DALLAS CAPITAL

SUCCESSSTORIES

OWNIT

Nationwide direct mortgage lender

Bill Dallas' candid case study
of a company transformed
by Dallas Capital

PREFACE

This case study is about a mortgage company in the 2000s, a decade that saw the highest highs and lowest lows of anyone's lifetime in the business. It is about a non-agency mortgage product, a type of loan more commonly known as sub-prime. It is about an intimate business relationship with a Wall Street giant who was later seen in a shotgun wedding with America's biggest bank (you didn't want to catch that bouquet). It is about a corporate bankruptcy. In other words, this case study is a success story.

OVERVIEW

National City Bank terminated my employment agreement and non-compete on September 3, 2001. CIVC Partners (First Franklin partner) and I completed the acquisition of Ownit Mortgage Solutions (formerly Oakmont Mortgage Company), a non-agency mortgage lender based in Woodland Hills, California, on December 31, 2003. CIVC Partners and Ownit's new management team led by me invested approximately $35 million to acquire Ownit and to provide the company with growth equity capital to support its growth initiatives.

Ownit Mortgage Solutions became a leading originator of non-agency, residential mortgage loans through a national wholesale network. During 2003 as we took over operations, Ownit's originations topped $1 billion, almost double 2002 originations of $570 million by Oakmont. By 2005 the company was originating close to $1 billion per month with its unique loan offering, The RightLoan, a high-quality, non-agency loan that focused on purchase money mortgages to borrowers with relatively high credit scores.

OPPORTUNITY…SOCIETY AND TECHNOLOGY CHANGE; THE MORTGAGE INDUSTRY DOES NOT

By the 1990s, the standard image of a working father and a stay-at-home mother living in the cul-de-sac was the stuff of TV reruns. Despite the shift in family and career structure, the industry's underwriting guidelines on what constituted "the perfect borrower" were still stuck in the 1960s. These old guidelines were ingrained in the automated underwriting engines developed during the 1990s: Fannie Mae's Desktop Underwriter/Originator (DU) and Freddie Mac's Loan Prospector (LP). It was great technology perpetuating antiquated thinking. Imagine using a smartphone to send Morse code!

It was time for a different kind of pricing engine. Conceived while I was still with First Franklin and refined at Ownit, The RightLoan was a risk-based pricing engine that used FICO, LTV to provide a price for all loans at point-of-sale based on risk grades (1-8) provided by S&P. This was quite a departure from our one-price-fits-all conforming market. The RightLoan was also a consumer brand for the loan product, letting people know they didn't need to be Ozzie and Harriet to get a good mortgage at a fair rate.

CHALLENGES

Ownit's plan was to nestle close to a respected capital partner, use their securitization shelf for The RightLoan, and grab market share as the industry continued to fragment and grow. In September 2005, Merrill Lynch recapitalized Ownit on a valuation of $500 million. I had built our relationship with ML since the First Franklin days when we had securitized three mortgage pools with them. As part of our new dealings, they would provide a $3.5 billion warehouse line to finance new lending and buy a guaranteed two-thirds of our production while having first-look rights with every loan.

The challenge was taking what we needed from Merrill Lynch while balancing their increased control over our fortunes through their 20% ownership stake and board seat. The challenge became more acute as the mortgage crisis grew. My leadership team and I saw the problems early—home prices rising far faster than incomes, early payment defaults (EPDs) and first payment defaults (FPDs) on purchase loans. We reduced high-risk loans, dropping our monthly volume from $1 billion to $600 million. I call that "duck or bleed." You can duck when there's incoming fire in the form of a major market correction, or you can freeze, take hits, and bleed.

WHAT WORKED...AND DIDN'T

Worked: Aggressive use of technology

The 1990s saw the emergence of the search engine as a tool for consumers and businesses. During the 1990s and 2000s, we built on the mortgage industry's versions of this breakthrough to identify and serve a substantial market segment: borrowers who didn't fit Freddie/Fannie's ideas of perfection but were good candidates for a fairly priced mortgage. This drove our product innovation, which is essential in the mortgage industry just like any other.

We didn't let technology trump human expertise and common sense. We used it to enhance those qualities. And we have maintained and grown this technology through successive companies. Ownit is gone, but the best is yet to come thanks to its technological legacy.

Worked: Selling minority stake for big gain

A partner with deep pockets and enthusiasm can drastically raise the value of a company upon buying a minority stake. The tech sector sees this regularly as big players bestow hefty valuations on startups when they take an ownership role.

Ownit enjoyed a similar boost when Merrill Lynch purchased 20% for $100 million, giving us a valuation of half-a-billion dollars. What a difference a day makes!

Didn't: Taking partner that did not share vision
Wait a minute…didn't I just list the ML purchase as "something that worked?" It did on paper but not in the hearts of certain participants. Our vision for Ownit was for the long haul, to develop a technology-based mortgage company specializing in The RightLoan as described. Merrill Lynch's vision was short term and had precious little to do with the borrowers themselves. When Ownit trimmed production to improve loan quality, ML got peeved. They made a billion-dollar play for my former-company-turned-competitor First Franklin due to their voracious appetite for loans to bundle as securities.

Didn't: Excessive interrelation between financing and sales
That subhead is a fancy way of saying "putting all our eggs in one basket," which we did by relying on Merrill Lynch for our warehouse line and our sales pipeline of closed loans. Obviously it was tough to resist ML giving us virtually free money to create loans and eagerly buying those loans once completed. This "excessive interrelation" correlates with any company's overdependence on a single partner in a supply chain and/or marketing channel. Beware.

BIGGEST LESSON(S) LEARNED

Ownit was my powerful lesson in the concepts of Good to Great. We had our BHAG: becoming a national lending leader. We had our hedgehog concept: being the best in the world at our non-agency niche with The RightLoan. We used a technology accelerator with our refined search engine as the core of our offering. And we faced the brutal facts by minimizing risk and finally closing the company at the onset of the biggest economic upheaval in 75 years.

WRAP-UP

While we took steps to eliminate high-risk lending, Merrill Lynch stayed in go-go mode, culminating in their bid for First Franklin. Not interested in a co-owner who would also be a competitor, I started negotiating the sale of Ownit to ML. The deal fell apart as the mortgage crisis accelerated at the end of 2006. At that point, Merrill Lynch turned off Ownit's credit spigot as other big Wall Street companies began demanding that we buy back $165 million in loans they had happily bought from us not long before.

Some people thought Merrill Lynch was trying to control the origination market by shutting down our financial lifeline while vying to purchase other lenders. Others thought we should find a replacement for Merrill Lynch and keep fighting into the new year of 2007. I thought one thing. It was time to close Ownit— quickly, efficiently, and transparently.

It was Christmas time, 2006. I took heat for the decision. It broke my heart to do it. The closure became a bankruptcy when a creditor sued. In the end, we returned approximately $40 million to creditors and $4.4 million to employees in final compensation. It wasn't pretty but it was a far better resolution than seen elsewhere, from Countrywide on down. Ownit was one of the first lenders listed on the infamous mortgage industry Implode-O-Meter. I'm proud of that. We didn't prolong the agony for our stakeholders.