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CIVC Partners Gains Big Return From Subprime Mortgage Company

By Leslie Green

Most general partners would probably say they don't like surprises when it comes to their investments, but once in a while a surprise ending might not be so bad. Especially in a situation like **CIVC Partners**' sale of subprime mortgage lender **First Franklin Financial Cos.** last year.

The Chicago-based firm had hoped for a 40% return on its investment when it put $25 million of equity into the company in 1996, but – *surprise* – CIVC saw a 125% return on investment upon the sale of First Franklin almost three years later, and partners aren't complaining one bit.

Even though CIVC did not purchase First Franklin until 1996, the firm's interest in mortgage banking companies began four years earlier with the acquisition of **Sunbelt National Mortgage Corp.** After selling the company 14 months later for a "very nice gain," CIVC's appetite was whet for another mortgage banking deal. By this time the partners had more experience in the area and had come across the smaller yet more appealing market of subprime or nonconforming mortgages, which targets customers that do not qualify for standard loans or mortgages for various reasons. The firm was attracted to the higher margins evident in this sector and set out to find a successful investment opportunity there.

"The subprime business was growing very rapidly in the mid-'90s," said **Keith Yamada**, a CIVC principal. "The reemergence of the securitization market started to fuel a lot of activity in the sector."

CIVC's search for the perfect subprime mortgage company spanned three years. The firm looked at many opportunities, but had trouble finding one that met its strict investment parameters.

"We felt that most of the ones we were seeing either lacked depth in management or lacked the kind of quality controls that would prevent them from taking too much asset risk in assessing the credit quality of their borrowers," said **Dan Helle**, a partner at the firm.

Finally, CIVC received a call from the investment banker handling the sale of First Franklin for **DLJ Merchant Banking Partners**. The banker had been informed of CIVC's potential interest in First Franklin by a consultant the firm had worked with in the Sunbelt deal three years before.

Although CIVC considered First Franklin to be a good match because of its high margins and strong management, Helle said the transaction itself was no picnic.

An About Face

The company was in the midst of a financial turnaround and a complete change in strategy that would eventually shut down its conforming loan origination activity in order to focus entirely on nonconforming loans. And to top it off, First Franklin was experiencing a money-losing year – an occurrence that might lead non-turnaround investors to balk at the chance to take ownership. But CIVC stepped up to the table. The fact that the company intended to become a subprime lender and was squeezing out its other business was definitely a plus, according to CIVC.

"We felt the financial situation of the company at the time was a risk that we could take on," Helle said. "Through our due diligence we could see the impact the change in their strategy would eventually have and we wanted to help them refine that strategy to accelerate their transition. By the time we got to closing, they were approaching the 'break-even' point and it was clear to us that they were going to be successful in their new role."

CIVC contributed $25 million of equity while First Franklin's management put in $3.5 million for the non-leveraged deal.

It's customary for mortgage banking companies to be fairly leveraged, Helle said. They make their loans out of proceeds from a warehouse line or a borrowing facility and it's usually unwise to put any more leverage on them, he added.

When CIVC closed the deal with First Franklin in November of 1996, the company had already undergone significant transformations. When CIVC began looking at the company six months earlier, it was providing $25 million to $30 million in nonconforming originations (this being the way one measures a mortgage banking company) and approximately $130 million in conforming originations.

In November, the two sides had evened out and the company was providing approximately $50 million per month in each category. Within a few months of CIVC's ownership, First Franklin had completely exited the conforming business. (Upon CIVC's exit of

First Franklin in 1999, the company was averaging $400 million a month in nonconforming originations.)

A Little Help, Please

Even before CIVC's involvement with First Franklin, the company had recognized the nonconforming business as "the place to be" for its higher margins and profitability, but was lacking in the area of an overall plan.

The company needed assistance in revising and refining their strategic plan, Helle said. "A lot of what we did was to provide the company and the management team with good benchmarking data so they could get a sense of the impact their transition into nonconforming loans was going to have," Helle said.

CIVC worked extensively with the management team to help them develop a model to measure their cost of originations against the value of the loans they were originating in order to refine their profitability. In turn, First Franklin was able to plan its growth more logically, especially in areas that had not yet been considered, like "this is how many people will be needed in such and such department and this is how much its going to cost," Helle said.

Consequently, CIVC further assisted First Franklin in the refinancing of its lending facility six times.

The Beginning of the End

As 1998 rolled around, CIVC got the itch to sell First Franklin, for a number of reasons.

The firm took notice of other subprime companies venturing into the public markets. However, CIVC decided against the initial public offering route because of the distressed state of the public capital markets at that time.

"Capital is obviously the raw material with which companies make their loans, and as the capital markets became more and more difficult – even though First Franklin continued to grow –the market got more stringent on the amount they were willing to lend both on a warehouse basis and on other capital lines," Yamada said.

But the urge to reap the returns of their investment in the now-profitable First Franklin could not be suppressed, especially when strategic and institutional buyers began to show interest in acquiring subprime mortgage companies similar to First Franklin. For example, since 1998, Washington Mutual acquired **Long Beach**, **First Union** bought **The Money Store** and **H&R Block** purchased **Option 1**.

Seeing the success of such transactions, CIVC decided it was a good time to test the waters for an outright sale of First Franklin. Adding fuel to the fire, the emergence of strategic buyers reminded CIVC of a situation several years before when banks began consolidating conforming businesses, which eventually led to a dramatic reduction in profit margins for the independent operators of these companies, said Helle.

"It became increasingly more difficult for an independent, much less a private equity-owned, company in this sector to grow with the much larger players showing so much interest," Yamada added. "That tipped us off that it was time to send the company on to the next stage, which was not private equity ownership."

CIVC hired **Salomon Smith Barney** and **Warburg, Dillon, Reade** to help sell First Franklin. After seeing interest from a number of potential buyers, National City Corp. emerged as the winning bidder and acquired First Franklin for almost $250 million.

"This was absolutely phenomenal for us," Helle said. "It far surpassed what we were expecting. Our return was triple what we had hoped and the company's orginations were double what we had anticipated in 1999. What a nice surprise." BUY

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