HOULIHAN LOKEY

# WHY BANKS ARE KICKING THE TIRES ON MORTGAGE COMPANIES

# Setting the Stage

In the 10 years following the Great Recession, the nation's largest banks ceded nearly 30% of their collective origination market share to independent mortgage banks (IMBs).[1] To this effect, the composition of the top 10 originators resembled this dynamic in an amplified manner, as displayed in the table below. In 2010, seven of the top 10 originators were banks, and they comprised approximately 69.1% of total market share. At year-end 2020, only three banks remained in the ranks of the top 10 originators—Wells Fargo, Chase, and U.S. Bank—with an aggregate market share of approximately 11.0%.[2]

## Historical Top 10 Mortgage Originators[2]

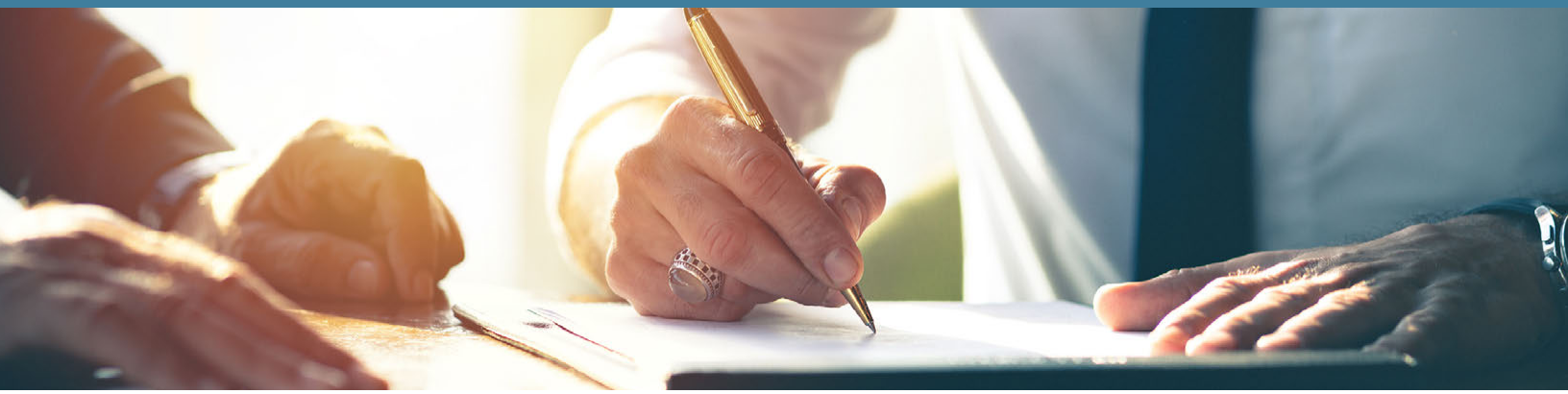
| 2010 | | | | 2015 | | | | 2020 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Rank | Originator | Orig. ($B) | Market Share (%) | Rank | Originator | Orig. ($B) | Market Share (%) | Rank | Originator | Orig. ($B) | Market Share (%) |
| 1 | Wells Fargo | $392.5 | 25.0% | 1 | Wells Fargo | $209.0 | 12.0% | 1 | Quicken Loans | $320.2 | 7.9% |
| 2 | Bank of America | 306.5 | 19.5% | 2 | Chase | 115.2 | 6.6% | 2 | Wells Fargo | 221.9 | 5.5% |
| 3 | Chase | 162.7 | 10.4% | 3 | Quicken Loans | 78.5 | 4.5% | 3 | PennyMac | 196.6 | 4.9% |
| 4 | GMAC/Ally Financial | 71.1 | 4.5% | 4 | Bank of America | 56.9 | 3.3% | 4 | United Wholesale | 182.5 | 4.5% |
| 5 | Citi | 66.8 | 4.3% | 5 | U.S. Bank | 52.8 | 3.0% | 5 | Chase | 133.4 | 3.3% |
| 6 | U.S. Bank | 55.8 | 3.6% | 6 | PennyMac | 48.4 | 2.8% | 6 | Freedom Mortgage | 122.2 | 3.0% |
| 7 | PHH | 49.0 | 3.1% | 7 | PHH | 39.0 | 2.3% | 7 | loanDepot | 100.8 | 2.5% |
| 8 | SunTrust | 29.0 | 1.8% | 8 | Freedom Mortgage | 36.8 | 2.1% | 8 | U.S. Bank | 89.0 | 2.2% |
| 9 | Quicken Loans | 28.4 | 1.8% | 9 | Citi | 34.4 | 2.0% | 9 | Caliber Home Loans | 80.1 | 2.0% |
| 10 | Provident Funding | 26.9 | 1.7% | 10 | Flagstar Bank | 29.4 | 1.7% | 10 | Guaranteed Rate | 73.3 | 1.8% |
| Banks in the Top 10 | | 1,084.3 | 69.1% | Banks in the Top 10 | | 497.7 | 28.7% | Banks in the Top 10 | | 444.3 | 11.0% |
| IMBs in the Top 10 | | 104.3 | 6.6% | IMBs in the Top 10 | | 202.8 | 11.7% | IMBs in the Top 10 | | 1,075.6 | 26.6% |

*Note: Highlighted blue names represent banks.*

There were several causes for this effect, including rising compliance expenses, costly settlements and reputational risks, stricter capital requirements on mortgage-related assets, and more. Some national, diversified banks went as far as wholly exiting mortgage-related divisions altogether, such as Citi's decision to shutter the doors of its in-house mortgage servicing division in 2018.

However, while several of the largest banks continued to retreat from the space over the last few years, regional banks began searching for meaningful entry points or opportunities to gain additional scale in the newly evolved landscape. In August 2018, Citizens Financial Group, Inc., acquired Franklin American Mortgage Company for $511 million in an all-cash deal. The tagline featured on the respective transaction announcement investor presentation was "Accelerates mortgage banking platform with enhanced scale and efficiency."

(1) *The Rising Role of the Independent Mortgage Bank—Benefits and Policy Implications, Mortgage Bankers Association.*
(2) *Inside Mortgage Finance.*



In February, Western Alliance Bancorporation (WAL) announced the acquisition of AmeriHome for an estimated $1 billion in cash.[3] WAL's investor presentation detailed the strategic merits and laid out the attractive financial dynamics, as highlighted in the table below.

## WAL Transaction Financial Attractiveness[4]

| | |
|---|---|
| >30% 2022E EPS Accretion | ~300bps 2022E ROATCE Accretion |
| <1 year TBVPS Earn-Back | >30% Pro Forma Fee Income Ratio (From 5%) |

Equity research analyst coverage surrounding the transaction announcement was largely positive, with WAL's consensus price target increasing 11% the next day.[5]

> The deal is compelling from a financial standpoint considering the 30% plus EPS accretion at a time when banks will struggle to grow EPS outside of LLR releases over the next two years. Moreover, the acquisition provides WAL better revenue diversification (30% pro forma fee revenues vs. 5% previously), while also further building out its existing mortgage franchise and finding a better home for excess balance sheet liquidity…Certainly there will be earnings volatility, but we think the potential funding, capital, and growth synergies from this acquisition far outweigh the impact of the volatility.

*—Wall Street Equity Research (February 17, 2021)*

The market reacted favorably to the announcement as well (siding with the equity research analysts and then some), sending WAL's stock price up 15.7% in the subsequent two weeks and thus outperforming the S&P 500 Financials Index by 12.2% over that same period.

*(3) Houlihan Lokey acted as an advisor to AmeriHome.*
*(4) WAL Investor Presentation dated February 16, 2021.*
*(5) S&P Capital IQ.*

# #1 M&A Advisor for Six Straight Years

All U.S. Transactions 2015, 2016, 2017, 2018, 2019, and 2020

Source: Refinitiv

Houlihan Lokey (NYSE:HLI) is a global investment bank with expertise in mergers and acquisitions, capital markets, financial restructuring, and valuation. The firm serves corporations, institutions, and governments worldwide with offices in the United States, Europe, the Middle East, and the Asia-Pacific region. Independent advice and intellectual rigor are hallmarks of the firm's commitment to client success across its advisory services. Houlihan Lokey is the No. 1 M&A advisor for the past six consecutive years in the U.S., the No. 1 global restructuring advisor for the past seven consecutive years, and the No. 1 global M&A fairness opinion advisor over the past 20 years, all based on number of transactions and according to data provided by Refinitiv.

**2020 M&A Advisory Rankings**
**All U.S. Transactions**

| Advisor | Deals |
|---|---|
| **Houlihan Lokey** | **210** |
| Goldman Sachs & Co | 172 |
| JP Morgan | 132 |
| Evercore Partners | 126 |
| Morgan Stanley | 123 |

*Source: Refinitiv.*

## North America

Atlanta
Boston
Chicago
Dallas
Houston
Los Angeles
Miami
Minneapolis
New York
San Francisco
Washington, D.C.

## Europe and Middle East

Amsterdam
Dubai
Frankfurt
London
Madrid
Milan
Paris

## Asia-Pacific

Beijing
Hong Kong
Singapore
Sydney
Tokyo

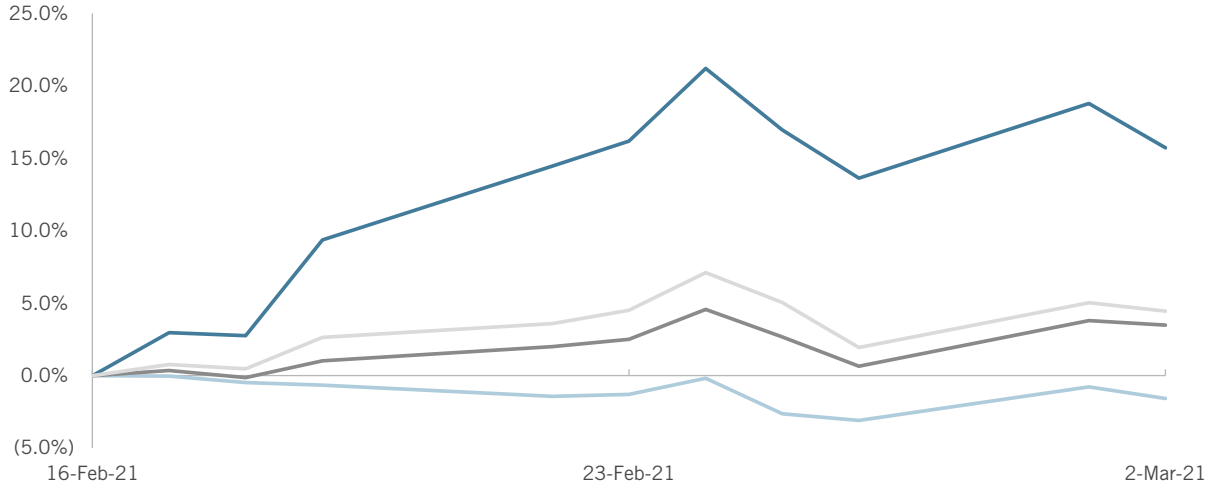
**1,500+**
Employees

**~45%**
Owned by Employees

**$1+ Billion**
in Revenue

HLI
LISTED
NYSE

## WAL Transaction Excess Returns Above Industry Benchmarks[6]




| | | Days After Transaction Announcement | | |
|---|---|---|---|---|
| | | 1 | 7 | 14 |
| WAL Returns Above: | S&P 500 | 3.0% | 17.5% | 17.3% |
| | S&P 500 Financials | 2.6% | 13.7% | 12.2% |
| | S&P 500 Banks | 2.2% | 11.7% | 11.3% |

As the saying goes: *Once is happenstance. Twice is coincidence. Three times is enemy action.*

Indeed, before sending this paper to print, New York Community Bank (NYCB) announced the acquisition of Flagstar Bancorp (Flagstar) in an all-stock merger valued at $2.6 billion.[7] While Flagstar is no IMB, NYCB's acquisition of the sixth largest bank mortgage originator and subservicer clearly highlights yet another bank's decision to reenter the residential mortgage sector in a meaningful way.

The acquisitive banks above saw an attractive and compelling case for growing their mortgage franchises. In the paragraphs that follow, we highlight five compelling reasons why banks are taking a hard look at IMBs these days and why we believe this type of transaction may turn into more prevalent "enemy action" across the sector.

# Five Reasons Why Banks Are Kicking the Tires on Mortgage Companies

## #1: Cheaper Valuation vs. Banks Contributes to Attractive Financial Dynamics

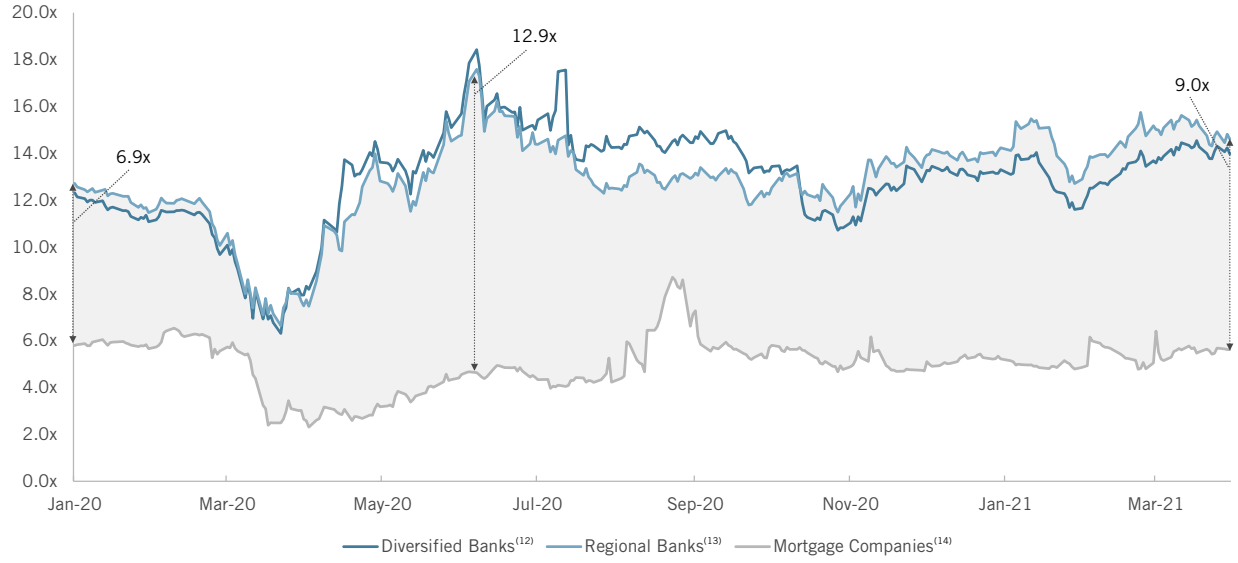
As illustrated in the chart on the following page, since January 2020, diversified[8] and regional banks[9] have traded on average at approximately 12.9x NTM P/E vs. 5.0x NTM P/E for mortgage companies.[10] At the end of March 2021, the differential between mortgage companies and regional banks stood at 9.0x.

This valuation differential can help lead to meaningful EPS accretion, ROATCE accretion, and relatively short TBVPS earn-back periods when banks are evaluating IMB targets.

In addition to returns-based metrics, banks have been highly interested in utilizing the origination fee income of IMBs as a counterbalance to net interest margin (NIM). During lower-interest-rate environments, banks typically see compressed NIMs; however, origination volumes and related fee income are typically robust during these periods. The Federal Reserve's policy shift toward a more muted approach to combatting near-term inflation reinforced a lower-for-longer theme and encouraged bank management teams to assertively evaluate their ability to generate fee income.

*(6) S&P Capital IQ.*
*(7) NYCB Investor Presentation dated April 26, 2021.*
*(8) Diversified Banks index includes Bank of America Corporation; Citigroup Inc.; JPMorgan Chase & Co.; U.S. Bancorp; and Wells Fargo & Co.*
*(9) Regional Banks index includes Citizens Financial Group, Inc.; Comerica Inc.; Fifth Third Bancorp; First Republic Bank; Huntington Bancshares Inc.; KeyCorp; M&T Bank Corp.; People's United Financial, Inc.; Regions Financial Corp.; SVB Financial Group; The PNC Financial Services Group, Inc.; Truist Financial Corp.; and Zions Bancorporation, National Association.*
*(10) Mortgage Companies index includes Mr. Cooper Group Inc.; Guild Holdings Co.; Home Point Capital Inc.; loanDepot, Inc.; PennyMac Financial Services, Inc.; Rocket Companies, Inc.; and UWM Holdings Corp.*

## Price to NTM Earnings[11] (Equal Weighted Indices)




Furthermore, with capabilities and expertise in hedging activities, banks are uniquely positioned to effectively manage MSR mark-to-market-related earnings volatility, an issue that hampers many IMBs.

In order to maintain strict confidentiality to preserve valuable sales force members, IMB transactions are occurring on a negotiated appointment basis versus a broad auction process. Well-nurtured relationships at the CEO or chairman level, or at the lending or take-out level, have provided logical and important entry points for this kind of dialogue.

## #2: Mortgage-Related Financings Lead to Stickier Customers

Mortgage-related origination and servicing activities lead to a stickier customer base. This dynamic can provide meaningful revenue opportunities for banks with an ability to cross-sell additional products like wealth management services or additional loan and credit products, including auto loans, personal loans, credit cards, and more. Some banks even choose to offer mortgage rate discounts for portfolio loans when combined with deposit relationships or asset management business to cross-sell the mortgage loan itself.

Recent mortgage market trends have highlighted that millennials are playing an ever-increasing role in the overall home-buying population as they've reached peak home-buying ages. Survey results have shown that 30% of millennials indicated that prior experience with a lender was an important factor in their choice of lenders, and 26% said it was important to choose their primary financial institution.[15] While banks can add cross-sell potential to the table, IMBs have proven themselves to be more effective at recapturing origination activity,[16] which provides for a valuable combination.

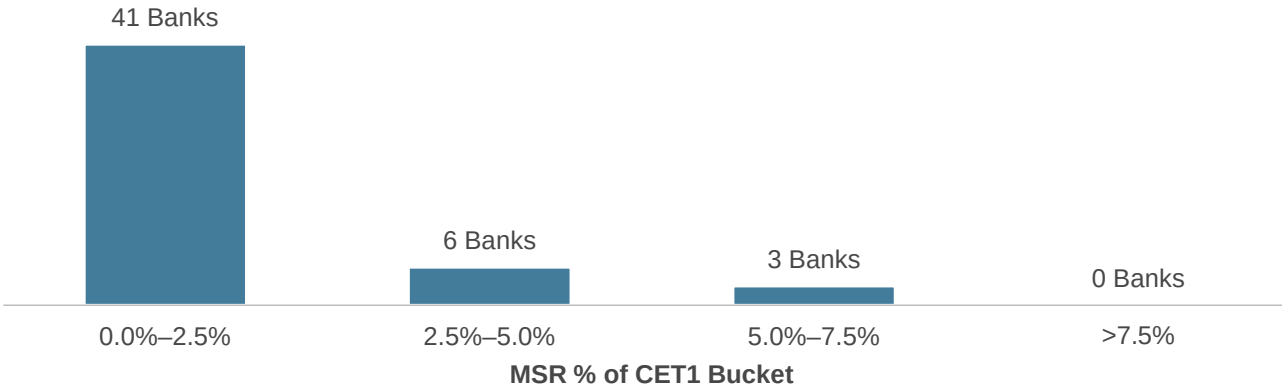
## #3: Ample Liquidity Can Help Optimize Capital Utilization

Access to deposits typically translates to ample liquidity for banks. Liquidity is a critical factor in profitably executing early buyouts in Ginnie Mae pools. It is no surprise that banks maintain substantially higher buyout efficiency scores than nonbank servicers, opportunistically capturing the related profitability.[17] Additionally, banks have the ability to provide take-outs for loans that would profitably be held on balance sheet, potentially expanding an IMB's product offering.

*(11) S&P Capital IQ as of 3/31/2021.*
*(12) Diversified Banks index includes Bank of America Corp.; Citigroup Inc.; JPMorgan Chase & Co.; U.S. Bancorp; and Wells Fargo & Co.*
*(13) Regional Banks index includes Citizens Financial Group, Inc.; Comerica Inc.; Fifth Third Bancorp; First Republic Bank; Huntington Bancshares Inc.; KeyCorp; M&T Bank Corp.; People's United Financial, Inc.; Regions Financial Corp.; SVB Financial Group; The PNC Financial Services Group, Inc.; Truist Financial Corp.; and Zions Bancorporation, National Association.*
*(14) Mortgage Companies index includes Mr. Cooper Group Inc.; Guild Holdings Co.; Home Point Capital Inc.; loanDepot, Inc.; PennyMac Financial Services, Inc.; Rocket Companies, Inc.; and UWM Holdings Corp.*
*(15) Fiserv.*
*(16) "The Large Bank Mortgage Banking Profitability Conundrum," STRATMOR Group.*
*(17) RiskSpan.*

Regarding capital constraints, the threshold on the level of MSRs that can comprise an institution's total CET1 increased from 10% to 25% as of April 2020, raising the attractiveness for banks to have access to MSR generation. As shown in the chart below, the top 50 banks by assets have meaningful capacity for MSR capital utilization, with 41 banks having less than 2.5% of CET1 currently comprising MSRs and the remaining nine having less than 7.5% of CET1 currently comprising MSRs.

### Distribution of the Top 50 U.S. Banks by Assets Within Ranges of MSR Percentage of CET1[18]




## #4: Scaled Technology and Direct-to-Consumer Access

The rise of financial technology companies has forced existing banks to modernize their technology and loan processing systems as well as their digital interactions with consumers. This prioritization has led to increasing capital expenditure budgets and the recruitment of the best technology talent in the financial services space.

While several tech-oriented IMBs boast best-in-class, consumer-facing platforms, a large percentage of the IMB population could benefit substantially from a prioritization and modernization of technology systems. Combining with a bank could provide this dynamic and lead to sizable economies of scale for technology-related loan processing costs.

Most banks strive to own a piece of the most important real estate available: space on consumers' phones. Enabling an acquired IMB to tap this channel could provide meaningful opportunities.

## #5: Policy Prioritization of Affordable Housing

The Biden administration has indicated that affordable housing is a top priority. Media coverage on the topic has hinted at the administration looking for ways to specifically encourage banks to broaden the availability of more affordable government mortgages. In the efforts of reducing perceived risk and encouraging banks to reenter the FHA and Ginnie Mae lending space, in October 2019, the Departments of Justice and Housing and Urban Development signed an interagency memorandum on the application of the False Claims Act (FCA).

> This interagency understanding is intended to address concerns that uncertain and unanticipated FCA liability for regulatory defects led to many well-capitalized lenders, including many banks and credit unions statutorily required to help meet the credit needs of the communities in which they do business, to largely withdraw from FHA lending.
>
> *—Department of Justice Press Release (October 28, 2019)*

One avenue the administration could take to more assertively encourage this behavior is to strengthen CRA standards. Acquiring an IMB—traditionally known for specializing in government mortgages—could be another way to expedite a bank's capability or reach in this product.

*(18) SNL Financial for most recently reported year.*

# Other Specialty Finance and Nonbank Acquisition Opportunities

Many of the same themes discussed above also apply to other specialty finance and nonbank targets.

We've seen recent activity in the purchase of commercial and consumer finance businesses, including Peoples Bank's acquisition of Triumph Premium Finance; Regions Bank's acquisition of Ascentium Lending; Duo Bank of Canada's acquisition of Fairstone Financing; and Ally Financial's acquisition of Health Credit Services, among others. On the broker-dealer front, recent activity includes Fifth Third Bank's acquisition of Hammond Hanlon Camp[19]; Bank of Montreal's acquisitions of Clearpool Group and KGS-Alpha; and Citizens Financial Group's acquisition of three separate M&A advisory firms: Trinity Capital, Bowstring Advisors, and Western Reserve Partners.

# Closing Thoughts

As banks continue to look for opportunities to find yield, fee income, and growth, we expect the dynamics above to keep IMBs and specialty finance platforms front and center on acquisition radars. As a leading advisor to the mortgage and specialty finance sectors, we are uniquely positioned to help you think through your alternatives and execute on your growth plan. Please reach out to any of the Houlihan Lokey contacts below to discuss.

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AmeriHome mortgage has been acquired by Western Alliance Bancorporation
Sellside Advisor

H2C Hammond Hanlon Camp LLC has been acquired by Fifth Third Bank
Sellside Advisor

Interstate Capital has been acquired by Triumph
Sellside Advisor

seneca MORTGAGE SERVICING has sold approximately $51 billion of mortgage servicing rights to Wells Fargo
Sellside Advisor

NewStar Equipment Finance a subsidiary of NewStar Financial has been acquired by Radius Bank
Sellside Advisor

*Tombstones included herein represent transactions closed from 2016 forward.*

*(19) Houlihan Lokey acted as the exclusive advisor to Hammond Hanlon Camp.*

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