FEATURE

# Making the Most of Mortgage Mergers

As interest rates plummet, here's why now might be the right time to pull off an M&A transaction.

*By* **Garth Graham**

If last year was a good year to acquire mortgage companies, 2019 is shaping up to be a good year to sell them. We saw a few notable deals to start off the year—Marketplace to New American Funding for $1 billion in annual originations, Eagle Home to Movement Mortgage for $2 billion, Platinum Mortgage to HomePoint for $3 billion. Those three transactions alone amounted to $6 billion in production that transitioned in the first few months of the year.

With lower interest rates in the spring, came a surge in origination volume and an ensuing increase in mortgage banking profits that began in the second quarter. A number of lenders that were thinking about selling their businesses are now holding off, waiting to see what the market will do while they continue to reap the outsized (some might label as "windfall") profits they are presently enjoying. What these lenders don't seem to recognize is that they may be better off selling their business when rates are relatively low and financial performance is good. It's obviously a sellers' market right now. Why not take advantage of it?

However, getting the market timing right is just one of the many challenges that come with selling a company. It's why potential sellers owe it to themselves to consider all the reasons why mortgage company acquisitions succeed or fail, how the value of each company is determined, and what they should be doing now to maximize their chance of a successful acquisition.

## Shifting Goalposts

While last year's uptick in merger and acquisition (M&A) activity in the mortgage business was primarily driven by a decline in income, most companies sold their businesses for one or more of the following reasons:

- Their balance sheet was under stress
- They saw bigger competitors making significant investments in technology and marketing that were unaffordable to them
- Personal reasons

Companies in the last category are often led by aging executives who are thinking about their retirement options, or who have much of their personal net worth tied up in their business. The thinking is, "I'll do better financially to work for somebody else or to turn the keys over and let my leadership team go work for somebody else."

The drop in interest rates in the spring of this year changed their motivations. Suddenly, there weren't nearly as many "distressed" sellers. Mortgage lenders who were stressing over balance sheet pressure and squeezing profit margins in 2018 and early 2019 saw business improve so markedly by mid-2019 that it was almost magical.

As the pressures on their businesses eased and financial performance became a monthly celebration, many of those lenders who were previously thinking about selling decided to hang in there for a while longer. This is the wrong strategy to adopt.

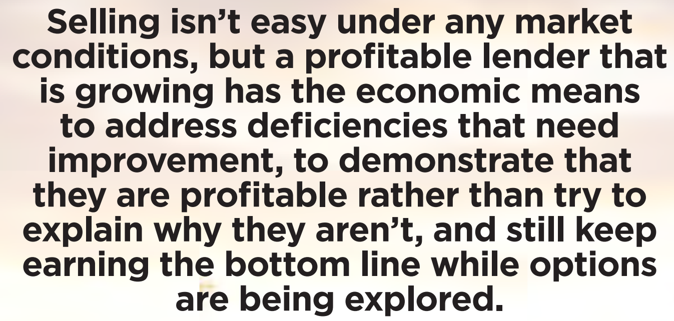
To achieve an optimal sale execution, you want to negotiate from a position of strength. By deferring a sale decision until the market signals that the party is over, you risk turning into a "scratch and dent" company that's now under more pressure to sell. Selling isn't easy under any market conditions, but a profitable lender that is growing has the economic means to address deficiencies that need improvement, to demonstrate that they are profitable rather than try to explain why they aren't, and to still keep earning the bottom line while options are being explored.

## The Value Proposition

There are various ways to determine what sort of value a mortgage origination company would command under current market conditions, but for this article, I'll stick to the three that I see used most often.

*Speed to Market:* New entrants generally look to acquire a mortgage company because it fits into a broader strategic roadmap for their business. For example, Zillow is a dominant player in the real estate industry, and their purchase of a mortgage company—Mortgage Lenders of America (MLOA) in late 2018—fit into their desire to have a broader range of mortgage capabilities. When Zillow acquired MLOA, they obtained the agency tickets (Fannie Mae, Freddie Mac, and Ginnie Mae), the state licenses, and an existing origination platform. It would have taken years and a significant expense to build those capabilities on their own.

*Discounted Cash Flow:* With most deals, buyers purchase the assets of the selling company. So, how do you determine what the company is worth? The traditional way is to evaluate the historical performance data as the basis to most accurately forecast the production cash flows, which you believe your platform will generate over the next three years, and then apply a discount rate that reasonably reflects the inherent risks in mortgage banking. In other words, the premium value of the company is driven by its expected cash flow in the future.



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The Discounted Cash Flow methodology is preferred by mortgage investors as well as those operating in many other industries. That said, figuring out the projected earnings of a mortgage company can be something of an art form. What makes it even trickier in the mortgage business is the unpredictable movements of interest rates, which have a significant impact on cash flow.

*The Build-Cost for the Same Production:* This is the one that's appealing for larger, independent mortgage lenders. These companies know what it costs to recruit a billion dollars of production because they've already experienced that recruiting process and know the expense and difficulty of it. STRATMOR data shows that the average loan officer (LO) attrition is approximately 40%; however, 80% of the business is done by the top 40% of originators, and the attrition of this segment of LOs (the high producers) is less than 10%. They are hard to recruit and can be expensive to obtain. The thinking behind the build-cost method is, "I know what it costs me, so I'd rather just buy it. If I buy a company, I can ramp up within 30 to 60 days, which is better than continually recruiting top producers," especially in today's highly competitive marketplace.

## Getting Help

Let's say you're the owner of a $1 billion mortgage bank, and you have somewhere between $5 million and $10 million locked up on your balance sheet. In many cases, that equity is a significant chunk of your personal net worth. However, you can't liquidate that equity until you sell the company. The market starts to go south, and accordingly, the equity on the balance sheet goes down. If you're like most owners who have been thinking about selling, you start to panic and rush forward with a deal—which is exactly the worse time to sell.

That's just one reason why it's so important to seek the help of an advisory firm that's experienced in mortgage mergers and acquisitions. If a potential buyer contacts a potential seller directly and asks, "Are you for sale?" most prospective sellers are going to say "no" whether they are or are not. They don't want to tip their hand, and they don't want to appear desperate. They also don't want to give another company inside information that can be used against them in the hand-to-hand combat of recruiting and retaining staff. With an advisory firm in the middle, buyers and sellers can become acquainted with each other privately and anonymously. Having an advisor who serves as a middleman in the first rounds of negotiations when each party is still anonymous and under a non-disclosure agreement (NDA) is optimal.

The initial role of the advisor is to help both sides understand each other. For example, the buyer may say, "I like this company, but I'm concerned about X, Y, and Z." These concerns would be communicated to the advisor up front, who would share them with the selling company. The seller can then address the concerns and give a pitch back to the buyer. With an advisor, the buyer and seller can size each other up without having to know the identity of the other party until the timing is right.

An effective advisor can help with matters like due diligence and weighing risks, but without question, the greatest value provided by an advisor is assessing whether the cultures of two companies are reasonably compatible. Cultural compatibility is the most critical factor in a successful transaction, and a third-party independent advisor is often better suited to offer an objective assessment on the strategic fit for both parties, or at a minimum to facilitate the discussions between parties about culture, values, and future aspirations.

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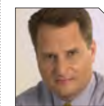
## Timing It Right

In terms of merger and acquisition activity during the remainder of 2019, we'll see fewer deals in the latter months of the year. By and large, mortgage companies are doing well right now. However, if we experience another slow fourth quarter as we did in 2018 or in 2014, a staggering number of companies will come to market, because by then, many companies will have "used up their mulligans." What does that mean?

When a company's retained earnings drop, its secondary investors and warehouse lenders start sweating, and they put that company on their watchlist. It was reported that at least one-third of independent mortgage banks were on someone's watchlist at the end of last year.

When the market improved in the spring, many of these companies performed their way off the watchlists—but it doesn't take many bad months to get back on those lists. The next time it happens to some lenders, investors may decide not to buy their loans anymore. Perhaps their warehouse partner wants to renegotiate warehouse terms, increasing costs, or cutting liquidity. At some point, the warehouse lenders could cut them off, and then things could go from bad to worse. After all, a mortgage banker without "the bank" has little value in a sale.

At that point, more mortgage company owners will decide they need to sell and there will be a glut of sellers on the market, with many of them selling under duress. That's why I advise any mortgage company that may be thinking of selling to take advantage of times when the market is good—and for most, it's very good right now. If you're in the game for the long haul, then you know the market is subject to ups and downs. So, enjoy the "ups" while they last. But if you've thought about selling your business, there is no better time to explore your options than now. **M**



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