

Subprime lenders see margin compression, mixed growth trends

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By Tim Zawacki

Representatives of four leading subprime mortgage lenders, speaking Feb. 8 during a panel discussion at the ABS West conference, had differing views about the growth outlook for their individual companies, though all agreed that margin compression in their market segment will continue.

Accredited Home Lenders Holding Co. Executive Vice President Ray McKewon reiterated the company's guidance for "modest" origination growth, without providing a specific 2005 target. He also said that earnings growth would decelerate in 2005, in line with Accredited's guidance for profits of \$6.90 per share — a level that would mark a 15% increase from the Thomson First Call mean estimate for 2004 EPS of \$6.00, which itself projects a 20.5% year-over-year gain from 2003 levels. He said that slower earnings growth "reflects the competitive environment, obviously."

Accredited is scheduled to release 2004 earnings before the market opens on Feb. 10.

In a market characterized by two kinds of players — those focused on growing share and maintaining a robust pipeline to keep per-unit processing costs down and those who emphasize disciplined underwriting to keep profit margins as wide as possible — Accredited's McKewon and Centex Home Equity Corp. CFO Jay Bray both stated during the panel discussion that they would not engage in irrational pricing.

McKewon said the subprime mortgage space has attracted financial services firms from "around the planet, with a boxcar full of money," leading to increased competition. Bray said market-share-driven companies need "very aggressive pricing" in order to generate the kind of volume that will permit them to meet earnings targets.

"I don't see it slowing down," Bray said, with respect to competition. But, he added, "We're not in the volume game."

McKewon said his company has adopted a "Dell mentality," in reference to the computer manufacturer that has had to cope with steadily decreasing prices for improved products throughout its existence. The idea, he said, is to "assume that margin compression isn't temporary."

All four panelists outlined different strategies for approaching the current environment.

Centex's Bray said he anticipates a "tough year in the wholesale, broker and corresponding channels," but sees opportunities for growth elsewhere. H&R Block Inc. unit Option One Mortgage Corp. CFO William O'Neill said he expects originations across the industry to be flat to down 10% in 2005. But his firm has been hiring sales people in anticipation of growth of 15% or more, with some of the increased business a product of home-price appreciation, in part.

Washington Mutual Inc. unit Long Beach Mortgage Co. Executive Vice President Michael Giampaolo offered the most upbeat and unique assessment of market opportunities and his com-

pany's approach to them. The company saw business "gain momentum" and "grow at a healthy clip," particularly during the second half of 2004, setting the stage for strong, double-digit loan growth in 2005, Giampaolo said. Long Beach Mortgage will emphasize geographic expansion into the Midwest and East Coast, where its market share trails that of the West Coast, by adding sales people and taking advantage of perceived weakness of regional players.

In addition, Long Beach Mortgage recently unveiled a unique, new 40-year mortgage, which is structured both as fixed- and three-year adjustable-rate products. The company has fielded 300 applications for the product in the short time it has been offered, Giampaolo said.

The 40-year product "offers a nice balance of looking at what's driving the market," Giampaolo said. In the company's core California market, payment affordability is the chief customer concern, Giampaolo said, and Long Beach Mortgage views the 40-year product as a way to meet demand while reducing its emphasis on the controversial interest-only product.

Moody's Investors Service Senior Credit Officer Marjan Riggi highlighted her firm's many concerns about I/O loans during the panel discussion, calling them "very risky."

Although the average FICO scores for I/O borrowers tend to be higher than that for traditional products, Riggi said Moody's biggest concern regards loss potential from "payment shock," particularly in I/O products in which payments reset from fixed to adjustable

rates and then again from interest-only to full amortization. The popular I/O product now comprises up to 60% of some securitized subprime loan pools, Riggi said.

"Buyers are very leveraged ... they have low savings rates," Riggi said. "They're not going to be bailed out by higher prices."

Option One's O'Neill said I/O loans and 80/20 "piggyback" loans, in which borrowers have no immediate equity interest now make up nearly one-third of his company's originations. The company charges an extra 25 basis points for I/O loans, and O'Neill hypothesized that demand for the product will decline as interest rates rise.

I/O loans represent about 15% of Long Beach Mortgage's production volume, Giampaolo said, resulting from strong demand in the high-cost California market. His company qualifies borrowers on the fully amortized pay-

ment, instead of the initial interest-only payment, helping to reduce credit risk.

While Giampaolo conceded that "the economics of the product don't make sense" over the long term," he said, "I don't think we'll see it go away."

Regardless of top-line strategies, subprime mortgage companies will be increasingly focused on expenses in order to grow the bottom line as interest rates rise, executives said. Depending on the firm, there could be considerable leverage on the cost side to help drive future profits.

McKewon said that Accredited's net origination costs are near the low end of the industry range.

"We do," he said, "infatuate ourselves with cost."

Option One, however, does not. And that might change.

"We're certainly not at the lower end," O'Neill said. Expenses will be "an increasing area of focus. We've had

pretty fat margins in the past. Now that margins are being compressed, people are going to have to focus on costs."

Bray said that Centex had hired outside consultants to review the company's processes to determine where efficiencies can be achieved.

"A lot of cost can come out of this business," he said.

Overall, three of the four panel participants said that they remain bullish on the subprime mortgage business, despite its increasing amount of challenges.

"Margins will be compressed for some time, who knows how long," O'Neill said. "But it's still a great business."

McKewon, meanwhile, described his outlook as "sober," though not bullish.

"There are challenges out there," he said. "But they are not insurmountable."

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