STRATMOR GROUP

FEATURING

WHAT PROSPECTIVE SELLERS CAN LEARN FROM TODAY'S M&A MARKETPLACE

STRATMOR *INSIGHTS*

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WELCOME

While we're enjoying unseasonably early Springtime weather here in Colorado, my colleagues on the East Coast have not been so fortunate. After a tough winter, they're due for another blizzard as I write this - in fact, NBC News states that "There's no painless way to put this for snow-choked New England: Get ready for "12 hours of hell!"

But cold weather can't get in the way of another edition of *STRATMOR Insights*. This month's "In-Focus" article is a terrific piece by Senior Partners Jeff Babcock and Jim Cameron entitled ***What Prospective Sellers Can Learn from Today's M&A Marketplace***. With interest rates on the rise and origination volumes likely to be down as refinances diminish, it's not too early for many lenders, especially independents, to think about selling their firm and ways to maximize value.

A possible down-turn in the market is always a good time to think about employee compensation, and this month's "Mortgage Metrics Matter" section presents some interesting results regarding Processor compensation drawn from our 2015 Compensation Connection Survey.

Our "In-the-Spotlight" section looks at select underwriting practices drawn from a survey focused on the impact of TRID on underwriting. What I found especially interesting was the degree to which lenders — independent lenders in particular — were allowing underwriters to work from home. Working from home not only can attract seasoned underwriters, but allows lenders to rapidly adjust capacity to demand, thereby keeping costs variable.

Finally, our "Speaking Borrower Satisfaction" section illuminates the high cost in borrower satisfaction that results when a borrower experiences a "problem" with the origination process, even if the problem is resolved.

At the back of this month's report, you will have the opportunity to rate the report and tell us how we're doing. It will take you but a minute and be a great help to us.

Lisa Springer, CEO

STRATMOR
INSIGHTS

IN THIS ISSUE

WHAT PROSPECTIVE SELLERS CAN LEARN FROM TODAY'S M&A MARKETPLACE

By Jeff Babcock and Jim Cameron

STRATMOR's early discussions with the shareholders of First Priority Financial began in the Fall of 2015. To accomplish their growth aspirations, Mike and Dave Soldati initially asked about their prospects for acquiring a small mortgage bank as an alternative to recruiting more LOs. Much to our surprise, the conversation reversed course to a discussion of First Priority's marketability and value as a potential seller.

After a somewhat dismal 2014, origination market conditions throughout 2015 had improved nicely to the point that midsize Independent mortgage bankers were enjoying their best year since the remarkable 2012 boom market. Consequently, there were relatively few M&A transactions consummated that could serve as good comparables to help prospective sellers, such as the Soldatis, calibrate their respective opportunity.

Fast forward to mid-2016 when Caliber Home Loans completed their acquisition of First Priority. This deal, along with several other transactions in the STRATMOR pipeline, now enable us to confidently provide tangible guidelines as to those characteristics that contribute positively to enterprise value versus those that materially detract from a lender's value and marketability. We have, through the process of representing selective sellers in recent transactions, acquired first-hand knowledge of those characteristics which are most critical in determining premium values.

STRATMOR's recent experience absolutely confirms that there are still many more motivated, well-capitalized buyers for retail origination platforms than there are such entities available for sale. It continues to be a true "sellers' market" for mid-size Independents. The challenge for prospective sellers is not just attracting a buyer, but aligning with the right buyer to optimize the sale execution of their company.

Accomplishing this is not a passive activity. Quite the contrary, we believe that selling shareholders can (and should) proactively position their organization to strategically fit with the most motivated buyers — and thereby realize the level of economic value which reasonably satisfies their financial expectations.

Key Factors for Maximizing Value

In our recent representation of two high-performing sellers, we learned first-hand that highly competitive bids from multiple bidders will be realized where the seller scores high on the following quantitative and qualitative criteria.

Sustained Profitability. Management's ability to achieve consistent Net Income margins is one of the most compelling value elements. By consistent, we mean profitability which is not simply linked to origination market conditions with wide variances between good years and bad years.

The best performance benchmark is the MBA and STRATMOR Peer Group Roundtable ("PGR") program for the middle-market Independent mortgage bankers in the Retail production channel. In this context, Net Income margin is defined as the channel profitability including all allocated expenses.

- For 2014, the PGR Retail margin averaged 50 basis points across all mid-size Independents.
- In 2015, this margin improved to 66 basis points and although full-year 2016 PGR data has not been fully compiled as of this date, STRATMOR anticipates mid-size Independents will once again report profit margins in the 60 to 70 basis point range.

Margin consistency says all kinds of good things about management, including pricing discipline, expense control, etc.

Product Mix. For obvious reasons, today's buyers are focused on (sometimes even obsessed with) a seller's purchase business share — but not just for the last six months. A consistently above-average purchase share demonstrates management's commitment to building and maintaining referral sources over several years. There is a sense that where this is the case, a lender's sales force will not revert to refinance volume when there is a mini interest rate rally. A strong purchase business culture eliminates some of volatility in the inherently cyclical mortgage business.

The next most impactful element of product mix is a prospective seller's government lending share (inclusive of FHA, VA and USDA loans). It is generally assumed that government originations generate higher revenues and margins than agency conventional loans. The PGR average government share for midsize Independents has been 40 percent for 2014/2015.

Another consideration is the share of jumbo originations. In contrast with government products, jumbo loans generate significantly lower revenues and are a drag on earnings. The PGR jumbo average for mid-size Independents is four percent. Obviously, therefore, a significantly above average jumbo share is generally a negative.

Model Match and Cultural Compatibility. These two concepts are thrown about loosely in M&A discussions, but they are both absolutely critical to

the success of an acquisition. Model match refers to the fundamental style of doing business — branch network composition, originator compensation structure, product focus, mortgage banking disciplines, etc.

Corporate culture is all about the effectiveness by which a lender deploys and manages its human capital. An assessment of culture typically includes corporate values, leadership style, strategic direction, management effectiveness, communications, accountability, etc. While no two organizational cultures will be exactly alike, they must be compatible. The history of mortgage banking M&A is littered with examples of failed transactions which resulted from culture clashes, many of which were probably avoidable if the parties made cultural considerations a higher priority.

Compliant Originator Compensation Plans. This topic has assumed greater significance with the advent of Dodd-Frank and is often among the first questions from a prospective buyer. Within this context, *compliant* means uniform commission structures based entirely on volume with as few variations as possible. Any commission arrangement that is tied to revenue levels is a doubtful plan. Incentive compensation will also be reviewed in terms of possible exposure to Fair Lending violations. Bank buyers are particularly sensitive to these issues given the strategic importance of "reputation" and "trust" across virtually all Bank operations.

Buyers also expressly prefer that a prospective seller has completed its transition of originators to a non-exempt status such that they are eligible for minimum wage and overtime compensation.

More generally, changes to lender compensation plans — especially changes to sales compensation — should be enacted prior to an acquisition so that the seller's staff does not perceive that such changes were implemented as part of the sale or initiated by the buyer. Where the buyer must initiate compensation changes, it introduces uncertainties that are likely to detract from value.

Sales Force Quality. In every mortgage company sale, the primary asset being acquired is the origination capacity, quality and loyalty of the lender's field sales force. Sales force quality is typically measured in terms of productivity, tenure/turnover, age and concentration. A detailed analysis of a lender's production performance provides an analytical assessment of sales management effectiveness (recruitment, training, motivation, retention).

At STRATMOR, we accomplish this assessment by segmenting a client lender's sales force into quintiles based on performance and then compare the metrics against the industry population using our *Originator Census* benchmarking survey tool.

Since the top 40 percent of originators typically account for about 80 percent of total production, it is

insightful to focus on these performers. For example, in a recent sell-side engagement, the client's top two originator deciles closed an average of 7 loans per month, had tenure of 5.6 years, were 46 years old and experienced virtually no turnover.

All this client's turnover occurred in to the bottom 40 percent of loan officers. And, since Originator Census data differentiates between voluntary and involuntary terminations, we can glean a sense of how proactive a lender is in clearing out low producers. Originator Census data also allows us to consider the ethnic and gender composition of a given lender's sales force. From a buyer's perspective, all of these originator segmentations and benchmarking comparisons with other lenders provides an objective picture of the seller's ability to achieve a production forecast.

Management Effectiveness and Tenure. Although subjective in nature, there appears to be a correlation between management effectiveness/tenure and financial performance ranking among PGR participants. For example, management effectiveness should be assessed in terms of leadership, strategic planning, employee satisfaction, accountability and communications. Does the subject company bring a history of adapting to change, innovation, creative utilization of technology, dependable management reporting and cost controls? Mortgage banking is a people business where 80 percent of expenses are related to compensation. Management's ability to leverage its human capital is therefore an indispensable skill.

Production Momentum. Management's track record in improving market share is the best measure of production momentum. Whenever feasible, STRATMOR encourages clients to seek out local or regional market share reports. A prospective seller that can demonstrate a consistent ability to gain market share, irrespective of the industry cycle, is more valuable than lenders whose volume tracks with the industry trends.

Company Reputation. Management's ability to earn respect and appreciation from counterparties, regulators, borrowers and even competitors provides great comfort to a prospective buyer. Investor Report Cards are one source of objective reputation assessment. Systematic measurement of borrower satisfaction, e.g., STRATMOR's M*ortgageSAT Borrower Satisfaction Benchmarking* program, and management's use of such insightful information are another indicator of a management team that listens and responds to the market.

Go-Forward Management Roles. Inasmuch as a key element of an acquisition's economics comes from eliminating redundant overhead and support functions, the enthusiastic commitment to such actions by key seller executives, who are most responsible for holding together the seller's production organization, is a critical deal point.

The Top 10 Worst Seller Characteristics

In our role of transaction advisor in dozens of mortgage company sales in recent years, we have observed certain seller characteristics which are often perceived as unfavorable. These practices tend to deter buyers, thereby reducing a seller's marketability, and detract from a given seller's enterprise value.

Included here are:

- A Substantial portion of production volume is originated in DBA branches and/or "for-profit" branches. By comparison with branches which

are branded with the corporate identity, DBA and for-profit branches are perceived as less loyal and greater flight risks, even though the data suggests that that might not necessarily be true.

- Originator compensation plans where the loan officer can select options tied to revenues (aka "pick-a-pay plans"). Such plans are typically categorized as non-compliant by buyers in spite of the fact that some such plans may have been vetted by the seller's attorneys.
- Any degree of pricing variance within a given MSA creates a potential exposure to Fair Lending compliance.
- Arrangements where the branch manager and/or loan officer can select the investor. Such arrangements generally work against secondary marketing best execution and can be a source of cultural problems.
- An exempt sales force (e.g., originators designated as "outside sales people"). Buyers have learned that an exempt sales force increases exposure to class action lawsuits initiated by originators.
- Situations in which seller's executives and/or selling shareholders account for a substantive share of current production introduces a degree of difficulty to the negotiating process.
- Situations in which the seller's geographic production footprint is scattered are generally not viewed favorably. Buyers strongly prefer to acquire a lender that has established a significant market presence in few selective markets,
- The existence of a major legal matter or regulatory action which cannot be resolved or settled prior to the closing date can be problematic.
- Buyers prefer that ownership of the selling entity be concentrated in the hands of a few players. Multi-ownership (say more than five shareholders) increases the complexity of the negotiations.
- Existence of an Employee Stock Ownership Plan (ESOP) generally renders the seller to be unmarketable.

While many of the impediments to a lender's marketability can be characterized as "low hanging fruit" that can quickly be corrected, many lenders will have impediments that simply cannot be eliminated or require substantial time and attention to remedy.

What is important, in our opinion, is that lenders objectively and periodically assess their marketability as part of their strategic planning and build appropriate actions into their operating plans.

LEARN MORE

To contact Jeff Babcock click here, or Jim Cameron click here for more information. ■

PROCESSOR INCENTIVE PLANS

INSIGHTS FROM THE STRATMOR COMPENSATION CONNECTION SURVEY

Since 2010, STRATMOR *Compensation Connection Survey* has provided lenders with valuable insights into not only levels of cash compensation, but more importantly into how incentive plans are structured. Determining compensation amounts and structure is fundamental to ensuring that your organization hires and retains the best talent while simultaneously controlling costs and justifying compensation to your stakeholders.

Currently, the compensation survey modules include:

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

The *Compensation Connection Survey* is built in modules to allow lenders to choose their level of participation. The Fulfillment module highlights key positions across all channels from Head of Fulfillment to Closers. This month's analysis looks at the Processor compensation and incentive plans. The results reflect lenders from all geographies and origination volumes.

Excerpts From the Survey Results

Q **What is the range of Total Compensation for a Processor?**

A **While it is important to know the average, it is also vital to understand the range of compensation being paid in the market, which is highlighted below.**

Average Compensation

- In 2015, Processors were paid, on **average, $58,681** which includes base salary, overtime and incentives.
- Based on the 44 companies who submitted data for the Processor position, **compensation ranged from about $42,000 at the low end to roughly $73,000 at the upper end** of our range.

	Processor					
	10%	25%	Median	75%	90%	Average
Total Compensation	$42,201	$51,319	$57,902	$64,175	$72,810	$58,681

Base Salary Compensation

To better understand what is driving the variation, we can also look at the ranges of Base Salary.

- For 2015, **Base Salary ranged from about $37,000 to roughly $56,000** with an average of about $46,000.
- These ranges in Base Salary account for a large portion of the variation in Total Compensation with the balance being differences in overtime and incentive compensation.

	Processor					
	10%	25%	Median	75%	90%	Average
Base Salary	$36,722	$38,332	$43,520	$51,193	$55,808	$45,575

Geographical Influences

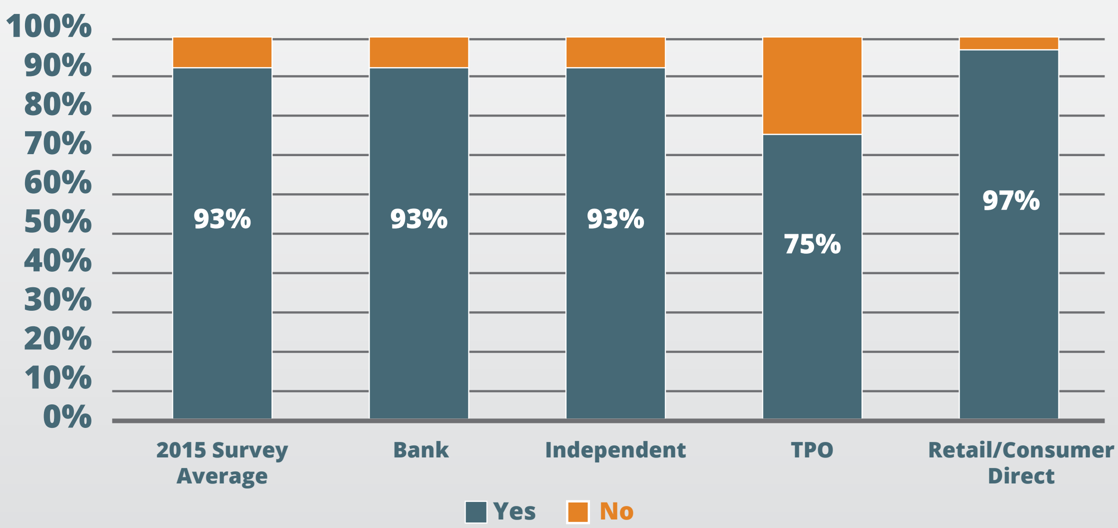
It is easy to attribute the differences in compensation to differences in geography with the lenders in coastal and metro markets being at the upper end of the pay ranges. However, our data does not show this to be true. There are differences related to geography that can be explained by standard cost of living indices. However, the primary driver of differences is the business model and the expectations the lender sets for its Processors.

Q **What percentage of Processors are paid an incentive?**

A **Based on our data, the vast majority (93%) of Processors are paid some incentive compensation. This holds true for both Banks and Independent lenders.**

- Interestingly, primarily **TPO lenders are less likely to pay Processor incentives at 75%**.
- For a TPO lender, the role of Processor tends to be more of a consolidator role versus the Retail Processor.
- Because the TPO lender is often receiving more complete files, the emphasis on productivity is diminished and may lead to a lower incidence of incentives.

Processors Paid Incentives

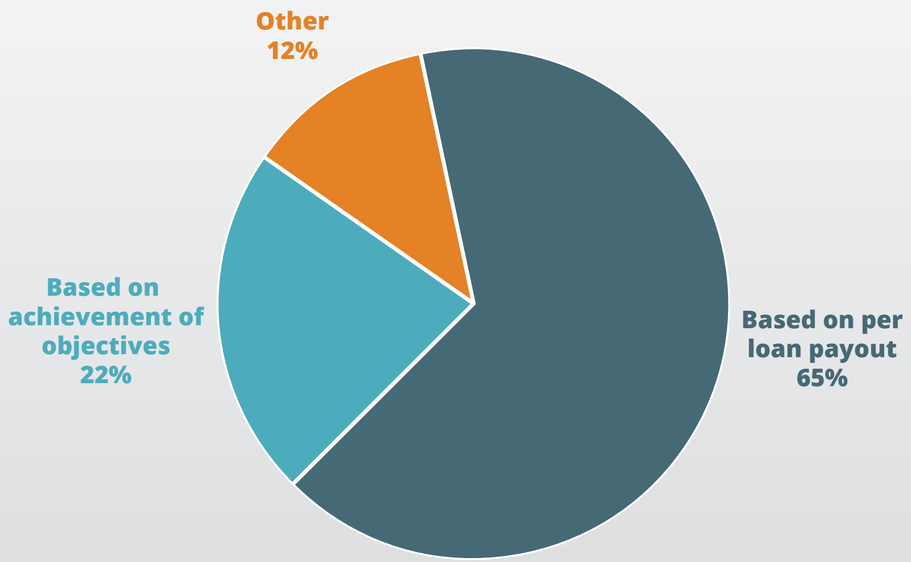


Q **How are Processor incentive plans structured?**

A **As discussed on the preceding page, the majority of Processors are paid incentive compensation. One of the unique features of *Compensation Connection* is that it asks lenders to report on the basis for their incentive payouts. The following are the findings.**

- For 2015, **Processor incentive was primarily based on a per loan payout (65%)** which could either be a flat amount or tiered to pay higher amounts for better productivity.
- **Another 22% of the incentives were based on the achievement of pre-defined objectives.** These objectives might include file quality, team performance and customer satisfaction.
- **The balance of incentives is based on other factors such as discretionary awards and overall company performance.** These drivers of incentives indicate that lenders care about throughput and productivity, but also care about file quality, team performance and other lender specific objectives.

Components of Processor Incentive Plans



PARTICPATE

The *2017 Compensation Connection*, which covers 2016 results is now open for registration. If you are interested in learning more about the survey or would like to participate, click here.

POST-TRID UNDERWRITING PRACTICES

In late 2015 — virtually simultaneous with the effective date of TRID — STRATMOR reported the results of a survey addressing underwriting practices in general and, in particular, how lenders had changed or were planning to change their underwriting practices in response to TRID. For this month's *In the Spotlight*, we focus on a few select results from this survey.

ABOUT THE SURVEY

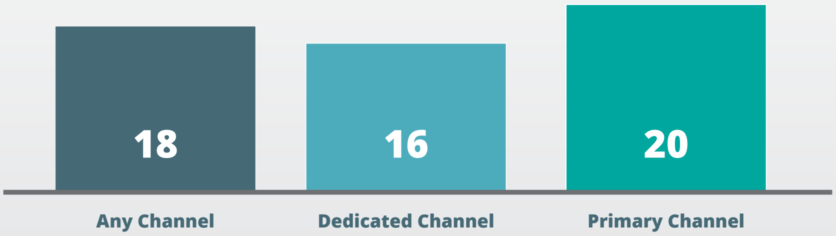
The *Post-TRID Underwriting Practices Survey* was conducted in late 2015. Fifty-four (54) lenders, consisting of 27 Independents (including Builder/Realtor lenders) and 27 Banks (including Credit Unions), participated in the survey.

Excerpts From the Survey Results

Q **With respect to origination channels, how does your company organize its underwriting operations?**

A **Lender underwriting operations are split roughly equally among three models:**

- **Underwrite for Any Channel:** Underwriters underwrite loans for any origination channel in which the lender operates (33%).
- **Underwrite for a Dedicated Channel:** Underwriters are dedicated to one origination channel (30%)
- **Underwrite for a Primary Channel:** Underwriters are assigned to a primary channel but may underwrite for other channels based on workload demands (37%).



	Any Channel	Dedicated Channel	Primary Channel
% of Total	33%	30%	37%
# of Respondents	18	16	20

Q Do you permit your underwriters to work from home?

A The predominant model appears to be allowing underwriters to work remotely on a selective basis.

- Often companies offer this to recruit or retain a seasoned underwriter.
- This practice is often used when the talent pool has been exhausted in a particular geography or as a way to quickly expand or contract capacity in line with demand.

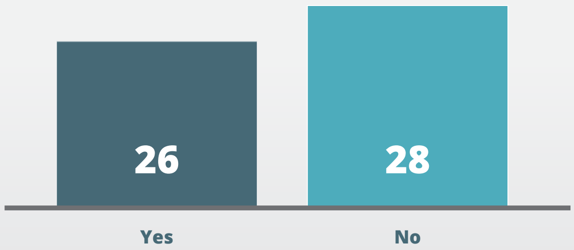
	Yes	On a Selective Basis	No
% of Total	33%	39%	28%
# of Respondents	18	21	15

- While 33% of the respondents allow underwriters to work from home, Independents are much more likely to offer this option (52%) versus Banks (15%).

	Banks	Independents	Total
# of Respondents by Category			
Yes	4	14	18
On a selective basis	10	11	21
No	13	2	15
% of Respondents by Category			
Yes	15%	52%	33%
On a Selective basis	37%	41%	39%
No	48%	7%	28%

Q Do you originate non-QM loans?

A Just under 48% of respondents originate non-QM loans.



	Yes	No
% of Total	48%	52%
# of Respondents	26	28

- However, Banks are significantly more likely to originate non-QM loans than independents (56% vs. 41%).
- This difference reflects the ability of Banks to internally fund non-QM loans, e.g., Jumbo ARMs.

	Banks	Independents	Total
# of Respondents by Category			
Yes	15	11	26
No	12	16	28
% of Respondents by Category			
Yes	56%	41%	48%
No	44%	59%	52%

In The Spotlight

POST-TRID UNDERWRITING PRACTICES

Find Out What Your Peers Are Doing About Key Industry Issues

Do you wish you could quickly find out what your peers at other lenders think about key issues and developments? And what actions they are considering, planning or have taken? If so, then you should consider participating in our STRATMOR *Spotlight Surveys* program, a fast turnaround, short survey program that gives senior mortgage executives a unique way to obtain the information they need to formulate effective strategy. Click here to learn more.

If you are interested in a free download of the complete *Spotlight Surveys* or would like to participate in the STRATMOR *Spotlight Surveys* program, click here. ■

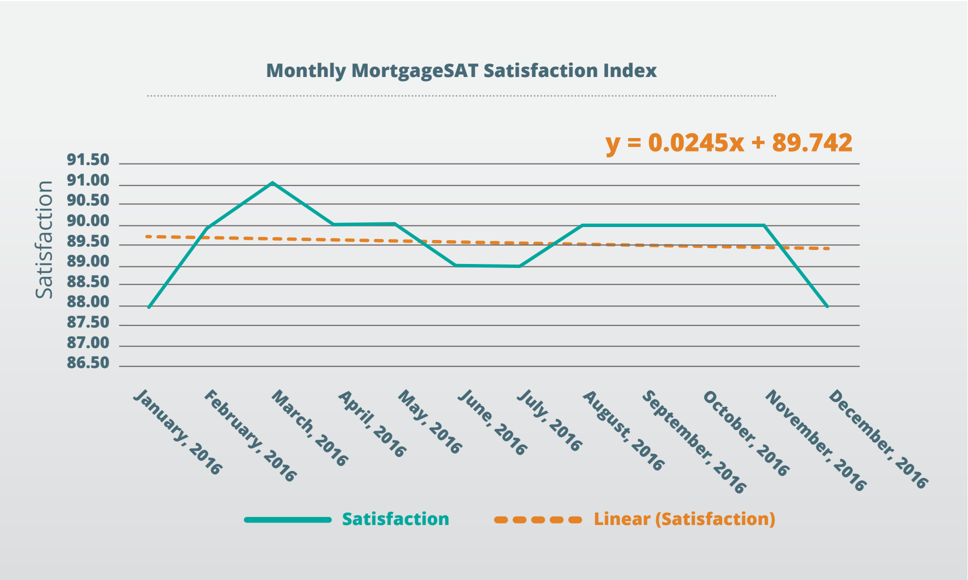
Speaking Borrower Satisfaction

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 the look-back with the December 2016 satisfaction score for this February 2017 edition of *STRATMOR Insights*. The Index Chart also includes a best-fit linear trend line along with the equation for that line (orange dashed line).



Total Borrower Satisfaction Dropped

After remaining at a score of 90 for four consecutive months (August through December), Total Borrower Satisfaction dropped sharply in December to 88, a score not seen since January 2016. It seems clear that time-off during the Holiday season took its toll on borrower satisfaction and we anticipate a recovery by February, as occurred during 2016.

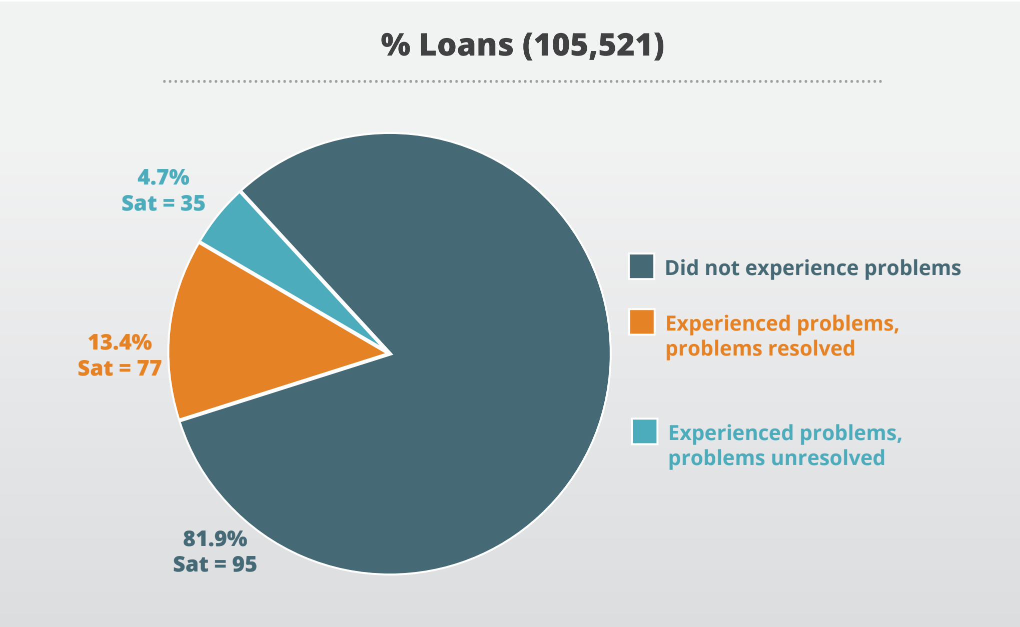
Speaking Borrower Satisfaction

TOPIC OF THE MONTH: PROBLEMS, PROBLEMS!

Based on a 2016 sample of 105,521 closed loans, 81.9% of borrowers reported experiencing no problems. And of the 18.1% of borrowers who experienced a problem, 13.4% reported the problem resolved, with 4.7% reporting that the problem was not resolved.

Borrowers reporting no problem (81.9%) had a very high average satisfaction score of 95. This score plummeted to a relatively low score of 77 for the 13.4% of borrowers who reported experiencing a problem that was subsequently resolved.

But lenders were really hammered by the 4.7% of borrowers who reported an unresolved problem. Such borrowers gave the lender an average satisfaction score of 35, extremely low, putting the lender at risk to getting negative reviews by such borrowers to friends, relatives and on social media.



Overall, borrower satisfaction was 89. But while zero problems are not possible given the nature of the origination process, our review of the areas causing problems suggests that a goal of reducing problems to just 5% of originations is achievable. At this level, overall satisfaction increases from a good score of 89 to an outstanding score of 94.

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

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SURVEYS

We invite you to download survey results or learn more about our open surveys and available survey results.

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COMPENSATION CONNECTION

Survey Now Open

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TELL US YOUR THOUGHTS

We invite you to take a quick 2 question survey so that we can continue to provide you with valuable information in our *STRATMOR Insights* report.

CLICK HERE