The **Vertical-Integration** Strategy

As we enter 2007, the industry comes off a year that saw Wall Street dive ever more deeply into the harvesting of profits from the mortgage sector. This article sums up all the major deals, as well as the factors driving them.

BY JEFFREY M. LEVINE

In 1997, a group of bankers from New York–based Lehman Brothers Inc.'s mortgage trading desk landed at the small airport in Scottsbluff, Nebraska, and drove past the cornfields and sugar-beet processing plant en route to a former truck terminal converted to a mortgage servicing call center. The company they were conducting due diligence on was Harbourton Mortgage Investment Corporation, a Fannie Mae/Freddie Mac/Ginnie Mae servicer that had been purchased from the Resolution Trust Corporation (RTC) a few years earlier by a publicly traded limited partnership.

Harbourton had developed an expertise in buying and servicing defaulted Federal Housing Administration (FHA) loans from Ginnie Mae pools (the precursor to special servicing) and, due to changes in tax laws affecting the company's capital structure, had

Figure 1 Broker/Dealer Acquisition of Mortgage Banks

Buyer/Target	Announcement Date	Deal Value ($ millions)	Price/Book	Price/LTM Earnings (x)
Bear Stearns Companies/Encore Credit Corp.	10/10/2006	$27.0	NA	NA
Merrill Lynch/First Franklin–NationPoint	9/05/2006	$1,300.0	200.0%	10.0
Morgan Stanley/Saxon Capital Inc.	8/08/2006	$706.1	121.8%	8.4
Deutsche Bank/MortgageIT Holdings	7/12/2006	$431.2	119.7%	18.2
Barclays PLC/HomEq Servicing Corp.	6/22/2006	$469.0	100.0%	NA
Deutsche Bank/Chapel Funding LLC	5/17/2006	NA	NA	NA
	Mean	**$586.7**	**135.4%**	**12.2**

SOURCE: SNL FINANCIAL

elected to sell its mortgage origination and servicing businesses.

Harbourton's corporate and production administration offices were located in Aurora, Colorado, a suburb of Denver. Lehman wound up purchasing the company and renaming it Aurora Loan Services Inc., now based in Littleton, Colorado, and thus was written the first chapter in the modern mortgage industry vertical-integration strategy by Wall Street. (In the 1980s, some earlier forays with Wall Street owners saw Shearson Lehman own and then sell Shearson Mortgage. And then in the 1990s, Dean Witter and Sears Mortgage were affiliated companies.)

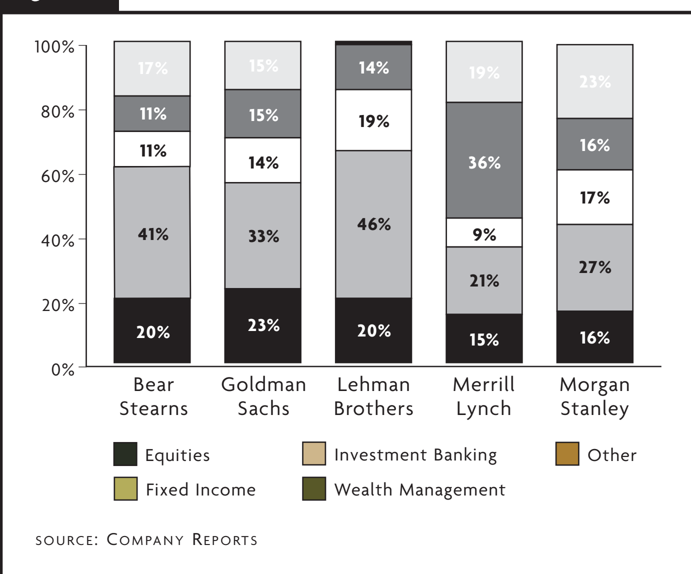
Since then, Lehman has significantly grown its mortgage operation to include all facets of origination and servicing. It accomplished this growth both organically and via the acquisition of other companies—including BNC Mortgage Inc., Irvine, California, and Finance America LLC, Irvine, California (both subprime wholesale lenders); SIB Mortgage Corporation, Branchburg, New Jersey (an alternative-A wholesale lender); and CNL Financial Group Inc., Orlando, Florida (a small-balance commercial mortgage lender).

During this same period, Bear Stearns & Co. Inc., New York, another long-time leader in mortgage trading and securitization, purchased and grew a subprime lender and servicer called EMC Mortgage Corporation, Irving, Texas, supplementing it along the way with bolt-on and *de novo* initiatives. These included an alt-A-centric wholesale lender named Bear Wholesale and, most recently, the acquisition of the subprime wholesale origination business of Encore Credit Corporation, Irvine, California.

Following the lead and success of both Lehman and Bear, other large Wall Street broker-dealers have begun acquiring mortgage banking businesses as part of their own strategies of vertical integration in the mortgage sector. (This trend has been well-reported in the trade press, including an article in the December 2006 issue of *Mortgage Banking* titled "Under Wall Street Ownership.") There were six such transactions in 2006 (see Figure 1), which include some of the largest mortgage acquisitions of the year:

- New York–based Deutsche Bank's acquisitions of New York–based MortgageIT Holdings Inc. (alt-A wholesale) and Lake Forest, California–based Chapel Funding LLC (subprime wholesale);
- New York–based Morgan Stanley's acquisition of Glen Allen, Virginia–based Saxon Capital Inc. (subprime servicer and wholesale lender);
- New York–based Merrill Lynch & Co. Inc.'s acquisition of San Jose, California–based First Franklin Financial Corporation (subprime wholesale); Lake Forest, California–based NationPoint (subprime consumer direct); and Pittsburgh-based National City Home Loan Services Inc. (subprime servicer);
- Bear Stearns' acquisition of Encore Credit Corporation (subprime wholesale); and
- London-based Barclays Capital's acquisition of Roseville, California–based HomEq Servicing Corporation (subprime servicer).

Figure 2 Wall Street Broker-Dealer Revenue Mix



SOURCE: COMPANY REPORTS

Why have the Wall Street firms so aggressively embraced this vertical-integration strategy? The answer is to protect and leverage the returns from their mortgage underwriting and securitization desks that purchased and securitized the bulk of alt-A and subprime loans in 2005.

In fact, revenues from the fixed-income divisions currently represent the largest component of the revenue mix for these broker-dealers, validating the core focus that Wall Street has assigned to the mortgage market (see Figure 2).

Key objectives of these dealers' vertical-integration strategy include:

- Guarantee a source of production for securitization;
- Eliminate the middleman wholesaler's profit;
- Maintain league table rankings;
- Realize benefit of lower warehouse and capital costs;

Figure **3** **Dealer Integration**

Origination			Broker-Dealer	Servicing		
Retail	**Wholesale**	**Conduit**		**Subprime/ Special**	**Alt-A**	**Prime**
■	■	■	ResCap/GMAC-RFC	■	■	■
■	■	■	Countrywide Securities	■	■	■
■	■	■	Morgan Stanley	■	■	
■	■	■	Merrill Lynch	■	■	
■	■	■	Deutsche Bank			
	■	■	Lehman Brothers	■	■	
	■	■	Bear Stearns	■	■	
	■	■	Credit Suisse First Boston[1]	■	■	
		■	The Winter Group[2]	■	■	
	■	■	Goldman Sachs[1]	■	■	
		■	Barclays	■	■	
	■	■	UBS		■	
		■	Société Générale			
		■	Greenwich			

[1] Ownership stakes in originators
[2] Winter Group has a second-lien focus

SOURCE: MILESTONE ADVISORS

■ Market intelligence for development of new loan products;

■ In-source servicing functions previously sold or outsourced;

■ Protect the value of the residual securitization tranches;

■ Add special servicing capabilities to maximize value from purchasing defaulted loans; and

■ Leverage the firms' expertise in running multinational, scale businesses.

How integrated are the dealers?

Figure 3 shows the breadth of integration by the different dealers. Clearly, Lehman Brothers and Bear Stearns have had the early advantage and are among the most integrated. Countrywide Securities Corporation, Calabasas, California, and ResCap (formerly GMAC-RFC), Minneapolis—while housed in specialty finance companies, not investment banks—have also built their own quite-active broker-dealer mortgage desks, and were early innovators in the vertical integration strategy.

As mentioned earlier, 2006 witnessed six large transactions by the Wall Street firms. These sales were motivated by either shifting capital structures in the independent mortgage sector (predominantly real estate investment trusts [REITs]) or strategic changes by parent companies.

As of mid-December 2006, additional subprime lenders exploring potential sales included Ameriquest Mortgage Co., Orange, California/Argent Mortgage Co., Irvine, California; Option One Mortgage Corporation, Irvine, California; and Fieldstone Mortgage Co., Columbia, Maryland. When combined with the companies already sold in 2006, this represents half of the top 15 subprime lenders and servicers either sold or for sale (see Figures 4 and 5).

Why have REITs been selling?

Many of the subprime lenders that have been sold (i.e., Los Angeles–based Aames Financial Corporation, Encore Credit Corporation, MortgageIT and Saxon Capital) were publicly traded REITs. The REIT structure was a popular and efficient manner for these lenders to go public in the robust mortgage business and steep-yield-curve environment of 2002–2004. (See Deal Talk column in the October 2006 issue of *Mortgage Banking* for a fuller discussion of this trend.)

Flush with new equity, REIT lenders aggressively grew both their origination franchises and investment portfolios. However, because REITs are required to distribute 90 percent of their taxable portfolio earnings to maintain a REIT tax status, they are dependant on new equity from the public markets for growth capital. Unfortunately, when the Federal Reserve began raising interest rates in June 2004 to temper inflation, the once-steep yield curve became inverted (see Figure 6) and dramatically reduced REIT portfolio earnings (and as a result, dividends) of the REITs.

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Figure 4 Top Subprime Lender Volume

Rank (Q3 2006)	Top 15 Subprime Lenders ($ millions)	Volume (Q3 2006)	Recent Sale Status
1	Wells Fargo Home Mortgage	$23,035	
2	New Century Financial Corp.	$13,800	
3	HSBC Finance	$11,744	
4	Countrywide Financial Corp.	$10,134	
5	WMC Mortgage Corp.	$9,023	
6	Option One Mortgage Corp.	$7,791	Exploring potential sale
7	Fremont Investment & Loan	$7,760	
8	First Franklin Financial	$7,668	Sold to Merrill Lynch
9	Washington Mutual	$7,419	
10	GMAC-RFC	$6,219	Sold to Cerberus-led investor group
11	CitiFinancial	$6,100	
12	Ameriquest Mortgage Corp.	$6,000	Exploring potential sale
13	Accredited Home Lenders	$4,229	
14	BNC Mortgage Inc.	$3,470	
15	Mortgage Lenders Network USA	$3,312	Exploring potential sale

SOURCES: *National Mortgage News*, Milestone Advisors

Figure 5 Top Subprime Servicer Volume

Rank (9/30/06)	Top 15 Subprime Servicers ($ millions)	Volume (9/30/06)	Recent Sale Status
1	Countrywide Financial Corp.	$114,516	
2	Ameriquest Mortgage Corp.	$113,000	Exploring potential sale
3	Chase	$80,634	
4	Option One Mortgage Corp.	$74,500	Exploring potential sale
5	CitiFinancial	$63,750	
6	Homecomings Financial (GMAC-RFC)	$53,525	Sold to Cerberus-led investor group
7	HSBC Mortgage Services	$51,098	
8	Ocwen Financial Corp.	$50,114	
9	Wells Fargo Home Mortgage	$49,836	
10	Litton Loan Servicing Inc.	$48,911	
11	New Century Financial Corp.	$42,300	
12	HomEq Servicing Corp.	$42,217	Sold to Barclays
13	National City Home Loan Services	$41,381	Sold to Merrill Lynch
14	Saxon Capital Inc.	$26,605	Sold to Morgan Stanley
15	Fremont Investment & Loan	$26,427	

SOURCES: *National Mortgage News*, Milestone Advisors

Combined with lower operating margins and higher repurchase and default losses, the earnings and dividend streams from these REITs decreased significantly, which caused the stock price to decline as well—with several players trading below book value (see Figures 7 and 8). With access to capital significantly limited, and excess operating capacity in the industry, many of these companies elected to sell or explore a sale.

Why wholesale? Why subprime?

Most of Wall Street's interest has been focused on wholesale, not retail lenders. Why? The answer is twofold: First, wholesale franchises can be scaled much more quickly to capture market share, and can operate with fewer staff and less physical infrastructure than retail models. Those are both appealing characteristics to broker-dealers, which themselves are scale and high-revenue/employee businesses.

Second, retail lending, with its direct-customer interface, opens up the exposure to fair lending and compliance concerns, which Wall Street firms are averse to. In fact, liabilities associated with alleged violations of the Fair Credit Reporting Act by certain subprime lenders in their retail divisions introduced a significant due-diligence concern on some of the sale transactions explored in 2006.

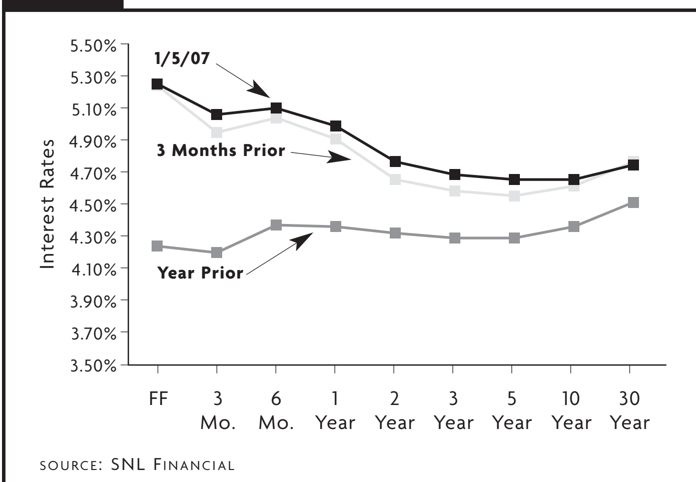

Figure **6** **Treasury Yield Curve**

SOURCE: SNL FINANCIAL

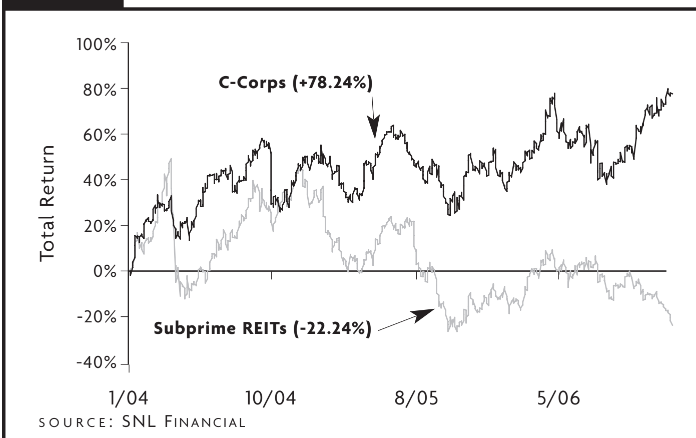

Figure **7** **C-Corps—Three-Year Total Return Performance**

SOURCE: SNL FINANCIAL

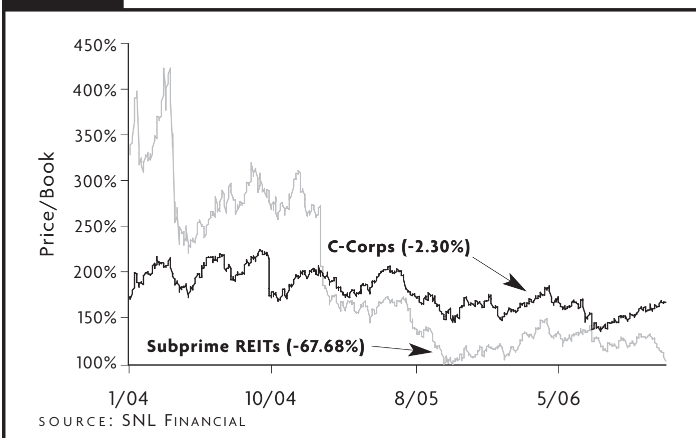

Figure **8** **C-Corps—Three-Year Price/Book Performance**

SOURCE: SNL FINANCIAL

Countrywide a Street firm?

Most people think of broker-dealers as only the traditional Wall Street firms. However, Countrywide Financial Corporation, Calabasas, California, for example, has been an early pioneer in mortgage bond sales and trading with its Countrywide Securities Corporation. GMAC-RFC (now ResCap) was also one of the early developers of mortgage loan sales and trading through the old Residential Funding Corporation conduit.

Both Countrywide and ResCap have built significantly vertically integrated mortgage businesses including multiple origination and acquisition channels, loan securitizations and sales, and top prime and subprime servicing and special-servicing platforms.

Many of the large commercial banks have also built sizable nonprime mortgage desks under their broker-dealers, and these banks are starting to execute their own vertical-integration strategies.

For example, the merger that resulted in New York–based JP Morgan Chase & Co. combined two very established and integrated mortgage banking businesses—JP Morgan's broker-dealer and corporate finance group, and Chase's prime and subprime origination and servicing platforms.

Similarly, New York–based Citigroup Inc. has its legacy prime mortgage lending and servicing businesses; its subprime lending businesses, acquired from Primerica Financial Services (which it acquired in the Citigroup/Travelers Group merger)

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and The Associates (which Citigroup acquired in 2000); and a leading mortgage desk and corporate finance platform built through both New York–based Citibank and the acquisition of New York–based Salomon Brothers/Smith Barney.

Charlotte, North Carolina–based Wachovia Corporation and Charlotte, North Carolina–based Bank of America have expanded their broker-dealer mortgage trading desk operations and corporate finance platforms, while also repositioning their residential mortgage banking businesses. Wachovia has used two recent acquisitions—that of San Diego–based AmNet Mortgage Inc. and Oakland, California–based Golden West Financial Corporation—and a recent sale (its HomEq subprime servicing platform) to reposition its mortgage banking strategy.

Wachovia has since combined Wachovia Mortgage's wholesale and correspondent lending groups under AmNet, which is now a subsidiary of Wachovia's broker-dealer, and placed the combined retail residential lending divisions of Wachovia Mortgage and Golden West under Wachovia's Retail Consumer Bank.

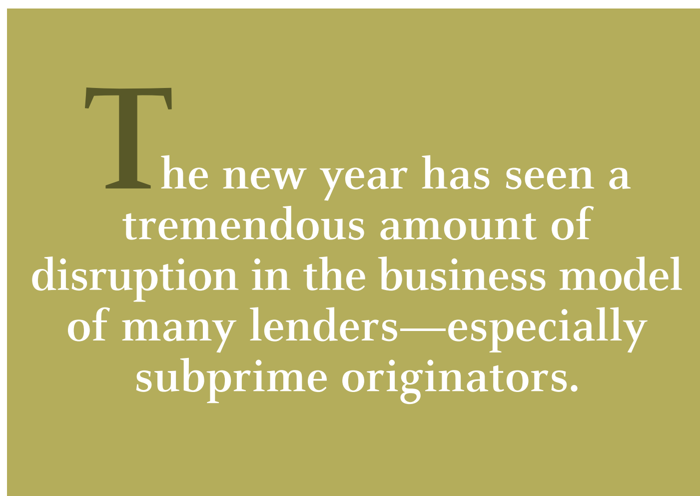
Finally, Seattle-based Washington Mutual has been steadily

growing its capital-markets operation by building on the Conduit/Securities Corporation it acquired from PNC Financial Services Group Inc., Pittsburgh, and refocusing its activities on nonprime and option adjustable-rate mortgage (option-ARM) acquisitions, securitizations and servicing.

Private-equity and hedge-fund investors

Private-equity firms and hedge funds have also become active acquirers in the mortgage banking sector. The distinction between these firms acting solely as private-equity investors (pay premiums) versus hedge funds (buy distressed) has blurred as many of these companies are beginning to vertically integrate as well.

Large players such as New York–based Cerberus Capital Management and New York–based Fortress Investment Group LLC own many properties across the specialty finance sector (e.g., retail, commercial, origination, servicing, interim financing), and other large hedge funds have been active acquirers of mortgage residual and collateralized debt obligation (CDO) investment portfolios.



Five examples of recent acquisition activity include (1) New York–based Kohlberg Kravis Roberts & Co.'s (KKR's) lead investment in Horsham, Pennsylvania–based GMAC Commercial Holding Corporation (now Capmark Financial Group Inc.); (2) Cerberus Capital's lead investment in GMAC-RFC; (3) Indianapolis-based Roark Capital Group's acquisition of Indianapolis-based Ace Mortgage Funding LLC; (4) Greenwich, Connecticut–based WDM Fund LP's acquisition of Oak Brook, Illinois–based United Financial Mortgage Corporation; and (5) Fortress Investment Group's acquisitions of Centex Home Equity Co. LLC (now Nationstar Mortgage, Dallas) and Parsippany, New Jersey–based Champion Mortgage Co. Inc.

Minority stakes

Most of the attention in the vertical-integration play has been on complete acquisitions of mortgage companies. However, a number of the Wall Street firms have also made strategic minority investments in companies in addition to, or, as opposed to, control acquisitions.

Recent examples include Citibank's minority investment in Paramus, New Jersey–based Opteum Financial Services LLC; New York–based Goldman Sachs Group's stake in San Jose, California–based LownHome Financial Holdings LLC (wholesale lending); New York–based Credit Suisse USA Inc.'s investment in Lake Oswego, Oregon–based Lime Financial Services Ltd.; and Deutsche Bank's investment in Orlando, Florida–based Pinnacle Commercial Mortgage LLC.

Earlier examples included the old RFC's numerous investments in warehouse and conduit clients through subordinated debt, working capital or shared execution programs. These investments, while carrying a meaningful coupon (either current or payment-in-kind), are done for strategic reasons, largely to garner warehouse financing and the more lucrative securitization underwriting and whole-loan deal flow. Plus, having a seat at the table with the company's management and owners gives a minority partner tremendous insight into the company and sets the stage for a potential majority buy-out or participation in a public offering.

Overseas expansion

Mortgage banking vertical-integration strategies have not been limited to the United States. Merrill Lynch, Lehman Brothers, GMAC-RFC (ResCap), Countrywide and Morgan Stanley have all built significant market share (initially through acquisitions) in the United Kingdom, particularly in the nonprime mortgage market.

Other markets that the broker-dealers are expanding into include Canada, Mexico, Germany, Italy, the Baltic States, Russia and China. These markets are less mature, giving the dealers more flexibility in creating loan products and securitization structures. However, the size of these markets varies, and the legal and regulatory environment is still in various stages of development.

Other related businesses

The majority of the focus of vertical integration has been on the residential lending and servicing sector. However, other businesses that the Wall Street mortgage desks have been expanding into include commercial mortgage conduit lending and servicing; small-balance commercial mortgage lending; and small-ticket warehouse lending.

Examples include Deutsche Bank's acquisition of Berkshire Capital (commercial real estate mortgage conduit) and investment in Orlando, Florida–based Pinnacle Financial Corporation (small-balance commercial), and acquisitions of small-ticket mortgage warehouse lenders by Citibank (First Collateral Services Inc.) and Bear Stearns (EMC Residential Mortgage Corporation).

2007 outlook: Liquidity is king

The new year has seen a tremendous amount of disruption in the business model of many lenders—especially subprime originators. Significantly increased levels of early-payment default loan repurchases are constraining the short-term profitability and liquidity of lenders, particularly highly leveraged independent companies, as the 2006 vintage loan production performs very poorly due to relaxed underwriting criteria and worsening consumer credit.

Companies such as Ownit Mortgage and Sebring Capital Partners LP have gone out of business and are liquidating,

while Mortgage Lenders Network has shut down its wholesale lending business. Other companies are trying to resolve loan repurchase demands while at the same time reducing operating capacity and costs, and tightening their product underwriting.

Firms with excess cash and capital are able to manage through this cycle, and, ironically, the remaining REITs (while not trading above book value) still have surplus capital raised from prior years to carry the companies through this current liquidity and restructuring period.

On the prime mortgage front, independent lenders and bank parents continue to re-examine their commitment to the mortgage industry. Out-of-footprint, wholesale businesses are the most likely sale candidates by banks, as narrowing margins with no cross-sell opportunities make returns on capital harder to achieve.

Ann Arbor, Michigan–based ABN AMRO Mortgage Group Inc. just announced its parent bank had reached an agreement for its sale to Citigroup. Mount Laurel, New Jersey–based PHH Mortgage Corporation is also currently for sale. Both are top-10 lenders with more than $383 billion (as of third-quarter 2006) in combined servicing rights, according to *National Mortgage News*. Two prime mortgage REITs, New York–based New York Mortgage Trust Inc. and Atlanta-based HomeBanc Corporation, are also exploring strategic options, including a potential sale of the companies or deconversion from REIT status.

Numerous small, privately held prime mortgage lenders that do not have scale or pricing efficiency to compete with the national lenders are also for sale or shutting down. The continued inversion of the yield curve, coupled with weakening housing markets, has reduced loan volume and profit margins at all prime lenders.

Final thoughts

In closing, we see the mortgage industry continuing to experience a tremendous amount of consolidation as excess capacity, reduced margins and a housing recession put significant strains on the sector. Wall Street has played, and will continue to play, a large role as a consolidator as it hopes to vertically integrate the entire manufacturing cycle from origination through distribution to servicing.

Large commercial banks also will play a meaningful role, along with well-capitalized independents, REITs and private-equity firms, as the traditional lines between bank/investment bank and financial buyer/strategic buyer become more blurred in today's ever-evolving consumer finance market.

As always, proven business models and management teams will prosper and attract capital, while weaker players will go out of business. And for consumers, they will continue to benefit from product innovation and historically low interest rates, which will promote a continued flow of core borrowing activity. **MB**

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