

MORTGAGE BANKING M&A

2007 REVIEW AND 2008 OUTLOOK

By Alain Toto, CFA

“High cash and capital costs of mortgage origination, as well as tight profit margins on conventional loans, are putting increasing pressure on mortgage banks to find ways to mitigate the negative cash flow profiles of their mortgage businesses.” This quote from Moody’s succinctly represents the liquidity and profitability challenges facing some mortgage originators today. What is even more significant is that the quote was made in December 2001. While each cycle is unique in its composition and resolve, the malaise being realized today serves as a reminder that the mortgage business is inherently cyclical in nature. The chart below paints a picture of distress for originators and stock price pressure among community banks, while the Prime Passive REIT’s have gained favor and proven themselves able to raise capital and put money to work at wider spreads.



What follows is a reflection on the recent events in the mortgage market and our outlook for the mortgage banking M&A landscape in 2008.

Reflection on Recent Events

As economists persistently published charts illustrating the disconnect between home price appreciation and household incomes, Wall Street continued to churn the securitization engine of ABS securities and CDOs. By 2005, non-agency securitizations captured greater than 50 percent market share of residential mortgage securitization issuance. Wage earning masses (many turned part-time real estate investors), with ample access to document their pay stubs, tax returns, and bank accounts, were afforded the ease of low doc/no doc mortgages and the liberty of negative amortization minimum payments. Financial engineering, product innovation, and risk intermediation were fully engaged.

The financial markets provide a democratic

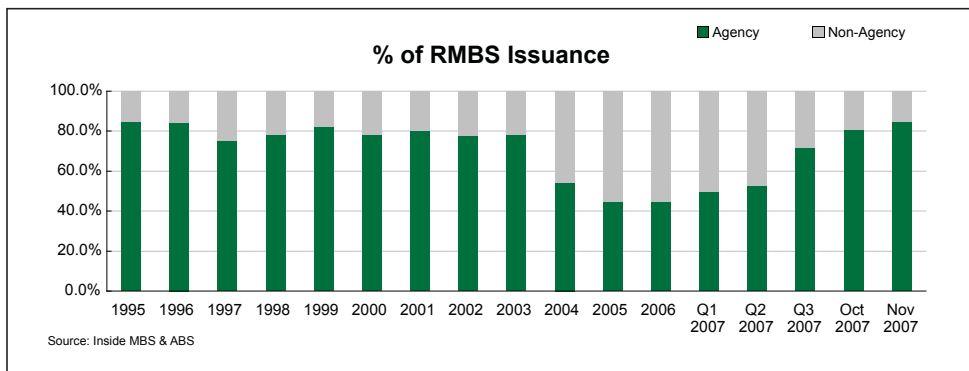
forum for investors to vote with their dollars, in an expression of their opinions and in a search for profits. One of the innovations of the modern mortgage market was expressing an opinion that credit fundamentals were unhealthy and that the housing market was destined for recessionary forces: the series of ABX credit default swap benchmark indices began to spike in early 2007 and continued to decline in value through the remainder of the year. The systematic re-pricing of risk and deteriorating credit performance eroded gain on sale margins to uneconomic levels. The increasing flow of Early Payment Default claims and the margin calls on levered assets (mortgage loans, mortgage servicing rights, residuals) consumed available liquidity. In the present state of the market, non-agency originations have declined to fractional levels from preceding years, and the GSEs have regained market share and bargaining power.

Resets for 2/28 and 3/27 products are expected to peak in the first quarter of 2008,

Source: SNL Financial
Pricing Date: 01/04/08

	% of 52W High	Total Rate of Return			Price/Book		
		3Month	1Year	3Year	1/4/2008	2006 Q4	2005 Q4
Prime Mortgage Banks	19%	-57.2%	-79.7%	-75.4%	36.6%	162.6%	160.1%
Subprime Mortgage Banks	18%	-49.6%	-79.5%	-88.0%	50.3%	97.2%	128.9%
Prime Active REITs	33%	-27.4%	-59.8%	-55.8%	93.3%	132.8%	131.0%
Prime Passive REITs	81%	12.6%	-11.1%	-0.2%	144.8%	113.6%	91.2%
Subprime Passive REITs	5%	-65.5%	-95.2%	-97.2%	NM	153.1%	128.7%
SNL Small Cap Bank & Thrift Index*	65%	-22.0%	-33.1%	-23.4%	142.7%	220.7%	213.3%

*Market Capitalization between \$250M-\$1B



while resets for Pay Option Adjustable Rate Mortgage (ARM) products are expected to peak near the summer of 2010. The mortgage market will continue to be tested for an enduring period of time. The new reality for mortgage banking is likely to bring more regulation, more transparency, re-engineering of the rating agencies, and a recalibrated agency model.

The Mortgage Banking Business Model

Mortgage banking is by its nature a leveraged business model. While banks have a deposit base to fund assets, independent mortgage originators rely on the velocity of capital from short-term funding (commercial paper, repurchase facilities, warehouse lines) to fund operations prior to securitization or whole loan sale. As long as the capital markets remain fluid, originators enjoy the fruits of leverage.

Much of the growth in the non-agency sector was characterized by ARM products sourced through third-party channels. ARM collateral exhibits a greater prepayment propensity and therefore helps to moderate origination cyclicality. The third-party channel circumvents the brick and mortar presence and affords more scale than the retail model and reduces the operating leverage from fixed cost burdens.

In the context of wealth creation, the wholesale channel suffers from lower barriers to entry and proved to be a less defensible business model with less effective underwriting stewardship and an inferior means for building franchise value. The ARM products were also the product of choice for investors with short-time horizons, who are now burdened with negative equity in their real estate investments.

The modernization of the securitization mar-

ket allowed risk to be intermediated globally; that the U.S. mortgage market has permeated to Australia, Canada, and Germany demonstrates that risk intermediation is truly global. The modern financial system was perceived to be stronger because originators could repackage the loans and sell them off their balance sheets, and the risk could be shared among many rather than a few. In effect, mortgage loans were not owned, but rather they were rented prior to securitization. The deterioration in securitization execution ultimately resulted in a capital call on originators as their balance sheets were marked to the new reality, which created liquidity failures.

Mortgage Banking M&A

A stressed operating environment in 2007 resulted in the shut down and exit of numerous mortgage companies, while also representing an active year in the M&A market. Merger transactions were generally executed at opportunistic levels with limited or no franchise premiums being paid. There was a greater flow of origination platform transactions in the first half of 2007, while the acquisitions in the second half of 2007 demonstrate a buyer interest in servicing platforms.

The confluence of elevated delinquencies and foreclosures and the active pace of coupon resets has stressed servicing capacity and timelines. Wall Street's vertical integration (for example, Morgan Stanley/Saxon, Barclays/HomeEq, Goldman Sachs/Litton) has helped to secure captive access to scarce special servicing capacity. Milestone expects that 2008 will witness continued buyer interest in securing servicing capacity, with bolt-on acquisitions to existing servicing platforms, as well as de novo activity of servicing platforms. Consistent with this theme, Milestone also

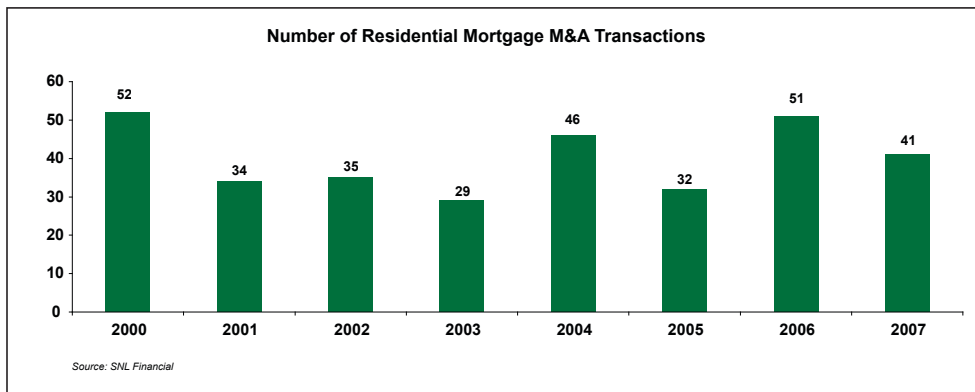
expects buyer interest in servicing platforms with a developed and fully integrated offshore presence in an effort to manage cost efficiency and to exploit scalability.

The imposing challenge in the servicing arena is the availability and high cost of financing, for both the MSR asset and servicer advances. The capital intensity of the servicing business has increased as liquidity providers advance less against servicing rights and servicer advances, and the coupling of slower prepayments and rising delinquencies increases the absolute level of servicer advances. Milestone expects continued investor interest in the servicing arena, with buyers positioning for capital returns through selective/economic asset selection for the servicing platform or through the exploit of scale.

Bank of America's announced acquisition of Countrywide may set the stage for increased activity among originators in 2008. Banks have generally been stripping their out-of-footprint origination presence, shutting down third-party channels, and paring down their product offering in an effort to reduce earnings volatility and release capital to reinvest in the core banking franchise. Milestone expects that private equity (and hedge fund hybrids) will more actively take the other side of this trade in 2008 in search of an entry platform for bolt-on acquisitions and consolidation, and the approach will be similar for private equity funds seeking to assimilate existing specialty finance portfolio companies.

As long as the securitization markets remain unfriendly, the prime spectrum of the credit market will offer the greatest stability and profit transparency in the originate-and-sell business model. The limited balance sheet capacity among depositories to portfolio non-agency collateral suggests that non-agency originations will revert to the mean at a tepid pace.

Private equity firms will act as contrarians with a cheap entry point into the market, with the ambition to roll-up and consolidate market share among the independents. Private equity firms will align their interests with seasoned management teams who have had exposure to various interest rate and credit cycles and possess the expertise to calibrate the business model and product offering for the next leg of opportunity. In addition to a cheap entry point, the prime spectrum of the market affords



private equity players an embedded call option to participate in any future refinance wave; should the non-prime sector exhibit signs of recovery, a prime player can pursue new opportunities from a position of strength and established capital market relationships.

Interestingly, private equity firms are becoming less averse to owning bank charters and are increasingly active in exploring acquisition opportunities of depositories. Greater forms of capital permanency within the mortgage banking model would introduce immunization against capital market volatility. While mortgage banking can not decouple itself fully from the inherent volatility of the capital markets, a more efficient capital structure would deliver more sustainable profitability. 2008 could witness more of the mortgage banking model transitioning to a depository hybrid, as private

equity players pursue an entry point in the mortgage market with a strategic eye to house originations within a regulated depository.

At the time of this writing, the Fed Funds rate was 4.25 percent while the September 2008 Fed Fund futures were trading around 3 percent, suggesting that market participants are expecting continued capital market volatility in 2008. The mortgage market will continue to experience turbulence in search of equilibrium and will consequently introduce opportunities for entry points to participate in the next leg of the mortgage cycle.

The current state of the mortgage market will exert influence on community banks through CD rate pricing pressure, heightened foreclosure activity, weaker credit fundamentals, and more studious regulatory oversight. Community banks with a healthy capital base and

the capacity to portfolio loans are positioned to benefit from the current environment through wide spreads existing in the Jumbo market, with Jumbo rates 70-80 basis points wider than conforming product. The acquisition of in-footprint regional independent mortgage companies can be executed opportunistically and can serve to augment asset growth and fee income.

As a final note, Milestone expects continued investor interest in two sectors of the mortgage market: small balance commercial and reverse mortgage lending. The small balance commercial market represents appealing credit fundamentals, underwriting standards, and an expanding investor base for securitization shelves, while also experiencing numerous industry exits in 2007. The investor interest in reverse mortgage lending continues to intensify, and servicing platforms (existing and de novo) continue to be built out. **6**

Alain Toto is a vice president of Milestone Advisors LLC, an investment banking firm providing merger and acquisition advisory and corporate finance services to financial services companies, including mortgage, commercial, consumer finance companies, banks, thrifts, and insurance companies. The views expressed in this article are solely those of the author.

Select Residential Mortgage M&A Transactions since January 2007

Buyer Name	Target Name	Announce Date	Deal Value (\$M)
Bear Stearns	Servicing Portfolio/Business of HomeBanc Corp	10/31/2007	61.0
Ranieri & Company	Servicing Platform of Aegis Mortgage	9/28/2007	0.5
Goldman Sachs	Litton Loan Servicing	9/27/2007	467.9
WL Ross & Co.	Servicing Platform of American Home Mortgage	9/25/2007	500.0
Sun Capital Partners	First NLC Financial Services	7/25/2007	NA
Prospect Mortgage	Metrocities Mortgage	6/7/2007	NA
Lone Star Funds	Accredited Home Lenders Holding Co.	6/4/2007	295.2
Prospect Mortgage	F&T Mortgage Inc.	5/31/2007	NA
Impac Mortgage Holdings, Inc.	Pinnacle Financial Corporation	5/21/2007	NA
Prospect Mortgage	Opteum Inc. (Retail Origination Platform)	5/7/2007	5.0
Bank of America	Reverse Mortgage Division of Seattle Mortgage	4/26/2007	NA
Credit Suisse	LIME Financial Services	4/17/2007	NA
C-BASS	FieldStone Investment Corp.	2/16/2007	188.1
IndyMac	New York Mortgage (Retail Origination Platform)	2/6/2007	13.4
Citadel Investment Group	ResMAE Mortgage Corporation	1/18/2007	0.7

Source: SNL Financial

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