STRATMOR GROUP

FEATURING

SOMETHING'S GOT TO GIVE: LENDER OPTIONS FOR NAVIGATING THE MORTGAGE INDUSTRY SHAKEOUT

STRATMOR INSIGHTS

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WELCOME

This time of year, families enjoy watching at least one movie version of Charles Dickens' *A Christmas Carol*, the story of miserly businessman Ebenezer Scrooge and his redemption on Christmas Eve after the visits of the ghosts of his past, present and future. It's a tale that reminds us of the consequences of our actions, even while it shows us it is never too late to positively transform.

Our lead story this month is also about the potential for transformation as we explore some of the options lenders have available to them to manage through a rapidly consolidating industry. Senior Partner Jim Cameron narrates "Something's Got to Give: Lender Options for Navigating the Mortgage Industry Shakeout," a story of M&As past (the very recent past, 2016 to 2018), present (the options available today), and future (what to do in 2019 and beyond). No matter where you are right now, Jim offers insights and advice that can help you transform your business for the better.

The new Borrower Experience article illustrates the cost consequences of not making changes to improve processes, specifically document collection from the borrower. MortgageSAT Director Mike Seminari shares findings from the MortgageSAT Program and the new MortgageSAT calculator that shed light on the devastating effect of asking borrowers multiple times for the same document. Don't miss the five steps you can take to transform and optimize your process that are included at the end of this article.

Thank you for joining us again this month. From all of us at STRATMOR, we wish you and yours a very Happy Holiday season and a bright and prosperous New Year 2019.

Lisa Springer, CEO

STRATMOR

INSIGHTS

IN THIS ISSUE

SOMETHING'S GOT TO GIVE: LENDER OPTIONS FOR NAVIGATING THE MORTGAGE INDUSTRY SHAKEOUT

By Senior Partner Jim Cameron

Unless you have been living under a rock, you know that this is a tough time in the mortgage business. There are too many lenders chasing too few borrowers, and because rates are not expected to decline any time soon, there won't be a refi rally to bail out lenders. Something has to give.

For those of us who have been in the industry for a while, we see many factors pointing to a period of industry consolidation — a down cycle. What are we seeing? Here are the vitals:

- **Rates** — Interest rates are up with no indication that they will drop.
- **Margins** — There is significant margin compression, and it's especially acute in third party channels as lenders attempt to manage capacity with price.
- **Volumes** — Activity is flat or down, and true seasonality is kicking in as one would expect in a purchase-dominated market. Recent increases in rates appear to be dampening home purchase demand. Refinances are limited to cash-outs as rate term transactions have all but gone away.
- **Expenses** — Cost per loan has been increasing as volume drops due to "sticky" fixed costs that are slow to change. And, we continue to face a challenge trying to control the high sales expenses that remain in the industry.
- **Profits** — With revenues down and costs up, production profits are in serious decline. While some lenders have cash flow from servicing portfolios and gains due to write ups of their servicing asset, many lenders do not have that luxury.
- **Capital** — Significant investments in technology are required just to stay in the game, so whether utilizing transactional pricing or building applications internally, the stakes are going up.

SOMETHING'S GOT TO GIVE: LENDER OPTIONS FOR NAVIGATING THE MORTGAGE INDUSTRY SHAKEOUT

As is true of any down cycle, this market presents an opportunity for well-capitalized and well-run lenders to be "consolidators" while struggling lenders with less capital are facing the prospect of being at least a reluctant — if not involuntary — "consolidatee."

To what extent will the mortgage industry consolidate? As data-driven trusted advisors to the mortgage industry, STRATMOR decided to apply our well-developed analytical capabilities to this question. We started with the data, considering first the number of announced transactions involving residential mortgage origination companies in 2016, 2017 and YTD 2018. While many transactions are not announced publicly and would therefore not be included in our count, we believe that the number of announced transactions is clearly indicative of the pace of consolidation in the industry.

By our count, there were only eight announced deals in 2016. Large Independent lenders like Freedom, Home Point and Caliber gobbled up smaller lenders while HomeBridge acquired Prospect Mortgage in the largest announced deal of the year. Throw in a couple of ESOPs (Employee Stock Ownership Plans) and that was about it for 2016.

Throughout 2016, STRATMOR's M&A advisory team engaged in dozens of conversations with prospective sellers. Most prospective sellers told us to contact them "maybe next year when things slow down." Of course, our response was to remind them that it is always better to sell a company from a position of strength.

Things began to heat up in 2017 with 11 announced deals. Once again, the buyer population was dominated by large Independents like Freedom, Stearns, Guaranteed Rate and Home Point. However, three banks announced acquisitions that year, including WinTrust, TCF and Flagstar. Importantly, two of the banks (WinTrust and Flagstar) are very familiar with the Independent mortgage banking model and culture.

Through November 2018, there were 28 transactions with more expected to be announced by year's end. The data supports the obvious conclusion — we are clearly entering a period of accelerated consolidation.

Who is Buying?

Table 1 below summarizes buyers by category.

Table 1

	Number of Buyers by Category				
	2016	2017	2018	Total	%
IMB	5	5	17	27	57%
Bank	1	4	6	11	23%
Instit/Other	-	2	4	6	13%
ESOP	2	-	1	3	6%
Total	**8**	**11**	**28**	**47**	**100%**

Not surprisingly, Independent Mortgage Bankers (IMBs) dominate the buyer category, led by well-known large independents such as Caliber, Guild, Freedom, Guaranteed Rate, Home Point and Stearns. Most of the large Independents have institutional money behind them in some form or fashion (e.g. Blackstone, Stone Point, LoanStar). Banks are next at 23 percent of the buyer population. However, approximately half of the bank buyers have more of an independent mortgage banking model, such as WinTrust, Flagstar and HarborOne. The Institutional/Other category includes New Residential, Eli Global, Zillow, Celebrity and Ocwen. While there has been much discussion of ESOPs lately, the three ESOPs announced in the past three years comprise only six percent of total buy-side transactions.

Who is Selling?

Table 2 below summarizes sellers by category.

Table 2

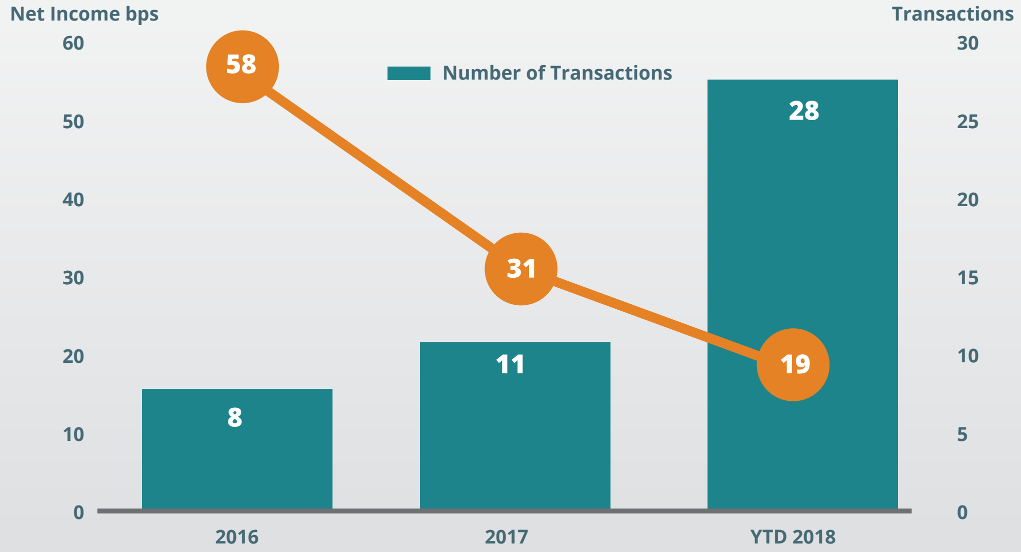
	Number of Sellers by Category				
	2016	2017	2018	Total	%
IMB	6	8	25	39	83%
Bank	2	2	2	6	13%
Instit/Other	-	1	1	2	4%
ESOP	-	-	-	-	0%
Total	**8**	**11**	**28**	**47**	**100%**

IMBs represent 83 percent of the seller population over the three-year period. While bank sellers are next at 13 percent, it is important to note the nature of the bank seller transactions. For example, in the case of Banc Home Loans and NYCB, the operations being sold off were more typical of an Independent mortgage banker. Adjusting for these two transactions would put the IMB percentage closer to 90 percent.

Table 3 below summarizes the number of announced deals per year along with the average production profits by year (excluding servicing) based on the MBA's *Quarterly Performance Report*.

Table 3

of Transactions Per Year Compared to Avg. Production Pretax Net Income



As one would expect in a mortgage industry down cycle, when profits decline, the pace of consolidation increases. When the MBA's fourth quarter results come in, we would expect the Pretax Net Income for full year 2018 to decline further from the 19 basis points level reported for Q3 YTD as the industry limps home in the fourth quarter.

Clearly, we are experiencing an intense period of industry consolidation which will extend well into 2019. The buyer population will be dominated by large well capitalized Independents, as well as hybrid banks that operate more of an Independent mortgage banking model. Sellers will continue to include IMBs struggling to maintain profitability while experiencing shrinking capital and liquidity.

When Will It End?

At STRATMOR, we are often asked to predict when margins will return to "normal." The answer? When excess capacity is removed from the industry. How long will it take for this to occur? One popular school of thought is that rapid consolidation will continue throughout Q1 and into Q2 2019 and that margins may normalize in the late spring and summer next year. While that would be nice for the lenders who survive this shakeout period, mortgage executives can't count on this happening. A lack of meaningful growth in the purchase market may delay the recovery period for the industry well beyond next summer. Lenders should continue to actively manage their business to survive this downturn.

What Options are Available to Lenders?

While today's market conditions are as challenging as they have been since the industry meltdown, there are several possible tactics and strategies that lenders can pursue. Here's the thing: Lenders had many more viable options during the past several years when times were good. Now that times are bad, there are fewer cards to play.

1. Optimize Cash from Operations

As the saying goes, "Cash is king," and it is the lifeblood of any business. While there are a variety of strategic and tactical options for lenders to consider, none of the options can be executed if the lender does not have positive cash flow. If you are bleeding cash, good luck trying to raise debt or equity capital or sell your business for more than book value. But there are a multitude of strategies and tactics lenders might employ to optimize profits and cash flow. Here are the basics:

- **Revenue Optimization** — review of secondary marketing pricing and practices, best execution strategy, leakage analysis.
- **Cost / Efficiency** — benchmark with peers, operations and process reviews, effective deployment of technology, managing sales compensation by reducing layers where possible and adjusting originator compensation over time where possible.

For some lenders, these profit optimization efforts may be a case of too little too late, while other lenders may be counting on the fact that they have enough capital and liquidity reserves to weather the storm. Through STRATMOR's decades of helping lenders, we can safely say there are no silver bullets. We help our clients with both strategy (doing the right thing) and tactics (doing things right). It's all about execution, and our best clients have the management discipline, culture and attention to detail to "out execute" peers.

2. Build Your Servicing Portfolio to a Critical Mass

Many larger Independents have steadily grown their servicing portfolio over the past decade. Some have increased servicing as part of a classic macro-hedge strategy where servicing values and profits go up as rates rise, which offsets decreased profits on the production side of the business. The key to this strategy is to keep the right balance between servicing portfolio levels and production volumes. Lenders who have adopted this strategy are benefiting from the servicing cash flows and MSR write-ups, which is helping to pay the bills and bolster capital levels during this production downturn. Lenders who have not already built up their servicing portfolio to a critical mass will not likely be able to do so in the short run.

3. Generate Cash from Prudent Use of Debt

While obtaining lines of credit or negotiating better warehouse line terms is a classic way to manage cash flow, now is not the time to go hat in hand to your bank, particularly with operating cash flows and profits under pressure. Prudent lenders have smartly managed their relationships with warehouse lenders over a long period of time to negotiate for lower rates, increased advance rates and more favorable terms. While negotiating smartly is good, veteran lenders who have managed through market cycles fully understand the value of maintaining a good relationship with their bank and are careful not to push too hard for warehouse financing in a "buyers' market." In today's market, a good relationship with the warehouse bank is paramount as covenant waivers are more the rule than the exception.

Lenders who have retained servicing have the option of negotiating MSR lines of credit or even lines of credit collateralized by servicing advances. Once again, for lenders who do not already have such lines in place, it may be a tall order to negotiate new lines.

Lenders have market options to raise subordinated debt as well, but again, this may be difficult to do with profits under pressure. Even if a lender successfully raises the sub debt, the cost of such capital may be punitive.

4. Raise Equity Capital

For many small to mid-size Independents, this starts with current shareholders, friends and family. Currently, many owner operators are contributing additional equity to maintain capital levels to meet bank, regulatory and investor requirements. There is nothing like having to write a big check to get an owner-operator to think about his or her strategic options.

Initial public offerings (IPOs) are very challenging even in the best of times and are a tall order for a traditional monoline mortgage banker given the volatility of the business. Stonegate Mortgage Corporation is the most recent example and that did not end well. Even a high-quality technology focused lender like loanDepot postponed their public offering a couple of years ago as the capital markets did not value the company at a level acceptable to the existing shareholders.

Some lenders have attempted to raise capital by selling a minority interest stake. While some large Independents have successfully raised minority interest equity capital, this option is simply not on the table for most mid-size mortgage bankers. Very few investors would want to invest in a mortgage banker without having a controlling interest, especially in today's market.

5. Form an ESOP

Employee Stock Ownership Plans (ESOPs) are an intriguing option for lenders and have been the topic of much discussion at industry conferences in the past few years. Churchill Mortgage, Axia Home Loans, USA Mortgage and Fairway Independent are recent examples of either full or partial ESOPs. In a leveraged ESOP, which is the most common structure, the go-forward entity must generate sufficient cash flows to pay down the debt over a defined period. While the debt can be paid down with pre-tax dollars, which is helpful, the entity must generate strong and sustainable cash flows for the numbers to work.

When an ESOP is formed, the trustee must have a valuation prepared by an independent appraiser to support/establish the deal value. Importantly, the valuation calculation assumes that the company will continue to operate as a stand-alone entity. This is in contrast with a strategic buyer valuation which "bakes" synergies into the future cash flows (e.g. better execution, lower cost of funds, elimination of duplicate expenses) and is thus more likely to generate a higher valuation. In short, today's lower profits and cash flows make it harder to support an acceptable stand-alone valuation to owners, even considering the potential tax and other benefits of an ESOP.

6. Shut Down

Shutting down would be extremely unattractive to most owner-operators. The negative psychological and emotional aspects of this scenario are distressing and heartbreaking (losing your life's work, public embarrassment, possible lifestyle changes, impact on co-workers, friends and family, etc.) From a financial perspective, the liquidation value of the entity is likely significantly lower than book value. It is not as simple as selling off assets and paying off liabilities.

There are other considerations such as:

- **Shut down costs** — lease buyouts, severance, negotiating out of various contractual obligations.
- **Trailing liabilities** — shareholders are still on the hook for these; they must either negotiate a buyout or keep the entity open with a certain amount of liquidity to meet obligations as they arise.

Since most creditors do not relish the thought of pursuing shareholders of defunct entities, they will typically attempt to negotiate a buyout arrangement. No matter how you slice it, shutting down is a worst-case scenario for most lenders.

7. Become a Broker

This option is similar to the shutdown option in our view. In this scenario, a lender would have to downsize dramatically and eliminate all mortgage banking related functions from underwriting through the back office. Then there is the question of economics — after the painful cuts have been made, lease buyouts negotiated, etc., could the entity make a reasonable profit within the confines of allowable broker compensation? While this is possible, it would be a stretch, and we have not seen a significant trend in this direction.

8. Sell Controlling Stake in the Company

As evidenced by the dramatic increase in announced transactions in 2018, this is an option that more and more lenders are executing in today's market. While deciding to sell the company is a gut-wrenching decision for shareholders, once that decision is made, we urge shareholders to retain an experienced advisory firm like STRATMOR that can help you through the entire process.

Where Are You in the M&A Process?

Lenders fall into one of three categories as depicted in Table 4 below.

Table 4

Category	Characteristics
Category 1 – Buyers	Large, well-capitalized, highly liquid, Hybrid Bank or PE backed, countercyclical servicing cash flows, good value proposition to seller sales staff, leading technology and brand
Category 2 – In Between	Reasonable capital levels and liquidity; while profits are down, no imminent cash or capital concerns; may have a servicing portfolio to help cash flows; depending on management's ability to execute, could slip into a Category 3 situation
Category 3 - Sellers	Small to mid-sized IMBs, low capital levels, limited liquidity, grew by "buying" market with high sales comp, not enough servicing to survive the down market

No matter what category you're in (likely buyer, likely seller, or somewhere in between), we are in a very challenging and turbulent time in our industry. STRATMOR has battle-tested action plans for each of the above categories. Generally, however, our advice to all lenders:

- If you must sell, take a deep breath, hire an advisor and do it correctly to achieve optimal results.
- If you want to grow organically and through acquisition, there will be plenty of opportunities to do so in the next 6-12 months.
- If you are somewhere in between, it is time to execute and execute well. The stakes are high.

STRATMOR CAN HELP YOU MEET THESE CHALLENGES

Would you like to discuss your options in this time of consolidation? STRATMOR works with lenders on strategies to solve complex challenges, streamline operations, improve profitability and accelerate growth. Please Contact Us or your STRATMOR partner or principal for assistance.

IS THIS SIMPLE MISTAKE COSTING YOU $200,000 A YEAR?

Suppose you were given a clear set of instructions to increase your revenue by $200,000 this coming year. You'd take a close look, wouldn't you?

According to STRATMOR's new MortgageSAT calculator, the average lender doing 5,000 loan units annually is losing $243,000 each year by failing to address a widely known issue plaguing borrower satisfaction: asking for the same document multiple times. The cost comes in lost referrals, repeat business and negative word of mouth. STRATMOR has seen very few lenders make serious strides in eradicating this problem, so consider this your call to action. A quarter of a million dollars (or more) is in the balance.

The Borrower Experience

IS THIS SIMPLE MISTAKE COSTING YOU $200,000 A YEAR?

The process of gathering and assembling documents and other information required by the lender is often the most unpleasant part of the loan origination process for the borrower. Having to remember old passwords and search through financial files to find prior-year tax returns, bank and brokerage statements, life insurance policies and other financial records can be stressful. Adding to this stress is the fact that some of the required information is personal in nature, information which the borrower may be uneasy about sharing with mortgage people who are little more than strangers.

The document gathering process starts with an upfront information request, most often by the loan officer, who is keen on getting the borrower into the loan process as quickly and easily as possible. With this motivation, these LOs may limit their initial data request to just the essential information needed to start the process. This leads to additional information requests later in the process, and sometimes, more than one person from the processing team asking for the same documents.

How do additional information requests affect borrower satisfaction? And, what's the impact on satisfaction when the lender asks for a document already provided by the borrower?

What the Numbers Show

The answers to the following information-request questions are based on the Net Promoter Score (NPS)[1] for the roughly 105 thousand borrowers who responded to the MortgageSAT post-closing survey from 4Q 2017 through 3Q 2018.

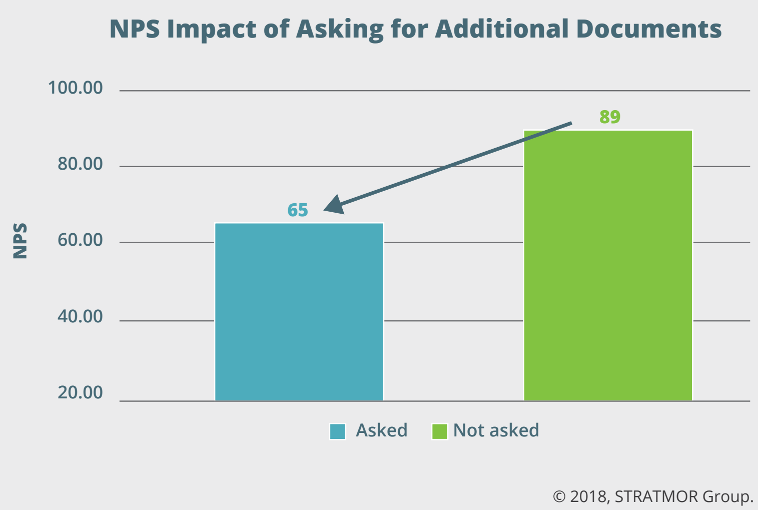
The NPS Impact of Asking for Additional Documents

Figure 1 below compares the NPS scores of those borrowers who were not asked for additional documents (NPS = 89) with those who were (NPS = 65). We see that for every 100 borrowers, there were 24 fewer endorsers or promoters of the lender. This means fewer referrals to friends and family; fewer kind words to real estate agents and, of course, a lower likelihood of the borrower doing business with you again. Lenders pay a pretty steep price for asking the borrower for additional information beyond the initial request.

This not a small, isolated issue. MortgageSAT data shows that about 50 percent of all borrowers are asked for additional documents. And while loading up the initial request with more documents can lower the number of additional requests, it may only serve to worsen the borrower's experience. To some degree, therefore, the lender is caught between a rock and a hard place.

[1] NPS is defined as the number of borrowers out of 100 who rate their borrowing experience a 9 or 10 on a 10-point scale (so-called "promoters") less the number of borrowers who rate their experience a 1 to 6 (so-called "detractors").

Figure 1



Asking for the Same Document More Than Once

Asking a second or third time for the same document makes lenders look disorganized and unprofessional and leaves borrowers thinking, "I already gave you what you asked for. Why can't you keep track of things?" It's both annoying and frustrating. Figure 2 shows that asking again for a document sours the borrower experience substantially, lowering the NPS score by almost 50 points, from 88 (for borrowers who were only asked once) to 39 (for borrowers who were asked more than once).

Here too, the problem is not a small one, with almost one of every three borrowers being asked to provide the same document multiple times.

Asking for Additional Documents and Making Multiple Requests for the Same Document

The impact of document requests on NPS is even more adverse when the borrower is not only hit with additional document requests but also multiple requests for the same document (which may be part of an additional request).

When this occurs — and MortgageSAT data suggests it happens to one out of every five borrowers — NPS drops to 32 (see Figure 3), 60 points below the NPS of 92 for the 41 percent of borrowers who are neither asked for additional data nor a document previously provided.

Figure 2

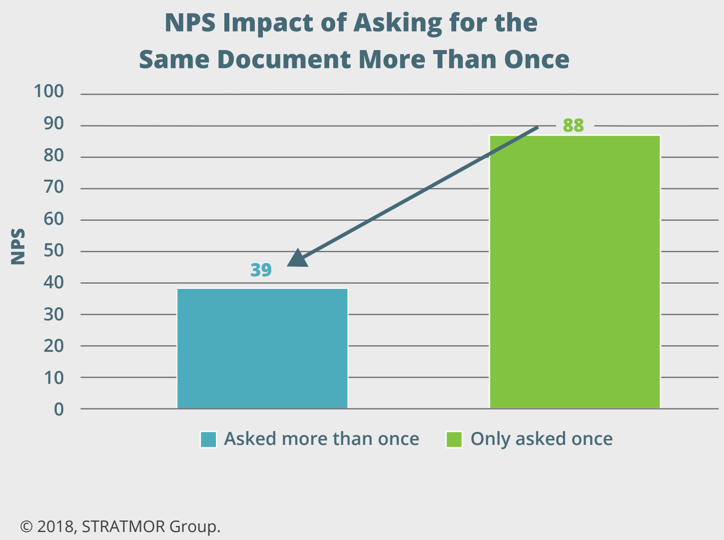
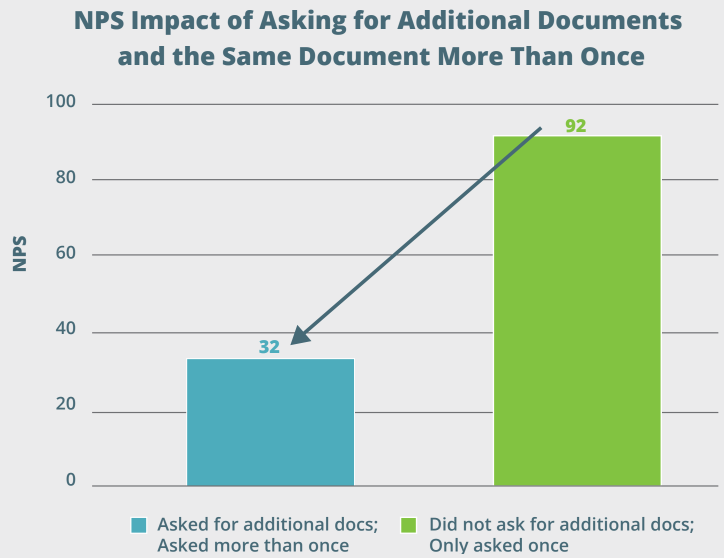


Figure 3



What's a Lender to Do?

MortgageSAT results tell us that multiple requests for a document previously submitted is what puts a lender's NPS score at serious risk. Asking for additional documents does not, on its own, result in an especially big hit to NPS and may, in many instances, be unavoidable.

Nonetheless, additional data requests and multiple requests for the same document pose a problem that lenders must solve if they are to significantly improve their overall NPS scores.

Here are some of the steps that lenders should consider:

1. **Communicate with your borrower.** Work hard at managing their expectations. When making the initial document request, explain to the borrower that additional information may be necessary, why and when. Let the borrower know that there is a possibility of needing updated documents like paystubs and bank statements. Doing so will mitigate the likelihood that your borrowers will be annoyed by subsequent requests for the same document. Where a request for a document previously submitted is the result of a lender misstep, have the LO or processor call the borrower, explain the situation and apologize for any inconvenience. Being accountable and transparent will sooth most borrowers.

2. L**everage the capabilities of your LOS/POS systems.** Make sure that your LOS or POS does not permit a document previously requested to be requested again without a review by the processor. More generally, your LOS system should track both the request and receipt of all documents and flag or possibly lock-out any requests for documents previously requested without a review.

3. **Communicate internally.** Whenever and wherever a list of additional needed documents is created, make sure that, as part of the normal information flow, the origination team — the loan originator, originator assistant, processor, underwriter and closer — get a chance to review the list before contacting the borrower, with an eye towards ensuring that a document on the list isn't already in-house or on the way.

4. **Measure results and follow-up on all situations involving a request for a document previously submitted.** At the end of the loan process, make sure your post-close survey asks questions such as: Were you asked for information multiple times? Were you asked for the same document(s) more than once? Were you called by your loan officer or processor in advance of additional document requests? Programs like MortgageSAT can make sure these questions are asked on every closed loan so that you can ultimately identify and remedy the causes of the repeat document requests.

5. **Build Borrower Experience into the variable compensation of processors**. While there are many ways to do this, one-way that STRATMOR supports is to have customer service, as measured by NPS, drive the size of an incentive compensation pool shared by processors and closers. Give these positions "skin in the game." Compensation incentives, however, should not be a substitute for follow-up of individual performance failures.

LEARN MORE

If you are interested in learning more about STRATMOR's MortgageSAT Borrower Satisfaction Program, visit the MortgageSAT webpage. Or reach out directly to Mike Seminari, Director of MortgageSAT, at 614.284.4030 or mike.seminari@stratmorgroup.com.