STRATMOR GROUP

Powering Performance. Together.

M&A Market Conditions: Opportunities for Midsize Independent Lenders

June 29, 2017

What Can Prospective/Eventual Sellers Do To Position Their Company For An Optimal Sale?

STRING

MAKING THE REAL ESTATE INDUSTRY MORE EFFICIENT

String: What We Do

We provide outsourced fulfillment support to

- **Mortgage lenders: across entire origination lifecycle**
- **Title agents: all title back-office tasks**

All of this is done

- **Behind the scenes (invisible to your end-customer)**
- **Seamlessly (built into your workflow)**

End-result: You have 100% control of

- **Your workflow**
- **Customer experience**

String: Who We Are

2003	Inception
HQ	Bethesda, MD
500,000	Mortgage documents processed annually
20 Million+	Mortgage and title transactions processed
5 Million	Man hours of experience in mortgage & title space

Familiar with all major mortgage platforms

String's Title Services

Title Search
- Current owner search
- Two owner search
- Full title search
- Update search
- Tax certifications
- L&V searches
- AVR search

Title Typing
- Property report
- Title commitments
- Title policies
- TSG/ PJR typing
- Legal description typing
- Title QC
- Easement plotting

Closing Support
- Pre & post close review
- Document recording
- Settlement statement
- Document preparation
- Scheduling of closing
- Escrow support

Title Curative Processing
- Payoff processing
- Subordination processing
- Lien release
- Document Recovery
- HOA support

Other VMC Services
- Broker price opinion
- Appraisal report
- Flood zone determination
- Vendor screening/ recruitment
- Vendor management

Title Plant Building
- Historical doc indexing
- Go forward indexing
- Plat map updates

String's Residential Mortgage Services

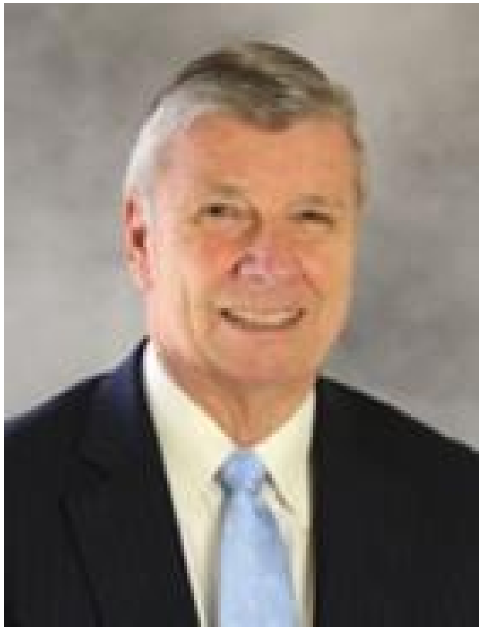
Processing Support
- Loan Set-up Assistance
- Order VOE/ Flood/ Title/ Credit report/ Appraisal
- Documents Indexing and Stacking
- Review documents and State specific disclosures
- Setting and Clearing Conditions

Underwriting Support
- Pre-Underwriting Review
- Setting-up Conditions
- Perform Calculation (LTV/CLTV/DTI)
- Clearing Conditions
- Post Underwriting Audit

Closing Support
- Pre-Closing Review
- Ordering Documents (Payoff & VOE)
- Reviewing of Documents
- Preparation of Closing Package
- Scheduling

Funding Support
- Pre-Funding Review
- Validate Initial and Final CD
- Ensure all Conditions are Closed
- Fund Validation
- Post Funding Audit

Post Closing Support
- Trailing Documents Retrieval
- Assemble Post Closing Loan Package
- Data Integrity Audit
- Indexing the Loan Documents
- Post Closing Audit



Jeff Babcock leads STRATMOR's mergers and acquisitions practice and was an original partner in the formation of STRATMOR Group's predecessor company in 1981.

Jim Cameron's assignments have focused on benchmarking and performance measurement, strategic planning, production franchise valuation, M&A advisory services & more.

STRATMOR Group is a mortgage advisory firm that works with lenders of all shapes and sizes.

Its services include

- Consulting Services
- Benchmarking & Cost Studies
- Technology Evaluation
- M&A To Middle-market Firms (dozens of consummated transactions)

M&A Outlook – STRATMOR's Perspective

- Consolidation among producers will continue to accelerate for several reasons
  - Flat origination market forecast (see next page)
  - Aging mortgage banker ownership
  - Competition in the digital mortgage footprint
  - Required capital levels keep rising
  - Favorable origination market conditions will not last forever
- Investor demand for Mid-Size Retail and Consumer Direct platforms far exceeds supply of sellers
  - Seller's market will persist as buyers show willingness to "pay up"
- Potential for recessionary economic cycle cannot be ignored
  - Rising Fed rate increase cycle has historically led to a recession 79% of the time
  - While rates may stay relatively low, negative impact on housing demand in general
- Well-positioned buyers offer some compelling acquisition synergies
- Virtually all Independent mortgage banks are (eventually) for sale
  - Major difference between bank-affiliated lenders vs. Independents
- An effective exit strategy requires careful advanced planning

Production Forecast: 2017 - 2019

National Mortgage Origination Volume: 2016 - 2019														
	2016			2016 vs. 2015	2017			2017 vs. 2016	2018			2018 vs. 2017	2019	2019 vs. 2018
	FNMA	MBA	Avg,	% Change	FNMA	MBA	Avg,	% Change	FNMA	MBA	Avg,	% Change	MBA	% Change
Mortgage Forecasts														
30 Yr. Mortgage Rate	3.6	3.6	**3.6**	**-8%**	4.0	4.2	**4.2**	**17%**	4.1	4.9	**4.5**	**17%**	**5.3**	**18%**
Single Family ($ mil)	1,963	1,891	**1,927**	**14%**	1,624	1,612	**1,618**	**-16%**	1,534	1,588	**1,561**	**-2%**	**1,640**	**5%**
Purchase ($ mil)	1,014	990	**1,002**	**11%**	1,078	1,084	**1,081**	**8%**	1,123	1,178	**1,151**	**9%**	**1,245**	**8%**
Refinance ($ mil)	949	901	**925**	**16%**	546	528	**537**	**-42%**	510	410	**460**	**-24%**	**395**	**-14%**
Refinance Share	48%	48%	**48%**	**3%**	34%	33%	**34%**	**-30%**	25%	26%	**26%**	**-22%**	**24%**	**-6%**

- Doesn’t appear that a “rising tide will raise all boats” over the next few years
  - 2017 projected to be down 17%, 2018 down another 2% and only 5% growth in 2019

Been A Seller's Market Since 2014

- Buyer population –
  - Larger Independents – many of these
  - Bank-affiliated lenders – fewer, but excellent buyers
  - Institutional investors (not confined to Private Equity Investors)
- What is motivating these buyers?
  - Push to achieve a critical mass of production volume to fund infrastructure, technology and compliance overhead
  - Geographic in-fill
  - Acquisitions seen as more efficient growth strategy compared to organic recruiting
  - Measure to deepen management "bench strength"
  - Alternative to building internal capability --- Consumer Direct is a good example
  - Achieving desired channel balance by acquiring a distributed retail platform
  - Institutional investors –
    - May have capital markets and servicing expertise but lack origination capability
    - Looking for a scalable platform – a launching pad

Limited Supply Of Well-Managed Sellers

- Factors which inhibit the flow of sellers putting themselves in play
  - Relish their independence and resistance to working for somebody
  - Expectation that their Enterprise Value will materially increase over the intermediate term due to double digit growth
  - Belief that their company will continue to achieve 2016 earnings for several years to come
  - Concerns about cultural compatibility --- especially with bank buyers
  - Insufficient value proposition from the buyer
    - Reflected in ability to bring across the sales force
  - Consolidation of redundant functions will mean elimination of jobs for loyal managers
  - Loss of local brand identity
  - Lack of “pain points” which often motivate a committed seller --- “everything is just great as we are currently operating”
  - Skepticism about achievability of earn outs

Pace of M&A Activity Has Accelerated Since 2014

- Age of one or more of the managing executives/shareholders has been a factor in most STRATMOR-assisted transactions
- Market timing has been a motivator for a handful of sellers
  - Concern that Seller's market can't last forever
- Competition among buyers has definitely improved deal terms
  - Moderate increase in up-front premium as % of total value
  - More attractive earn out terms --- including some structured as a production override rather than share of profitability
- Concern about maintaining technological pace with the major players
- Perceived need to add differentiated firepower to compete in recruiting Loan Officers and Branch Managers
- Desire to offload administrative functions (especially compliance) so as to concentrate on production management and recruiting
  - Highest and best use of talent

Observations On Company Valuations/Transaction Structure

- Key element of acquisition negotiations tends to center around that portion of a lender's premium value which is paid at closing. Several factors will influence these negotiations
  - Consistency of the seller's financial performance history
  - Purchase business share and Government lending share
  - Quality, longevity and loyalty of the seller's sale force
  - Sales and fulfillment productivity
  - Tenure and effectiveness of the Senior Management team
  - Counterparty reputation
- Earning the remainder of the Production Franchise Premium is contingent on the seller's go-forward performance under the new ownership umbrella
    - Earn Outs are typically three years in duration
    - Can be based on a sharing of the consolidated Net Income
    - Sometimes structured as a basis point override on future production volume

Biggest Challenges For Successful Acquisition: Seller's Perspective

- **Market Timing:** Is now the right time to sell my Company? If I wait two more years, will my Enterprise Value improve significantly? Enough to offset the risk of deteriorating market conditions?
- **Forgoing Independence:** Am I emotionally prepared to report to a new boss? Will I be granted sufficient authority to make all of the daily operating decisions to sustain our model?
- **Cultural Compatibility**: Will my people be happy and productive under this new partner? Single most important element of an acquisition's success, yet difficult to measure, assess and understand in advance of the closing
- **Trust:** Will the buyer deliver on the most impactful of their promises? Will they facilitate the achievement of my Earn Out?
- **Value Proposition:** Can the buyer formulate/provide a tangible and sufficiently attractive value proposition to help retain our origination staff?
- **Acquisition Synergies:** Will we be effective at motivating our people to leverage the benefits which the buyer brings to the table?
- **Impact of Functional Consolidation**: Might some position eliminations damage morale as certain popular loyal managers depart?
- **Value of Seller's Brand**: How influential is our current brand with our referral sources? Will the buyer allow the continuance of DBA's?

Biggest Challenges For Successful Acquisition: Buyer's Perspective

- **Cultural Compatibility:** Key intangible in a successful deal, yet very difficult to anticipate where issues might arise
  - Should be # one priority for both parties during the transition period
- **Retaining Influencers**: How to bring across and motivate the executives and functional managers who are viewed as thought leaders to promote the benefits of the combined operating model?
- **Up-Front Premium**: Justifying the amount of this non-refundable payment required to compete for a high performing seller
- **Model Match:** How compatible is the seller's approach to the basics of mortgage originations? (e.g. fulfillment model, pricing philosophy, etc.)
- **Minimize Changes**: Avoiding making substantive changes in the early years to the seller's organization, branding, compensation and sales management practices
- **Functional Consolidation:** Managing the process and pace of eliminating redundant functions within the seller's organization to mitigate disruptions
  - Always under pressure to realize the consolidation cost savings to achieve the acquisition economies assumed in the purchase price valuation
- **Communications**: How to effectively present and promote the corporate strategy to develop a shared sense of purpose, especially when the deal is announced and during the first year
- **Employee Recognition**: No greater motivator than to make people feel they are making an important contribution; especially impact on the seller's organization

Observations On Company Valuations/Transaction Structure

- While the marketplace preference is still for asset purchases, buyer resistance to stock transactions has abated
  - Exposure to credit quality issues is less of a concern today
  - Some stock transactions have been negotiated to mitigate the adverse tax effect of selling a C Corporation
- Inherent mortgage industry cyclicality and resulting earnings volatility negate the accuracy of an earnings multiple as a reliable indicator of value
- Multiple of Book Value does not accurately reflect the value of a mortgage origination franchise
  - Yet Private Equity Investors tend to focus on book multiples
  - The amount of book value can vary significantly based on shareholder's liquidity, tax and financial diversification strategies
- Marketplace preference for determining **production franchise premium** using a Discounted Cash Flow approach
  - Premium value is equal to the Net Present Value of future production cash flows
  - DCF approach incorporates the entire spectrum of a mortgage origination company's business model

Critical Valuation Assumptions

- Challenging to craft a **credible** production forecast in a world of macro-economic uncertainty; key assumptions include
  - Historical originator turnover and retention of the most productive half of the sales force
  - Development of production momentum to consistently gain market share
  - Inherent unreliability of national market forecasts – the net result of a set of assumptions that may or may not be valid
  - Ability of the seller's sale force to leverage the buyer's acquisition synergies to improve originator productivity
- Reliability of historical financial trends to predict future production cash flows
  - Need to incorporate several years of financial performance, not just the most recent great year
  - Forecasting the direction of interest rates is pure speculation and generally not an element of the valuation process
- Quantifying the Gain on Sale improvement enabled by the buyer's Capital Markets execution
- Other key assumptions around acquisition synergies
  - Enhanced Net Warehouse Spread
  - Net consolidation cost savings --- after buyer's corporate allocation
- Selection of the appropriate Discount Rate used to calculate the Net Present Value of a seller's production cash flows

Impact Of Non-Financial Factors On A Valuation

- **Corporate Culture:** Always at the top of the check sheet
- **Purchase Business Trend:** Low refinance share means less volatility; easier to forecast production volume means lower risk to the buyer
- **Product Mix:** Above-average Government lending share and below average Jumbo share provide a big lift to revenues
- **Sales Force Composition**: Measured in terms of productivity, concentration, tenure, age and gender
- **Effectiveness of Senior Management:** Approach to mortgage banking disciplines, sales management practices, recruiting successes, commitment to strategic planning, communications, compensation compliance
- **Origination Footprint:** Established relevance in a few markets vs. scattered presence in multiple markets
- **Counterparty Reputation:** Should include warehouse lenders, investors, regulators and even regional competitors
- **Selling Motivation(s):** Are there significant pain points which a suitable acquisition will address?

An Effective Advisor Can Enhance The Likely Outcome

- Rendering valuation and company marketability advice to help shareholders make an informed decision
  - Establishes attainable expectations from the onset
- Access to performance benchmarking database upgrades the quality of the analytical process
- Advisor’s marketplace credibility expands a seller’s exposure to the buyer population --- especially if recognized for representing quality opportunities
- Long-standing working relationship with the good buyers
  - Plus experience in dealing with the not-so-good buyers
- Dedicated resources to assume responsibility for the analytical and logistical tasks
  - Most seller executives are already fully occupied running their business
- Vast exposure to a full range of transaction structuring
  - Can serve as the “heavy” in negotiating sensitive issues
- Lend support to negotiating the critical issues in the Employment Agreements
- Retention of an advisor sends a message to the marketplace that you are a serious and committed seller

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