Independent Mortgage Banks Need to Consider Risk Sharing Alliances

By Burke Dempsey

The mortgage landscape is now changing faster than most independent mortgage banks can retain the necessary capital or human resources. As business theory goes, if one doesn't keep up with the landscape change, organizational risk mounts. And risk one day surfaces in some not so pleasant way. Technology, regulatory burdens and new tax law are already keeping independent mortgage C-suite executives busy before they can even get out the door to pay a call on a potential merger partner. As if that weren't already enough to add to the to-do list, rising rates and lowered projected volumes in 2018 will decrease revenues and margins as competition will be beyond fierce to avoid capitulation. The upshot for 2018 is a *negative* Return on Effort (ROE) and a need to risk share by finding a financial or strategic partner.

Risk share to reduce sleepless nights

Working harder for these self-starter executives is not the answer in a 24/7 world, when one may be competing against someone on another continent or even a robot. The catalyst for many to partner will be the wake-up call from warehouse lenders for more margin, the CFO alerting to dwindling cash in the checking account, or the production manager notifying a top office just walked-over to a competitor.

Others who planned for this decisive moment and accept the business axiom of risk sharing will benefit from their openness on a number of strategic, financial and operating fronts. They acknowledge that dramatic changes will occur to them and their employees when they agree to accept outside capital, or merge with another company, but they view the initial discomfort and learning curve as worth the long-term benefits. They embrace and *become part of* the change, which in turn, promotes a virtuous loop that allows the proforma company to merge again and again, and stake out a defendable place in the landscape.

The decade of watchful waiting is over. It's time to make a move

The challenge has always been that independent mortgage bankers like being *independent*. It is something that harkens back to the formation of our country and to which we can all relate and admire. But independent mortgage bankers like the Colonies before the United States, are not averse to consolidation, they just don't see what's in it for them. And until now, they were correct. The public market for mortgage banks was so upside down post the Great Recession, that it made no sense for any independent mortgage bank to sell at a discount to already severely discounted public comparables. Rugged individualism and common sense prevailed! Waiting to sell, however, depleted equity like firewood in a cold winter. As the independents came outside in the spring of 2017 to survey the situation, they found what appeared to be clear credit skies, but some ominous clouds off in the distance. They know they don't have enough wood for another year like 2017.

Traditional mergers of originators have been slow, but there are many ways to risk share

In 2017 there were only several dozen M&A transactions with an announced total value of $2 billion. That is a tiny sliver of the theoretical equity value of the origination and servicing market. And 75% of that value was for servicing deals as savvy acquirers like New Residential with low cost and quickly raised capital could take advantage of weakened sellers at a great upward inflection point in rates. Meanwhile, there were limited deals between originators as independents spent 2017 waiting for the quarterly depletion of their equity to stop or reverse before entering discussions with a partner—but the depletions continue, and it is only a matter of time before the merger (aka risk sharing) discussions begin in earnest.

That said, as Charts 1 and 2 show, the transactions that did occur in 2017 were notable for creativity in structure and the emergence of serial acquirers. Freedom, Guaranteed Rate, Guild, HomeBridge, and Stearns each announced more than one transaction, and each of those transactions was an interesting case study. Regional commercial banks are re-entering the game following the success of Flagstar who also announced two mortgage banking transactions. TH Lee got back in the business of sponsoring mortgage companies with its Guaranteed Rate Investment, which single-handedly helped to re-define pricing for scale originators in a very good way. We also saw a clever "three-fer" move by LoanDepot in partnering with AV Homes, to not only get access to a unique set of HENRY buyers, and enhance their mortgage plant utilization levels, but also to promulgate their Mello software.

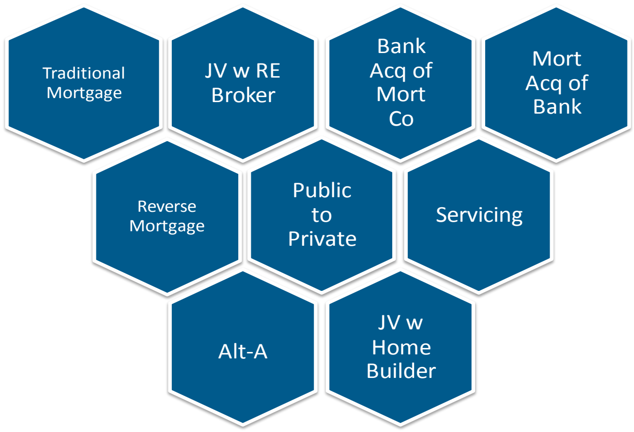

Figure 1

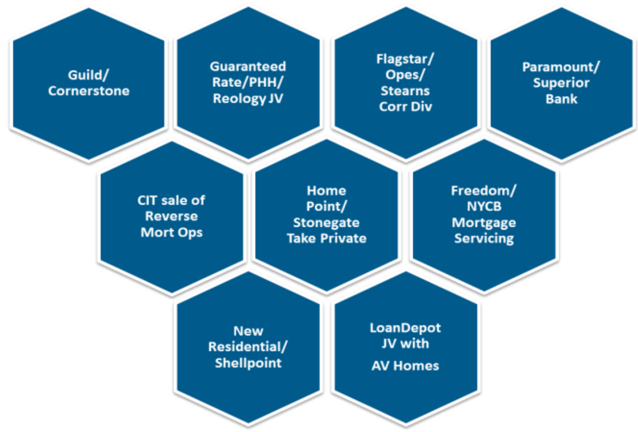

Figure 2

The takeaway here is that these players are disciples of growth via risk-sharing. Not long ago the above mentioned companies were relatively small, but ambitious independents. They understood that if they could keep adding capital and talent they could avoid being one of those cautionary case studies at a business school. In a $1.7 trillion annual industry there is room for more scale players. Like the Colonies that became the United States, there was certainly a lot of jostling for position and blood spilled, but in the end, those independent state mergers into a country became unassailable across the globe.

The benefits of risk sharing

With newly improved valuation and deal structures, independents can finally start to see something that's in it for them to circle the wagons and form these unions. They may find these positive benefits, as smaller banks did in the massive consolidation that occurred from interstate banking legislation in 1985:

- Better upfront premiums, 51/49 or earnout alternatives, stock purchase structures, and attractive employment contract terms as the shadow of The Great Recession recedes
- The opportunity for significant future additional capital gains and dividend increases as their upstream partner merges with someone else, the so-called "double dip", or goes public
- Their best employees find enhanced career opportunities and compensation
- The owners who want to continue working have greater resources at their disposal to tackle more far-reaching projects

Don't be tardy to the party

The key is to FOBO not LOWO. Get out and meet many potential partners to be the First Out with the Best Offer, not the Last Out with the Worst Offer. As we saw with the bank consolidation of the 80's and '90s, those that stepped up early (FOBO) not only received better premiums, but also participated in "double-dips" and massively increased dividends over the time frame. Their best employees became senior and well-compensated employees of a very large enterprise. The power of financial compounding and broader career opportunity really worked in the seller's favor.

The smaller players who spurned what they felt were "low-ball" offers, not only had to continue to spend an inordinate amount of their revenues for technology and compliance that would be redundant in a sale; they needed to spend copious time and money to protect their employees from being recruited away. However, when it came time to sell they found in many cases that top buyers were no longer interested—buyers had found substitute acquisitions, or had the resources to open their own local operations, often recruiting away the seller's local team with public stock or higher compensation. So waiting and being last out resulted in a dramatically lower price, terms and conditions, if a deal could be made at all. And many of the lucrative post-merger positions were by then held by executives who had merged out early. Thus LOWO is even worse than it sounds. The difference between the FOBO and the LOWO was stark and one independents must reflect on carefully as 2018 may be more challenging than 2017.

Taking action means the independent culture will be preserved
Merging doesn't mean an independent has lost its raison d'etre any more than two people getting married lose their identities. In fact, the sum can be greater than the parts, for the owners of each company and their top employees. As was experienced by Main Street retailers, standing still was like walking backwards in the face of malls, then Amazon. If the word "merger" doesn't resonate, call it risk sharing. Then consider all the elements of one's business at risk right now, every day in the most sanguine of stock and bond markets, and decide if the owners, managers, and employees can deal with even more risk as those conditions deteriorate. If so, God Bless American Exceptionalism for working out of seemingly impossible circumstances, and if not, contact me and let's get a plan to risk share with someone.

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