FEATURING

THE IMPORTANCE OF "CHARACTER" IN NEGOTIATING A SUCCESSFUL ACQUISITION

STRATMOR INSIGHTS

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WELCOME

Welcome to this second issue of *STRATMOR Insights*, a free monthly Report from STRATMOR Group that will provide you with interesting, data-driven articles that deliver select results and insights from our mortgage industry surveys, programs and consulting experience.

This month's "In-Focus" think-piece, featuring commentary by M&A Specialist and Senior Partner, Jeff Babcock, looks at importance of "character" on the part of both buyer and seller in negotiating an acquisition that works. Whether you're a buyer or seller, I think that Jeff's lists of the "Five Behaviors That Support Successful Acquisitions" and "Five Behaviors to Avoid in M&A Meetings" should be required reading.

Our "Mortgage Metrics Matter" section takes a look at some of the key results regarding Underwriter Compensation coming out of our most recent Compensation Connection Survey. You may be surprised by the relatively high percentage of Underwriters who work remotely (presumably from home), especially Underwriters working for Independent Lenders.

This month's "In The Spotlight" highlights some of the key findings coming out of a recent Spotlight survey focused on Back Office Incentive compensation. Despite concerns that volume or throughput based incentives may degrade quality, survey results suggest that almost 90% of lenders have back office incentive compensation plans, and that most of these plans are volume/throughput-based.

In "Speaking Borrower Satisfaction," you'll learn that June's National Borrower Satisfaction Index dropped slightly as the industry enters the peak-volume summer months and that having your LOs attend loan closings really does improve borrower satisfaction.

All of us at STRATMOR hope that *STRATMOR Insights* will become a monthly staple of what you read to keep up with the mortgage industry. In this regard, your ***feedback*** is more than welcome.

Lisa Springer, CEO

STRATMOR
INSIGHTS

IN THIS ISSUE

THE IMPORTANCE OF "CHARACTER" IN NEGOTIATING A SUCCESSFUL ACQUISITION

By Jeff Babcock

On the surface, mortgage banking M&A activity is driven by an intensive analytical drill. Typically, the principals to a transaction focus on performance benchmarking, product mix trending, staff productivity, compensation and incentives, organizational structure, consolidation and synergy opportunities, production forecasting, discounted cash flow calculations and transaction cash flow projections, etc.

While the numbers and related analyses are fundamental to the negotiating process, there is an overarching element — call it "emotional IQ" — which will often determine the ultimate success of an acquisition. By emotional IQ, we are referring to the behavioral style exhibited by the principal players during the courtship and negotiations phase of the M&A process. This is what we broadly define as "character" in an M&A context. We have observed that character certainly plays a role in marshalling the deal to the closing table, but also contributes importantly to the ultimate success of the acquisition.

Culture and Corporate Values

In STRATMOR's experience, assessment of and appreciation for character is often subordinated by the analytical demands of a given transaction. Of course, the parties to a transaction always acknowledge the importance of corporate culture — meaning the effectiveness by which the human capital of an organization is managed and deployed. Culture encompasses a blending of corporate values with business practices that determine a broad range of outcomes from customer experience to risk tolerance to employee recognition. Since a lender's most valuable assets go home every evening, it is critical that the corporate culture encourages these assets to show up the next morning. The failure to achieve or validate cultural compatibility between buyer and seller will generally doom an acquisition, even one with the most promising underlying economics.

In-Focus

THE IMPORTANCE OF "CHARACTER" IN NEGOTIATING A SUCCESSFUL ACQUISITION

Because retention of the seller's sales force is both crucial to achieving the economic potential of a mortgage banking acquisition and highly susceptible to cultural compatibility, the financial consideration in mortgage banking M&A transactions typically includes substantial performance-based earn-out payments from the buyer to the seller over a 2-to 5-year period following the acquisition.

A substantial earn-out component makes it especially important to the seller that the buyer's culture be compatible with their own. More generally, where an earn-out exists, it becomes especially important to completing a transaction that the buyer and seller work out a post-transaction implementation plan that is likely to retain and motivate the seller's sales force. Accomplishing this requires that buyer and seller not only negotiate the "price," but also the go-forward plan, with the latter being accomplished in collegial fashion.

The failure to achieve and validate cultural compatibility between buyer and seller will generally doom an acquisition.

How We Define Character

Although some elements of management's character may be embodied in the corporate culture, here we are really trying to isolate those specific behaviors that foster a working relationship and unity between people who were probably strangers prior to the start of transaction discussions and ensuing negotiations.

In the context of a business marriage, STRATMOR has identified trust, adaptability, compromise and humility as elements of character which we have observed in the most successful recent deals where we served as the transaction advisor.

- **Trust** results from a dialogue based on transparency, integrity, openness and completeness. For example, stating clear preferences and objectives fosters trust, even if your message includes conditions which you fear the other party does not want to hear.

- **Adaptability** is a necessity in an industry like mortgage banking where macro-economic conditions – over which the players have absolutely no control or much ability to predict – determine future performance and opportunities. We must function in a cyclical environment which generates financial volatility and is subject to powerful external forces (e.g., regulation and compliance). Management's ability to demonstrate effective adaptation is a powerful influencer.

- **Compromise** and concessions are a feature of fair and equitable negotiations. It is essential that both parties to a transaction perceive that the final deal terms represent a winning outcome. How synergies are incorporated into the consideration paid to the seller by the buyer is one area that can often scuttle a transaction. Often, the buyer has a lower cost of funds, better secondary marketing execution and lower back-office costs than the seller, which serve to increase the margins on the incremental origination volume the seller brings to the table. Generally, the seller wants such improved margins to be included in the transaction price (including the earn-out) whereas the buyer does not.

- **Humility** is a matter of degree. Typically, both parties have pride in the business model they built and its resulting performance, but not to the degree that it shuts off receptivity to exploring new ideas such as workflow efficiencies, clever marketing campaigns, employee development, etc. Parking the corporate ego at the door fosters creativity and collaboration.

THE IMPORTANCE OF "CHARACTER" IN NEGOTIATING A SUCCESSFUL ACQUISITION

In most transactions, the first interaction between the parties begins with a get-acquainted conference call. While there is typically some prior exchange of preliminary origination and financial metrics, the foundation of the potential relationship is established during this initial dialogue…and it usually is based on a shared sense of character. The style of communications is most impactful here: openness, mutuality, ability to articulate preferences and objectives, even telephone manners will often determine the first impression and whether the personal chemistry is sufficiently appealing to move to the next step.

I recall one of these get-acquainted calls where STRATMOR was representing the buyer. The selling shareholders sent all the right signals during the 60-minute conversation such that our client responded "Those are our type of guys… if everything checks, that's our deal!" The sellers exhibited character from the opening bell. By contrast in another such call, the seller implied that the buyer would be "stupid" not to adopt the selling lender's origination culture. Needless to say, that early display of arrogance ended the discussions.

Five Behaviors That Support Successful Acquisitions

The following are a handful of behaviors, which are common to the most successful acquisitions in which STRATMOR has participated:

1. To mitigate the number one risk in an acquisition, both parties must recognize that the highest priority is to bring across the seller's originator sales force and that there must be a collaborative effort to develop a compelling value proposition and post-acquisition plan designed to retain the producers.
2. The seller is highly motivated to leverage the acquisition synergies that the buyer brings to the table. The seller's sales force is encouraged (and maybe even incented) to use the availability of new loan products, utilize sales and marketing tools and capitalize on system upgrades to expand their referral sources.
3. The buyer understands that a company sale represents the ultimate "report card" on the seller's life work, so there is an emotional element to the negotiations. Here's where empathy can demonstrate character.
4. There is a sincere effort to understand the strategic opportunity underlying the potential acquisition. Initial discussions should be focused on realizing the strategic potential and not get bogged down in operation detail.
5. Acknowledge the reality that certain functional managers in the seller's organization will be consolidated out of their job. These are often people who have been loyal, dedicated players. The consolidation of redundant functions must be planned carefully and phased to avoid transition speedbumps and handled with sensitivity.

Five Behaviors To Avoid In M&A Meetings

The following are five behaviors that can quickly derail M&A negotiations:

1. Never withhold information that might be received as unfavorable to your negotiating position or financial expectations. Assume that the due diligence process will uncover any and all skeletons. Full disclosure early in the discovery process engenders trust and transparency. It builds interpersonal comfort between the players.

2. The buyer should not insist on making substantive changes to the seller's originator compensation programs for at least the first year.

3. Avoid statements that imply superiority of your business model compared to the other party or the industry norms. Such an approach hinders compromise to achieve a common good and comes off as arrogant.

4. Seller's people must understand that they will become employees of the buyer organization and recognize that they cannot operate as a "company within a company."

5. Seller should not be obsessed with preserving jobs when consolidation of redundant functions makes compelling economic sense.

Conclusions

Where there is character in evidence, the result is always respect and appreciation. In mortgage banking, where people account for 80% of total expenses, respect and appreciation are absolutely critical to a successful marriage. To contact Jeff Babcock for more information, click here. ■

UNDERWRITER COMPENSATION

Insights from the STRATMOR COMPENSATION CONNECTION SURVEY

Determining compensation amounts and structure are fundamental to ensuring that your organization hires and retains the best talent and motivates personnel to perform consistent with your goals and objectives. Benchmarking peer compensation is also important to controlling costs and justifying compensation to your stakeholders.

Since 2010, STRATMOR's Compensation Connection Survey has been providing lenders with valuable insights into not only levels of cash compensation paid by peers but, more importantly, into how peer incentive plans are structured. The Compensation Connection Survey consists of distinct compensation modules that allow lenders to participate in compensation surveys of those personnel groups of most interest to them.

Currently, the compensation survey modules include:

- **Executive Management**
- **Retail Sales**
- **Consumer Direct Sales**
- **TPO Sales**
- **Fulfillment (All Channels)**
- **Production Support**

Of all the positions covered by these modules, the one that generates the most interest — and which is the subject of this month's *Mortgage Metrics Matter* section — is **Underwriter Compensation**, which is covered in the Fulfillment Survey along with Processors, Closers and other key fulfillment job functions.

The Underwriter Compensation results presented here represent lenders of all sizes and geographies. While the predominant channel underlying results is Retail, the results also reflect an average for Underwriters in both the Consumer Direct and TPO channels.

Mortgage Metrics Matter

UNDERWRITER COMPENSATION

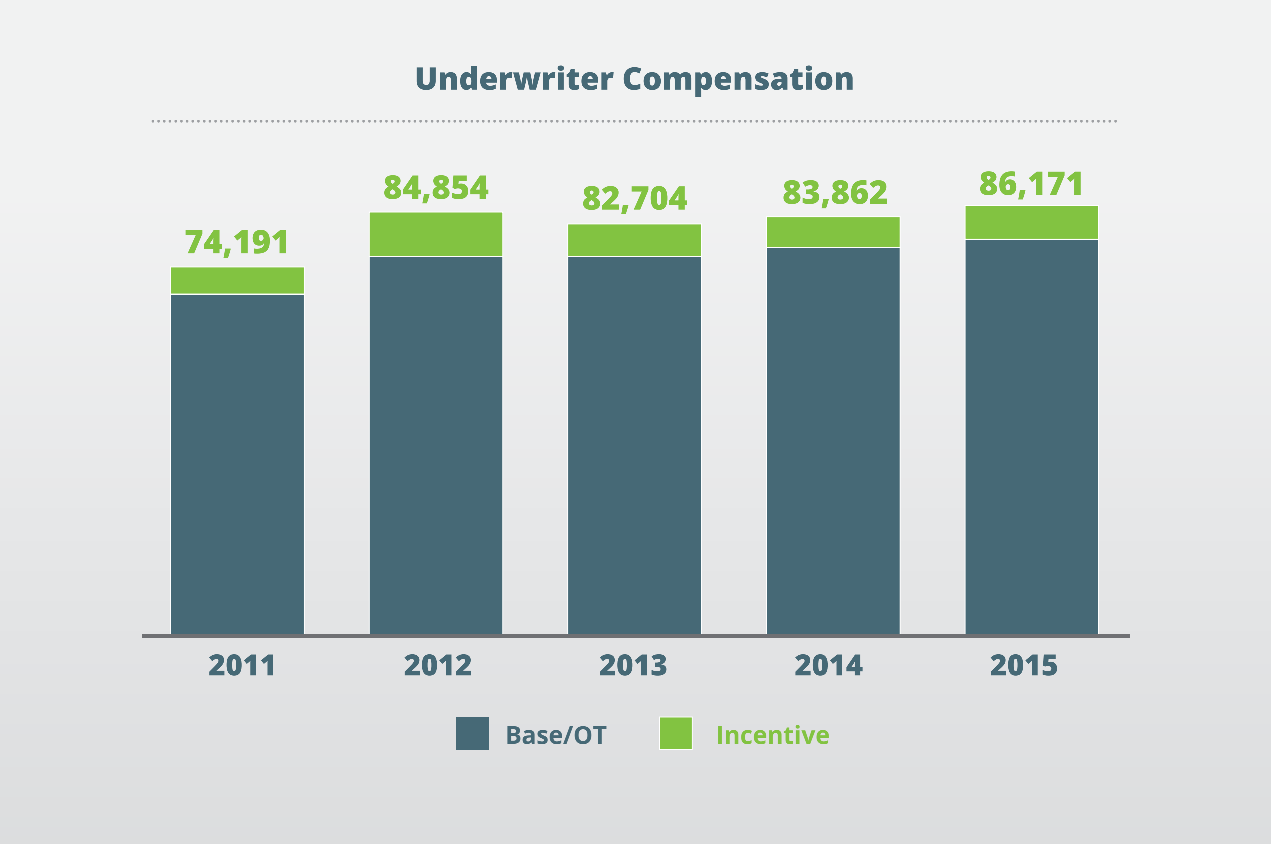
Excerpts From the Survey Results

The following are the results from a few of the key questions answered by the most recent *Compensation Connection Survey*:

Q **How is Underwriter compensation trending?**

A **Anecdotally, we hear of big signing bonuses and ballooning Underwriter Compensation. However, based on our survey data, that includes results from 36 companies for 2015, we find the following results:**

- **Underwriter Compensation increased 2.7% from 2014 to 2015, which is not a material jump and likely reflects standard merit increases.**
- **We did see a significant jump from 2011 to 2012 with an increase of 15% but since then Underwriter Compensation has remained relatively steady.**



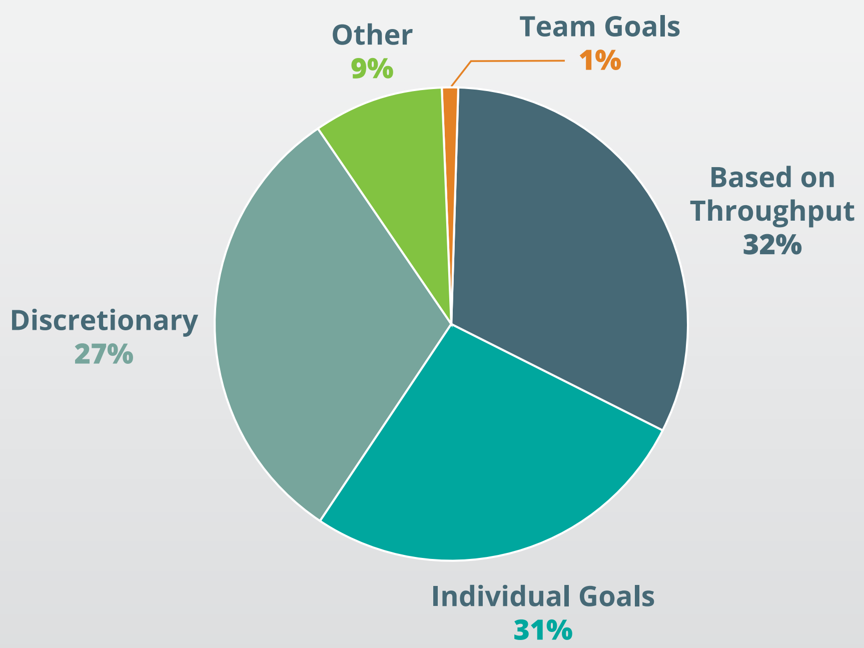
Q **What drives Underwriter incentive plans?**

A **Survey participants were asked what percentage of incentive compensation is related to a variety of categories. The results below represent the average of all 36 responses, in which we find that incentive payouts to Underwriters split roughly into thirds.**

- **One-third based on throughput or productivity**
- **One-third based on individual goals that could include file quality, turn time and other company specific measurable goals or objectives**
- **The final third includes Discretionary awards and other non-categorized factors. This would include incentives awarded based on parent company or division performance.**

Based on this, it appears that companies take a balanced approach that rewards productivity but also emphasizes other non-volume related factors.

UW Compensation Composition



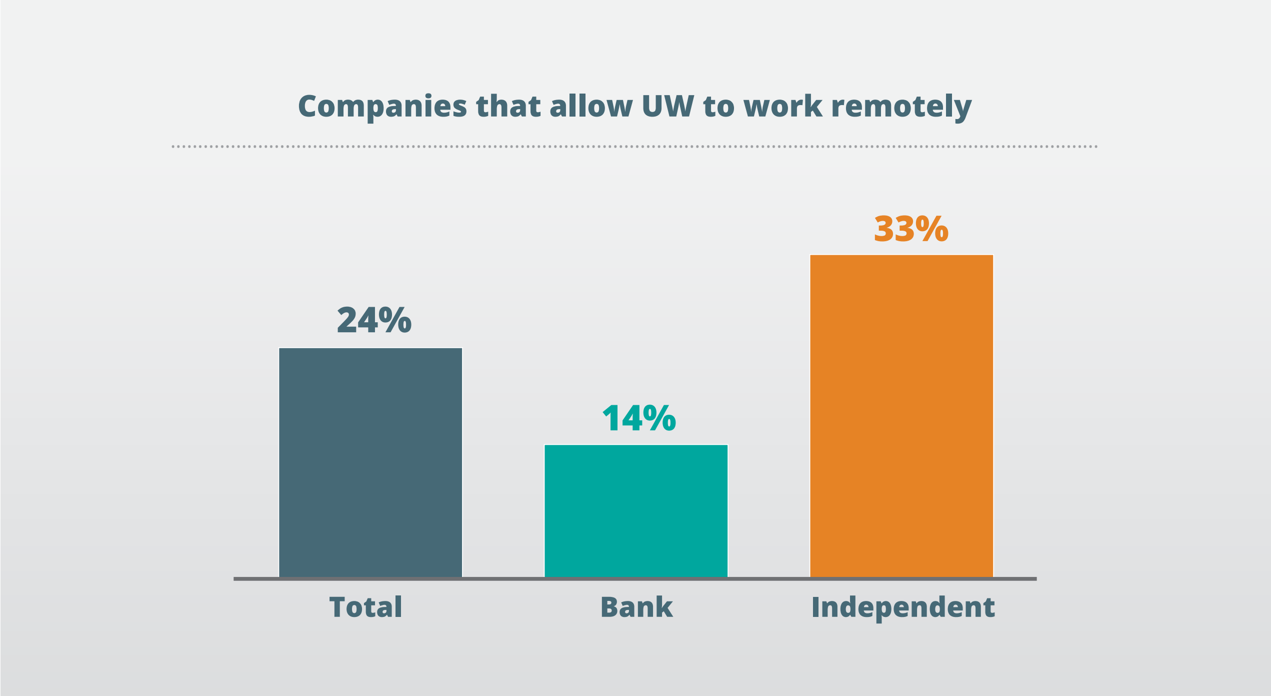
Mortgage Metrics Matter

UNDERWRITER COMPENSATION

Q **Do companies allow Underwriters to work remotely?**

A **Participant companies report the percentage of Underwriters that either work In-House or Remote, which varies from company to company.**

- **Some companies reporting 100% working remotely and some reporting 0%**
- **Based on our data, 24% of Underwriters work remotely**
- **Because we cross-tabulate the data based on company type, we can see that the results vary for Banks and Independents**
- **Independents are more likely to have Underwriters working remote (33%) than Banks (14%). The corporate culture and controls at a Bank appear to limit this practice, which may also limit their ability to recruit Underwriters who have become accustomed to working remotely.**



PARTICPATE IN THE SURVEY NOW

The *Compensation Connection Survey* has reopened for submissions of 2015 data. If you are interested in learning more about the survey or would like to participate, click here.

BACK OFFICE INCENTIVES SURVEY

Providing the right mix of incentives for back office origination personnel, such as processors, underwriters, closers, post-closers and shippers, requires a range of incentives and variable-based components to keep workers happy and motivated. But what is the best mix for your back office staff and what incentives are truly effective in motivating and retaining these employees? These are the questions addressed by STRATMOR's recent *Back Office Incentives Survey*.

Motivating and retaining your back office employees requires a strategic employee incentive program.

Background

The *Back Office Incentives Survey* was the third survey issued under STRATMOR's Spotlight Program (which was then called the STRATMOR PeerViews Survey Program). It was launched in early May 2015 and remained open until May 31, 2015. Invitations were sent to 1,987 individuals representing 994 unique lenders. Responses were received from 122 unique lenders.

In The Spotlight

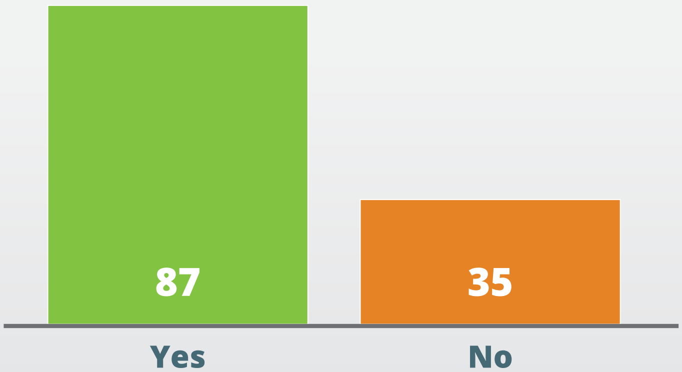
BACK OFFICE INCENTIVES SURVEY

STRATMOR INSIGHTS

The following are select results from STRATMOR's recent *Back Office Incentives Survey*.

Q **Does your compensation plan for any of your company's fulfillment and production support personnel (processors, underwriters, closers, post closers and shippers) include an incentive or variable-based component?**

A **71% of respondents (122 lenders) have an incentive or variable-based component in one or more of their compensation plans for back office personnel**



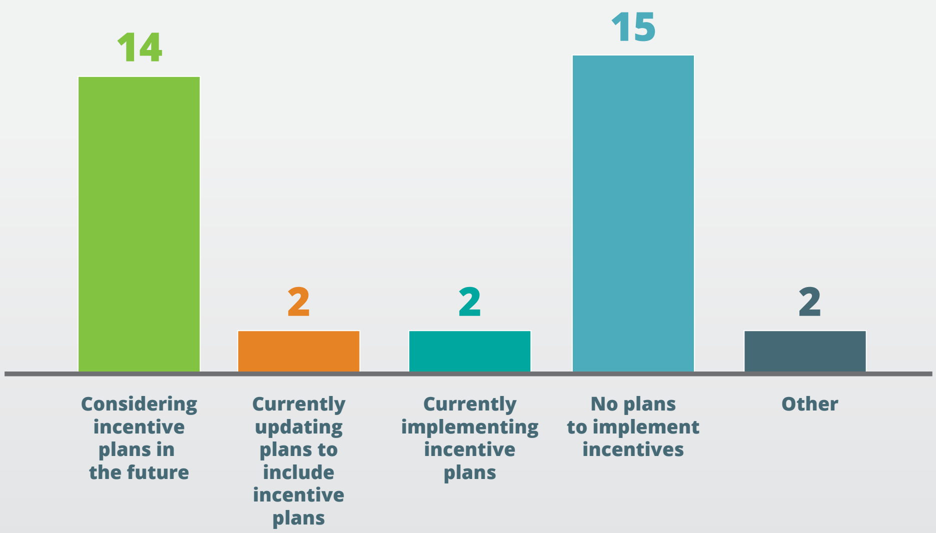
	Yes	No
% of Total	71%	29%
# of Respondents	87	35

In The Spotlight

BACK OFFICE INCENTIVES SURVEY

Q **If your company currently does not have incentive plans in place for back office origination personnel, do you have any plans to do so?**

A **A little more than 50% of the 35 lenders reporting that they do not currently have incentive plans for back office personnel but are considering such plans for the future (14) or are currently in various stages of putting such plans in place.**



	Considering incentive plans in the future	Currently updating plans to include incentive plans	Currently implementing incentive plans	No plans to implement incentives	Other
% of 'No' Responses (35)	40%	6%	6%	43%	6%
# of Respondents	14	2	2	15	2

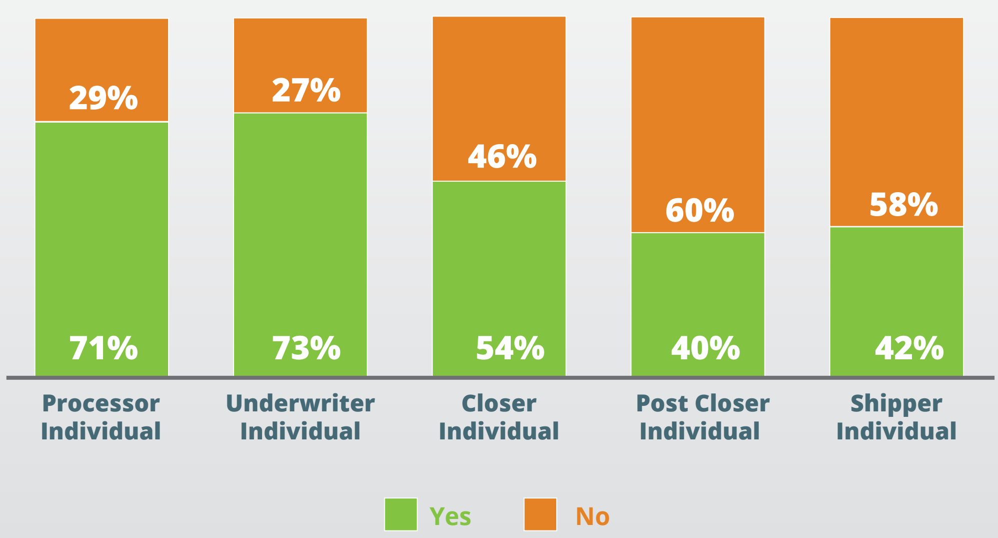
Based on the responses to the above two questions, it appears that in the near future almost 86% of lenders will have incentive plans in place for back office origination personnel.

In The Spotlight

BACK OFFICE INCENTIVES SURVEY

Q **If volume or throughput-based incentives are part of your incentive plan, does the plan require that a volume or throughput threshold be reached before paying out an incentive?**

A **The predominant compensation model is that volume/throughput incentives for Processors and Underwriters are paid once a certain threshold is reached. Closers are more balanced while the Production Support staff is more likely to be paid an incentive on every unit.**

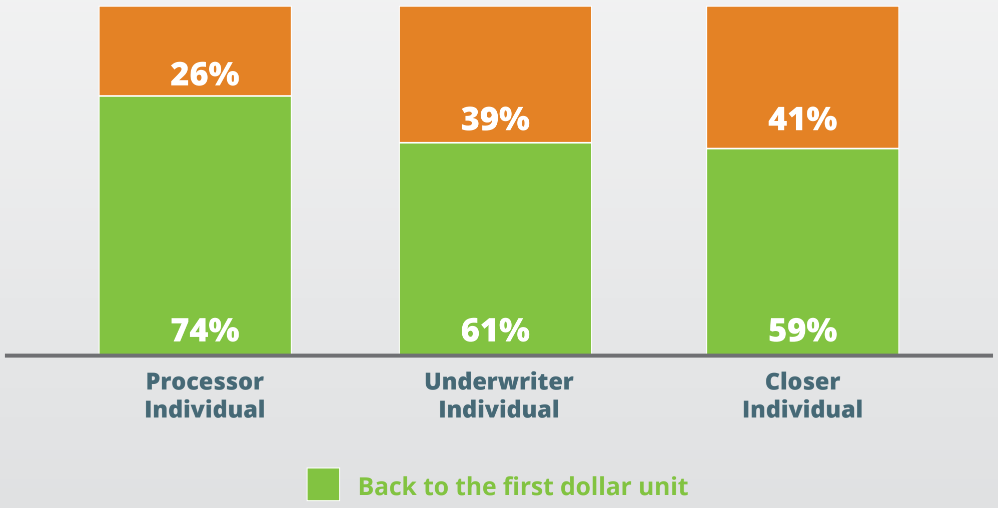


STRATMOR believes that peak period pressures on fulfillment elevate the importance of volume/ throughput productivity; hence, the requirement that processors and underwriters reach a volume or throughput threshold before an incentive is paid.

In The Spotlight

BACK OFFICE INCENTIVES SURVEY

Additional findings show that when the productivity threshold is reached, the incentive is generally paid back to the first dollar or unit of production. This approach further increases the incentive for fulfillment personnel to reach their productivity thresholds, which are typically set at or near industry benchmarking standards.



To view and download the *Back Office Incentives Survey,* click here

Speaking Borrower Satisfaction

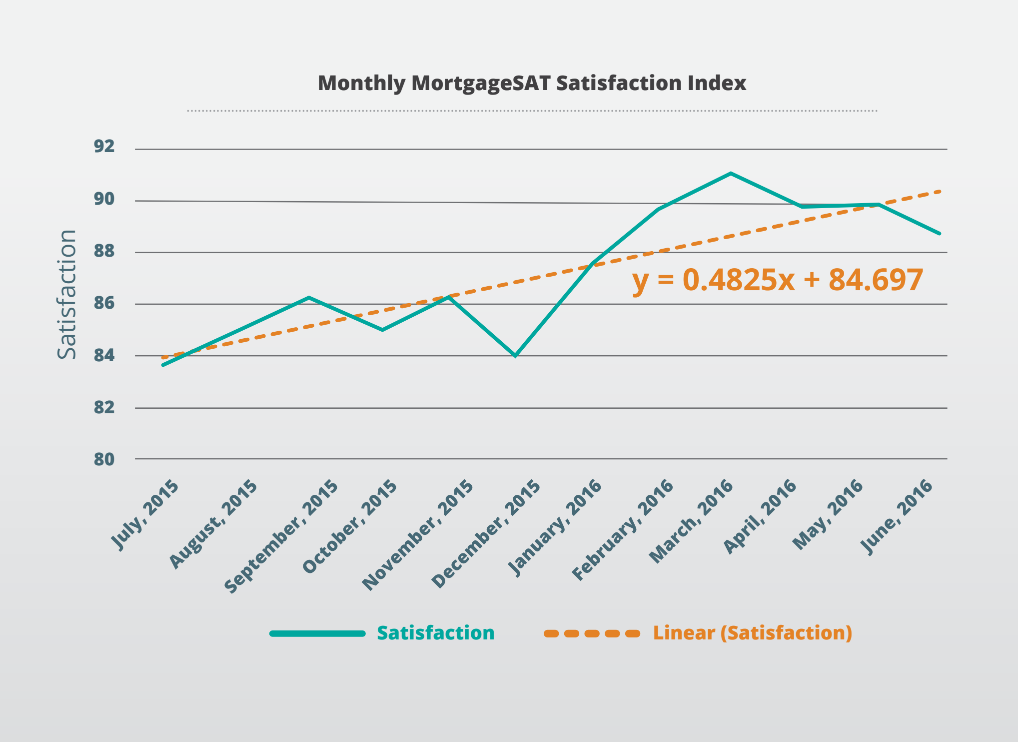
OVERVIEW

Each month's edition of STRATMOR Insights includes a "Speaking Borrower Satisfaction" section containing a National Borrower Satisfaction Index plus a Topic of The Month based on data collected by *STRATMOR's MortgageSAT Borrower Satisfaction Program*.

National Borrower Satisfaction Index

The National Borrower Satisfaction Index chart below displays the *Total Borrower Satisfaction Score* for MortgageSAT participating lenders over a 12 month look-back period starting with the second preceding month, e.g., starting with the June 2016 satisfaction score for this August's edition of *STRATMOR Insights*.

The chart also includes a best-fit linear trend line along with the equation for that line. In the Chart below, we see from the equation for the orange dashed best-fit linear trend line, that from July 2015 through June 2016, borrower satisfaction has on-average increased by 0.48 points per month.



Borrower satisfaction scores declined in June:

This *12-month rolling monthly average is down by roughly 0.06* from the 0.54 average increase per month reported in July's STRATMOR Insights and reflects a 1 point drop in borrower satisfaction to 89 in June from the April and May satisfaction scores of 90.

We attribute this small decline in satisfaction to a sharp increase in June origination volume (almost 20% higher than April) that likely caused a decline in service levels.

Further declines appear likely as we move into July and August as the high volume of purchase closings collides with back office summer vacation schedules at many lenders.

Speaking Borrower Satisfaction

TOPIC OF THE MONTH: ORIGINATOR ATTENDANCE AT CLOSING

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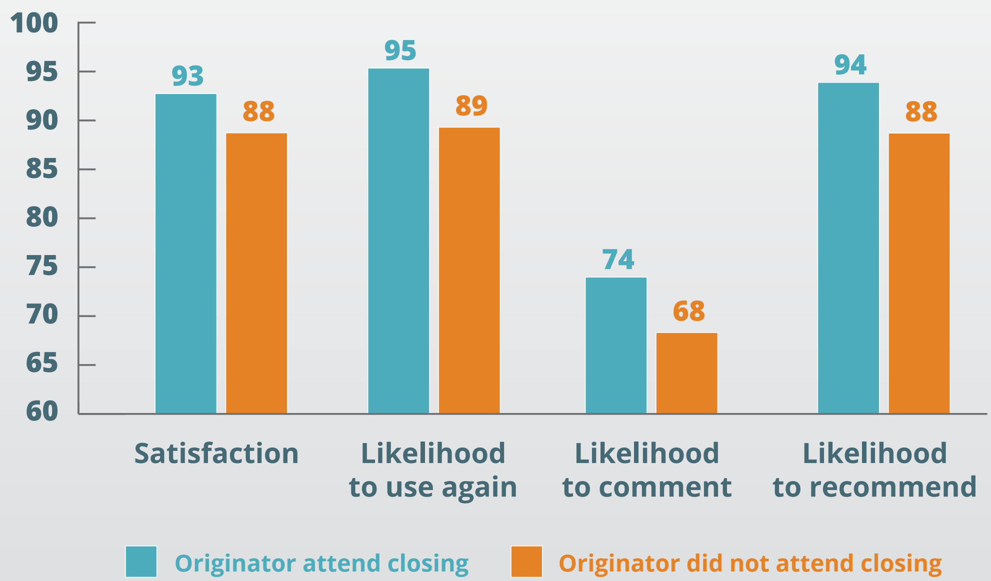
Impact on Satisfaction When the Originator Attends the Closing

Over the years, many lenders have touted the value of having their originators attend the Closing, if for no other reason than the potential sales and marketing benefits of meeting the Realtor® and home buyer. There is also the added benefit for the loan originator of potential contact with the seller as well as their Realtor. MortgageSAT results for 2016 YTD through July strongly confirm this viewpoint.

Satisfaction and likelihood to use again/recommend improve when originators attend closing (2016 YTD)



Speaking Borrower Satisfaction

TOPIC OF THE MONTH: ORIGINATOR ATTENDANCE AT CLOSING

FINDING #1: When originators attend the Closing, not only does Borrower Satisfaction increase (by almost 7%), but so does the Likelihood to Use Again.

FINDING #2: In the short-term, when originators attend the closing, the Likelihood to Recommend lenders to others (mostly family and friends) and Likelihood to Comment favorably on social media both increased.

FINDING #3: The increase in borrower satisfaction when the originator attends the closing also hints at one reason why Borrower Satisfaction for the Retail Channel is higher than for the Consumer Direct Channel, for which loan originators are tied to a call-center and cannot attend the Closing.

FINDING #4: While, theoretically, there may be an opportunity cost associated with having loan originators attend the Closings of their loans, with most retail loan originators producing just 3-5 closed loans per month, the drain on their time represents only 5% to 10% of their available hours (assuming a 40 hour work week).

Based on these findings, it appears that requiring retail loan originators to attend their loan Closings is likely to be very cost effective – and it requires virtually no capital investment. Originator attendance at loan Closings can have a positive impact on Borrower Satisfaction with potential marketing and sales benefits. To us, this is a "low hanging fruit" opportunity.

To learn more about STRATMOR's *MortgageSAT Borrower Satisfaction Program*, click here.

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COMPENSATION CONNECTION — CLICK HERE