

Smart

A LOOK BACK OVER THE LAST DECADE REVEALS A DISTINCT CONNECTION BETWEEN PRIVATE EQUITY funding, mortgage banking growth and industry innovation. While private equity funding is seen as fundamentally opportunistic, it has provided the industry with well-timed investments, leading to real value creation. Repeatedly, private equity investors' tolerance for risk has moved the industry forward, serving as a catalyst for change when other, more traditional funding sources backed away.

It is reasonable to predict, then, as history repeats itself, today's owners and managers will consider private equity funding as a source of capital both now and in the future.

Understanding private equity investors' role and history in this industry is of significant benefit to today's players. This article seeks to outline private equity groups' attraction to the mortgage industry, illustrate a number of mortgage banking hits and misses experienced by private equity investors and, with private equity funding readily available, offer advice on how to find "smart capital."

Private equity funding has been a catalyst for change at significant turning points in the mortgage business. Today it is working to fund business models that may be tomorrow's success stories. A review of recent history charts the hits and misses of some private investors in the business.

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Capital

What is private equity?

Private equity is considered nontraditional funding from private investors willing to capitalize organizational start-ups, expansions (such as consolidations) or transitions (such as buy-outs) in exchange for equity ownership. There are essentially two types of private equity firms. Venture capital groups are typically interested in early-stage ventures, while buy-out equity groups are usually attracted to late-stage, mature companies; however, some investor organizations do overlap in the deals they are willing to fund (see Figure 1).

When do private equity firms typically enter?

- When funding from other sources is hard to come by;
- When the industry is “sorting itself out” during periods of dislocation or transformation; and
- When market conditions present strategic, higher-risk opportunities such as turnarounds or new business models.

Private equity in mortgage banking: A surprising fit?

Hundreds of millions of dollars in private equity money have been invested in mortgage banking in the past 15 years. That’s perhaps surprising, given that financial services typically are not thought to offer the higher-than-average returns private equity investors seek. But the fact is some financial services niches, including mortgage banking, do offer high-return opportunities during certain periods.

Mortgage banking has always been highly cyclical, expanding and contracting abruptly and often severely with interest rate cycles. These cycles have created windows of opportunity for private equity investors. As a result, the smart capital has fostered change and fueled value creation in the industry.

Today, traditional funding sources are grappling with how to analyze the new electronic marketplace. Uncertainty about the effect the Internet will have on the mortgage market has created high-risk/high-return opportunities. As a result, private equity firms have stepped in to fund development of today’s innovative online mortgage banking solu-

tions. This type of funding is also helping to fuel consolidation in the vendor services sector. But then, this isn’t really surprising if we look back and consider the role private equity investors have played in the mortgage banking industry in earlier times.

Private equity in the RTC era (1989–1994)

While private equity firms had invested in mortgage banking previously (Advance Mortgage Company and North American Mortgage Company, formerly IMCO), the late 1980s ushered in a new era of attraction by equity capital groups. During this time, the Resolution Trust Corporation (RTC) began to dispose of \$400 billion worth of insolvent thrifts—many of which had mortgage banking operations.

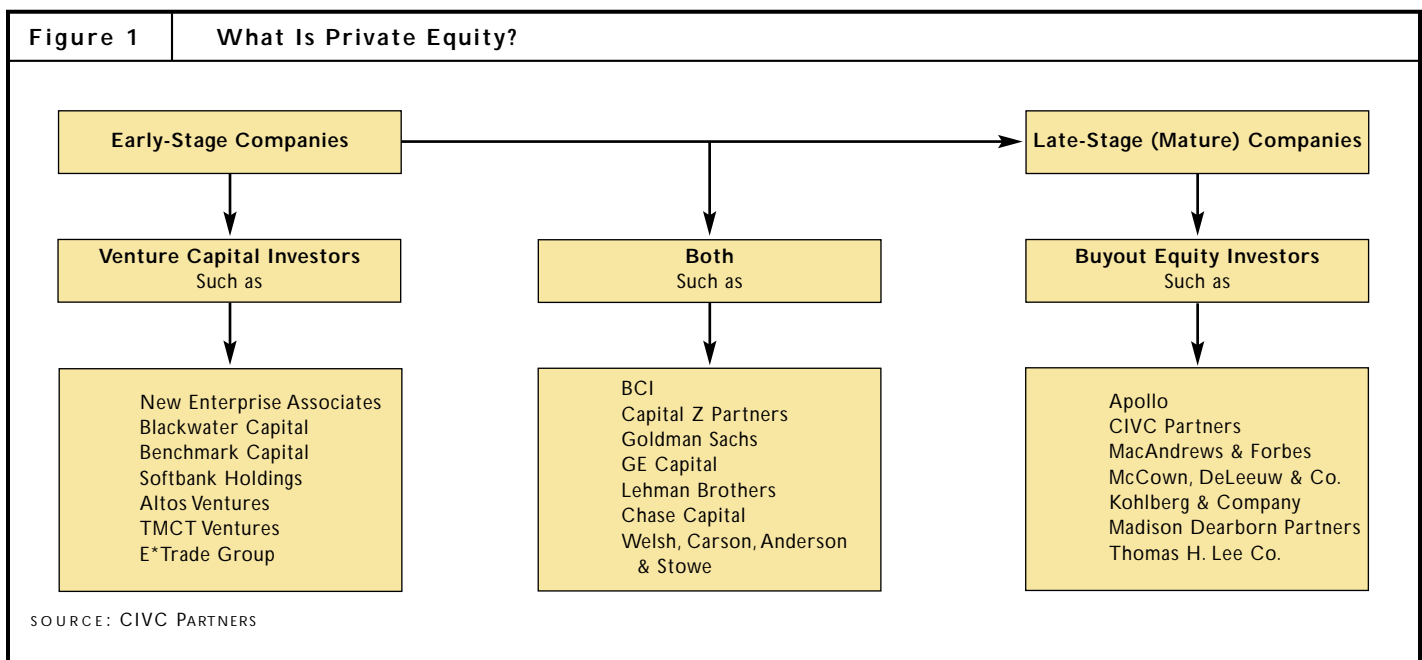
This oversupply of mortgage banking operations for sale came at the same time that the banking industry was experiencing a general shortage of capital. The combination markedly depressed prices for mortgage-banking assets as banks—the natural buyers—didn’t have the currency or the risk appetite to buy. Clearly, the industry needed to sort itself out.

Enter private equity investors. They saw value in the underlying assets, had the capital to buy them and could add expertise to help turn them around. Chicago-based CIVC Partners’ investment in Sunbelt National Mortgage, for example, and McAndrews & Forbes’ investment in Troy & Nichols were both successful, while McCown, DeLeeuw & Co.’s investment in Victoria Mortgage missed the mark.

CIVC PARTNERS UNCOVERS VALUE IN SUNBELT—INTERNAL RATE OF RETURNS EXCEEDS 100 PERCENT

With a strong working knowledge of the organization

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(a result of closely partnering with management), CIVC Partners got beneath the surface of Sunbelt's origination franchise and uncovered the potential to build significant value. So together with Sunbelt's prior management, CIVC acquired the company from the RTC in November 1992.

As planned, CIVC and management expanded the origination franchise during 1993 and rode the wave of a revived origination market resulting from numerous cuts to the Federal Reserve discount rate. As the market for originations boomed and the economy strengthened in general, banks became buyers of mortgage banking enterprises once again. True to the role of the private equity investor, CIVC and management sold Sunbelt to Memphis, Tennessee-based First Tennessee National Bank, recognizing that the franchise would better withstand the inevitable next downturn in the hands of a bank with scale. First Tennessee was also a strategic buyer, identifying Sunbelt as the core to its strategy of building a top-10 presence in the mortgage banking industry. The sale was completed in January 1994, with internal rate of returns (IRRs) to private equity and management investors exceeding 100 percent.

TROY & NICHOLS ACQUIRED BY MCANDREWS & FORBES—
LATER SOLD TO CHASE MANHATTAN BANK

The Troy & Nichols story mirrors Sunbelt's in many respects. It, too, had good servicing capability and, after purchase by a private equity firm, built a strong origination franchise valuable to large consolidators. Also like Sunbelt, Troy & Nichols' private equity investor had good timing in entering and exiting the industry.

McAndrews & Forbes acquired Troy & Nichols from the RTC in June 1992. Shortly after closing, McAndrews & Forbes began consolidating another mortgage servicing operation that it owned (First Gibraltar Mortgage Corporation, Houston) into the very efficient Troy & Nichols servicing center. This added value to both servicing portfolios by significantly driving the overall cost of servicing down. After the transaction closed, the origination franchise benefited from the improved interest rate environment far more than was anticipated.

By late 1992, demand for mortgage banking assets was rising; McAndrews & Forbes decided to sell . . . and Chase Manhattan Bank purchased Troy & Nichols in June 1993. McAndrews & Forbes reportedly more than doubled its money in the year that it owned Troy & Nichols, according to a confidential source close to the transaction.

McCOWN, DELEEuw & Co. ACQUIRES VICTORIA MORTGAGE—
AND MISSES THE EXIT

While Sunbelt and Troy & Nichols were sold to large institutions with the ability to withstand the industry's interest rate cycles, McCown, DeLeeuw & Co. wasn't so fortunate with its investment in Victoria Mortgage. Victoria remained independent through the next industry down cycle and ultimately failed, as it couldn't support the high overhead associated with its origination network.

McCown, DeLeeuw purchased Victoria Mortgage from the RTC in late 1991. Victoria was a servicing company, and soon after the acquisition, interest rates fell, prepayments

climbed and the servicing-only company could not build an origination capability fast enough to make up for the servicing runoff. By the time the origination channel was built, the cycle had turned again and the origination network couldn't generate loans cost-effectively. This saga ended with the closure of Victoria Mortgage in 1996.

During the RTC era, a number of private equity investors generated hits with their investments, while some missed the mark. Those with the smarter capital (i.e., a well-grounded understanding of the business supported by a strong management team), as well as better timing, succeeded. They understood the need for a balance of servicing and origination, built or strengthened those capabilities—and exited before the next downturn in the cycle.

It became clear that origination needed to be in the hands of larger players with the economies of scale to weather the interest-rate cycles inevitable in the industry. By the end of the RTC era, private equity investors had served their role in helping the industry sort itself out, create value and spur growth.

Private equity in the subprime era (1995–1999)

The subprime wave began fairly quietly, with family-owned businesses such as Quality Mortgage Group, Oxnard, California; Aames Financial Corporation, Los Angeles; First Alliance Corporation, Encino, California; and Delta Financial Corporation, Woodbury, New York, building steady but relatively small-scale businesses that made loans to borrowers whose credit histories did not match Fannie Mae and Freddie Mac requirements. Margins were attractive—4 percent gross margins versus less than 1 percent for prime mortgages.

When Wall Street began to securitize these loans, greatly enhancing liquidity, originations exploded, sparking double-digit growth. Prices for subprime firms were high. Qualified management teams for start-ups were difficult to find and the easy availability of capital meant that subprime firms did not particularly need private equity funding to grow their businesses. Wall Street was willing to provide warehouse and overadvance lines to new entrants such as Irvine, California-based BNC Mortgage, Inc., and Irvine, California-based One Stop Mortgage, Inc., which did not have institutional equity investors. So private equity investors directed their capital toward opportunities less obvious to the marketplace and in deals that, on the surface, were less attractive to traditional funding sources.

THOMAS LEE'S ACQUISITION OF OLD STONE HITS WITH A SUBSEQUENT IPO

In the case of Providence, Rhode Island-based Old Stone Corporation, Thomas H. Lee Co., Boston, simply saw the subprime opportunity before it became obvious to the rest of the investor market. Thomas Lee's management buy-out of

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Jacksonville, Florida-based EquiCredit Corporation from Old Stone occurred in November 1991—well ahead of the subprime wave. With smart capital in hand, Thomas Lee identified the attractive margins and growth opportunities in the subprime market and capitalized on them.

EquiCredit grew both its origination and servicing portfolios aggressively. Lee took the company public in early 1993 at \$14 per share, then completely exited the company when EquiCredit was acquired by Barnett Banks in 1995 in a friendly transaction at \$32 per share.

CIVC'S ACQUISITION OF FIRST FRANKLIN GENERATES SIGNIFICANT GROWTH

CIVC's purchase of First Franklin Financial Corporation, San Jose, California, from New York-based DLJ Merchant Banking Partners LP is a classic example of private equity providing capital to transform an existing business. When DLJ acquired First Franklin in mid-1993, it merged the company with another prime mortgage company it had acquired, Franklin Mortgage. Unfortunately, Franklin Mortgage had many loan-quality problems that were beginning to become evident, and the two origination networks were redundant. The combined company was hit hard by the downturn in originations in 1994.

Recognizing that the prime business had been commoditized—and that a small, independent prime originator couldn't survive—First Franklin's management team began to shift the company's focus to subprime. It needed more capital to execute the strategy, but DLJ had changed its investment focus. And with its poor experience in mortgage banking, DLJ simply wasn't willing to provide the necessary capital to pursue First Franklin's strategy. DLJ sold First Franklin to CIVC in 1996.

Under new ownership, an immediate and aggressive transformation of the company to subprime began. As a result, subprime originations climbed from less than \$50 million per month at the time of purchase to more than \$500 million per month three years later. CIVC sold First Franklin to National City Bank in August 1999, with internal rates of return exceeding 100 percent.

PRIVATE EQUITY INVESTORS MISS THE MARK WITH AAMES AND IMC MORTGAGE

By mid-1998, turmoil hit the subprime market. Skyrocketing volumes of prepayments and heavy refinancing activity drained liquidity out of the securitization pools. Problems with accounting methods also surfaced. Crises in Asian financial markets prompted liquidity to dry up for asset-backed securities.

Without liquidity, valuations crashed and the consolidation among subprime lenders began. Once again, market conditions set the stage for private equity investments—as now capital was in demand for turnaround situations. But this environment proved to be tumultuous for even the most savvy private equity investors.

For example, McAndrews & Forbes invested \$38 million in Aames in April 1998, when the stock price was around \$68 per share (off from a reverse split-adjusted peak of nearly \$150 per share in late 1996). With the stock price plummeting into the teens, New York-based Capital Z Partners stepped in

to provide Aames with additional funding—first in late 1998, again in mid-1999 and again in mid-2000, for a total investment of well over \$100 million. Today, Aames stock trades around \$1 per share.

During the same time period, and under similar circumstances, Greenwich Street Capital Partners, New York, invested in IMC Mortgage Co., Tampa, Florida. Today, IMC Mortgage is working its way through liquidation.

Some industry analysts attribute these apparent misses to management and investors alike who were overly confident in their abilities to make money without effectively addressing underlying business and industry issues. While that may be true in some cases, the problems that developed in the subprime industry beguiled even those private equity investors generally thought to understand the mortgage banking business. And the fact remains that in the subprime era, private equity firms offered several mortgage banking organizations opportunities traditional investors would not.

Whether ahead of the curve (in the case of Thomas Lee) or standing in the gap (in the case of CIVC), significant growth and value were added to the industry that may have otherwise gone unrealized had this funding source not been available. What happened in the subprime era underscores the need for smart capital. Seeking out smart capital means examining the private equity firm's expertise, determining its ability to identify critical success factors under specific market conditions and assessing its sense of timing. The subprime era demonstrated that similar investment strategies with *differing* entrance and exit decisions can lead to vastly different results.

What happened in the subprime era underscores the need for smart capital.

Private equity today—dual strategies

STRATEGY ONE: ONLINE

Private equity investors entered the online frontier early and in some cases used the initial public offering (IPO) market to make their exits. Until recently, the Internet IPO market was hot. Investors of every kind were scrambling to fund any Internet start-up they could get their hands on—including the online mortgage market. But then reality set in.

Today, private equity firms, with their tolerance for risk, are helping to sort out which business models will succeed in the online frontier. As a result, private equity investors are incubating innovative online mortgage banking solutions while lower-risk participants wait for the winning business models to emerge.

Private equity was used to fund the start-up of companies such as E-LOAN, LendingTree, mortgage.com, Pedestal, IMX and Ultraprime. Private equity firms are getting in on the ground floor, supporting investments in technology and brand development and taking the risk of negative cash flow and an unproven business model.

Some of these models will prove successful over time, but many will not. We believe, for example, that the business-to-consumer (B2C) model has run its course *now* as companies competing in this space grapple with significant marketing and technology challenges.

E-LOAN, Dublin, California, for example, was formed in 1999 with the backing of Benchmark Capital Partners, Menlo Park, California, and Softbank Corporation, Tokyo. E-LOAN's goal was to act as a broker, directing consumers to the best mortgage deal. E-LOAN's backers succeeded in positioning it as a desirable IPO—the company went public in mid-1999 at \$16 per share and traded as high as \$75 per share. But as of this writing, with the B2C model losing its luster (and E-LOAN unable to originate loans at a competitive cost), the stock trades at less than \$5 per share—nearly one-third of its IPO price.

Backed by private funds from Capital Z, ULSAP, GE Capital and Goldman Sachs, Charlotte, North Carolina-based LendingTree's mission is to do the legwork for consumers, providing a choice of three or four lenders that offer loan quotes to win the consumer's mortgage business. Similar to E-LOAN, LendingTree's stock has taken a beating, falling from a range of \$15 to \$17 at its initial offering in February 2000 to \$4 to \$5 just six months later. LendingTree's stock now appears to be recovering slightly, and trades around \$9 per share.

Mortgage.com, Sunrise, Florida, which was funded with private equity initially, began as a business-to-consumer site and has since shifted its focus to the business-to-business (B2B) market. Its stock is still smarting, though, having dropped from a high of more than \$22 per share in September 1999 to the \$1 to \$2 per share range at time of publication.

Similarly, iOwn, San Francisco, which began as a B2C model billing itself as a one-stop resource for home listings and low-cost online loans, is now pursuing a B2B strategy. iOwn was initially funded by Altos Ventures, with subsequent investments by The Tribune Company, Doll Technology Investment Fund, Hyperion Partners, Lehman Brothers and TMCT Ventures. While an S-1 was filed for an initial public offering in December 1999, no offering has yet been completed.

Like many companies pursuing B2C online strategies, these particular companies have not been looked upon favorably by the public markets, and it is unclear *which* B2C online mortgage banking models will be embraced. As a result, we believe private equity investors are now focusing on two subsectors of the mortgage banking industry that offer greater opportunity online: online mortgage market exchanges and Web enablers. A brief description of each follows:

■ **Online mortgage market exchanges.** Online mortgage market exchanges generate competition and offer transparency to the marketplace because they provide efficient exchange of data. This will likely lead to more efficient pricing. Consistent with their role in fueling market change, private equity investors will be attracted to this subsector. Examples include Washington, D.C.-based Pedestal Capital Markets, Inc., and Dulles, Virginia-based Ultraprise Corpo-

ration, which are both creating online secondary mortgage market exchanges. Although their business models differ, both were funded by individuals and are now backed by private equity firms.

Other examples in this sector are IMX Exchange, San Ramon, California, and LoanTrader.com, Irvine, California, both of which are helping mortgage brokers sell loans to lenders online, thus increasing liquidity and efficiency. It should be noted that while IMX filed an S-1, no offering has yet been completed. Company sources report that IMX is currently working on another round of private financing. And while the company recently announced layoffs, IMX's chairman has reported that volume is strong—with the company setting record volume levels within the past month.

■ **Web enablers.** These are companies whose business models enable other mortgage market participants to do business on the Internet. Private equity firms are a natural match for this sector because of the early, risky stage of Web enablers. It is very difficult to predict who will succeed and fail—attracting investors and users to the best business concepts.

Examples include GHR Systems, Wayne, Pennsylvania, offering a suite of business-to-business products for online origination, including pricing and decision making. San Jose-based LoanCity.com provides brokers with a search engine and access to residential loan programs from the nation's leading lenders. LoanCity.com was originally backed by New Enterprise Associates and E*TRADE Group. It completed its second round of funding late in 1999, totaling \$38.4 million. The investors included more than half a dozen private equity firms. Sources say LoanCity.com is in the process of completing another round of financing.

STRATEGY TWO: CONSOLIDATION

Private equity investors are typically attracted to early-stage consolidation. The vendor services subsector is a likely candidate for market consolidation, and private equity groups are already positioning themselves to fund this market change. Small local and regional credit reporting, appraisal and closing services companies, for example, exemplify sectors typically targeted for roll-ups by private equity funds—fragmented markets comprised of relatively small companies that could realize significant operating efficiencies and gain access to national clients by consolidating.

Private equity is particularly helpful in funding the significant technology investments that vendor services companies need to work with Fannie Mae, Freddie Mac and other automated mortgage underwriting systems. These companies also need to invest in customer service—for example, allowing lenders to check work flow status online (e.g., stage of title work, appraisals, etc.).

For example, Lender Services, Inc. (LSI), Coraopolis,

Private equity investors are typically attracted to early-stage consolidation.

Pennsylvania, is one of the largest providers of bundled vendor services. In 1998, LSI was recapitalized by private-equity funds—primarily from Desai Capital Management, Inc. With the help of new capital, LSI is constructing a B2B platform that is grounded in digital delivery to clients and suppliers, links a spectrum of services, adds decision-making and customization options, and is supported by data management and procurement technologies.

This is not the first time investors have tried to consolidate mortgage service vendors. Welsh Carson Anderson & Stowe created Strategic Mortgage Services in the mid-1990s with the goal of bringing all origination services under one umbrella. There are a number of reasons why this horizontal-consolidation strategy did not succeed; chief among them was the inability to completely integrate operations and back-office functions across the full range of origination services. We believe this strategy was simply pursued too early; most likely, a phase of vertical consolidation was needed first.

Today's consolidation plays are taking a much more vertical approach. Factual Data Corporation (FDC), Loveland, Colorado, is a good example of the type of vendor-services consolidation being facilitated by private equity. Factual Data specializes in providing customized credit reports and is one of a limited number of vendors approved for both Fannie Mae and Freddie Mac automated mortgage underwriting systems. FDC's customers include large national mortgage banks as well as small regional banks and brokers. CIVC Partners and BCI made significant investments in FDC in 1999, attracted by FDC's impressive technology platform as well as the fragmented nature of the industry.

While it's fairly early in the process, we anticipate that vertical consolidation among vendors will continue for the foreseeable future, and that private equity funding will play a significant role. Ultimately, horizontal integration also will likely occur once vertical integration is complete. We're beginning to see greater crossover between the Internet and vendor consolidation, with a number of consolidation plays incorporating an Internet element. For example, FDC has developed the capability to deliver its reports to customers over the Internet, providing a faster, more automated process. Technology is also fueling consolidation by making these businesses scalable, allowing them to more easily and quickly integrate acquisitions.

Look for the smart capital

A look back over the last decade shows that private equity investors have served as catalysts for change and as value generators in the mortgage industry, particularly when traditional funding sources (understandably) preferred to stay on the sidelines. The risk tolerance of private equity investors has opened windows of opportunity at times when the industry needed sorting out—including times like today, when the Internet presents a number of unknowns.

Unquestionably, private equity investors have spawned a

Figure 2

What Attributes Are Attractive to Private Equity Investors?

- Strong management team
- Viable infrastructure and underlying business fundamentals
- Opportunities to create value through innovation (new revenue, cost savings, etc.)
- Return on investment targets over a 3–7 year time frame:

Buyout Equity Firms	→	25%+
Venture Capital Firms	→	40%+

SOURCES: SOURCE: CIVC PARTNERS

number of industry success stories that otherwise never would have been realized. But that tolerance for risk has also led to a number of misses throughout the years. Industry misses, while certainly not identical in circumstances, often share underlying symptoms—primarily poor timing, and in some cases, a limited understanding of industry economics.

So it is essential for owners and managers to seek out smart capital. No doubt the process of acquiring smart capital may present some annoyances (such as detailed scrutiny of your business and the industry)—but it is clearly the better choice. The alternative may save you some frustration, but an investor who doesn't know the market or jumps into a deal too quickly could easily pull out too early—leaving you with few choices.

Owners and managers seeking smart capital are well advised to thoroughly review a private equity investor's expertise in the mortgage industry. Ask for a full review of the firm's track record in the business as well as its analysis of marketplace conditions and critical success factors. Consider what details the investor wants from you—and how closely the information is reviewed. It is likely that the more targeted the examination of your organization, the more clearly the investor understands the underlying economics of your industry (see Figure 2).

Owners and managers are often in the best position to identify private equity opportunities early. You're also likely to recognize the right time to sell. In both cases, speak up and facilitate the process. A poorly timed investment or exit can undo the hard work of an entire organization.

In the recent history of the mortgage business, there has been a distinct connection between private equity funding and innovation and growth in the industry. If history repeats itself—and we believe it will—private equity investors are likely to play a catalyst role going forward. Understanding the role of private equity, its value to the industry and the distinct advantage of smart capital is an important knowledge base for owners and managers who are moving into the new world of mortgage banking. MB

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