Mortgage Banking Solutions

# Mergers and Acquisitions

## What Mortgage Bankers Need to Know About Creating and Implementing an Exit Strategy

Mortgage Banking Solutions

## Introduction

In the mortgage banking industry, the consideration of mergers and acquisitions is an important component of long-term executive strategy. The merging of one's company with another or the selling of one's company to another is often unplanned. Before adequate preparation for a merger or acquisition can be developed, companies often find themselves facing catastrophic circumstances such as:

- Death of the sole proprietor
- Divorce (failure to create a buy-sell agreement)
- Repurchasing Issues
- Lawsuits and liability issues

Catastrophic events are the worst reasons to sell one's company, because they can potentially reduce or void the company of value. The better reason to sell is to create a purposeful exit strategy.

There is perhaps no industry that is more ripe for the possibility of a merger or acquisition than is the mortgage banking industry. For mortgage bankers especially, the fallout of mergers and acquisitions should not be left to chance. A strong *exit strategy* must be in place for the company to secure against losses and to prepare for potential gains. Implementation of an exit strategy may occur if:

- Proprietors are approaching retirement age
- Net worth will not be sufficient to sustain planned growth
- Net worth is no longer sufficient to sustain repurchase demands
- Additional capital is needed to meet compliance

Most mortgage bankers fail to create a strong exit plan from the onset. The typical proprietor enters into a merger or is acquired by another company inadvertently. The results of poor preparation can be detrimental to both parties involved.

Proprietors who want to maximize the value of their investment activities must always position their companies to sell.

## Why a Proprietor Would Want to Sell

Positioning one's company to sell is the key component of creating an exit strategy. There are many potential benefits a proprietor may claim in selling all or a portion of his business.

- *Being part of a Depository or larger Financial Institution* Selling the business may give the proprietor the opportunity to participate in the market as a better capitalized, more efficient operator. Financial institutions typically don't have much of a mortgage banking presence or an understanding of the mortgage business itself. Many large mortgage bankers are seeking to acquire smaller mortgage companies. The fresh start with a new set of resources may offer the proprietor a chance to be a more viable contender in the industry

- *Acquiring small mortgage bankers*. Many small mortgage bankers will need a home and can be acquired at a reasonable price and terms. Regulatory requirements and new agency requirements for net worth may lead many small mortgage bankers to be willing to sell at less than they may think their companies are worth. In merging a portion of his business in an acquisition, the proprietor will be able to leverage the resources of many smaller mortgage bankers to serve a wider market.

- *Meeting regulatory requirements*. Restructuring the business may assist the proprietor in keeping up with regulations. Certain legal requirements can be easily met through selling a portion of the company.

- *Improving profitability*. In a merger or acquisition, the proprietor may be able to improve profitability for his company as well as the other companies involved. Using derived benefits such as mandatory deliveries, volume incentives, and consolidation of HR and accounting may attain increased profitability.

*The Growth Opportunity in Selling*

To sum up the individual reasons a proprietor may want to sell, it all boils down to the opportunity for growing, becoming more efficient and increasing profit margins and profits.

Growth can be attained by opening more branches and hiring more people; increasing market share and penetrating new markets, bot in the mortgage banking industry, it is often more efficient to grow through mergers and acquisitions. The added value of acquiring resources with existing core competencies in the mortgage banking arena is sufficient for consideration.

## Concerns a Proprietor May Have in Selling

Although selling all or a portion of one's company may bring about many benefits, there are some concerns that need to be addressed.

- First, the proprietor must realize that he is relinquishing a great amount of control in selling his company. He will no longer be the sole decision-maker. When merging with or acquiring another company, the ownership will likely be spread out among multiple players. The proprietor will then have to spread his decision-making authority on business and financial issues out among his other partners.

- Secondly, the proprietor may lose part of his business identity in selling his company. There is an element of ego that plays into a merger or acquisition. The proprietor may have to change his name or key elements of his brand in order to accommodate those of the company or companies he is merging with. Many times, the adjustment of identity loss can be among the hardest transitions for proprietors to make.

- Thirdly, the proprietor must be prepared to cope with the personalities of new ownership. Personality factors play a large role in the ability to make sound day-to-day business decisions. The proprietor must be able to see himself working alongside the owners of the companies he is merging with. Otherwise, it may prove difficult to operate as efficiently and effectively as before the merger or acquisition.

- Finally, the proprietor must be willing to take short-term pay cuts or earnings distributions for long-term growth. Most proprietors are LLCs or S-Corps and have no tax incentive to leave their money in the company. As a result, they typically take large profits out of the company on an annual basis. When a merger or acquisition is completed, however, the corporate structure will likely mandate a substantial decrease in the amount of annual profits taken from the company to increase retained earnings. The trade-off, of course, is that the proprietor will have more sustainable profits in the long-term, but he must be willing to sacrifice large paydays in the short-term.

In addition to understanding the personal losses a proprietor may face in undergoing a merger or acquisition, he also must have a thorough understanding of how the management team of the new entity will be structured.

It is highly unlikely that a proprietor will be able to successfully sell his company and walk away with no involvement and a large sum of cash. Savvy buyers seek out companies who are successful. When a proprietor sells his business, he must be willing to play an active role in its operations--at least initially--in order to maintain the continuity of the company's success. In fact, the agencies; Fannie Mae, Freddie Mac, and Ginnie Mae are very specific they do not want *any* disruption in the continuity of management during a change of ownership.

Companies are successful because of the people who work in them. In order for a successful transition in a merger or acquisition, there should be very little disruption in management. Buyers want to know that the success in the companies they are acquiring or merging with is sustainable. In order to give that level of guarantee, most proprietors will have to remain involved in the company for some period of time.

## Creating an Exit Strategy

The cost of creating an exit strategy, although necessary for the proprietor's sustainable long-term success, can be relatively expensive. The lowest cost is the consulting fee, typically ranging from $15 - 25 thousand. The higher cost can be the implementation and possible restructuring, for the costs may be minimal or very high.

The time-frame for creating an exit strategy is typically around 30 days. It usually takes about a month for consultants to examine a proprietor's situation and lay out a thorough strategy for how he might best position his company to sell when the time comes.

Items that a consultant's report may include are:

- Identification of the company's current position
- Financial modeling for the company's future
- Discussion and strategy on what the company could become
- Strategic recommendations for the company going forward

The actual creation of the exit strategy is the simplest, most painless part of the process. When the time comes to sell the company, it is the implementation of the exit strategy that can prove more difficult.

## Implementing an Exit Strategy

The implementation of the exit strategy can be very complex. The time frame can be anywhere from two weeks to two years, depending on the issues that need to be resolved. Actually putting into practice the exit strategy is, therefore, the point at which consultants become most valuable.

Before implementation, the proprietor must be fully committed to the recommendations consultants make and completing the strategy. Consultants, for example, may see the proprietor has plenty of volume and that a need exists for the implementation of a hedging program and converting from best efforts to mandatory deliveries. Consultants will then bring in one of their people or specialized risk managers to help the proprietor create the right policies and procedures, as well has assisting him in training the staff.

The cost and time of the implementation must be quantified and buy-in from the proprietor is essential. The proprietor must ask himself whether or not each recommendation fits the plan of his target. Many proprietors pick all or several of the consultant's recommendations and start down the path of implementation. Before beginning implementation, it is absolutely essential that the proprietor has a thorough grasp of the time and cost that will be required and the commitment to see the implementation through.

Consultants will also assist proprietors by coaching them on the pitfalls of implementing an exit strategy. Prior to beginning implementation, proprietors will often get resistance in certain areas. For example the implementation of a lock desk, will change the relationship between loan officers and investors, where loan officers are allowed to lock loans directly with investors. Preparing proprietors for resistance is a fundamental aspect of the consulting process.

*Due Diligence*

A core component of implementing the exit strategy is the process of due diligence. Proprietors must be willing to open up their books and have the confidence to allow a team of trusted advisors to look at items of which they may not necessarily be proud. Typically, consultants will want to see production reports, financial reports, and reports on quality control. There will be many areas subject to exploration and much documentation must be made available.

The most difficult and intrusive part of due diligence, however, isn't the exploration of data. Rather, it is the interviews of employees. Consultants will go in and ask people how they do their jobs and how they see themselves in the organization. Questions will be asked as to how employees think the organizational structure could be better, where the problems are that they face every day, and where they think the solutions lie. The verbal side of the interview is often more telling than the documentation.

Typically, consultants will send management a list of data they want to see and create a basic interview schedule. The task of consultants is to make the process of due diligence as painless as possible. Rarely should the process construed as disruptive. The Consultants' task is to enlist the staff to cooperate with them. In good companies, most employees are proud of their jobs and are very forthcoming. It is only in instances where employees or managers feel inadequate or if they have something to hide that the process can be considered intrusive.

## Conclusion

Many fundamental shifts are happening right now in the mortgage banking industry. There is much activity occurring around net worth requirements, changes in loan officer compensations, and adjustments in regulatory compliance.

Many proprietors are exploring their options for mergers and acquisitions. Currently, more questions are being asked of consultants about the transition in merging with and acquiring other companies than have been asked in the past several years.

Many proprietors are asking themselves whether they would be better served by selling their companies and becoming part of something bigger. The trend toward consideration of mergers and acquisitions continues to climb. Mortgage bankers are seeing opportunities to achieve greater success through mergers and acquisitions. To be prepared for the process, proprietors must be ready and willing to seek out the assistance of consultants in the creation and implementation of a successful exit strategy.

## About Mortgage Banking Solutions

Mortgage Banking Solutions is group of mortgage banking professionals who have owned and operated their own businesses and have gained a wealth of knowledge, wisdom, and understanding. As the pre-eminent mortgage banking consulting firm, its mission is to construct for clients their unique roadmap to success, strengthen their operations, and empower them to achieve exceptional financial results.