

CLAYTON HOLDINGS INC
Form 10-Q
November 13, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

x

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

For the quarterly period ended September 30, 2006

OR

o

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

For the transition period from to

Commission File Number 000-51846

CLAYTON HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State of incorporation)

20-2660764
(I.R.S. Employer Identification No.)

2 Corporate Drive, Shelton, CT
(Address of principal executive offices)

06484
(Zip Code)

Registrant's telephone number, including area code: **(203) 926-5600**

(Former Name, Former Address and Former Fiscal year, if changed since last report)

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

Edgar Filing: CLAYTON HOLDINGS INC - Form 10-Q

to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

20,611,372 shares of Common Stock, par value \$0.01 per share, outstanding as of November 6, 2006.

CLAYTON HOLDINGS, INC. AND SUBSIDIARIES

INDEX

	Page
Part I. Financial Information	
Item 1. Financial Statements	
Condensed Consolidated Balance Sheets as of September 30, 2006 (unaudited) and December 31, 2005	1
Condensed Consolidated Statements of Income (unaudited) for the three and nine months ended September 30, 2006 and 2005	2
Condensed Consolidated Statement of Changes in Stockholders' Equity (unaudited) for the nine months ended September 30, 2006	3
Condensed Consolidated Statements of Cash Flows (unaudited) for the nine months ended September 30, 2006 and 2005	4
Notes to Condensed Consolidated Financial Statements (unaudited)	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	20
Item 3. Quantitative and Qualitative Disclosures About Market Risk	32
Item 4. Controls and Procedures	32
Part II. Other Information	
Item 1. Legal Proceedings	34
Item 1A. Risk Factors	34
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	34
Item 3. Defaults Upon Senior Securities	34
Item 4. Submission of Matters to a Vote of Security Holders	34
Item 5. Other Information	34
Item 6. Exhibits	34
Signatures	35
Exhibit Index	

PART I. FINANCIAL INFORMATION**Item 1. Financial Statements****CLAYTON HOLDINGS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

	September 30, 2006 (unaudited)	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 23,407,841	\$ 7,208,875
Cash held in escrow	1,002,777	
Restricted cash	25,378,170	4,966,839
Accounts receivable, net of allowance for doubtful accounts of \$121,703 and \$72,264 as of September 30, 2006 and December 31, 2005, respectively	39,940,992	37,205,223
Unbilled receivables	17,077,495	14,925,988
Prepaid expenses and other current assets	3,290,791	3,942,676
Prepaid income taxes	1,811,026	3,730,970
Deferred tax assets	350,805	165,566
Due from affiliated entities		23,434
Total current assets	112,259,897	72,169,571
Property and equipment, net	20,340,742	18,175,717
Goodwill	73,958,797	69,843,468
Intangible assets, net	77,864,475	84,739,774
Other assets, net	1,841,197	2,576,827
Total assets	\$ 286,265,108	\$ 247,505,357
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Long-term debt and capital lease obligations, current portion	\$ 1,097,368	\$ 1,639,411
Accounts payable and accrued expenses	23,042,095	18,842,078
Servicer escrow liability	25,378,170	4,966,839
Total current liabilities	49,517,633	25,448,328
Long-term debt and capital lease obligations, net of current portion	79,527,023	148,777,172
Deferred tax liabilities	2,961,220	3,381,001
Deferred revenue	68,534	217,888
Deferred rent	1,008,204	1,013,687
Total liabilities	133,082,614	178,838,076
Commitments and contingencies		
Series A convertible preferred stock, par value \$0.01 per share, no shares authorized, issued and outstanding as of September 30, 2006; 8,825,241 shares authorized, issued and outstanding as of December 31, 2005		12,258,319
Series B convertible preferred stock, par value \$0.01 per share, no shares authorized, issued and outstanding as of September 30, 2006; 24,185,493 shares authorized, issued and outstanding as of December 31, 2005		43,866,683
Stockholders equity:		
Common stock, par value \$0.01 per share, 150,000,000 and 60,000,000 shares authorized and 20,564,926 and 3,281,607 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively	205,649	32,816

Edgar Filing: CLAYTON HOLDINGS INC - Form 10-Q

Class B common stock, par value \$0.01 per share, no shares authorized, issued and outstanding as of September 30, 2006; 357,020 shares authorized, issued and outstanding as of December 31, 2005		3,570
Preferred stock, par value \$0.01 per share, 10,000,000 shares authorized, no shares issued and outstanding as of September 30, 2006		
Additional paid-in capital	140,252,582	4,115,827
Retained earnings	12,724,263	8,390,066
Total stockholders' equity	153,182,494	12,542,279
Total liabilities and stockholders' equity	\$ 286,265,108	\$ 247,505,357

The accompanying notes are an integral part of these statements.

1

CLAYTON HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	2006	2005	2006	2005
Revenue	\$ 60,969,255	\$ 54,031,051	\$ 178,000,902	\$ 151,201,610
Cost of services:				
Compensation expense	29,707,045	24,923,443	90,439,495	71,764,024
Travel and related expenses	6,302,644	7,455,077	20,182,431	21,924,136
Other direct costs	2,164,172	1,672,184	7,548,790	4,037,539
Total cost of services	38,173,861	34,050,704	118,170,716	97,725,699
Gross profit	22,795,394	19,980,347	59,830,186	53,475,911
Operating expenses:				
Salaries and benefits	5,960,658	4,718,809	16,990,876	14,000,953
Other selling, general and administrative expenses	5,064,044	4,014,497	14,948,766	12,400,510
Depreciation and amortization	2,184,949	1,187,304	5,684,205	3,137,926
Amortization of intangibles	2,577,696	2,540,172	7,721,125	7,633,833
Total operating expenses	15,787,347	12,460,782	45,344,972	37,173,222
Income from operations	7,008,047	7,519,565	14,485,214	16,302,689
Interest expense, net	1,760,016	1,999,319	6,505,625	5,825,451
Loss from extinguishment of debt			746,002	
Income before provision for income taxes	5,248,031	5,520,246	7,233,587	10,477,238
Income tax expense	2,188,133	2,184,517	2,899,390	4,162,461
Net income	\$ 3,059,898	\$ 3,335,729	\$ 4,334,197	\$ 6,314,777
Earnings per share:				
Basic	\$ 0.15	\$ 0.28	\$ 0.24	\$ 0.53
Diluted	\$ 0.14	\$ 0.27	\$ 0.23	\$ 0.51
Weighted average shares outstanding:				
Basic	20,536,709	11,889,201	17,776,603	11,887,779
Diluted	21,312,210	12,378,509	18,578,126	12,288,909

The accompanying notes are an integral part of these statements.

CLAYTON HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

(unaudited)

	Number of shares		Value		Additional paid-in capital	Retained Earnings	Total
	Common Stock	Class B Common Stock	Common Stock	Class B Common Stock			
Balance, December 31, 2005	3,281,607	357,020	\$ 32,816	\$ 3,570	\$ 4,115,827	\$ 8,390,066	\$ 12,542,279
Issuance of common stock	8,625,000		86,250		131,753,767		131,840,017
Conversion of convertible preferred stock to redeemable preferred stock and redemption of redeemable preferred stock, net	8,252,679		82,527		3,277,523		3,360,050
Conversion of series B common stock	357,020	(357,020)	3,570	(3,570)			
Stock based compensation					1,023,759		1,023,759
Exercise of stock options	48,620		486		81,706		82,192
Net income for the nine months ended September 30, 2006						4,334,197	4,334,197
Balance, September 30, 2006	20,564,926		\$ 205,649		\$ 140,252,582	\$ 12,724,263	\$ 153,182,494

The accompanying notes are an integral part of this statement.

CLAYTON HOLDINGS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	For the nine months ended September 30,	
	2006	2005
Cash flows from operating activities:		
Net income	\$ 4,334,197	\$ 6,314,777
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,684,205	3,137,926
Amortization of intangibles	7,721,125	7,633,833
Amortization of debt issuance cost	267,693	450,838
Accretion of note		69,512
Loss from extinguishment of debt	746,002	
Stock based compensation	1,023,759	148,356
Deferred income taxes	(605,026)	(1,170,122)
Loss on sale of fixed assets	5,648	120,239
Provision for doubtful accounts	178,743	226,690
Changes in operating assets and liabilities, net of business combinations:		
Accounts receivable	(2,125,487)	(14,476,737)
Unbilled receivables	(2,151,507)	878,459
Prepaid expenses and other current assets	667,301	(1,389,279)
Prepaid income taxes	1,919,945	(1,250,894)
Due to an affiliated entity	23,434	(267,990)
Other assets, net	(90,921)	(13,490)
Accounts payable and accrued expenses	4,236,695	1,097,780
Deferred revenue	(816,390)	581,618
Deferred rent	(5,483)	405,731
Net cash provided by operating activities	21,013,933	2,497,247
Cash flows from investing activities:		
Proceeds from sale of fixed assets	35,000	20,055
Capital expenditures	(6,698,654)	(8,026,002)
Acquisition of businesses	(5,727,168)	(825,326)
Cash held in escrow from acquisition of businesses inclusive of interest earned	(1,002,777)	
Net cash used in investing activities	(13,393,599)	(8,831,273)
Cash flows from financing activities:		
Proceeds from revolving credit facility	7,400,000	25,150,000
Repayments of revolving credit facility	(7,400,000)	(16,726,908)
Repayments of loans payable		(75,155)
Repayments of capital lease obligations	(216,966)	(81,519)
Repayment of term loan	(70,200,501)	(3,875,000)
Deferred charges related to the issuance of debt	(161,158)	
Proceeds from issuance of common stock upon initial public offering	146,625,000	
Underwriting commissions and offering expenses	(14,784,499)	
Redemption of convertible preferred stock	(52,764,950)	
Proceeds from the exercise of stock options	81,706	19,047
Distributions to stockholders		(4,000,000)
Net cash provided by financing activities	8,578,632	410,465
Net increase (decrease) in cash and cash equivalents	16,198,966	(5,923,561)

Edgar Filing: CLAYTON HOLDINGS INC - Form 10-Q

Cash and cash equivalents at the beginning of the period	7,208,875	12,450,147
Cash and cash equivalents at the end of the period	\$ 23,407,841	\$ 6,526,586

The accompanying notes are an integral part of these statements.

4

CLAYTON HOLDINGS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

Note 1 Organization, Description of Business and Basis of Presentation

Clayton Holdings, Inc. (collectively with its wholly owned subsidiaries, the Company) was formed on March 31, 2005 as a Delaware corporation. The Company was formed to combine two companies which were under common control, GRP Holdings, Inc. (GRP), a Delaware corporation, and TMHC Holdings, Inc. (TMHC), a Delaware corporation. GRP was formed to acquire Clayton Services, Inc. (CSI) and First Madison Services, Inc. (FMS) from unrelated parties on August 2, 2004. TMHC was formed to acquire Clayton Fixed Income Services Inc., formerly known as The Murrayhill Company (CFIS), from an unrelated party on May 24, 2004. Each holding company was controlled by TA Associates (TA) prior to the combination. In accordance with accounting principles generally accepted in the United States of America (US GAAP), assets transferred between entities under common control are accounted for at historical cost similar to a pooling of interests, and the financial statements of previously separate companies for periods they were under common control are restated on a combined basis. The Company's consolidated financial statements include the results of GRP and TMHC beginning from the date of acquisition of a controlling interest by TA, which were August 2, 2004 and May 24, 2004, respectively.

The Company provides a full suite of outsourced services, information-based analytics and specialty consulting for buyers and sellers of, and investors in, mortgage-related loans and securities and other debt instruments. The Company's services include transaction management, which consists of due diligence, conduit support services, professional staffing services, compliance products and services as well as credit risk management and securities surveillance, and special servicing. The Company uses proprietary technology and processes to provide these services across the lifecycle of a loan, from loan origination, aggregation and securities issuance to the surveillance and administration of loans and securities. The Company provides a majority of its services to participants in the non-agency segment of the mortgage-backed securities, or MBS, market and the non-conforming mortgage loan market.

Basis of Presentation

The accompanying condensed consolidated financial statements are unaudited. In the opinion of management, all adjustments, consisting of only normal recurring adjustments considered necessary for a fair presentation, have been included. Certain information and footnote disclosures normally included in financial statements prepared in accordance with US GAAP have been condensed or omitted. It is suggested that these unaudited condensed consolidated financial statements be read in conjunction with the consolidated financial statements, accounting policies and notes included in the Company's registration statement on Form S-1 (File No. 333-129526) declared effective by the Securities and Exchange Commission on March 23, 2006, which includes audited financial statements for the year ended December 31, 2005. Results for the interim periods are not necessarily indicative of results for the full year.

Initial Public Offering of Common Stock

On March 29, 2006, the Company sold 8,625,000 shares, inclusive of an over-allotment option of 1,125,000 shares, of its common stock in an initial public offering (IPO) of common stock at a price to the public of \$17.00 per share, for net proceeds of approximately \$131,800,000 after deducting the underwriting discount and approximately \$4,500,000 of offering expenses. The Company used approximately \$130,200,000 of the proceeds to pay down indebtedness and to redeem all outstanding shares of redeemable preferred stock, which were issued upon the conversion of the Company's convertible preferred stock. The Company used the remaining approximately \$1,600,000 for general corporate purposes. After giving effect to this offering, the Company had 20,516,306 shares of common stock outstanding.

All share information has been adjusted to reflect a 1-for-4 reverse stock split of common stock and class B common stock, which was consummated on March 1, 2006.

Note 2 Summary of Significant Accounting Policies

Significant accounting policies followed by the Company, as summarized below, are in conformity with US GAAP.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company. All significant intercompany transactions and balances have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, as well as the disclosure of contingent assets and liabilities in the financial statements and accompanying notes. Some of these accounting policies require the application of significant judgment by management in the selection of appropriate assumptions for determining these estimates. By their nature, these judgments are subject to an inherent degree of uncertainty; therefore, the Company cannot give assurance that actual results will not differ significantly from estimated results. Management bases these judgments on the Company's historical experience, management's forecasts and other available information, as appropriate. The most significant estimates reflected in the financial statements include deferred tax assets and liabilities, income tax accruals, valuation allowance for accounts receivable, unbilled receivables, asset impairments, the valuation of stock options and the valuation of intangible assets and assessments of their useful lives, and related party transactions. Actual results could differ from estimated amounts. The Company also makes estimates in determining other ordinary accruals.

Segment Reporting

The Company's activities are considered to be in a single industry segment for financial reporting purposes. The Company provides services that support the purchase and sale of, and investment in, mortgage loans and related securities across the mortgage loan lifecycle. Revenues from the Company's various products and services are affected by the same factors, primarily the origination of non-conforming mortgage loans and the issuance of non-agency mortgage-backed securities.

Deferred Financing Costs

The Company amortizes the costs that it incurs to obtain debt financing over the terms of the underlying obligations using the effective interest method for the portion of the costs associated with term loan debt and using the straight line method for the portion of the costs associated with the revolving credit facility. The amortization of deferred financing costs is included in interest expense. Unamortized deferred financing costs are included in other assets, net in the accompanying condensed consolidated balance sheets. As a result of the Company's IPO (see Note 1) on March 29, 2006, the Company repaid \$70,000,000 of principal on its \$150,000,000 term loan and wrote off a proportionate share of the unamortized deferred financing costs associated with the term loan. A loss on extinguishment of \$746,002 reflecting this write off is reflected in the statement of income for the nine months ended September 30, 2006. Unamortized deferred financing costs at September 30, 2006 and December 31, 2005 were \$1,501,562 and \$2,354,099, respectively, and are included on the accompanying consolidated balance sheets in other assets, net.

Revenue Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, the service has been performed, the fee is fixed and determinable, and collection of the resulting receivable is reasonably assured.

The Company derives most of its revenues from professional service activities. Revenues consisting of billed fees and pass-through expenses are recorded as work is performed and expenses are incurred. Revenues also include expenses billed to clients, which includes travel and other out-of-pocket expenses, and other reimbursable expenses. Based on aggregate volume of all travel expenses incurred for both corporate purposes and client service activities, the Company is eligible to receive certain retroactive volume discounts from several of its travel providers. Such amounts are accrued as earned, are netted against travel and related expenses and historically have not been material. For the three months ended September 30, 2006 and 2005, pass-through expenses included in revenues were \$6,302,644 and \$7,455,077, respectively. For the nine months ended September 30, 2006 and 2005, pass-through expenses included in revenues were \$20,182,431 and \$21,924,136, respectively.

The Company records provisions for fee adjustments and discretionary pricing adjustments as a reduction of revenues. Revenues recognized, but not yet billed to clients, have been recorded as unbilled receivables in the accompanying condensed consolidated balance sheets.

Stock-based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123(R), Accounting for Stock Based Compensation which establishes standards for transactions in which an entity exchanges its equity instruments for goods or services. This standard requires an issuer to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. This eliminates the exception to account for such awards using the intrinsic method previously allowable under Accounting Principles Board (APB) Opinion No. 25. In March 2005, the SEC released Staff Accounting Bulletin (SAB) 107, Share-Based Payment, which expresses views of the SEC Staff about the application of SFAS No. 123(R). SFAS No. 123(R) became effective for annual reporting periods beginning on or after June 15, 2005. The Company previously adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, for all awards granted to employees. On January 1, 2006, the Company adopted SFAS No. 123(R) and SFAS No. 123(R) does not have a material impact on its financial statements.

According to the provisions of the incentive stock option agreements between the Company and its employees, the vesting term for certain options outstanding as of the date of the IPO accelerated by either one year or twenty percent, varying in accordance with the terms of the employee s specific incentive stock option agreement. In addition, 130,208 of performance based options became immediately vested. Therefore, on March 29, 2006, the Company recognized \$611,696 of additional compensation expense from this accelerated vesting.

Concentration of Credit Risk and Significant Customers

At September 30, 2006, 23.9% and 31.6% of the Company s billed and unbilled receivables were related to its two largest clients, respectively. At December 31, 2005, 30.1% and 25.5% of the Company s billed and unbilled receivables were related to its two largest clients, respectively.

For the three months ended September 30, 2006 and 2005, revenue from the Company s largest three clients accounted for an aggregate of 30.2% and 33.3% of total revenue, respectively. Revenue from two clients exceeded 10% of revenue for the three months ended September 30, 2006 and revenue from three clients exceeded 10% of revenue for the three months ended September 30, 2005.

For the nine months ended September 30, 2006 and 2005, revenue from the Company s largest three clients accounted for an aggregate of 32.0% and 35.5% of total revenue, respectively. Revenue from two clients exceeded 10% of revenue for the nine months ended September 30, 2006 and revenue from three clients exceeded 10% of revenue for the nine months ended September 30, 2005.

Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted-average number of shares of common stock and common stock equivalents outstanding during the period. The Company's convertible preferred stock is deemed to be a common stock equivalent and included in the computation of basic earnings per share because it receives dividends at a rate that results in a per share amount that is equivalent to the per share amount paid on common stock. Diluted earnings per share gives effect to dilutive options, warrants and other potential common stock outstanding during the period. At September 30, 2006, outstanding options to purchase 210,000 and 130,000 common shares had exercise prices in excess of the average market price of common shares for the three and nine month periods ended September 30, 2006, respectively. At September 30, 2005, outstanding options to purchase 254,580 and 887,094 common shares had exercise prices in excess of the average market price of common shares for the three and nine month periods ended September 30, 2005, respectively. These options were not included in the computation of diluted earnings per share for the respective periods because the effect would be antidilutive.

The following table presents a reconciliation of the numerators and denominators of basic and diluted net income per share for the three and nine months ended September 30, 2006 and 2005:

	For the three months ended September 30, 2006		For the three months ended September 30, 2005	
	Basic	Diluted	Basic	Diluted
Net income	\$ 3,059,898	\$ 3,059,898	\$ 3,335,729	\$ 3,335,729
Weighted average number of common shares outstanding	20,536,709	20,536,709	11,889,201	11,889,201
Dilutive effect of stock options		775,501		489,308
Total weighted average number of common shares outstanding	20,536,709	21,312,210	11,889,201	12,378,509
Earnings per share	\$ 0.15	\$ 0.14	\$ 0.28	\$ 0.27

	For the nine months ended September 30, 2006		For the nine months ended September 30, 2005	
	Basic	Diluted	Basic	Diluted
Net income	\$ 4,334,197	\$ 4,334,197	\$ 6,314,777	\$ 6,314,777
Weighted average number of common shares outstanding	17,776,603	17,776,603	11,887,779	11,887,779
Dilutive effect of stock options		801,523		401,130
Total weighted average number of common shares outstanding	17,776,603	18,578,126	11,887,779	12,288,909
Earnings per share	\$ 0.24	\$ 0.23	\$ 0.53	\$ 0.51

Adoption of New Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement 109. FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return including a decision whether to file or not to file in a particular jurisdiction. FIN 48 is effective for fiscal years beginning after December 15, 2006. If there are changes in net assets as a result of application of FIN 48 these will be accounted for as an adjustment to retained earnings. The Company is currently assessing the impact of FIN 48 on its consolidated financial position and results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 establishes a common definition for fair value to be applied to US GAAP guidance requiring use of fair value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of SFAS No. 157 on its consolidated financial position and results of operations.

In September 2006, the Securities and Exchange Commission (SEC) staff issued Staff Accounting Bulletin (SAB) 108 Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 requires that public companies utilize a dual-approach to assessing the quantitative effects of financial misstatements. This dual approach includes both an income statement focused assessment and a balance sheet focused assessment. The guidance in SAB 108 must be applied to annual financial statements for fiscal years ending after November 15, 2006. The Company is currently assessing the impact of adopting SAB 108 but does not expect that it will have a material effect on its consolidated financial position or results of operations.

Note 3 Business Acquisitions

Asset Purchase from M R Network I, Ltd.

On February 3, 2006, the Company entered into an asset purchase agreement through a subsidiary pursuant to which the subsidiary acquired substantially all of the assets and assumed certain liabilities of M R Network I, Ltd. (formerly d/b/a Mortgage Resource Network and currently d/b/a Clayton Lender Solutions, Inc.) for an estimated aggregate purchase price of \$5,727,168, pending a final closing balance sheet. The asset purchase agreement provided for a 60-day period subsequent to the closing date to provide a closing balance sheet which will be used to determine final fair market values. The agreement also established two escrow accounts aggregating \$600,000 which are reflected in the accompanying condensed consolidated balance sheet, including accumulated interest, at September 30, 2006 as cash held in escrow. This escrow is held against any claims the Company may have for indemnification or a working capital shortfall upon preparation of the final closing balance sheet. The 60-day period to reach agreement on the final closing balance sheet was extended so that the Company can better evaluate the fair value of assets acquired.

In July, 2006, an additional escrow account in the amount of \$392,842 was established by the former principal owners of M R Network I, Ltd. This amount will be retained by the Company if the Company is not able to collect certain accounts receivable balances included in the assets acquired by the Company. As a result, the purchase price and the amount allocated to goodwill were reduced by the amount of the escrow account. This acquisition has not been presented on a pro forma basis because it is not deemed to be material.

The purchase price was allocated as follows:

Accounts receivable	\$ 789,024
Prepaid expenses	15,417
Property and equipment	949,555
Goodwill	4,115,329
Intangible assets - customer relationships	771,000
Intangible assets - noncompetition agreement	74,000
Deposit	25,986
Liabilities assumed	(1,013,143)
	\$ 5,727,168

Note 4 Cash, Cash Equivalents and Restricted Cash

At September 30, 2006 and December 31, 2005, the Company maintained cash and cash equivalent balances in excess of \$100,000 at two separate financial institutions. Accounts at these institutions are insured by the Federal Deposit Insurance Corporation up to \$100,000. At September 30, 2006 and December 31, 2005, the cash balances exceeded \$100,000 by \$46,831,575 and \$13,447,318, respectively, including restricted cash.

At September 30, 2006 and December 31, 2005, the Company maintained restricted cash balances of \$25,378,170 and \$4,966,839, respectively. This balance represented funds received in connection with certain loan servicing functions the Company performs for a customer. Such funds are received throughout the month and remitted to the customer on a monthly basis. The balance on hand is included in servicer escrow liability in the accompanying condensed consolidated balance sheets.

Note 5 Property and Equipment, net

Property and equipment, net consists of the following:

	September 30, 2006	December 31, 2005
Computer and office equipment	\$ 9,474,716	\$ 6,526,737
Software	16,734,694	8,100,020
Furniture and fixtures	3,272,443	2,926,452
Leasehold improvements	1,839,604	1,391,952
Website	280,317	280,317
Automobiles	112,336	171,395
	31,714,110	19,396,873
Less accumulated depreciation and amortization	11,762,807	6,117,862
	19,951,303	13,279,011
Software under development	389,439	4,896,706
	\$ 20,340,742	\$ 18,175,717

Included in software at September 30, 2006 and December 31, 2005, is \$10,213,442 and \$3,189,915, respectively, of internally developed software placed in service. Software under development represents other internally developed software that has not yet been placed in service.

For the three months ended September 30, 2006 and 2005 depreciation and amortization expense charged to operations was \$2,184,949 and \$1,187,304, respectively. For the nine months ended September 30, 2006 and 2005 depreciation and amortization expense charged to operations was \$5,684,205 and \$3,137,926, respectively.

Note 6 Goodwill and Other Intangible Assets

As of September 30, 2006 and December 31, 2005, intangible assets not subject to amortization consist of goodwill of \$73,958,797 and \$69,843,468, respectively, and trade names and trademarks of \$15,504,917 and \$15,504,338, respectively.

Edgar Filing: CLAYTON HOLDINGS INC - Form 10-Q

At September 30, 2006, the Company's intangible assets with identifiable useful lives, which continue to be amortized, consist of the following:

	Gross carrying amount	Accumulated amortization	Net
Customer relationships			
Transaction management and advisory	\$ 36,400,000	\$ 4,381,482	\$ 32,018,518
Staffing services	4,300,000	931,667	3,368,333
Portfolio management	11,485,600	2,761,009	8,724,591
Client backlog	2,146,200	1,010,791	1,135,409
Technology	26,842,900	11,746,441	15,096,459
Noncompetition agreements	3,568,950	1,566,598	2,002,352
Patent	20,451	6,555	13,896
	\$ 84,764,101	\$ 22,404,543	\$ 62,359,558

At December 31, 2005, the Company's intangible assets with identifiable useful lives, which continue to be amortized, consist of the following:

	Gross carrying amount	Accumulated amortization	Net
Customer relationships			
Transaction management and advisory	\$ 36,400,000	\$ 2,864,815	\$ 33,535,185
Staffing services	4,300,000	609,167	3,690,833
Portfolio management	10,714,600	1,776,817	8,937,783
Client backlog	2,146,200	688,861	1,457,339
Technology	26,842,900	7,720,006	19,122,894
Noncompetition agreements	3,494,950	1,022,292	2,472,658
Patent	20,204	1,460	18,744
	\$ 83,918,854	\$ 14,683,418	\$ 69,235,436

Amortization expense for the three months ended September 30, 2006 and 2005 was \$2,577,696 and \$2,540,172, respectively. Amortization expense for the nine months ended September 30, 2006 and 2005 was \$7,721,125 and \$7,633,833, respectively.

Note 7 Revolving Credit Facility, Long-Term Debt and Capital Lease Obligations

Long-term debt and capital lease obligations consist of the following:

	September 30, 2006	December 31, 2005
Term loans	\$ 79,799,499	\$ 150,000,000
Capital lease obligations	824,892	416,583
Total long-term debt	80,624,391	150,416,583
Less current portion	1,097,368	1,639,411
Long-term debt, net of current portion	\$ 79,527,023	\$ 148,777,172

Credit Agreement

On December 8, 2005 the Company entered into a credit agreement (the *Credit Agreement*) with a financial institution. The *Credit Agreement*, provided the Company with a \$150,000,000 term loan, all of which was funded at closing, and a \$40,000,000 revolving credit facility, none of which was funded at closing. Subject to the agreement of the lenders to increase their commitments, the Company had the option to borrow up to an additional \$10,000,000 under the revolving credit facility, for an aggregate revolving credit facility of \$50,000,000. On January 11, 2006 and April 28, 2006, the Company exercised its option and amended the *Credit Agreement* to increase the revolving credit facility by \$5,000,000 on each date, such that the Company had an aggregate revolving credit facility of \$50,000,000 as of, and subsequent to, April 28, 2006. The *Credit Agreement* expires on December 8, 2011.

After the Company's initial public offering was completed on March 29, 2006 the Company repaid \$70,000,000 of the \$150,000,000 outstanding term loan balance without incurring any prepayment penalty. In addition, \$7,400,000 which was outstanding under the revolving credit facility was repaid. The first \$375,000 of the \$70,000,000 term loan payment was applied against the principal payment due on March 31, 2006 and future principal repayments were recalculated pro rata based on the remaining balance. Therefore, scheduled quarterly payments of the term loan through December 31, 2010 were reduced from \$375,000 to \$200,501 with the remaining balance of \$76,190,476 payable in four quarterly installments of \$19,047,619 in 2011. As a result of the repayment of the term loan the Company wrote off a proportionate share of deferred financing costs associated with the term loan (see Note 2, *Deferred Financing Costs*) and reflected a loss on extinguishment of \$746,002 in the condensed consolidated statement of income for the nine months ended September 30, 2006.

The *Credit Agreement* is collateralized by substantially all of the assets of the Company. The agreement contains covenants which, among other matters, require the Company to maintain certain levels of interest coverage ratio, fixed charge ratio and total leverage ratio. Such covenants commenced effectiveness on March 31, 2006. The Company is in compliance with these covenants. In addition, the *Credit Agreement* places limitations on total annual capital expenditures, indebtedness, liens, dividends and distributions, asset sales, transactions with affiliates, acquisitions and conduct of business, all as defined in the agreement. The *Credit Agreement* also contains provisions for an increased rate of interest during periods of default.

Loans under the *Credit Agreement* bear interest at the applicable London interbank offered rate (*LIBOR*) plus 3.00% or Prime rate plus 2.0%, at the Company's option. In addition, the Company is required to pay a commitment fee of 0.5% based on the calculation of the excess of the revolving credit loan commitment over the revolving outstanding balance as defined.

At September 30, 2006 and December 31, 2005, the revolving credit facility had no outstanding balance and there was an outstanding balance of \$79,799,499 and \$150,000,000, respectively, under the term loan with an interest rate of 8.33% and 9.25%, respectively.

Interest Rate Cap

In September 2004, CSI purchased an interest rate cap agreement to reduce the potential impact that interest rate increases could have on its floating-rate debt interest expense. The terms of the interest rate cap provide that the Company would receive quarterly payments equal to the notional amount multiplied by the difference by which *LIBOR* exceeds 5%. During the third quarter of 2006 the Company received approximately \$19,300 which was recorded as a reduction of interest expense. The initial notional amount was \$20,000,000 and declines during the term of the agreement, which expired on September 30, 2006. As of December 31, 2005, the notional amount was \$16,937,500. The interest rate cap does not qualify for hedge accounting under SFAS No. 133, as amended. The initial premium of \$29,900 was recorded as an asset on the date of purchase. Subsequent declines in the fair value of this derivative were recorded as interest expense in the accompanying condensed consolidated statements of income. For the three and nine months ended September 30, 2005, the Company recorded \$0 and \$7,860, respectively, of interest expense to reflect a decline in the fair value of this asset during the respective periods. In January 2006, the Company recorded interest expense of \$1,915 to reduce the book value of this asset to zero.

Capitalized Lease Obligations

At September 30, 2006, the Company leased \$1,068,087 of equipment under agreements accounted for as capital leases with accumulated depreciation of \$240,219. The obligations for the equipment required the Company to make monthly payments through March 2011, with implicit interest rates from 7.06% to 19.06%.

At December 31, 2005, the Company leased \$467,584 of equipment under agreements accounted for as capital leases with accumulated depreciation of \$51,597. The obligations for the equipment required the Company to make monthly payments through August 2010, with implicit interest rates from 7.06% to 19.06%.

Note 8 Preferred Stock

As of December 31, 2005 the Company had 8,825,241 shares designated as Series A Redeemable Preferred Stock, par value \$0.01 per share, and 27,837,046 shares designated as Series B Redeemable Preferred Stock, par value \$0.01 per share, none of which were outstanding. As of December 31, 2005, the Company had 8,825,241 shares designated as Series A Convertible Preferred Stock, par value \$0.01 per share, and 24,185,493 shares designated as Series B Convertible Preferred Stock, par value \$0.01 per share, all of which were outstanding. As of December 31, 2005, the Series A and Series B convertible preferred stock were carried on the consolidated balance sheet at their liquidation preference of \$12,258,319 and \$43,866,683, respectively.

On March 29, 2006, the Company completed its initial public offering of common stock, resulting in the conversion of the Series A Convertible Preferred Stock into 2,206,308 shares of common stock, par value \$0.01 per share, and 8,825,241 shares of Series A Redeemable Preferred Stock, and the conversion of 24,185,493 shares of Series B Convertible Preferred Stock into 6,046,371 shares of common stock, par value \$0.01 per share, and 24,185,493 shares of Series B Redeemable Preferred Stock. A portion of the proceeds from the initial public offering was used to redeem all shares of the Series A Redeemable Preferred Stock and Series B Redeemable Preferred Stock for \$52,764,950, and all of the Series A and Series B Redeemable Preferred Stock were immediately retired. The difference between the liquidation preference amount of the convertible preferred stock and the redemption amount of the redeemable preferred stock was allocated to the common stock resulting from the conversion and credited to additional paid-in capital.

Note 9 Commitments and Contingencies

Operating Leases

The Company leases its office facilities and certain equipment under noncancelable operating lease arrangements expiring on various dates through 2013. Such leases include fixed or minimum payments plus, in some cases, scheduled base rent increases over the term of the lease and additional rents based on the Consumer Price Index. Certain leases provide for monthly payments of real estate taxes, insurance and other operating expenses applicable to the property.

For the three months ended September 30, 2006 and 2005, rent expense was approximately \$895,651 and \$696,621, respectively. For the nine months ended September 30, 2006 and 2005, rent expense was approximately \$2,790,855 and \$2,090,008, respectively.

Litigation

In the normal course of business, the Company is subject to various legal proceedings and claims, the resolution of which, in management's opinion, will not have a material adverse effect on the financial position or the results of operations of the Company.

Note 10 Common Stock

At December 31, 2005, the Company had 60,000,000 shares of common stock authorized, of which 3,281,607 were issued and outstanding.

Prior to the initial public offering, the Company's outstanding capital stock consisted of: (i) 3,281,607 shares of common stock, par value \$0.01 per share; (ii) 357,020 shares of Class B common stock, par value \$0.01 per share; (iii) 8,825,241 shares of Series A Convertible Preferred Stock, par value \$0.01 per share; and (iv) 24,185,493 shares of Series B Convertible Preferred Stock, par value \$0.01 per share.

In connection with, and upon the completion of, the initial public offering on March 29, 2006, 8,825,241 shares of Series A Convertible Preferred Stock were converted into 2,206,308 shares of common stock and 8,825,241 shares of Series A Redeemable Preferred Stock, and 24,185,493 shares of Series B Convertible Preferred Stock were converted into 6,046,371 shares of common stock and 24,185,493 shares of Series B Redeemable Preferred Stock.

Upon the consummation of the initial public offering, all outstanding shares of Class B common stock were converted into 357,020 shares of common stock, par value \$0.01 per share, and each share of Class B Common Stock was retired.

Inclusive of an over-allotment option of 1,125,000 shares of its common stock, the Company sold 8,625,000 shares of common stock in its initial public offering at a price to the public of \$17.00 per share, for net proceeds of approximately \$131,800,000 after deducting the underwriting discount and approximately \$4,500,000 of offering expenses. After giving effect to this offering and the conversion transactions described above, the Company had 20,516,306 shares of common stock outstanding as of March 29, 2006.

On March 29, 2006, in connection with the Company's initial public offering, the Fourth Amended and Restated Certificate of Incorporation, which was adopted by the stockholders prior to the initial public offering, was filed with the State of Delaware. The Company's Certificate of Incorporation was amended to change the authorized capital stock of the Company from an aggregate of 160,000,000 shares, consisting of (a) 69,673,021 shares of preferred stock, par value \$0.01 per share, consisting of Series A Convertible Preferred Stock, Series B Convertible Preferred Stock, Series A Redeemable Preferred Stock and Series B Redeemable Preferred Stock, (b) 80,326,979 shares of common stock, consisting of common stock and Class B common stock, and (c) 10,000,000 shares of undesignated preferred stock to a total of 160,000,000 shares of capital stock consisting of (i) 150,000,000 shares of common stock, par value \$0.01 per share, and (ii) 10,000,000 shares of undesignated preferred stock, par value \$0.01 per share.

All share information has been adjusted to reflect a 1-for-4 reverse stock split of common stock and class B common stock, which was consummated on March 1, 2006.

At September 30, 2006, the Company had 150,000,000 shares of common stock authorized, of which 20,564,926 were issued and outstanding.

Note 11- Related Party Transactions

On March 29, 2006 the Company paid \$52,764,950 from proceeds from its IPO to redeem from investment funds affiliated with TA Associates and other preferred stockholders, including Brian L. Libman, a director of the Company, all of the shares of redeemable preferred stock outstanding immediately following the conversion of Series A Convertible Preferred Stock and Series B Convertible Preferred Stock.

The Company's Chief Executive Officer, who was appointed in April 2005, has served on the Board of Directors of another public company since 1995 and is currently the chairman of this entity's audit committee. This unrelated entity acquires and originates non-conforming residential and commercial loans.

The Company has provided due diligence and professional staffing services to this entity and revenues aggregated \$27,375 for the three and nine month periods ended September 30, 2006, and \$64,042 and \$643,809 for the three and nine month periods ended September 30, 2005, respectively.

CFIS has contracts to perform Credit Risk Management services for portfolios managed by a stockholder. Revenues generated from the contracts for the nine months ended September 30, 2006 and 2005 were approximately \$476,421 and \$507,748, respectively, and for the three months ended September 30, 2006 and 2005 were approximately \$162,698 and \$215,349, respectively, and were included in service fee revenue in the condensed consolidated statements of income. Accounts receivable from this party at September 30, 2006 and December 31, 2005, were \$90,077 and \$74,555, respectively.

Until December 8, 2005, the Company had subordinated note and subordinated convertible note purchase agreements with certain stockholders of the Company. For the nine months ended September 30, 2005 interest expense on these notes was \$2,706,667. There was no interest expense on these notes in the nine months ended September 30, 2006.

Note 12 Stock Options

The Company's 2005 Stock Option and Grant Plan (2005 Option Plan) permitted the Company to make grants of incentive stock options, non-qualified stock options, restricted stock awards and unrestricted stock awards to officers, employees, directors, consultants and other key persons. Stock options granted under the 2005 Option Plan have a maximum term of ten years from the date of grant and incentive stock options have an exercise price of no less than the fair market value of the common stock on the date of grant. In connection with the adoption of the Company's 2006 Option Plan, which is discussed below, the board of directors determined not to grant any further awards under the 2005 Option Plan.

On January 26, 2006, the Company's Board of Directors approved the adoption of the Company's 2006 Stock Option and Incentive Plan (2006 Option Plan), and the 2006 Option Plan was subsequently approved by stockholders on March 8, 2006. The 2006 Option Plan permits grants of incentive stock options, non-qualified stock options, stock appreciation rights, deferred stock awards, restricted stock awards, unrestricted stock awards and dividend equivalent rights. The Company reserved 1,814,130 shares of common stock for issuance of awards under the 2006 Option Plan, subject to adjustment for any stock split, dividend or other change in the Company's capitalization. Generally, shares that are forfeited or cancelled from awards under the 2006 Option Plan will be available for future grants. Stock options granted under the 2006 Option Plan have a maximum term of ten years from the date of grant and incentive stock option awards have an exercise price of no less than the fair market value of the common stock on the date of grant, which will be on the last day of the month of the award. The options generally vest over a period of four years, with 25% of each grant vesting after one year and the remaining shares vesting monthly over the following three years. As of September 30, 2006, 210,000 awards had been granted under the 2006 Option Plan. The Company issues new shares upon the exercise of stock options.

Edgar Filing: CLAYTON HOLDINGS INC - Form 10-Q

Changes in options outstanding during the nine months ended September 30, 2006 are as follows:

	Number of Shares	Weighted Average Exercise Price
Options outstanding, December 31, 2005	1,460,656	\$ 4.52
Granted	210,000	14.14
Exercised	48,620	1.68
Forfeited	41,295	4.17
Options outstanding, September 30, 2006	1,580,741	\$ 5.89
Weighted average fair value of options granted for the nine months ended September 30, 2006		\$ 5.63
Options available for future grant at September 30, 2006		1,604,130

The intrinsic value of options exercised in the nine months ended September 30, 2006 was approximately \$530,000.

Changes in unvested options outstanding during the nine months ended September 30, 2006 are as follows:

	Number of Shares	Weighted Average Exercise Price
Unvested options outstanding, December 31, 2005	1,209,592	\$ 4.77
Granted	209,001	14.13
Vested	719,598	4.73
Cancelled or forfeited	36,922	3.85
Unvested options outstanding, September 30, 2006	662,073	\$ 7.83

The following table summarizes information about stock options outstanding at September 30, 2006:

September 30, 2006

Exercise Price	Options Outstanding			Options Exercisable		
	Number Outstanding	Remaining Contractual Life (yrs)	Intrinsic Value as of September 30, 2006	Number Exercisable	Weighted Average Exercise Price	Intrinsic Value as of September 30, 2006
\$ 0.98	361,132	8.17	\$ 4,187,123	252,762	\$ 0.98	\$ 2,930,634
4.00	62,500	7.65	535,625	57,291	4.00	490,984
4.13	86,817	8.24	732,909	65,936	4.13	556,632
6.00	520,833	8.57	3,421,873	366,210	6.00	2,406,000
6.36	109,869	8.82	682,286	58,678	6.36	364,390
6.80	229,590	9.00	1,324,734	116,356	6.80	671,374
12.34	30,000	9.92	6,900		12.34	
12.57	25,000	10.00			12.57	
13.05	25,000	9.80			13.05	
14.05	102,000	9.67			14.05	
17.00	15,500	9.48		1,435	17.00	
20.40	5,000	9.49			20.40	
21.38	7,500	9.51			21.38	
	1,580,741	8.66	\$ 10,891,450	\$ 918,668	\$ 4.50	\$ 7,420,01

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123(R), Accounting for Stock Based Compensation which establishes standards for transactions in which an entity exchanges its equity instruments for goods or services. This standard requires an issuer to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. This eliminates the exception to account for such awards using the intrinsic method previously allowable under Accounting Principles Board (APB) Opinion No. 25. In March 2005, the SEC released Staff Accounting Bulletin (SAB) 107, Share-Based Payment, which expresses views of the SEC Staff about the application of SFAS No. 123(R). SFAS No. 123(R) became effective for annual reporting periods beginning on or after June 15, 2005. The Company previously adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, for all awards granted to employees. On January 1, 2006 the Company adopted SFAS No. 123(R) and SFAS No. 123(R) does not have a material impact on its financial statements.

The Company completed its initial public offering on March 29, 2006. According to the provisions of incentive stock option agreements between the Company and its employees, the vesting term for certain options outstanding as of the date of the IPO accelerated by either one year or twenty percent, varying in accordance with the terms of the employee s specific incentive stock option agreement. In addition, 130,208 of performance based options became immediately vested. Therefore, on March 29, 2006 the Company recognized \$611,696 of additional compensation expense from this accelerated vesting.

The ongoing effect on consolidated results of operations of financial condition will be dependent upon future stock based compensation awards granted. The Company utilizes the Black-Scholes option valuation method to calculate the fair market value of the options using assumptions in effect on the date of the grant, as follows:

	Nine Months Ended			September 30,		
	September 30, 2006			2005		
Expected life (in years)	6.5	7.5		6.25		
Risk-free interest rate	4.6	5.1	%	3.9	4.2	%
Volatility	25	28	%	25		%
Dividend	0		%	0		%

For the three months ended September 30, 2006 and 2005 the Company recognized expenses related to the stock option grants summarized above over the vesting period of such options of approximately \$170,000 and \$70,000, respectively. For the nine months ended September 30, 2006 and 2005 the Company recognized expenses related to the stock option grants summarized above over the vesting period of such options of approximately \$1,024,000 and \$148,000, respectively. In addition, the Company will recognize approximately \$1,755,000 of expense related to these grants over the remaining vesting period of such options. This expense is expected to be recognized over a weighted-average period of 2.92 years.

Note 13 Subsequent Events

On October 18, 2006, the Company accepted the resignation of its Chief Information Officer. In connection with this resignation, which shall be effective on February 28, 2007, the Company and the employee entered into a separation agreement, filed as Exhibit 10.1 to the Form 8-K filed by the Company on October 18, 2006.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward Looking Statements and Projections

This Quarterly Report on Form 10-Q contains forward looking statements. Forward looking statements relate to future events or our future financial performance. We generally identify forward looking statements by terminology such as may, will, should, expects, plans, anticipates, could, intends, target, projects, contemplates, believes, estimates, predicts, potential or continue or the negative of these terms or other similar words. These statements are only predictions. We have based these forward looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our business, results of operations and financial condition. The outcome of the events described in these forward looking statements is subject to risks, uncertainties and other factors described in Management's Discussion and Analysis of Financial Condition and Results of Operations, elsewhere in this Quarterly Report on Form 10-Q and in our Quarterly Report on Form 10-Q for the three month period ended March 31, 2006. Accordingly, you should not rely upon forward looking statements as predictions of future events. We cannot assure you that the events and circumstances reflected in the forward looking statements will be achieved or occur, and actual results could differ materially from those projected in the forward looking statements. The forward looking statements made in this Quarterly Report on Form 10-Q relate only to events as of the date on which the statements are made. We undertake no obligation to update any forward looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events.

Overview

We provide a full suite of outsourced services, mortgage-related analytics and specialized consulting services for buyers and sellers of, and investors in, mortgage-related loans and securities and other debt instruments. Our services include transaction management, which consists of due diligence, mortgage processing services for buyers of mortgage loans (conduit support services), professional staffing services, and compliance products and services, as well as monitoring of mortgage-backed securities (credit risk management and surveillance), and specialized loan servicing services (special servicing). We provide a majority of our services to participants in the non-agency mortgage-backed securities, or MBS, market and the non-conforming mortgage loan market. We believe that several trends support the demand for our services, including:

- the growth in outsourced services by capital markets firms and other major mortgage loan market participants;
- the increased complexities and requirements of federal, state and local regulations applicable to the mortgage loan industry;
- investors' growing demand for loan performance data; and
- buyers purchasing smaller pools of loans from a larger number of sellers, increasing the need for our conduit support services.

Our revenue is also driven by non-agency MBS issuance and the aggregate number of non-conforming mortgage loan originations. Changes in the volume of non-agency MBS issuances and non-conforming mortgage loan originations may impact the number of loans for which we perform our services, leading to a corresponding change in gross revenue. We are increasingly utilizing our centralized underwriting facilities to perform our services which should reduce the amount of per loan travel expenses.

We believe the volume of non-agency MBS securitizations and non-conforming mortgage loan originations may be lower in 2006 than in 2005. We expect the non-agency MBS securitization and non-conforming mortgage loan origination markets to continue growing over the long term, although the rate of growth may be slower than in recent years. We believe there is an increasing demand for and the availability of new loan products, increased home ownership driven in part by first-time homeowners, minorities and immigrants, and increased liquidity in the non-agency MBS market. We face a number of risks in our industry and the market for our services is highly competitive. Our business is driven in part by the MBS market, the mortgage lending industry and the housing market, each of which is highly sensitive to trends in the general economy, including interest rates, perceived and actual economic conditions, taxation policies, availability of credit, employment levels and wage and salary levels. Adverse changes in any of these trends, or a decline in the sale of both new and existing homes or in home values, could lessen the demand for mortgage loans, which could result over time in a reduced demand for our services and diminish our revenue. A material reduction in the number of loans available for securitization may cause our clients to engage us for fewer services, which could have an adverse effect on our business and results of operations. Moreover, the majority of our business is generated through our largest 20 clients. The loss of one or more of these clients could adversely affect our business and results of operations. Lastly, we are dependent on our independent loan review specialists to perform our services. Our business could suffer if we are unable to recruit and retain additional qualified independent loan review specialists.

Basis of Presentation

We were formed as a Delaware corporation in March 2005, following the combination of the holding companies of each of Clayton Services and its subsidiaries, including First Madison, and CFIS, formerly The Murrayhill Company, or Murrayhill. Prior to the combination, each holding company was controlled by investment funds affiliated with TA Associates. In accordance with US GAAP relating to companies under common control prior to their combination, the financial statements of the previously separate companies under common control are restated on a combined basis from the dates of their respective acquisitions by the controlling entity. Accordingly, for accounting purposes, the date of our inception was May 24, 2004, the date that investment funds affiliated with TA Associates acquired CFIS, the first of the combined entities that were brought under common control.

Critical Accounting Policies

Basis of Presentation

Our condensed consolidated financial statements are unaudited. In our opinion, all adjustments, consisting of only normal recurring adjustments considered necessary for a fair presentation, have been included. Certain information and footnote disclosures normally included in financial statements prepared in accordance with US GAAP have been condensed or omitted. It is suggested that these unaudited condensed consolidated financial statements be read in conjunction with the consolidated financial statements, accounting policies and notes included in our registration statement on Form S-1 (File No. 333-129526) declared effective by the Securities and Exchange Commission on March 23, 2006, which includes audited financial statements for the year ended December 31, 2005. Results for the interim periods are not necessarily indicative of results for the full year.

In preparing our financial statements in conformity with US GAAP, we have to make estimates and assumptions about future events that affect the amounts of reported assets, liabilities, revenues and expenses, as well as the disclosure of contingent assets and liabilities in the financial statements and accompanying notes. Some of our accounting policies require the application of significant judgment by management in the selection of appropriate assumptions for determining these estimates. By their nature, these judgments are subject to an inherent degree of uncertainty; therefore, we cannot assure you that actual results will not differ significantly from estimated results. We base these judgments on our historical experience, management's forecasts and other available information, as appropriate.

Our most critical accounting policies, which reflect significant management estimates and judgment in determining reported amounts in the condensed consolidated financial statements are as follows:

Revenue Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, the service has been performed, the fee is fixed and determinable, and collection of the resulting receivable is reasonably assured.

We derive most of our revenue from professional service activities. Revenue consisting of billed fees and pass-through expenses is recorded as work is performed and expenses are incurred. Revenue also includes expenses billed to clients, which include travel and other out-of-pocket expenses, and other reimbursable expenses.

We record provisions for fee adjustments and discretionary pricing adjustments as a reduction of revenue. Revenue recognized, but not yet billed to clients, has been recorded as unbilled receivables in the Company's condensed consolidated balance sheets.

Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123(R), Accounting for Stock Based Compensation which establishes standards for transactions in which an entity exchanges its equity instruments for goods or services. This standard requires an issuer to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. This eliminates the exception to account for such awards using the intrinsic method previously allowable under Accounting Principles Board (APB) Opinion No. 25. In March 2005, the SEC released Staff Accounting Bulletin (SAB) 107, Share-Based Payment, which expresses views of the SEC Staff about the application of SFAS No. 123(R). SFAS No. 123(R) became effective for annual reporting periods beginning on or after June 15, 2005. We previously adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, for all awards granted to employees. On January 1, 2006 we adopted SFAS No. 123(R) and it does not have a material impact on our financial statements.

According to the provisions of incentive stock option agreements between the Company and its employees, the vesting term for certain options outstanding as of the date of the IPO accelerated by either one year or twenty percent, varying in accordance with the terms of the employee's specific incentive stock option agreement. In addition, 130,208 of performance based options became immediately vested. Therefore, on March 29, 2006, we recognized \$611,696 of additional compensation expense from this accelerated vesting.

Options to purchase 210,000 shares were granted in the nine months ended September 30, 2006 with an average exercise price of \$14.14 per share.

Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted-average number of shares of common stock and common stock equivalents outstanding during the period. Our convertible preferred stock is deemed to be a common stock equivalent and included in the computation of basic earnings per share because it receives dividends at a rate that results in a per share amount that is equivalent to the per share amount paid on common stock. Diluted earnings per share gives effect to dilutive options, warrants and other potential common stock outstanding during the period. At September 30, 2006, outstanding options to purchase 210,000 and 130,000 common shares had exercise prices in excess of the average market price of common shares for the three and nine month periods ended September 30, 2006, respectively. At September 30, 2005, outstanding options to purchase 254,580 and 887,094 common shares had exercise prices in excess of the average market price of common shares for the

three and nine month periods ended September 30, 2005, respectively. These options were not included in the computation of diluted earnings per share for the respective periods because the effect would be antidilutive.

Valuation of Long-lived Assets Excluding Goodwill

We evaluate all of our long-lived assets, including intangible assets other than goodwill and fixed assets, periodically for impairment in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-lived Assets (SFAS No. 144). SFAS No. 144 requires that long-lived assets be evaluated for impairment when events or changes in facts and circumstances indicate that their carrying value may not be recoverable. If events or circumstances indicate that the carrying value of an asset may not be recoverable, we assess the recoverability of identified intangible assets by comparing the projected undiscounted net cash flows associated with the related asset or group of assets over their remaining lives against their respective carrying amounts. The amount of impairment will be measured as the difference between the carrying value and the fair value of the impaired asset. An impairment will be recorded as an operating expense in the period of the impairment and as a reduction in the carrying value of that asset.

Intangible Assets

Intangible assets consist of customer relationships, technology, trade name and trademarks, non-competition agreements and excess of cost over fair value of net assets acquired, or goodwill. Customer relationships are the value of the specifically acquired customer relationships. Technology is the value of recreating the completed technology infrastructure. Trade name and trademarks are the value inherent in the recognition of Clayton and the other names that we use. The value of the non-competition agreements are an appraisal of potential lost revenues that would arise from an individual initiating a competing enterprise.

Except for goodwill, trade names and trademarks, all intangible assets are stated at cost less accumulated amortization. The costs attributable to the identified intangibles were based on a number of significant assumptions as determined by the Company and its independent appraisal expert. Identifiable intangible assets with finite lives are amortized under the straight-line method over their applicable estimated useful lives.

The Company adopted SFAS No. 142 Goodwill and Other Intangible Assets (SFAS No. 142), which provides, among other things, that goodwill and intangibles with indefinite lives are no longer amortized but are reviewed for impairment at least annually (beginning with the first anniversary of the acquisition date). Annual impairment tests were conducted for Clayton Services and CFIS in 2006 and there was no impairment to goodwill or intangibles with indefinite lives of either entity.

Revenue

We generate a majority of our revenue by providing professional outsourced services across the lifecycle of a mortgage loan.

Our transaction management services are provided under time-and-materials or per file billing arrangements. Under time-and-materials arrangements, we bill our clients on an hourly basis with travel and other reimbursable expenses passed through and recognized as revenue. Under per file billing arrangements, we bill our clients for each file reviewed with travel and other reimbursable expenses passed through separately or included in the per file rate. Revenues consisting of billed fees and pass-through expenses, which include travel and other reimbursable expenses, are recorded as work is performed and expenses are incurred. Revenues recognized, but not yet billed to clients, have been recorded as unbilled receivables in our condensed consolidated balance sheets. For the three and nine months ended September 30, 2006, transaction management revenue accounted for 79.4% of total revenue.

Our credit risk management, surveillance and special servicing services provide a revenue stream which is generally recurring in nature. In a typical MBS transaction for which we provide surveillance services, we are engaged by the trustee of an MBS issuance to provide our services over the life of the trust and are paid monthly directly from the cash flow of the trust. A majority of our surveillance revenue is based upon a negotiated rate multiplied by the outstanding principal balance of the underlying mortgage

loans in the MBS issuance. These fees are recognized each month as services are rendered. Our special servicing activities are conducted under annual or multi-year contracts for which we typically receive revenue on a per loan per month basis. For the three and nine months ended September 30, 2006, surveillance and special servicing services revenue accounted for 20.6% of total revenue.

For the three months ended September 30, 2006 and 2005, revenue from our largest three clients accounted for an aggregate of 30.2% and 33.3% of total revenue, respectively. Revenue from two clients exceeded 10% of revenue for the three months ended September 30, 2006 and revenue from three clients exceeded 10% of revenue for the three months ended September 30, 2005.

For the nine months ended September 30, 2006 and 2005, revenue from our largest three clients accounted for an aggregate of 32.0% and 35.5% of total revenue, respectively. Revenue from two clients exceeded 10% of revenue for the nine months ended September 30, 2006 and revenue from three clients exceeded 10% of revenue for the nine months ended September 30, 2005.

Cost of Services

Compensation Expense

Compensation expense consists primarily of compensation for independent loan review specialists and employees directly involved in the delivery of our services, which include our client service managers who manage our engagements. Compensation expense also includes payroll related benefits for our direct employees. The professionals we retain from a professional employment organization, including our independent loan review specialists, do not receive any employee benefits from us and are only compensated for actual hours worked. Our direct cost of operations does not include an allocation of overhead costs.

Travel and Related Expenses

Travel and related expenses consist of expenses incurred in enabling employees and independent loan review specialists to travel to clients' sites and are comprised of airfare, hotel and car rental expenses. A majority of these expenses is either directly billed to clients or included in the per file rates charged. As such, these expenses are directly or indirectly included in our revenue.

Other Direct Costs

Other direct costs include the cost of third party mortgage loan services (primarily collateral appraisal fees), outside support for our compliance services used in connection with our loan reviews, independent loan review specialist training and miscellaneous non-billable transaction costs.

Operating Expenses

Operating expenses primarily consist of corporate overhead costs not directly associated with a specific transaction or contract, such as salaries and benefits, marketing and administrative expenses, professional fees and depreciation and amortization expenses.

In connection with becoming a public company, we have incurred significant additional operating expenses such as increased audit fees, professional fees, directors and officers' insurance costs, compensation for our board of directors, and expenses related to hiring additional personnel and expanding our administrative functions. Many of these expenses either were not incurred or were incurred at a lower level by us as a private company.

Salaries and Benefits

Salaries and benefits consist of employee compensation for those employees who are not directly billable to a particular assignment including costs of administrative, finance, human resources, technology and executive personnel.

Other Selling, General and Administrative Expenses

Other selling, general and administrative expenses consist of costs such as rent and utilities, marketing, advertising and promotion expenses, non-reimbursable travel and entertainment, information technology, insurance, education, training and hiring expenses other than for independent loan review specialists and professional fees consisting of legal, accounting and other consulting fees in connection with the ongoing operation of our business including audit and Sarbanes-Oxley Act of 2002 compliance.

Depreciation and Amortization

We incur depreciation and amortization expenses for costs related to the capitalization of property and equipment and software developed for internal use on a straight-line basis over the estimated useful lives of the assets, which range from three to seven years. Leasehold improvements and assets under capital lease are amortized over the shorter of the estimated useful life of the asset or the lease term.

Treatment of Goodwill and Amortization of Intangibles

We also incur amortization expenses for costs related to the capitalization of identifiable intangible assets including customer relationships, technology and non-competition agreements.

We account for acquisitions of companies in accordance with Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations* (SFAS No. 141). We allocate purchase price to tangible assets, intangible assets, and liabilities based on fair values with the excess of purchase price amount being allocated to goodwill. The allocation of the purchase price to these intangible assets is based on a number of significant assumptions as determined by us and in the case of material acquisitions our independent appraisal expert, including evaluations of the future income producing capabilities of these assets and related future expected cash flows. We also make estimates about the useful lives of the acquired intangible assets. Should different conditions result in the determination that the value of the goodwill and acquired intangible assets has been impaired, we could incur write-downs of goodwill or intangible assets, or changes in the estimation of useful lives of those intangible assets. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS No. 142), goodwill is not amortized, but is subject to annual impairment testing which is discussed in greater detail below.

In accordance with SFAS No. 142, goodwill is subject to annual impairment tests or on a more frequent basis if events or conditions indicate that goodwill may be impaired. Goodwill is tested for impairment at a level of reporting referred to as a reporting unit. The first step of our annual test is to compare the fair value of our shares to the carrying value of our net assets of the reporting unit. If we determine that our carrying value exceeds our fair value, we would conduct a second step to the goodwill impairment test. The second step compares the implied fair value of the goodwill (determined as the excess fair value over the fair value assigned to our other assets and liabilities) to the carrying amount of goodwill. When the carrying amount of goodwill exceeds the implied fair value of goodwill, an impairment loss is recognized.

We evaluate all of our long-lived assets, including intangible assets other than goodwill and fixed assets, periodically for impairment in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets* (SFAS No. 144). SFAS No. 144 requires that long-lived assets be evaluated for impairment when events or changes in facts and circumstances indicate that their carrying value may not be recoverable. If events or circumstances indicate that the carrying value of an asset may not be recoverable, the amount of impairment will be measured as the difference between the carrying value and the fair value of the impaired asset. An impairment will be recorded as an operating expense in the period of the impairment and as a reduction in the carrying value of that asset.

Net Interest Expense

Net interest expense consists of interest paid on our debt net of interest received on our cash balances. Interest expense for the nine months ended September 30, 2006 primarily consisted of interest on our \$150,000,000 term loan, amortization of debt issuance costs related to the term loan and interest on our revolving line of credit. Interest expense for the nine months ended September 30, 2005 primarily consisted of interest on our prior term loan, which had a balance of \$37,750,000 at the start of the period, and interest on 12% senior subordinated and 12% subordinated notes issued to TA Associates and our other noteholders in connection with the acquisitions of Clayton Services and CFIS, respectively, by investment funds affiliated with TA Associates. The combined balance of the 12% senior subordinated and 12% subordinated notes at the start of the period was \$29,486,478. The remaining balances of the prior term loan, the 12% senior subordinated notes and the 12% subordinated notes were repaid with the proceeds from our \$150,000,000 term loan on December 8, 2005.

Loss from Extinguishment of Debt

On March 29, 2006, following our initial public offering, we repaid \$70,000,000 of the outstanding balance on our \$150,000,000 term loan and the entire \$7,400,000 outstanding balance on our revolving line of credit. Due to the prepayment of \$70,000,000 on our term loan, we wrote-off a portion of the debt issuance costs on the term loan and recognized a loss from extinguishment of debt of \$746,002.

Results of Operations

Comparison of Three Month Periods Ended September 30, 2006 and 2005

Revenue

Our revenue was \$61.0 million for the three months ended September 30, 2006, an increase of \$7.0 million or 12.8%, compared to revenue of \$54.0 million for the three months ended September 30, 2005. The increase was primarily due to an increase in volume in our conduit support services and special servicing businesses, as well as growth in our surveillance services due in part to an increased joint sales effort following the combination of CFIS and Clayton. Revenue for the three months ended September 30, 2006 included \$1.8 million from Clayton Lender Solutions, Inc., (formerly d/b/a as Mortgage Resource Network), following the Company's acquisition of substantially all of the assets of that business in February 2006. Our total revenues per loan increased 0.4%, as growth in our non-loan related services offset reduced revenues per loan in our core due diligence business. Revenues per loan in our core due diligence business decreased during the period due to an increase in the percentage of loans serviced in our central underwriting facility and an increase in the prevalence of other file reviews, in which we verify a limited number of data points in a loan file. The total number of loans serviced increased by 12.4%.

Cost of Services

Our cost of services was \$38.2 million for the three months ended September 30, 2006, an increase of \$4.1 million or 12.1%, compared to cost of services of \$34.1 million for the three months ended September 30, 2005. This increase was attributable to the specific factors discussed below.

Compensation Expense. Compensation expense was \$29.7 million for the three months ended September 30, 2006, an increase of \$4.8 million or 19.2%, compared to compensation expense of \$24.9 million for the three months ended September 30, 2005. The increase was primarily due to the growth in our conduit support services, special servicing, consulting and surveillance businesses, as well as the acquisition of Clayton Lender Solutions, Inc. Compensation expense in our due diligence business also increased, as increased fixed expenses due to investments in product development and management infrastructure offset reduced variable expenses per loan.

Travel and Related Expenses. Travel and related expenses were \$6.3 million for the three months ended September 30, 2006, a decrease of \$1.2 million or 15.5%, compared to travel and related expenses of \$7.5 million for the three months ended September 30, 2005. Travel expenses per loan decreased by 24.8% due to reduced travel expenses per loan in our core due diligence business and a decrease in travel expenses in our non-loan related professional staffing services business. Travel expenses per loan in our core due diligence business decreased due to reduced expenses per loan in our field business and an increase in the percentage of loans serviced in our central underwriting facility.

Other Direct Costs. Other direct costs were \$2.2 million for the three months ended September 30, 2006, an increase of \$0.5 million or 29.4%, compared to other direct costs of \$1.7 million for the three months ended September 30, 2005. The increase was primarily due to an increase in third-party appraisal fees due to an increase in appraisal revenue in our due diligence business.

Operating Expenses

Operating expenses were \$15.8 million for the three months ended September 30, 2006, an increase of \$3.3 million or 26.7%, compared to operating expenses of \$12.5 million for the three months ended September 30, 2005. This increase was attributable to the specific factors discussed below.

Salaries and Benefits. Salaries and benefits were \$6.0 million for the three months ended September 30, 2006, an increase of \$1.3 million or 26.3%, compared to salaries and benefits of \$4.7 million for the three months ended September 30, 2005. This increase was primarily due to the costs of additional administrative, finance, human resources, technology and executive personnel which were added in preparation for becoming a public company and following the acquisition of Clayton Lender Solutions, Inc.

Other Selling, General and Administrative Expenses. Other selling, general and administrative expenses were \$5.1 million for the three months ended September 30, 2006, an increase of \$1.1 million or 26.1%, as compared to selling, general and administrative expenses of \$4.0 million for the three months ended September 30, 2005. This increase was due to general increases in occupancy, corporate governance, insurance, relocation and non-reimbursable travel costs relating to growth in our business, the acquisition of Clayton Lender Solutions, Inc. and becoming a public company. These increases were partially offset by reduced consulting expenses and professional fees.

Depreciation and Amortization. Depreciation and amortization was \$2.2 million for the three months ended September 30, 2006, an increase of \$1.0 million or 84.0%, compared to depreciation and amortization of \$1.2 million for the three months ended September 30, 2005. This increase was primarily due to depreciation recorded on additional property and equipment and software developed for internal use. These additions were made to enhance our corporate infrastructure and technology platform in support of the growth in business operations and in preparation for becoming a public company.

Amortization of Intangibles. Amortization of intangibles was \$2.6 million for the three months ended September 30, 2006, an increase of \$0.1 million or 1.5%, compared to amortization of intangibles of \$2.5 million for the three months ended September 30, 2005.

Interest Expense, net

Interest expense, net was \$1.8 million for the three months ended September 30, 2006, a decrease of \$0.2 million or 12.0%, compared to interest expense, net of \$2.0 million for the three months ended September 30, 2005. This decrease was due to decreased borrowings under our credit facilities due to the prepayment of \$70.0 million owed under our senior term loan following our initial public offering in March 2006 and higher interest income. See *Liquidity and Capital Resources*.

Comparison of Nine Month Periods Ended September 30, 2006 and 2005

Revenue

Our revenue was \$178.0 million for the nine months ended September 30, 2006, an increase of \$26.8 million or 17.7%, compared to revenue of \$151.2 million for the nine months ended September 30, 2005. The increase was primarily due to an increase in volume in our conduit support services, special servicing and professional staffing services businesses as well as growth in our surveillance services due in part to an increased joint sales effort following the combination of CFIS and Clayton. Revenue for the nine months ended September 30, 2006 included \$5.0 million from Clayton Lender Solutions, Inc., following the Company's acquisition of substantially all of the assets of that business in February 2006. Due to growth in our non-loan related services, our total revenues per loan increased 18.4%. This increase offset a 0.5% decrease in the number of loans serviced during the nine months ended September 30, 2006 as compared to the nine months ended September 30, 2005. Revenues per loan in our core due diligence business decreased during the period due to an increase in the percentage of loans serviced in our central underwriting facility and an increase in the prevalence of other file reviews, in which we verify a limited number of data points in a loan file.

Cost of Services

Our cost of services was \$118.2 million for the nine months ended September 30, 2006, an increase of \$20.5 million or 20.9%, compared to cost of services of \$97.7 million for the nine months ended September 30, 2005. This increase was attributable to the specific factors discussed below.

Compensation Expense. Compensation expense was \$90.4 million for the nine months ended September 30, 2006, an increase of \$18.6 million or 26.0%, compared to compensation expense of \$71.8 million for the nine months ended September 30, 2005. The increase was primarily due to the growth in our conduit support services, professional staffing services, special servicing and consulting businesses, as well as the acquisition of Clayton Lender Solutions, Inc. Compensation expense in our core due diligence business also increased, as a result of increased fixed expenses due to investments in product development and management infrastructure.

Travel and Related Expenses. Travel and related expenses were \$20.2 million for the nine months ended September 30, 2006, a decrease of \$1.7 million or 7.9%, compared to travel and related expenses of \$21.9 million for the nine months ended September 30, 2005. Travel expenses per loan decreased by 7.5%, as reduced travel expenses per loan in our core due diligence business offset increased travel expense in our non-loan related professional staffing services business. Travel expenses per loan in our core due diligence business declined due to an increase in the percentage of loans serviced in our central underwriting facility.

Other Direct Costs. Other direct costs were \$7.5 million for the nine months ended September 30, 2006, an increase of \$3.5 million or 87.0%, compared to other direct costs of \$4.0 million for the nine months ended September 30, 2005. The increase was primarily due to an increase in third-party appraisal fees due to an increase in appraisal revenue in our due diligence business.

Operating Expenses

Operating expenses were \$45.3 million for the nine months ended September 30, 2006, an increase of \$8.1 million or 22.0%, compared to operating expenses of \$37.2 million for the nine months ended September 30, 2005. This increase was attributable to the specific factors discussed below.

Salaries and Benefits. Salaries and benefits were \$17.0 million for the nine months ended September 30, 2006, an increase of \$3.0 million or 21.4%, compared to salaries and benefits of \$14.0 million for the nine months ended September 30, 2005. Salaries and benefits expense for the nine months ended September 30, 2006 included \$0.6 million of expense related to the acceleration of vesting of certain stock

options as a result of the Company's initial public offering in March 2006. The remaining increase was primarily due to the costs of additional administrative, finance, human resources, technology and executive personnel which were added in preparation for becoming a public company and following the acquisition of Clayton Lender Solutions, Inc.

Other Selling, General and Administrative Expenses. Other selling, general and administrative expenses were \$15.0 million for the nine months ended September 30, 2006, an increase of \$2.6 million or 20.5%, compared to selling, general and administrative expenses of \$12.4 million for the nine months ended September 30, 2005. This increase was due to general increases in occupancy, corporate governance, insurance, recruiting, relocation, non-reimbursable travel and telecommunications costs relating to growth in our business, the acquisition of Clayton Lender Solutions, Inc. and becoming a public company. These increases were partially offset by reduced consulting expenses and professional fees.

Depreciation and Amortization. Depreciation and amortization was \$5.7 million for the nine months ended September 30, 2006, an increase of \$2.6 million or 81.1%, compared to depreciation and amortization of \$3.1 million for the nine months ended September 30, 2005. This increase was primarily due to depreciation recorded on additional property and equipment and software developed for internal use. These additions were made to enhance our corporate infrastructure and technology platform in support of the growth in business operations and in preparation for becoming a public company.

Amortization of Intangibles. Amortization of intangibles was \$7.7 million for the nine months ended September 30, 2006, an increase of \$0.1 million or 1.1%, compared to amortization of intangibles of \$7.6 million for the nine months ended September 30, 2005.

Interest Expense, net

Interest expense, net was \$6.5 million for the nine months ended September 30, 2006, an increase of \$0.7 million or 11.7%, compared to interest expense, net of \$5.8 million for the nine months ended September 30, 2005. This increase was due to increased borrowings outstanding under our credit facilities during the first three months of the year prior to our initial public offering. See *Liquidity and Capital Resources*.

Loss from Extinguishment of Debt

For the nine months ended September 30, 2006, we recognized a loss from extinguishment of debt of \$0.7 million due to the write-off of debt issuance costs as a result of a \$70.0 million prepayment on our term loan following our initial public offering. See *Liquidity and Capital Resources*.

Liquidity and Capital Resources

Historically, we have financed our growth from cash flow from operations and bank borrowings. We believe that funds generated from operations, together with existing cash and available borrowings under our credit agreement, will be sufficient to finance our current operations, planned capital expenditures and internal growth at least through the next twelve months. On March 29, 2006, we issued 8,625,000 shares of common stock, including 1,125,000 shares issued through the exercise of the underwriters' over-allotment option, at a price of \$17.00 per share through our initial public offering of common stock.

On March 1, 2006, we consummated a 1-for-4 reverse stock split of our common stock and class B common stock.

Immediately prior to the completion of the offering, the following transactions occurred:

- all of our 357,020 outstanding shares of class B common stock converted into 357,020 shares of common stock.
- our series A convertible preferred stock converted into 2,206,308 shares of common stock and 8,825,241 shares of series A redeemable preferred stock.
- our series B convertible preferred stock converted into 6,046,371 shares of common stock and 24,185,493 shares of series B redeemable preferred stock.

Our net proceeds of \$131.8 million, net of \$14.8 million of offering expenses and the underwriting discount, were used to:

- redeem \$52.8 million of redeemable preferred stock that resulted from the conversion of our Series A convertible preferred stock and Series B convertible preferred stock immediately prior to the completion of the initial public offering.
- repay \$70.0 million owed under the senior term loan portion of our credit facility.
- repay \$7.4 million owed under the revolving credit portion of our credit facility.
- fund \$1.6 million of working capital.

On February 3, 2006, we acquired substantially all of the assets and assumed certain liabilities of Clayton Lender Solutions, Inc. (formerly known as Mortgage Resource Network) for an aggregate purchase price and fees aggregating approximately \$5.7 million. Working capital was used to fund the acquisition of such assets and assumed liabilities. Clayton Lender Solutions, Inc. is engaged in the business of providing outsourced mortgage processing and fulfillment services to the mortgage industry, including mortgage brokers, lenders and securitizers.

Our operating activities provided cash of \$21.0 million and \$2.5 million in the nine months ended September 30, 2006 and 2005, respectively. Cash provided from operations is generated primarily from net income and the timing of accounts receivable collections and disbursements of accounts payable. Cash provided by operations for the nine months ended September 30, 2006 was generated from net income of \$4.3 million plus \$15.4 million of non cash charges plus \$1.3 million from a net decrease in current assets, primarily due to an increase in accrued expenses and a decrease in prepaid taxes partially offset by an increase in accounts receivable and unbilled receivables and a decrease in deferred revenue. Cash provided by operations for the nine months ended September 30, 2005 resulted from \$6.3 million of net income plus \$11.4 million of non cash charges and was negatively impacted by a net increase in operating assets of \$15.3 million primarily from an increase in the balance of accounts receivable as a result of an increase in the amount of time receivables remained outstanding. We believe cash flow from operations will be sufficient to finance our current operations for the next twelve months.

Our investing activities used cash of \$13.4 million and \$8.8 million in the nine months ended September 30, 2006 and 2005, respectively. Cash used in investing activities in the nine months ended September 30, 2006 primarily consisted of the Clayton Lender Solutions, Inc. acquisition and capital expenditures. Cash used in investing activities in the nine months ended September 30, 2005 primarily consisted of capital expenditures and the acquisition of NYSIS, Inc.

Our financing activities provided cash of \$8.6 million and \$0.4 million in the nine months ended September 30, 2006 and 2005, respectively. The principal sources of cash from financing activities in the nine months ended September 30, 2006 were the proceeds from the initial public offering described above and, to a lesser extent, borrowings under our revolving credit agreement. This was partially offset by the redemption of preferred stock and repayments of outstanding debt under our credit facility described above. The principal sources of cash from financing activities in the nine months ended September 30, 2005 were borrowings under our prior revolving credit agreement, partially offset by loan repayments and distributions to shareholders.

Cash paid for interest expense was \$6.0 million and \$5.4 million in each of the nine months ended September 30, 2006 and 2005, respectively. In the nine months ended September 30, 2006, the majority of interest expense was paid on borrowings outstanding under our term loan. In the nine months ended September 30, 2005, the majority of interest expense was paid on borrowings outstanding under our subordinated notes, senior subordinated notes, prior revolving line of credit and prior term loan.

Credit Agreement

On December 8, 2005, we entered into a \$190.0 million senior credit facility. The credit facility provided for a \$150.0 million term loan, and a revolving credit facility of \$40.0 million. The credit facility also provided us with an option, subject to the consent of the lenders, to increase the revolving credit facility by \$10.0 million to an aggregate of \$50.0 million. We exercised the option to increase our revolving credit facility on January 11, 2006 and April 28, 2006, and amended our credit facility to increase the revolving loan facility by \$5.0 million on each date, for an aggregate revolving credit facility of \$50.0 million as of April 28, 2006. Following our initial public offering in March 2006, we repaid \$70.0 million outstanding under the term loan and repaid \$7.4 million outstanding under the revolving credit facility.

The credit agreement terminates on December 8, 2011. Principal repayments on the term loan of \$200,500 are required on a quarterly basis for each quarter through 2010, and the remaining principal balance at the end of 2010 is repayable in equal quarterly installments during 2011. This facility can be used to fund acquisitions requiring cash, as well as to fund short-term liquidity needs. Liquidity needs occasionally arise as a result of differences in the timing between collecting our accounts receivable and making disbursements to support our operations.

The credit agreement is collateralized by substantially all of our assets. The agreement contains covenants which, among other matters, require us to maintain certain levels of interest coverage ratio, fixed charge ratio and total leverage ratio. As of September 30, 2006, we were in compliance with all debt covenants. In addition, the credit agreement places limitations on total annual capital expenditures, indebtedness, liens, dividends and distributions, asset sales, transactions with affiliates, acquisitions and conduct of business, all as defined in the agreement. The credit agreement also contains provisions for an increased interest rate during periods of default. We do not believe that these covenants will affect our ability to operate our business.

Loans under the credit agreement bear interest at the applicable LIBOR rate plus 3.0% or Prime Rate plus 2.0%, at our option. In addition, we are required to pay a commitment fee of 0.5% based on the calculation of the excess of the revolving credit loan commitment over the outstanding balance as defined.

At September 30, 2006, there was an outstanding balance of \$79.8 million under the term loan and no outstanding balance under the revolving credit facility.

Interest Rate Cap

In September 2004, we purchased an interest rate cap agreement to reduce the potential impact that interest rate increases could have on our floating-rate debt interest expense. In January 2006, the Company recorded interest expense of \$1,915 to reduce the book value of this asset to zero. The terms of the interest rate cap agreement, which expired on September 30, 2006, provide that we would receive quarterly payments equal to the notional amount multiplied by the difference by which LIBOR exceeds 5%. During the third quarter of 2006 the Company received approximately \$19,300 which was recorded as a reduction of interest expense. The initial premium of \$29,900 was recorded as an asset on the date of purchase. Subsequent declines in the fair value of this derivative were recorded as interest expense.

Contractual Obligations

The following table describes our cash commitments, in thousands, to settle contractual obligations as of September 30, 2006.

	Total	Less than 1 year	1-3 years	4-5 years	More than 5 years
Term loans and loans payable	\$ 79,799	\$ 200	\$ 2,406	\$ 77,193	\$
Capital lease obligations	959	92	751	116	
Operating lease obligations	9,067	707	6,772	1,113	475
Total	\$ 89,825	\$ 999	\$ 9,929	\$ 78,422	\$ 475

Off-Balance-Sheet Arrangements

As of September 30, 2006, we did not have any significant off-balance-sheet arrangements, as defined in Item 303(a)(4)(ii) of Regulation S-K of the SEC.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

During the nine months ended September 30, 2006, there were no material changes in our market risk exposure. For a discussion of our market risk associated with interest rate risk and equity price risk as of December 31, 2005, see Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our registration statement on Form S-1 (File No. 333-129526), declared effective by the Securities and Exchange Commission on March 23, 2006, which includes audited financial statements for the year ended December 31, 2005.

Item 4. Controls and Procedures***Evaluation of Disclosure Controls and Procedures***

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2006. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2006, our chief executive officer and chief financial officer concluded that, as of such date, the Company's disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control Over Financial Reporting

During the quarter ended September 30, 2006, we added and integrated professionals possessing significant accounting and control expertise to our finance and accounting staff, drafted and implemented critical accounting policies and procedures, and trained certain key personnel with responsibilities for financial and tax reporting to address the material weakness in our internal control over financial reporting identified as existing on March 31, 2006 and June 30, 2006. Other than these actions, no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the three months ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

33

Part II OTHER INFORMATION

Item 1. Legal Proceedings

Not applicable.

Item 1A. Risk Factors

Not applicable.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Submission of Matters to a Vote of Security Holders

On July 26, 2006, we held our Annual Meeting of Stockholders. At the meeting, the stockholders re-elected Frank P. Filippis, Stephen M. Lamando and Margaret Sue Ellis to the Board of Directors, each to serve for a three-year term as a Class I Director. 19,323,905 votes were cast for Mr. Filippis' election; 136,454 votes were cast to withhold authority for Mr. Filippis. 19,144,818 votes were cast for Mr. Lamando's election; 315,541 votes were cast to withhold authority for Mr. Lamando. 19,148,007 votes were cast for Ms. Ellis' election; 312,352 votes were cast to withhold authority for Ms. Ellis. Also at the meeting, the stockholders ratified the appointment of Grant Thornton LLP as our independent registered public accounting firm for the current year. The votes cast to ratify Grant Thornton LLP's appointment were as follows: 19,454,580 shares voted for, 1,670 voted against and 4,109 shares abstained from voting.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

The exhibits listed in the Exhibit Index immediately preceding the exhibits are filed as part of this Quarterly Report on Form 10-Q and such Exhibit Index is incorporated herein by reference.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CLAYTON HOLDINGS, INC.

Date: November 10, 2006

By: /s/ Frederick C. Herbst
Frederick C. Herbst
Chief Financial Officer
(Duly Authorized Officer and Principal
Financial Officer)

35

EXHIBIT INDEX

Listed and indexed below are all Exhibits filed as part of this report.

Exhibit No.	Description
31.1	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, Rule 13a-14(a)/15d-14(a), by Chief Executive Officer.
31.2	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, Rule 13a-14(a)/15d-14(a), by Chief Financial Officer.
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, by Chief Executive Officer and Chief Financial Officer.
