

MORTGAGE BANKING M&A

2008 Review and 2009 Outlook

BY ALAIN TOTO, CFA

Market prophecy is a challenge under normal circumstances and increasingly nuanced in an environment where the Federal Reserve lowers the Fed Funds rate to an unprecedented low of 0.25 percent, Treasury Bills trade at negative yields, and global stock markets lose more than \$30 trillion in value from their peak levels.

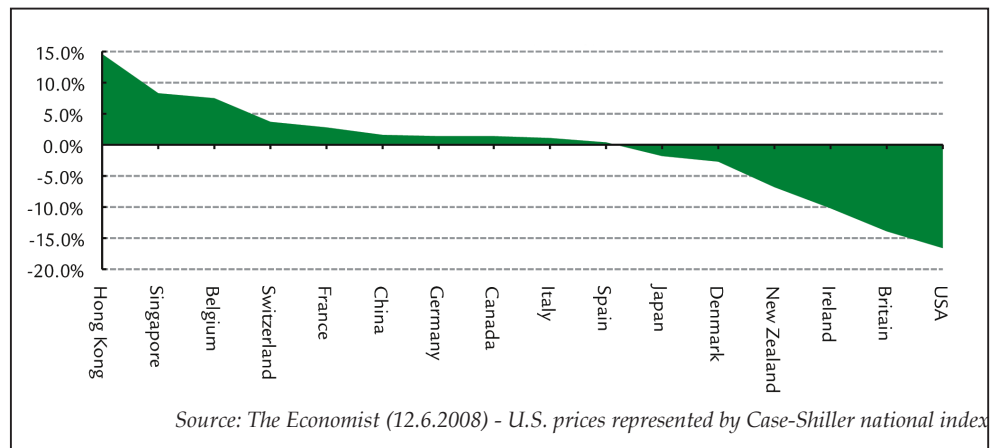
Much has been written about AIG, Bear Stearns, Lehman Brothers, Fannie Mae, Freddie Mac and the “flavor of the month” in government programs. The commonality among these events is the crisis in the housing market.

While the housing market has historically operated

with four to five months of inventory, the housing market is presently struggling to digest inventory levels that are double that of historical norms, further stressed by elevated foreclosure activity. The National Association of Realtors reported that 45 percent of all home sales in November 2008 were “distressed sales.” The confluence of excess inventory and heightened foreclosure activity will continue to translate into house price depreciation through 2009 until the market achieves a state of equilibrium.

Three recent developments will facilitate the housing market advancing closer to equilibrium: (1) the Federal Reserve’s announcement that it will initiate a program to purchase up to \$100 billion in government sponsored entity direct obligations and purchase up to \$500 billion in agency mortgage-backed securities, (2) contemplation

House Price Indicators Year-Over-Year % Change



National Association of Realtors Single-Family Inventory (Months)



of a government-funded 4.5 percent fixed-rate mortgage for new home purchases and (3) discussion of allowing existing agency borrowers to participate in the streamlined refinance program without requiring a new appraisal. As a counter to the delevering of balance sheets in the financial sector, the

government continues to explore programs to foster market recovery.

In this article we will reflect on the 2008 M&A market in the mortgage sector, as well as articulate our outlook for the mortgage banking M&A landscape in 2009.



Review of 2008

At last year's writing, Milestone suggested that the following themes would encapsulate mortgage M&A deal flow in 2008:

- Activity in mortgage servicing platforms;
- Focus on the prime credit spectrum in origination platforms, with a strategic objective to position for a refinance wave;
- Private equity participants to act as contrarians to secure an entry platform and align with seasoned management teams, with the ambition to roll up and consolidate market share among independents;
- The need for greater capital permanency would transition more of the mortgage banking business model to operate within a depository.

Several of these themes materialized in 2008, namely transaction activity in servicing platforms, the focus on prime origination, and mortgage transactions that involved a depository financing strategy.

Servicing platform transactions were focused predominately on the nonprime sector of the market. Wilbur Ross' acquisition of Option One's servicing platform (\$53 billion in mortgage servicing rights) ranks the Wilbur Ross/American Home servicing platform as the second largest subprime servicer, next to Countrywide, and creates improved economies of scale while securing and transitioning to Option One's Fidelity servicing platform and proprietary special servicing technology systems.

Vantium Capital is affiliated with the large hedge fund group Apollo and has acquired Acqura Loan Services to service distressed assets acquired through a related fund at Apollo. Acqura services subprime portfolios, and the transaction also included assets from Strategic Recovery Group, a company that collects on defaulted and charged-off debt. As a general theme, servicing platform transactions in 2008 were motivated by the desire to secure scarce special servicing capacity, much like Wall Street's vertical integration (for example, Morgan Stanley/Saxon, Barclays/HomeEq, Goldman Sachs/Litton) has secured captive special servicing talents and capacity to deal with internal balance sheet issues at the investment banks.

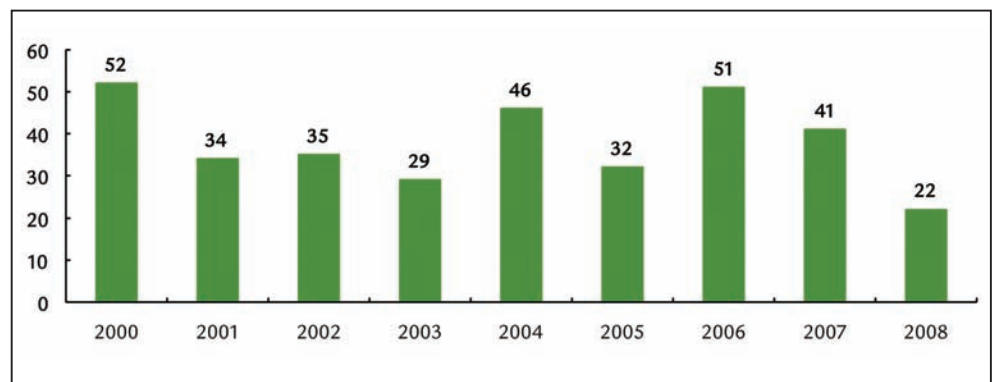
With regard to origination platforms, the

Select Residential Mortgage M&A Transactions Since January 2008

Buyer Name	Target Name	Announce Date	Deal Value (\$M)
Wintrust Financial Corp	Professional Mortgage Partners	12/23/08	NA
Walter Industries	Hanover Capital Mortgage Holdings	9/30/08	NA
Vantium Capital	Acqura Loan Services (servicing platform)	9/23/08	NA
Lexia (Shinsei Bank)	Specialized Loan Servicing (servicing platform)	9/8/08	NA
Investor Group Led by ManageAmerica	Origen Financial	8/1/08	1.0
Impac Mortgage	UBS (special servicing platform)	7/14/08	NA
Prospect Mortgage	Retail Mortgage Branches from IndyMac	7/8/08	NA
MetLife (MetLife Bank)	First Horizon Home Loans	6/3/08	NA
Green Tree Servicing	Origen Financial (servicing platform)	4/30/08	NA
WSFS Financial Corporation	1st Reverse Financial Services	4/30/08	NA
MetLife (MetLife Bank)	EverBank Reverse Mortgage	4/3/08	NA
Wilbur Ross & Co. (INVESCO)	Option One Mortgage Corp. (servicing platform)	3/17/08	1,100.0
Quicken Loans & Rockbridge Equity Partners	One Mortgage Network	1/22/08	NA
Bank of America	Countrywide Financial	1/11/08	4,145.3

Source: SNL Financial and Bloomberg LP

Number of Residential Mortgage M&A Transactions



most notable transaction was MetLife's acquisition of First Horizon Home Loans. As a Top 15 prime residential lender with annual originations in excess of \$25 billion, the scope to intermediate such a large transaction in a stressed market environment was limited to either a new entrant seeking to partner with a leading management team to create an immediate presence in the sector, or a large private equity investor motivated to secure a top-ranked platform at opportunistic pricing. Private equity investors have been actively assessing opportunities in the mortgage sector; however, the opaque status of warehouse lending relationships deprives them of longer term transparency in execution. MetLife will house the origination and servicing platform (acquired \$20 billion in

mortgage servicing rights) within its depository, MetLife Bank, thereby supplementing and diversifying existing wholesale funding relationships with bank deposits.

Worthy of mention is the recently announced recapitalization of Flagstar Bancorp by private equity investor MatlinPatterson (spin-off from Credit Suisse). Flagstar is a publicly traded thrift with \$27 billion in originations (Q3 08 annualized), predominately sourced through third-party channels. Flagstar has \$7.4 billion in deposits across 173 branches, with a \$60 billion mortgage-servicing portfolio. Through an affiliate entity, MatlinPatterson will invest \$250 million into Flagstar (\$50 million market cap), structured as convertible participating

voting preferred shares with a 70 percent diluted ownership interest. The transaction is contingent on Flagstar receiving at least \$250 million in proceeds from the sale of preferred stock and warrants to the Treasury Department under the Capital Purchase Program. As previously mentioned, private equity investors have actively explored opportunities in the mortgage sector but have not executed due to funding considerations. The Flagstar transaction is illustrative of opportunities where private equity will act when layers of capital can be comingled at different economic costs to structure a viable transaction.

Outlook for 2009

In a market where investors can acquire loans significantly cheaper than they can be originated, it would be bold to posture for an active mortgage M&A market. While the existing industry fundamentals are not conducive to M&A activity, the increasing propensity to realize a refinance wave may stimulate investor interest in origination franchises with the intent to build and monetize longer term value.

Mortgage rates are in proximity to levels reached in the 2002/2003 refinance wave. However, the refinance index stands at approximately 6,750, which is about 30 percent lower than the peak of approximately 10,000 in mid-2003. Lower home values will preclude many borrowers from qualifying for a new loan; however, some of the inertia in

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refinance volumes can be overcome through government initiatives, such as the “no appraisal” streamlined refinance noted earlier.

Milestone expects that the new administration will bring coordinated monetary and fiscal policy to directly address the housing issue and will engineer solutions to stimulate housing turnover. The key outstanding market hurdle is the scarcity of warehouse lending facilities to originate significantly higher volumes. This will result in the super-regional and large-cap depositories commanding dominant market share as they exploit their competitive advantage in liquidity.

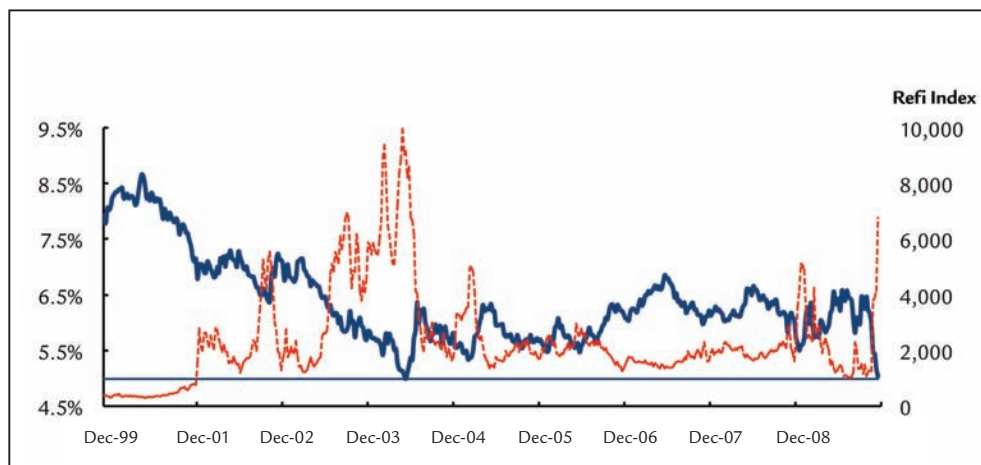
Based on figures supplied by National Mortgage News in Q3 2008, Milestone estimates that independent mortgage companies represent nearly 20 percent of total residential mortgage originations. As regional banks capture origination market share stemming from retrenchment in the market,

Milestone expects select regional banks to acquire smaller independents to expand their in-footprint coverage to neighboring geographies. At the same time, Milestone expects that larger independents will seek to solidify their funding base through depository acquisitions.

Milestone expects that the reverse mortgage market will continue to experience growth. Unit volume growth of FHA-insured, reverse mortgages has increased at a compound annual growth rate in excess of 50 percent from 2002-2007. Harvard University’s Joint Center for Housing Studies projects that the number of owner heads of households aged 60-69 will increase by 53 percent between 2005 and 2015. Aside from the attractive age demographics that support continued growth and consumer adoption of this financial product, new FHA-insured reverse mortgage limits were implemented in November 2008 and have been increased to \$417,000 from an average of approximately \$230,000 in 2007 and will therefore significantly expand the availability of the product. Of more strategic relevancy, the FDIC has announced the sale of IndyMac to a consortium of private equity investors, with the transaction including Financial Freedom.

Prior to the IndyMac conservatorship, Financial Freedom was the leading reverse mortgage originator, with nearly 50 percent market share in 2007. It remains unclear if Financial Freedom will be sold separately in a subsequent transaction or housed long-term within IndyMac, but we expect that the new owner will seek to position the platform for growth and will stimulate continued adoption

Mortgage Bankers Association 30 Year Fixed-Rate Mortgage Rate vs Refinance Index



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Buyer Name	Target Name	Announce Date	Deal Value (\$M)
WSFS Financial Corporation	1st Reverse Financial Services	4/30/08	NA
MetLife (MetLife Bank)	EverBank Reverse Mortgage	4/3/08	NA
Quicken Loans & Rockbridge Equity Partners	One Mortgage Network	1/22/08	NA
KBC	Vertical Lend	8/8/07	NA
Genworth Financial	Liberty Reverse Mortgage	7/9/07	50.0
Generation Mortgage	Amston Mortgage Company	7/10/07	NA
Bank of America	Seattle Mortgage	4/26/07	NA
EverBank	BNY Mortgage	3/26/07	NA

Source: SNL Financial and Bloomberg LP

of the product among consumers. As the reverse mortgage industry continues to evolve, Milestone expects continued transaction activity in this sector across both origination and servicing platforms.

As a final note, Milestone expects that the nonagency origination and securitization markets will remain closed through 2009. Until equilibrium is reached in the housing market, agency and government originations will command the market. Milestone believes

that the initial TARP mandate of purchasing distressed mortgage assets would have accelerated the housing bottom through the facilitation of price discovery. Private pools of capital have curtailed their whole loan purchases in the absence of clarity about the government's intention to act as a market clearing participant. Lastly, Milestone expects status quo for both Fannie Mae and Freddie Mac as the new administration first tackles housing inventories and foreclosures and

defers decisions on the GSEs to 2010.

As the economy eventually recovers, consumers will develop an appetite for flavors other than vanilla. Alternative forms of mortgage capital will develop for jumbo product and nonagency criteria (interest only, limited documentation, self-employed). The exact form of this alternative nonagency market is unclear and could include a combination of private conduits, covered bonds, and RE-ITs—all coupled with more common-sense underwriting and credit enhancement. **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, include mortgage, commercial, consumer finance companies, banks, thrifts, insurance companies and financial technology companies. The views expressed in this article are solely those of the author.