x
American River Bankshares	AMRB	20.40	18.21x	17.00x	15.11x
Parke Bank	PKBK	16.42	14.16x	13.68x	12.16x
Merrill Merchants Bancshares, Inc.	MERB	23.55	18.40x	17.84x	16.58x
Britton & Koontz Capital Corporation	BKKB	17.49	14.45x	13.05x	na
Community Capital Corp.	CYL	21.50	15.58x	14.83x	13.87x
Guaranty Federal Bancshares, Inc.	GFED	19.20	16.13x	13.24x	na
Central Virginia Bankshares, Inc.	CVBK	26.14	14.36x	14.60x	13.98x
Evans Bancorp, Inc.	EVBN	23.45	13.88x	13.03x	na
Norwood Financial Corp.	NWFL	29.57	16.61x	15.81x	14.29x
Landmark Bancorp, Inc.	LARK	29.75	14.03x	14.51x	12.93x
MidSouth Bancorp, Inc.	MSL	35.00	17.41x	16.67x	14.89x
		Minimum	-19.13x	13.03x	12.05x
		Maximum	47.52x	234.67x	50.29x
		Average	18.97x	31.04x	17.09x
		Median	16.74x	16.67x	14.41x

Source: SNL Financial, Thomson First Call.

**Table 3. Newtek Merchant Solutions (NMS)**  
Transaction-processing peers

Company	Ticker	Price as of 7/8/04	Price/Est. 2004 EPS	Price/Est 2005 EPS
Fiserv, Inc.	FISV	\$36.70	19.21x	16.61x
First Data Corp.	FDC	44.07	20.59x	17.77x
Total System Services	TSS	22.09	29.07x	25.69x
Efunds Corp.	EFD	16.72	20.64x	17.79x
Automatic Data	ADP	40.45	25.93x	23.38x
		Average	23.09x	20.25x
		Median	20.64x	17.79x

Source: Thomson First Call.

**Table 4. CrystalTech**  
Internet enterprise peers

Company	Ticker	Price as of 7/8/04	Price/Est. 2004 EPS	Price/Est 2005 EPS
E-Bay Inc	EBAY	\$83.65	70.29x	52.94x
Amazon .com	AMZN	49.50	48.06x	35.36x
Yahoo Inc	YHOO	30.08	91.15x	66.84x
Earthlink, Inc.	ELNK	9.23	14.89x	10.61x
Time Warner Inc	TWX	17.35	28.44x	24.44x
		Average	50.57x	38.04x
		Median	48.06x	35.36x

Source: Thomson First Call.

Finally, we come to the capcos. We find we are unable to attach any sort of valuation to reported capco income or earnings. In our estimation, the value in the capcos is created when they are formed, not when income from tax credits and interest/insurance expense are recognized. Not coincidentally, most of the cash flows associated with the capcos occur at formation whereas the GAAP impact is all non-cash. For that very

reason, however, we have included in our valuation the capco capital we have projected the company will raise in 2005, less the estimated expense of providing insurance making the insurer the primary obligor of the cash payments required on the notes issued by the company in forming the capco, or approximately \$20 million. The capital raised in organizing a capco is no less a driver of future earnings growth than the earnings retained from the company's three principal lines of business. Although the money so raised is not income, we assume the company will deploy the capital profitably and the returns ultimately generated will be taxable. Thus, we have tax-effected the \$20 million. In essence, we have substituted the capital that we anticipate will be generated by the capco for our estimates of reported capco income and expense. It is the former that will be ploughed back into the company's businesses, not the latter. On a per share basis, this comes to \$0.34. To that estimate, we have, perhaps arbitrarily, applied a multiple of 5x, which is one third of the smallest of the multiples assigned the company's three principal lines of business. Even though the returns eventually generated by this capital cannot be known with any reasonable degree of confidence, we believe this valuation is conservative. The company is currently investing in its own businesses, providing us comfort that the returns ultimately earned will be similar to those enjoyed by SBA lending, merchant card processing and web-hosting.

Adding these values up, we arrive at an estimate of fair value of \$6.09 (Table 5).

	2005E	P/E multiple accorded median peer	Resulting valuation
SBA Lending (NSBF)	\$0.13	14.41x	\$1.86
Electronic payment processing (NMS)	0.08	17.79x	1.35
Web hosting (CrystalTech)	0.03	35.36x	1.19
New capcos (projected funds, net of insurance)	0.34	5.00x	1.69
		Total	\$6.09

*Source: Company reports, RCP estimates, Thomson First Call.*

To validate this conclusion, we performed a discounted cash flow (DCF) analysis, a summarization of which is contained in Table 6. We have used estimated earnings over the next ten years as a proxy for cash flow

	Whole dollar	Discount factors (1)	DCFs
<b>Discounted cash flows:</b>			
Estimated cash earnings from non-Capco businesses in 2005:	\$8,362	83.33%	\$6,968
Estimated proceeds, net of insurance, of two new capcos anticipated in 2005	\$20,000	83.33%	\$16,667
Assume cash earnings increase by 25% for years 2 - 5	\$10,452	69.44%	\$7,259
	\$13,065	57.87%	\$7,561
	\$16,332	48.23%	\$7,876
	\$20,415	40.19%	\$8,204
Assume cash earnings increase by 15% for years 6 - 10	\$22,966	33.49%	\$7,691
	\$25,837	27.91%	\$7,211
	\$29,067	23.26%	\$6,760
	\$32,700	19.38%	\$6,338
	\$36,788	16.15%	\$5,941
Terminal value assuming firm can grow earnings 5% in perpetuity	\$772,542	16.15%	\$124,770
	\$1,008,526		\$213,245
Divide by estimated diluted share count of 35 million			35,000
			<b>\$6.09</b>

(1) 20% discount rate.

*Source: Company reports, RCP estimates and assumptions.*

because the company's capital spending requirements are very small. We have also included the \$20 million we have forecasted the company will net in the formation of capcos in 2005. Because only pure cash flows are considered in this model, we have not tax-effected the \$20 million in capital raised after providing for insurance. The DCF model assumes the company can advance earnings at 25% a year, on average, for each of the next five years, then at half that rate, or 12.5%, for the following five years, and, finally, at 5% in perpetuity. We use a discount rate of 20%, which is about twice that obtained with the capital asset pricing model (CAPM). We feel the additional discount adequately takes into account the risk factors outlined below. The DCF model yields a remarkably similar estimate of fair value.

Rounding to the nearest whole dollar, we have established a 12-month price target of \$6.00. It should be noted that neither of these valuation methodologies assume the formation of any more capcos after 2005. To the extent the company does organize additional capcos—and can deploy the capital so raised at the necessary rate of return—these valuations may require adjustment.

## RISKS AND IMPEDIMENTS

The major impediments to achieving the potential returns identified above are that Newtek's operating earnings may fall short of our estimates and/or the investment community may apply a greater discount to the company's estimated cash flows or assign the projected earnings of the company's component businesses a smaller multiple than we have in our valuation exercises. Also, a key element in the valuation at which we arrived is the assumption that the company can raise \$20 million, net of insurance, from the formation of two capcos next year and deploy that capital at rates of return similar to those of its operating businesses. To the extent there are delays in organizing the capcos, or the capital raised falls short of our expectation, or the company cannot re-invest the capital at a satisfactory rate of return, our estimate of fair value may be rendered aggressive. Another impediment to achieving the returns calculated above is that some market participants—regardless of the valuation model used—may not give the company any credit at all for any capital raised through the capco mechanism.

The greatest risks to near-term earnings, in our opinion, are the following:

- Failure to complete the CrystalTech acquisition in the timeframe proposed or at all. Projected earnings from the web-hosting business and the valuations assigned them represent a not insignificant component of our total earnings estimates and overall valuation. Furthermore, underlying our estimates of revenue and pretax income in the SBA lending and electronic payment processing businesses is the assumption that Newtek will be able to cross-market those products to CrystalTech's 26,000—and growing—customer base. If the company does not complete the proposed acquisition by the contractual deadline of July 19, 2004 or fails to complete it at all, the rationale for many of our assumptions and estimates—of both earnings and fair value—would be undermined.
- Integration risk. Even if the proposed transaction with CrystalTech takes place as contemplated, there is the challenge of merging two different corporate cultures, systems migration, and integration risks. Integration issues could preoccupy management and divert resources that may be better utilized elsewhere. Additionally, CrystalTech's customer base may be very different than the clients of Newtek's other business units, rendering it difficult to cross-sell the products and services of those units. Because we believe the company will continue to make acquisitions to broaden its product line and diversify its sources of revenue, these issues may surface in the future as well.
- Failure to meet cross-selling objectives. Once again, the company's ability to cross-sell the various business units' products and services to the customers of other units is critical to meeting our estimates of earnings and fair value. This capability is also fundamental to the success of Newtek's strategy. In order for the company's cross-selling initiatives to succeed, each of the individual business units—and their employees—must have the appropriate incentives in place and they must feel confident when referring a client to another organization under the Newtek umbrella.
- Withdrawal of support for the SBA's 7(a) program. Over the last several decades, the 7(a) program has become very popular and very successful, actually returning money to the U.S. government. In many respects, it has become a "sacred cow" on Capitol Hill. The SBA, however, is a budgetary agency and

must apply for a new appropriation every year. To the extent the appropriation falls short of SBA officials' requests or Congress fails to approve a new budget, the agency may be forced to curtail its lending. In 2003, for instance, Congress failed to authorize a new budget before the end of the government's fiscal year in September. The SBA had to operate under what is known as a "continuing resolution" until April 2004. During this period, SBA officials curtailed their lending by reducing the size of the loan the agency would guarantee to \$750,000 from \$2,000,000. Because the size of the average Newtek SBA loan is much smaller, the restriction did not adversely impact the company. However, at some point, the U.S. government's budgeting process—and the snafus that typically ensue—may hinder the company in its efforts to expand its lending activities.

- Capital markets funding. The portion of the SBA loans Newtek retains for investment is funded by a line of credit from Deutsche Bank. Unlike federally insured deposits capital markets sources of funds can be impermanent and unsecure. During periods of interest rate volatility, economic distress or general illiquidity in the capital markets, portions of this line of credit or the entire facility may become unavailable. In the liquidity crisis of fall 1998, even committed lines of credit were pulled. In such an event, the company may be forced to rein in its lending, stop making new loans altogether, or sell portions of its existing portfolio. In a worst-case scenario, the company may have to sell those loans at a loss.
- High rate of formation and failure of small businesses, especially among those businesses to which Newtek caters. Small businesses exhibit a high rate of formation and failure, particularly those in the hospitality, restaurant and retail industries. These high-transaction volume businesses are those to which the company merchant card services unit, NMS, actively markets. Higher-than-normal turnover in these types of enterprises could prove very disruptive to Newtek's transaction-processing and other businesses.
- Prolonged economic slump or slow growth in output. Although a recession or slowdown in the growth of GDP has unfavorable ramifications for all businesses, large and small, the decline in spending and investment that typically accompany such conditions affect small businesses disproportionately. Many small businesses simply lack the capital, the resources or the diversification to withstand more than a temporary drop-off in customer activity.
- Execution risk. Meeting our estimates—as well as its own goals and objectives—will require that the company execute well on strategic initiatives. The company, however, does not have a lengthy operating history. The current business model just began developing a little over two years ago. Prior to that, the company was, for all intents and purposes, a passive investment vehicle. Furthermore, although the current management team has had extensive experience in the capital markets and small business development, Newtek's executives have not yet established a long track record of successfully operating a business.

The most significant considerations that may weigh upon the valuation of NKBS shares are:

- Concentration of ownership. Even with the completion of a follow-on offering of 6.0 million shares in June—and assuming the full exercise of the over-allotment option, which would include the sale of 0.5 million shares by selling stockholders—insiders (which we define as officers, directors, and existing stakeholders with beneficial ownership of 5% or more of the company's outstanding shares) would still control over 50% of the company's common stock; the top three officers alone will have, collectively, maintained a 42.5% stake according to our estimates. This imparts effective control to these insiders, whose interests may not necessarily be aligned with outside shareholders, particularly in the event of a tender offer or proposed merger. The concentration of ownership—and the potential conflicts of interest that may arise from such a capital structure—could discourage some investors, especially institutional investors, from taking a position or limiting the size of their position. Before the most recent offering, only 13.5% of the outstanding shares, or 3.6 million, were held by institutions<sup>6</sup>. Adjusting this figure for the offering priced June 28, 2004—and assuming the over-allotment option is exercised in full—brings total institutional ownership to approximately 25% of the total shares outstanding by our calculations. Lack of sponsorship among institutional investors, who seem keenly attuned to corporate governance

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<sup>6</sup> Bloomberg.

issues in today's investing environment, could place pressure on the multiples awarded Newtek's earnings.

- *Narrow float and thin trading volumes.* Related to the concentration of ownership issue is the fact that just over half of the estimated 33.9 million shares estimated to be outstanding after the most recently completed offering—once again assuming full exercise of the over-allotment option—can be considered part of stock's float, or the number of shares available for trade. And, prior to the secondary offering, only about 45,000 shares per day, on average, changed hands over the last three and twelve months, respectively. The rather illiquid nature of trading in NKBS shares exposes them to sharp movements in price on relatively small increases in volume. Additionally, many institutional investors have expressed a preference for those issues in which they are able to build large positions and liquidate them quickly. The narrow float and small volumes in which NKBS trades may deter those investors from taking a position in the shares.
- *Perceived lack of strategic focus.* Newtek's business model has evolved considerably since the company's establishment in 1998. The current strategy of providing high value and cost efficient services to small and medium-sized businesses did not begin to emerge until just two years ago. Furthermore, the strategy represents a marked departure from that articulated in Newtek's 2000 10-K: developing and holding a majority position or control of early-stage companies principally focused on technology, especially the Internet and e-commerce. Any material departure from the strategic mandates the firm has given itself may undermine management's credibility and the institutional support Newtek's shares appear to have garnered recently.

## INCOME STATEMENT SUMMARY

### Newtek Business Services, Inc.

New York, N.Y.

\$ in 000s, except per share data

INCOME STATEMENT-Summary	Total 2001	Total 2002	Mar-03	Jun-03	Sep-03	Dec-03	Total 2003	Mar-04	Jun-04E	Sep-04E	Dec-04E	Total 2004E	Total 2005E	CAGR 2003-2005
<b>Gross revenue by business segment</b>														
SBA Lending	-	-	1,322	1,683	1,638	2,746	7,390	2,141	2,675	4,058	4,328	13,202	20,090	65%
Merchant services	121	1,584	848	1,140	1,880	2,429	6,297	3,233	4,000	4,800	5,600	17,633	32,000	125%
Web hosting	-	-	-	-	-	-	-	-	-	1,900	2,100	4,000	8,000	nmf
Capco & other	23,784	33,085	10,749	11,897	22,911	1,248	46,805	2,496	7,800	11,800	14,300	36,396	39,000	-9%
Total	23,905	34,669	12,919	14,720	26,429	6,423	60,492	7,870	14,475	22,558	26,328	71,231	99,090	28%
<b>Pretax income</b>														
SBA Lending	-	-	(293)	(174)	378	841	751	289	355	1,682	1,837	4,163	7,673	220%
Merchant services	(76)	(1,259)	(375)	(184)	(219)	(142)	(920)	11	75	75	75	236	4,500	nmf
Web hosting	-	-	-	-	-	-	-	-	-	1,000	1,100	2,100	2,000	nmf
Capco & other	1,540	8,441	3,410	4,794	15,372	(6,935)	16,641	(3,188)	1,550	4,900	6,750	10,012	9,700	-24%
Total	1,464	7,183	2,742	4,435	15,531	(6,236)	16,472	(2,888)	1,980	7,657	9,762	16,510	23,873	20%
							10%					32%	38%	
<b>% of total gross revenue</b>														
SBA Lending	-	-	10%	11%	6%	43%	12%	27%	18%	18%	16%	19%	20%	
Merchant services	1%	5%	7%	8%	7%	38%	10%	41%	28%	21%	21%	25%	32%	
Web hosting	0%	0%	0%	0%	0%	0%	0%	0%	0%	8%	8%	6%	8%	
Capco & other	99%	95%	83%	81%	87%	19%	77%	32%	54%	52%	54%	51%	39%	
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	
<b>% of total pretax income</b>														
SBA Lending	-	-	-11%	-4%	2%	nmf	5%	nmf	18%	22%	19%	25%	32%	
Merchant services	-5%	-18%	-14%	-4%	-1%	nmf	-6%	nmf	4%	1%	1%	1%	19%	
Web hosting	0%	0%	0%	0%	0%	nmf	0%	nmf	0%	13%	11%	13%	8%	
Capco & other	105%	118%	124%	108%	99%	nmf	101%	nmf	78%	64%	69%	61%	41%	
Total	100%	100%	100%	100%	100%	nmf	100%	nmf	100%	100%	100%	100%	100%	

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## INCOME STATEMENT DETAILS

INCOME STATEMENT-Details	Total 2001	Total 2002	Mar-03	Jun-03	Sep-03	Dec-03	Total 2003	Mar-04	Jun-04E	Sep-04E	Dec-04E	Total 2004E	Total 2005E
<b>SBA Lending</b>													
Interest income	-	-	915	894	804	929	3,543	925	960	996	1,132	4,013	5,780
Interest expense	-	-	(505)	(494)	(471)	(446)	(1,916)	(502)	(510)	(459)	(459)	(1,930)	(2,344)
Net interest income	-	-	411	400	333	483	1,627	423	450	537	673	2,083	3,436
Loan loss provision	-	-	-	(339)	7	(142)	(473)	(105)	(109)	(118)	(132)	(464)	(674)
Net interest income after LLP	-	-	411	61	341	342	1,154	318	341	419	541	1,619	2,762
Servicing income	-	-	368	1,050	898	(1,121)	1,195	167	415	442	506	1,530	3,410
Gain on sale of SBA loans	-	-	-	-	244	1,263	1,507	945	1,200	2,520	2,590	7,255	10,500
Other income	-	-	39	(261)	(308)	1,675	1,145	104	100	100	100	404	400
<b>Gross revenue</b>	-	-	1,322	1,683	1,638	2,746	7,390	2,141	2,675	4,058	4,328	13,202	20,090
<b>Net revenue</b>	-	-	818	851	1,175	2,159	5,001	1,534	2,055	3,482	3,737	10,808	17,073
Operating expenses	-	-	1,110	1,025	797	1,318	4,250	1,245	1,700	1,800	1,900	6,645	8,500
Minority interest	-	-	-	-	-	-	-	-	-	-	-	-	900
<b>Income bef taxes and XO item</b>	-	-	(293)	(174)	378	841	751	289	355	1,682	1,837	4,163	7,673
<b>Merchant services</b>													
Electronic payment processing fees	121	1,584	848	1,140	1,880	2,429	6,297	3,233	4,000	4,800	5,600	17,633	32,000
Operating expenses	197	2,843	1,223	1,325	2,098	2,571	7,217	3,222	3,925	4,725	5,525	17,397	27,500
<b>Income bef taxes and XO item</b>	(76)	(1,259)	(375)	(184)	(219)	(142)	(920)	11	75	75	75	236	4,500
<b>Web hosting</b>													
Web hosting revenue	-	-	-	-	-	-	-	-	-	1,900	2,100	4,000	8,000
Web hosting expenses	-	-	-	-	-	-	-	-	-	900	1,000	1,900	6,000
<b>Income bef taxes and XO item</b>	-	-	-	-	-	-	-	-	-	1,000	1,100	2,100	2,000
<b>Capco and other</b>													
Income from tax credits	21,498	30,603	10,389	11,471	22,067	1,006	44,933	2,024	7,000	11,000	13,500	33,524	35,000
Other income	2,286	2,482	360	426	844	242	1,872	472	800	800	800	2,872	4,000
<b>Gross revenue</b>	23,784	33,085	10,749	11,897	22,911	1,248	46,805	2,496	7,800	11,800	14,300	36,396	39,000
Interest expense	10,677	10,733	3,002	2,822	2,729	3,044	11,597	3,021	3,200	3,300	3,400	12,921	15,000
Insurance expense	1,530	1,951	573	638	623	635	2,469	715	600	750	900	2,965	3,500
Minority interest	509	335	(288)	968	1,232	(314)	1,598	(300)	500	500	500	1,200	(700)
Goodwill impairment	-	-	-	-	-	1,435	1,435	-	-	-	-	-	-
Valuation adjustments	645	1,602	1,713	20	257	5	1,996	-	-	-	-	-	-
Equity in losses of affiliates	2,280	729	55	63	-	(118)	-	-	-	-	-	-	-
Other operating expenses	6,603	9,294	2,285	2,591	2,697	3,496	11,070	2,248	1,950	2,350	2,750	9,298	11,500
<b>Income bef taxes and XO item</b>	1,540	8,441	3,410	4,794	15,372	(6,935)	16,641	(3,188)	1,550	4,900	6,750	10,012	9,700
<b>Total inc before taxes and XO item</b>	1,464	7,183	2,742	4,435	15,531	(6,236)	16,472	(2,888)	1,980	7,657	9,762	16,510	23,873
Tax (provision)/benefit	(534)	(2,658)	(1,069)	(1,730)	(6,057)	1,766	(7,090)	1,185	(812)	(3,139)	(4,002)	(6,768)	(9,788)
Income before XO item	930	4,525	1,673	2,706	9,473	(4,470)	9,382	(1,703)	1,168	4,517	5,759	9,742	14,085
Extraordinary item	-	3,643	187	-	-	-	187	-	-	-	-	-	-
<b>Net income</b>	930	8,168	1,860	2,706	9,473	(4,470)	9,569	(1,703)	1,168	4,517	5,759	9,742	14,085
Average diluted shares	21,910	24,294	25,661	26,047	26,111	26,111	26,177	26,471	26,800	33,300	33,500	30,018	35,000
<b>Diluted EPS</b>	0.04	0.34	0.07	0.10	0.36	(0.17)	0.37	(0.06)	0.04	0.14	0.17	0.32	0.40
<b>Diluted EPS before XO item</b>	0.04	0.19	0.07	0.10	0.36	(0.17)	0.36	(0.06)	0.04	0.14	0.17	0.32	0.40

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**BALANCE SHEET**

<b>BALANCE SHEET</b>	Total 2001	Total 2002	Mar-03	Jun-03	Sep-03	Dec-03	Total 2003	Mar-04	Jun-04E	Sep-04E	Dec-04E	Total 2004E	Total 2005E
Cash and cash equivalents	31,172	41,171	42,669	38,027	35,000	35,552	35,552	45,245	60,639	48,714	46,137	46,137	46,487
Credits in lieu of cash	21,811	41,581	48,061	53,345	73,412	71,294	71,294	68,497	70,997	77,497	86,497	86,497	103,497
SBA loans receivable	-	56,073	53,766	52,489	50,623	52,051	52,051	52,474	53,665	61,037	68,572	68,572	98,123
SBA loans held for sale	-	-	-	-	804	3,620	3,620	2,282	2,282	2,282	2,282	2,282	2,282
Other receivables	199	3,885	3,463	3,231	3,370	3,421	3,421	3,802	4,000	4,200	4,400	4,400	5,200
Investments in qualified businesses													
--equity method investments	12,174	1,091	538	1,165	300	300	300	300	300	300	300	300	300
--held to maturity	2,276	3,962	2,962	2,891	2,593	1,420	1,420	1,284	1,200	1,100	1,000	1,000	800
Prepays	11,575	14,632	15,088	15,840	14,448	15,944	15,944	17,044	18,144	19,244	20,344	20,344	24,744
Customer merchant accounts	-	357	-	-	3,209	3,024	3,024	2,889	4,515	4,444	4,373	4,373	4,090
Capitalized servicing asset	-	-	-	-	-	-	-	1,163	1,435	2,072	2,688	2,688	5,012
Goodwill	964	2,863	2,863	3,225	3,225	1,833	1,833	1,833	14,244	14,244	14,244	14,244	14,244
Other assets	3,192	3,440	3,448	3,603	3,744	3,725	3,725	3,907	4,575	4,775	4,975	4,975	5,775
<b>Total assets</b>	<b>83,363</b>	<b>169,055</b>	<b>172,857</b>	<b>173,817</b>	<b>190,728</b>	<b>192,184</b>	<b>192,184</b>	<b>200,721</b>	<b>235,996</b>	<b>239,910</b>	<b>255,813</b>	<b>255,813</b>	<b>310,555</b>
Notes payable	13,262	9,695	9,686	9,084	10,081	8,945	8,945	11,043	13,000	15,000	17,000	17,000	25,000
Borrowings under line of credit	575	450	450	-	-	-	-	-	-	-	-	-	-
Bank notes payable	-	53,824	52,813	51,126	48,970	51,990	51,990	55,642	53,150	47,489	53,141	53,141	75,304
Note payable in credits in lieu of cash	49,641	65,196	64,378	61,103	61,832	65,697	65,697	69,726	71,976	74,226	76,476	76,476	85,476
Deferred taxes	1,563	3,726	4,796	6,525	12,583	10,816	10,816	9,632	11,600	13,600	12,500	12,500	14,500
Other liabilities	1,848	4,218	9,143	11,359	17,762	6,095	6,095	5,933	9,842	10,000	10,200	10,200	11,000
<b>Total liabilities</b>	<b>66,890</b>	<b>137,110</b>	<b>141,265</b>	<b>139,198</b>	<b>151,227</b>	<b>143,543</b>	<b>143,543</b>	<b>151,976</b>	<b>159,568</b>	<b>160,316</b>	<b>169,317</b>	<b>169,317</b>	<b>211,281</b>
Minority interest	5,082	4,773	6,484	7,453	8,689	8,393	8,393	8,093	7,800	7,500	7,200	7,200	6,000
<b>Total equity</b>	<b>11,392</b>	<b>27,172</b>	<b>29,903</b>	<b>33,692</b>	<b>43,395</b>	<b>40,247</b>	<b>40,247</b>	<b>40,653</b>	<b>69,221</b>	<b>73,438</b>	<b>78,898</b>	<b>78,898</b>	<b>91,783</b>
<b>EOP shares</b>	<b>22,213</b>	<b>25,341</b>	<b>25,580</b>	<b>25,889</b>	<b>25,949</b>	<b>26,209</b>	<b>26,209</b>	<b>26,652</b>	<b>33,300</b>	<b>33,500</b>	<b>33,700</b>	<b>33,700</b>	<b>34,500</b>
Book value per share	0.51	1.07	1.17	1.30	1.67	1.54	1.54	1.53	2.08	2.19	2.34	2.34	2.66
Tangible book value per share	0.47	0.96	1.06	1.18	1.55	1.47	1.47	1.46	1.65	1.77	1.92	1.92	2.25

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**CASH FLOW STATEMENT (\$ in millions)**

<b>CASH FLOW STATEMENT</b>	Total 2001	Total 2002	Mar-03	Jun-03	Sep-03	Dec-03	Total 2003	Mar-04	Jun-04E	Sep-04E	Dec-04E	Total 2004E	Total 2005E
Net income	930	8,168	1,860	2,705	9,473	(4,468)	9,570	(1,703)	1,168	4,517	5,759	9,742	14,085
Adj to reconcile NI to operating CFs:													
Income from tax credits	(21,498)	(30,603)	(10,389)	(11,471)	(22,067)	(1,006)	(44,933)	(2,024)	(7,000)	(11,000)	(13,500)	(33,524)	(35,000)
Deferred income taxes	535	2,657	1,069	1,730	6,057	(1,767)	7,090	(1,184)	1,968	2,000	(1,100)	1,684	2,000
Depreciation & amortization	74	148	45	22	192	226	484	290	320	320	320	1,250	1,800
Loan loss provision	-	-	-	339	(7)	142	473	105	109	118	132	464	674
SBA loans originated for sale	-	-	-	-	-	(18,685)	(18,685)	(8,112)	(12,000)	(25,200)	(25,900)	(71,212)	(105,000)
Proceeds from sale of SBA loans	-	-	-	-	2,438	12,627	15,065	9,449	12,000	25,200	25,900	72,549	105,000
Accretion of interest income	(161)	(176)	(44)	(44)	(33)	(55)	(176)	(44)	(44)	(44)	(44)	(176)	(176)
Accretion of interest expense	10,677	10,733	3,091	2,822	2,729	2,955	11,597	3,021	3,200	3,300	3,400	12,921	15,000
Non-cash compensation	97	230	105	30	48	387	570	262	250	250	250	1,012	1,000
Minority interest	509	335	(288)	968	1,232	(314)	1,598	(300)	500	500	500	1,200	200
Net change in working capital	181	(83)	641	64	1,008	765	2,476	(1,365)	(939)	(432)	(368)	(3,103)	(1,625)
Valuation adjustments/impairment	2,820	(1,318)	1,581	83	(211)	1,440	2,894	-	-	-	-	-	-
<b>Net cash flows from operations</b>	<b>(5,837)</b>	<b>(9,909)</b>	<b>(2,330)</b>	<b>(2,752)</b>	<b>859</b>	<b>(7,753)</b>	<b>(11,976)</b>	<b>(1,604)</b>	<b>(467)</b>	<b>(471)</b>	<b>(4,650)</b>	<b>(7,191)</b>	<b>(2,042)</b>
Investing activities:													
Investments in qualified businesses	(24,588)	(16,196)	(3,200)	(1,310)	(5,355)	(845)	(10,710)	(282)	(1,000)	(1,000)	(1,000)	(3,282)	(4,000)
Return of investments	12,072	14,045	1,577	530	2,570	1,649	6,326	1,751	1,750	1,750	1,750	7,001	5,000
Consol of majority-owned cos.	10,893	8,872	1,409	141	3,753	688	5,992	(1,332)	1,400	1,400	1,400	2,868	2,500
Purchase of furniture, fixtures, equip	(107)	(279)	(12)	(116)	(192)	(4)	(324)	(216)	(300)	(300)	(300)	(1,116)	(1,500)
Purchase of AMS, Crystal Tech, net	-	-	-	-	(1,493)	(215)	(1,708)	-	(10,651)	-	-	(10,651)	-
SBA loans originated for investment	-	-	-	-	(3,725)	(2,692)	(6,417)	(3,138)	(4,000)	(10,800)	(11,100)	(29,038)	(45,000)
Payments on SBA loans	-	-	2,307	938	2,345	3,959	9,549	2,354	2,400	2,500	2,600	9,854	11,400
Other	(249)	2,823	-	(30)	30	(5)	(5)	(15)	-	-	-	(15)	-
<b>Net cash flows from investing act.</b>	<b>(1,979)</b>	<b>9,266</b>	<b>2,080</b>	<b>153</b>	<b>(2,066)</b>	<b>2,537</b>	<b>2,704</b>	<b>(880)</b>	<b>(10,401)</b>	<b>(6,450)</b>	<b>(6,650)</b>	<b>(24,381)</b>	<b>(31,600)</b>
Financing activities:													
Proceeds of notes payable	-	30,000	-	-	1,000	5,658	6,658	10,925	1,957	2,000	2,000	16,883	8,000
Note syndication	-	(14,514)	-	(475)	(290)	(1,768)	(2,534)	(3,347)	(405)	2,906	7,821	6,975	11,829
Proceeds from notes payable-ins.	5,200	-	-	-	-	-	-	-	(250)	(4,250)	(6,750)	(11,250)	(8,000)
Principal pmts on notes payable-ins.	(1,596)	(7,034)	-	(578)	(910)	(767)	(2,255)	(779)	-	-	-	(779)	-
Repayment of notes payable-bank	-	(125)	(1,017)	(1,682)	(2,156)	3,988	(866)	(120)	-	-	-	(120)	-
Distributions to members	(609)	-	-	-	-	-	-	-	-	-	-	-	-
Proceeds/(pmts), bank borrowings	575	481	-	-	-	(1,834)	(1,834)	3,652	(2,492)	(5,660)	5,651	1,151	22,163
Proceeds from stock sales	726	2,091	2,766	690	180	826	4,463	1,848	27,450	-	-	29,298	-
Other	(5)	(256)	-	-	6	16	22	-	-	-	-	-	-
<b>Net cash flows from financing activity</b>	<b>4,291</b>	<b>10,642</b>	<b>1,750</b>	<b>(2,045)</b>	<b>(2,170)</b>	<b>6,119</b>	<b>3,654</b>	<b>12,179</b>	<b>26,260</b>	<b>(5,004)</b>	<b>8,722</b>	<b>42,157</b>	<b>33,992</b>
<b>Net incr/(decr) in cash</b>	<b>(3,525)</b>	<b>9,998</b>	<b>1,500</b>	<b>(4,644)</b>	<b>(3,377)</b>	<b>903</b>	<b>(5,618)</b>	<b>9,695</b>	<b>15,392</b>	<b>(11,925)</b>	<b>(2,577)</b>	<b>10,584</b>	<b>350</b>
Beginning bal., cash and equivalents	34,697	31,172	41,170	42,671	38,026	34,650	41,170	35,553	45,248	60,639	48,714	35,553	46,137
<b>Ending balance, cash and equivalents</b>	<b>31,172</b>	<b>41,170</b>	<b>42,671</b>	<b>38,026</b>	<b>34,650</b>	<b>35,553</b>	<b>35,553</b>	<b>45,248</b>	<b>60,639</b>	<b>48,714</b>	<b>46,137</b>	<b>46,137</b>	<b>46,487</b>

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### KEY ASSUMPTIONS

KEY ASSUMPTIONS-SBA Lending, Newtek Small Business Finance	Total 2002	Mar-03	Jun-03	Sep-03	Dec-03	Total 2003	Mar-04	Jun-04E	Sep-04E	Dec-04E	Total 2004E	Total 2005E
SBA loans originated for sale	-	-	-	3,243	15,442	18,685	8,112	12,000	25,200	25,900	71,212	105,000
SBA loans originated for investment	-	-	-	482	5,935	6,417	3,138	4,000	10,800	11,100	29,038	45,000
Total SBA loan originations	-	-	-	3,725	21,377	25,101	11,250	16,000	36,000	37,000	100,250	150,000
% originated for sale	-	0%	0%	87%	72%	74%	72%	75%	70%	70%	71%	70%
% originated for investment	-	0%	0%	13%	28%	26%	28%	25%	30%	30%	29%	30%
EOP loans held for investment	56,073	53,766	52,489	50,623	52,051	52,051	52,474	53,665	61,037	68,572	68,572	98,123
EOP loans held for sale	-	-	-	804	3,620	3,620	2,282	2,282	2,282	2,282	2,282	2,282
Average balances	-	54,919	53,127	51,959	53,549	53,389	55,214	55,352	59,038	67,087	70,855	85,630
Loan coupon	-	7.00%	6.75%	6.75%	6.75%	6.75%	6.75%	6.75%	6.75%	6.75%	6.75%	6.75%
Net yield	-	6.67%	6.73%	6.19%	6.94%	6.64%	6.70%	6.94%	6.75%	6.75%	5.66%	6.75%
Wgtd avg premium on loan sales (%)	-	-	-	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
Wgtd avg premium on loan sales (\$)	-	-	-	244	1,263	1,507	945	1,200	2,520	2,590	7,255	10,500
Line of credit/bank notes payable												
Advance rate	-	98%	97%	95%	93%	93%	102%	95%	75%	75%	87%	75%
EOP balances	53,824	52,813	51,126	48,970	51,990	51,990	55,642	53,150	47,489	53,141	53,141	75,304
Average balances	-	53,319	51,969	50,048	50,480	51,454	53,816	54,396	50,320	50,315	52,212	64,223
Cost of borrowing (nominal)	-	3.75%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
Cost of borrowing (adjusted)	-	3.79%	3.80%	3.76%	3.53%	3.72%	3.73%	3.75%	3.65%	3.65%	3.70%	3.65%
Servicing:												
UPB of loans serviced for others	141,500	na	na	na	123,832	123,832	127,768	131,783	148,746	165,349	165,349	229,012
Average balance	-	na	na	na	na	na	125,800	129,775	140,264	157,048	138,222	229,012
Servicing spread (%)	-	na	na	na	na	na	1.50%	1.55%	1.60%	1.70%	1.59%	1.85%
Servicing income, net of amort/impair	-	na	na	na	na	na	167	415	442	506	1,530	3,410
EOP Servicing rights	-	na	na	na	na	754	1,163	1,435	2,072	2,688	2,688	5,012
Implied capitalization rate	-	0.00%	0.00%	0.00%	0.00%	0.00%	5.85%	3.00%	3.00%	3.00%	3.32%	3.00%
Annualized amortization rate	-	0%	0%	0%	0%	0%	26%	26%	26%	26%	26%	26%

Source: Company reports and RCP estimates.

**Disclosures:**

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**Distribution of Ratings/IB Services Firmwide**

Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [B/SB]	149	80.11	32	21.48
HOLD [NR/N]	34	18.28	2	5.88
SELL [S]	3	1.61	0	0.00

**Ratings System Definitions** - RCP employs a rating system based on the following:

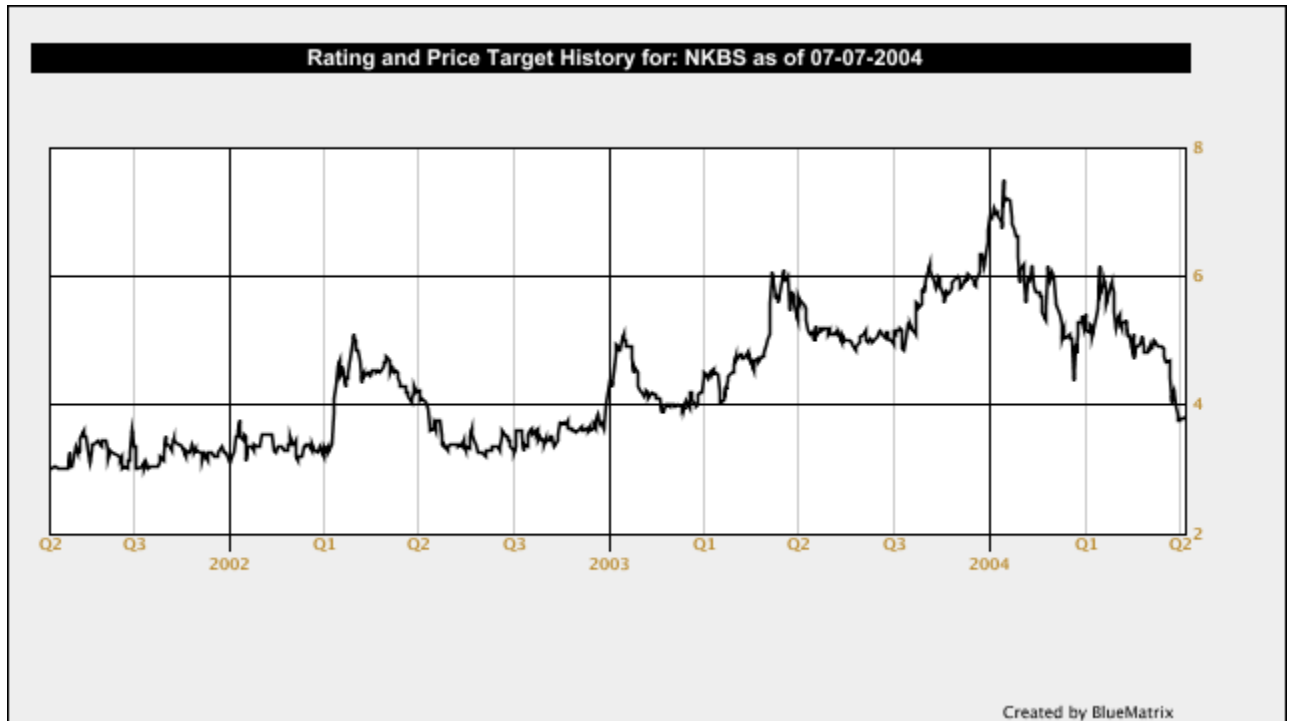
**Strong Buy:** A security, which at the time the rating is instituted and or reiterated, indicates an expectation of a total return of at least 40% over the next 12 months.

**Buy:** A security, which at the time the rating is instituted, indicates an expectation of a total return between 10% and 40% over the next 12 months.

**Neutral:** A security, which at the time the rating is instituted, indicates an expectation of a total return between negative 10% and 10% over the next 12 months.

**Sell:** A security, which at the time the rating is instituted, indicates an expectation that the price will depreciate by more than 10% over the next 12 months.

Our rating system attempts to incorporate industry, company and/or overall market risk and volatility. Consequently, at any given point in time, our investment rating on a stock and its implied price movement may not correspond to the stated 12-month price target.



For historical disclosure information, please see link below:

<https://roth.bluematrix.com/charts/large/NKBS.png>

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