MORTGAGE M&A MINUTE

DECEMBER 2024

Market Snapshot

15% increase in global M&A deal volume in 2024 (through December 19) over 2023 (Dealogic)

34% increase in global M&A volume for private equity sponsor-led transactions in 2024 over 2023 (Dealogic)

9 years since the total number of deals was as low as the number of deals completed in 2024 (Financial Times)

19% increase in "megadeals" ($5 billion or more) in 2024 over 2023 (London Stock Exchange Group)

Quick Numbers

6.9% Quarterly increase in mortgage refinances in third quarter 2024 (ATTOM)

7.09% The highest average refinance rate in the United States as of December 18, 2024 was in the State of Kentucky (Zillow Mortgage API)

4.8% Monthly increase in existing-home sales in November 2024, the highest level of existing-home sales since March 2024 (Barron's)

2.3% Quarterly increase in home equity loan or line transactions in third quarter 2024 (ATTOM)

1.7% quarterly decrease in new mortgage originations in Q3 2024 (ATTOM)

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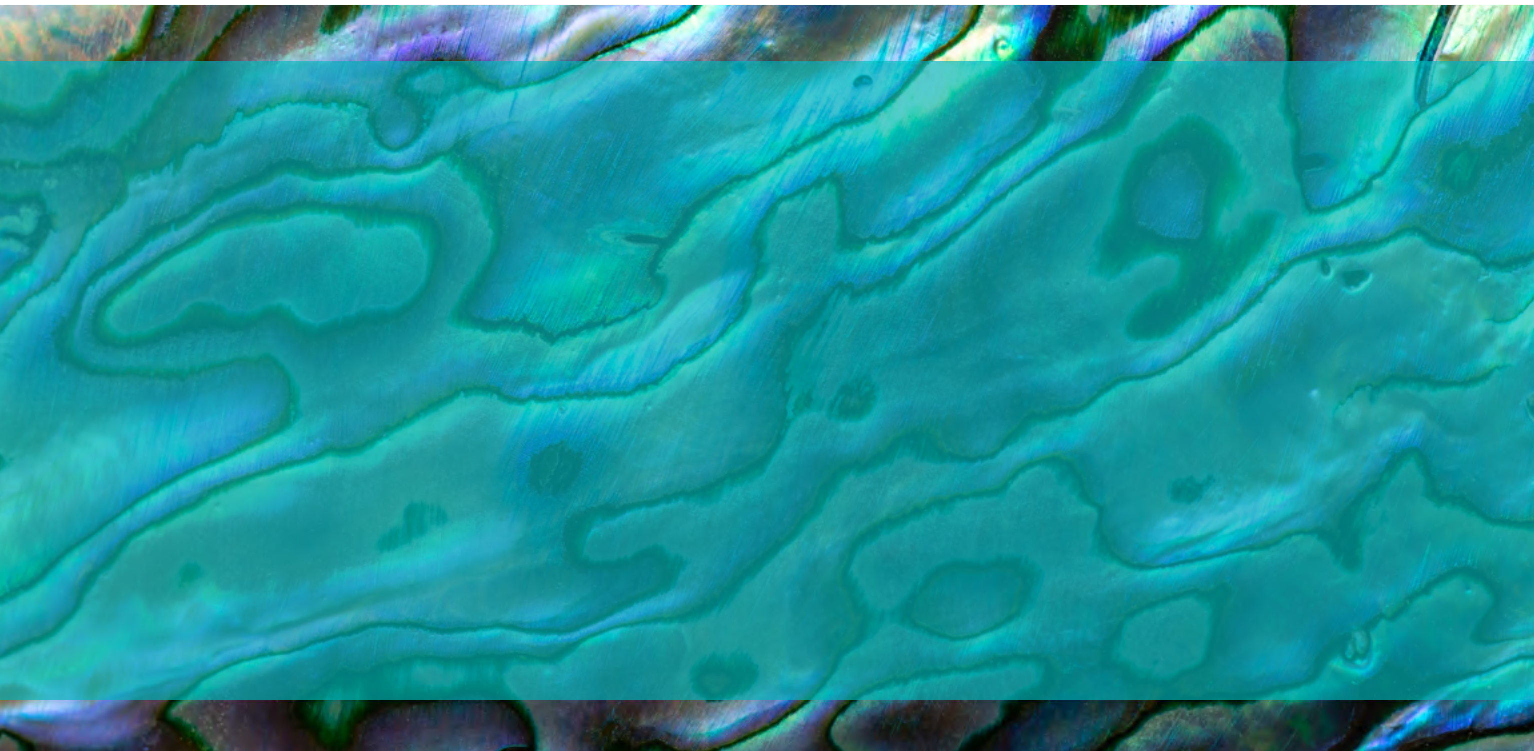

Shell Acquisitions: Will 2025 be another big year?

It has been just two months since our last (and first) *Mortgage M&A Minute* newsletter, and a lot has transpired. The Presidential election is behind us. A second Trump administration is ahead of us. Just days after the election, the Fed cut interest rates by a quarter of a percentage point and cut rates another quarter percentage point on December 18.

Despite the three rate cuts since the summer, mortgage rates have remained fairly steady. After a drop to a 52-week low in late September (6.08 percent for the 30-year fixed rate and 5.15 percent for the 15-year fixed rate), rates have risen back up to 6.60 percent for the 30-year and 5.84 percent for the 15-year as of December 19.[1]

As we noted in our prior newsletter, asset volatility and regulatory and capital requirements continue to drive traditional banks away from large mortgage servicing rights (MSRs) portfolios but non-bank servicers (like Mr. Cooper/ Nationstar) continue to acquire MSRs and build their servicing portfolios. Mr. Cooper announced on November 1 that it closed on its acquisition of the mortgage servicing and third-party origination operations of Flagstar Bank, N.A. (the bank subsidiary of Flagstar Financial, Inc.). We were lucky enough to play a role in that transaction, representing Flagstar .
The transaction helped Flagstar improve its CET1 capital ratio and simplify its business model. Mr. Cooper used the deal to continue to build its servicing and subservicing portfolio. This transaction is just the latest example in a trend of non-banks building market share in mortgage servicing.

We continue to get calls from all types of investors and potential buyers about acquiring a shell servicing entity or identifying the most important issues when evaluating such a transaction. We have worked on numerous shell acquisitions. Some have closed successfully and others have not. There are some common issues that arise. In this edition of the *Mortgage M&A Minute*, we will discuss those issues and some potential resolutions for when they arise.

We are often asked what makes an attractive shell entity? Certainly, it is important for the entity to have all of the necessary or desired agency tickets and state licenses. In certain cases, buyers may prefer that a shell not have, or surrender, licenses in states that have cumbersome and lengthy change of control processes. This is an issue that we have advised clients on and depending on the investment goals and states at issue, various solutions can be created to reach a timely closing while obtaining the approvals that are required to operate the business as contemplated after closing. Other attractive characteristics of a shell servicing target include a robust and scalable (and transferable) technology platform, a strong management team, and in some cases, subservicing contracts or MSRs to provide a base level of

1 https://freddiemac.com/pmms as of 12/19/2024.

cash flow to build from. Each of these characteristics must be understood by an acquirer and seller's legal counsel to ensure the transaction is executed as seamlessly as possible.

On the flip side, from a legal (risk) perspective, we are also looking for the unicorn—an entity with all of the attractive features noted above and a squeaky clean track record and compliance history—no consent orders, no negative audit findings, low repurchase history, etc. Many times, shell entities are on the market as a result of a recent sale or shutdown of the entity's origination platform. Depending on the volume or activities of that platform, the shell could have significant legacy liability that needs to be accounted for in the acquisition. We hope to come across this mythical clean shell entity, but have yet to see it! Accordingly, the key to most shell acquisitions is to find a way to allocate the risk in a way that works for both parties.

Most often, the valuation of the shell entity is not aligned with the potential legacy risk profile. For instance, a typical shell entity valued at $1-3 million may have legacy compliance and repurchase risk that is several multiples greater than that value depending on its historical volume or the type of origination and/or servicing that the entity participated in. In an equity acquisition (required to get the benefit of the change-of-control process for the agency and state licenses) that legacy risk can be a real concern for potential buyers. Depending on the status of the seller, indemnification may not be a viable or sufficient solution for allocating the risk. We have used escrows and holdbacks, but the imbalance between risk and purchase price often limits the effectiveness of those protections as well. The best protection is a full due diligence process, including loan level diligence, compliance process diligence and regulatory diligence. Extensive due diligence, coupled with a creditworthy seller to back indemnification or a significant escrow or holdback, can limit the downside risk to the greatest extent possible. However, there are no guarantees and acquiring a shell servicer brings along risk and potential successor liability. This risk needs to be balanced against the future growth and value to be captured by owning a servicing operation, including any related recapture opportunity or ability to seek outside capital looking to participate in the servicing revenues.

Shell transactions can be tricky, but they can also be valuable. Engaging the right team of legal experts and consultants is key to identifying a shell target and getting the deal done. If we can help you evaluate any opportunities, please reach out.

MSR Purchase and Sale Transactions: An Overview

Regardless of whether an owner of mortgage servicing rights (MSRs) is selling the MSRs as part of the sale of its overall servicing business or is just selling a portion of its MSR portfolio in a stand-alone "MSR trade," the process and transaction terms can be very similar, except that a seller of an entire servicing business will be more focused on limiting trailing obligations. The following describes some of the typical features of MSR purchase and sale transactions.

1. **Pricing and the Bid Process:** MSRs are typically offered for sale in a bid process, often handled by a third-party broker engaged by the seller, to obtain the best pricing. The seller or broker will provide a data tape regarding the characteristics of the loan portfolio and proposed high level terms and timing for the transaction. The purchase price

is typically calculated as a multiple of the weighted average servicing fees of the mortgage loans multiplied by the outstanding principal balance of the mortgage loans.

2. **Letter of Intent:** Once a bid is accepted, the seller and the purchaser will usually enter into a non-binding letter of intent (LOI) outlining more specifics regarding the transaction terms and the conditions for closing, including the execution of a binding MSR purchase and sale agreement (MSRPA). If the parties elect not to enter into a hedge with respect to the purchase price at the time of entering into an LOI to protect against interest rate movements, they may contractually provide for a purchase price adjustment (up or down) depending on movements of a designated swap rate between the date of the LOI and the execution of the MSRPA (or the closing date).

3. **Transaction Terms:** In addition to the purchase price, some of the key transaction terms set forth in the MSRPA include:
   - Payment of Purchase Price: The purchase price is typically paid in three installments, with the bulk of the purchase price paid on the closing date (the date on which the MSRs and servicing economics transfer to the purchaser), a smaller portion that is paid on or about the servicing transfer date (the date on which the physical servicing is transferred to the purchaser or its servicer), which is typically 30 to 60 days after the closing date, and a portion that is retained as a "document holdback" until the required mortgage loan documents are delivered to the purchaser or its document custodian.
   - Payment for Advances: In addition to the purchase price for the MSRs, the purchaser will pay the seller for any outstanding servicing advances that have been made by the seller in connection with servicing the loans (so long as the advances were properly made and are recoverable).
   - Representations, Warranties and Remedies: The MSRPA typically will include a number of corporate and loan-level representations and warranties and indemnification and repurchase provisions in the event of breaches of the representations and warranties. In certain cases, the parties will negotiate certain limitations on the remedies, such as sunsets, caps, baskets and minimum claim amounts or deductibles.
   - Servicing Transfer Provisions: The MSRPA will include provisions regarding the seller's obligations to transfer the servicing of the mortgage loans to the purchaser or its servicer, and may include detailed servicing transfer instructions provided by the purchaser or its servicer.

4. **Investor Consents:** In addition to any internal corporate approvals, a condition to closing of the MSR transaction will include obtaining the consent or approval of the owner of the mortgage loans, which may be a government agency, e.g., Fannie Mae and Freddie Mac, or private investors, including securitization trusts.

5. **Other Closing Conditions:** In addition to obtaining investor consents, other closing conditions may include satisfaction of purchaser's due diligence of the mortgage loans and the release of any liens if the seller has financed the MSRs and/or servicing advances.

6. **Post-Closing Servicing Transfer; Interim Servicing:** The physical transfer of servicing of the mortgage loans will typically take place 30 to 60 days following the settlement date for the MSRs. This allows time for the seller to provide required "good-bye" letters to the borrowers and for the seller and purchaser to coordinate the servicing transfer, including the transfer of loan data and servicing files. The seller will interim service the mortgage loans on behalf of the purchaser during the period between the closing date and the servicing transfer date.

Of course, no transaction involving MSRs is identical, especially when it is part of a larger M&A transaction. Hunton's structured finance team has handled dozens of bulk MSR purchase and sale transactions involving mortgage loans with aggregate principal balances of more than $100 billion over the past two years. This industry-leading experience, combined with our deep knowledge of mortgage origination and servicing related M&A, give our cross-discipline team the ability to assist in almost any flavor of transaction involving MSRs.

Q&A with Joe Garrett and Michael McAuley of Garrett, McAuley & Co.

We sat down with Joe Garrett and Michael McAuley of Garrett, McAuley & Co. to talk about the year ahead and what they are seeing in the market. We have had the pleasure of working on transactions with, and across from, the Garrett, McAuley team. In addition to M&A advice, they provide a range of other services, along with producing an entertaining and informative weekly newsletter that is read across the mortgage industry.

Joe and Michael are two separate individuals, but we have edited our conversation for clarity and condensed their thoughts into one for ease of reading.

Q: We have worked with, and across from, your team on multiple transactions, but can you describe what services you provide to clients in addition to advising on potential M&A activity?

A: We work wherever banks and mortgages intersect. We offer a variety of services, one of the primary ones being our FOCIS reviews which is named for its review of financial metrics, operations, compliance and controls, interest rate risk and systems and servicing. We focus on helping banks or lenders increase their profitability and develop best practices. We have specific expertise with regard to the warehouse business and evaluating correspondent origination platforms. That work is personally done by Mike or Joe.

Q: What are your expectations for 2025?

A: In recent years there was a saying, "stay alive until '25" in the industry. Unfortunately, we don't see that statement being true as we head into 2025. Our expectation is that originations will be just as bad or worse in 2025 as they were in 2024. A recent Mortgage Bankers Association survey showed that 71 percent of the industry was profitable in October. This might seem like good news, but the profit margin was only 18 basis points which equates to about $515. That isn't enough to keep a business afloat in the long run.

Q: Well, that isn't too promising. How about servicing assets which have been more popular in the high-interest rate environment?

A: Our focus is origination, but servicing has seemed to perform better in this environment. From our conversations with servicing focused businesses, delinquencies (particularly on Ginnie Mae products) are rising and expected to continue rising and ultimately, most players with their hands in servicing are still tied to, or reliant on, originations to some degree.

Q: Let's end on a more positive note. Where are you seeing originators have success in this difficult environment?

A: Our advice to clients is to not try to be smarter than the competition but to be different from the competition. We've seen clients and other companies have success by moving away from focusing on traditional agency loans and focusing more on Non-QM loan products or other smaller or niche markets, such as manufactured housing. Of course, this may not be for everyone, but it is one area where growth is occurring.

Another bright spot for originators is that their focus on managing cost structures is finally starting to pay off. More widespread adoption of AI and automation tools has allowed for many services that 10 to 15 years ago would have been performed in the "back office" in the US or overseas to be automated. This has allowed originators to save money, even if they were able to outsource some of these services to lower-cost foreign jurisdictions previously. The automation has provided a cost-savings and efficiency gain.

Contact

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