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# Pricing, Profitability Stand Out **In Sea of Loan Similarities**

Accredited Home Lenders notched $8 billion in mortgage origination volume last year, while total revenues increased 117 percent. Its secret: profitable non-prime customers.

**by Michael Sisk**

**The salubrious effects of rising home values and low interest** rates are unmistakable at a place like Accredited Home Lenders, which focuses on originating, servicing and selling non-conforming or non-prime loans. For while it remains incredibly cheap to access the hefty paper appreciation of homes, Americans show a fearlessness in the face of increasing debt levels.

Through the use of technology, smart employee compensation and a competitive culture hyper-focused on profitability—"I swear to God the janitors know the company's ROE" of 40 percent, quips one analyst—the San Diego-based company has blossomed in this environment. It has also begun to use securitization to smooth out income.

The firm, which also does business as Home Funds Direct, notched mortgage origination volume of $8 billion last year, compared to $4.3 billion in 2002, an increase of 85 percent; total revenues increased 117 percent to $435.2 million from $200.8 million the prior year. Meanwhile, net income for the year ended at $100 million, or $4.98 per diluted share, an increase of 247 percent over $28.8 million for the year earlier. In a sluggish job environment, the company added generously to its payroll—going from about 1,400 people at the start of 2003 to more than 2,000 at year-end.

The market has certainly taken notice. Since its initial public offering in February of 2003—not particularly great timing given the looming war with Iraq—when the stocked debuted at $7.29, shareholders have been rewarded with a price that has nearly quintupled by March. Per-share earnings estimates for 2004 are about $5.10, giving the stock some room to run this year assuming a multiple of seven to eight times EPS, analysts say.

All this is good news, says Richard Eckert, a senior research analyst at Roth Capital Partners, but there is room for concern. First, any claim the company has some technology that sets it apart from competitors is false. "Sophisticated options adjustment, hedging, prepayment, predictive modeling, the reality is that [such] advanced computer technology is off the shelf now. Anybody can buy sophisticated analytics," Eckert says.

A second major point to bear in mind is the role of securitization in Accredited's success, and the degree to which institutional investors' hunger for the relatively higher yields offered by these non-prime-loan securitizations. Big institutional investors simply can't meet their long-term liabilities with the Treasury market's meager yields. "They just can't do it with Treasurys. They have to look to the asset-backed market. It's a rabid asset-backed market. Investors will pay anything for an asset-backed loan, and so the success is born in the secondary market, not in the borrowers themselves," Eckert says.

This investor demand, plus the still generous warehousing terms—some warehouse lenders will still fund 98 to 99 percent of the loan inventory while a potential securitizer aggregates loans—mean there's virtually no barrier to entry for this type of business, Eckert warns. Given the technology and the demand, "any idiot can originate a loan," he says.

Scott Valentin, an analyst at Friedman Billings Ramsey, which is accompanying Accredited executives on a nationwide meet and greet with investors, concurs, a bit less bluntly, that this is a risk. "Establishing a wholesale lending operation requires a relatively small commitment of capital and human resources," he says. "This low barrier to entry can impact origination volumes, yields and earnings."

What Accredited does very well, however, and what distinguishes it from competitors is its management and its culture, Eckert says.

"What I love is their profit culture," he says. "It's a tightly run ship. Everyone knows what they want to do and are incented to do it. Every mortgage company tries to build a culture, but Accredited does a better job than most. It's a company where they post the performance of loan processing teams internally. Everyone competes. It's great for shareholders."

Valentin opines that Accredited "has created a culture that provides economic incentives to prudently assess the risk in loans, to price the risk accurately and to price the risk to assure fairness to the borrower and profitability for the company. In our opinion, this culture remains firmly intact. ...This culture may sacrifice marginal production volume in the near term, but will produce above-average profitability and returns to shareholders in the long term."

CEO Jim Konrath, former chief executive of Security Pacific Financial Services, along with evp Ray McKewon, a former venture capitalist, founded the company in 1990. Konrath explains that while technology might be off the shelf, the demands Accredited puts on its loan officer to effectively use the technology is anything but standard—and a major contributor to the company's success.

Every account executive carries a laptop into the field and can plug in everything from FICO scores to loan-to-value ratios so that they have a full understanding of what the loan should sell for and how to price it. Many Accredited borrowers are not those with tarnished credit histories, but those that cannot, or choose not to, declare their income when applying for a loan. While they can be tricky to underwrite, they can be very profitable.

"Our executives are not paid on volume, they're paid on profitability," Konrath says. Accredited now has a 1.8 percent delinquency rate on its loans, down from 5.5 percent at the end of 2001. "We incent the account executives to know the loans," he says. "The sales force needs to know the loans and whether they will close. That's a real driver for how we do business."

And it's a business plan that Konrath insists will carry the company through an interest rate adjustment. In particular, he argues that 52 percent of the business is for people taking cash out of their homes or debt consolidation, often for medical needs or because they are otherwise overextended and need money no matter what the rate environment. "That doesn't go away when interest rates increase," Konrath says. "In fact, you could argue it increases. The non-prime cycle is nowhere near as pronounced as the prime cycle," he adds, where borrowers are much more rate-sensitive.

Moreover, he says, an increase of 100 or 150 basis points still puts interest rates at historically low levels that might not discourage purchasing too severely. Konrath says that 39 percent of Accredited's businesses is for purchases and nine percent is rate and return refinancing. "We think the purchase money will continue to grow,' he says. "Our philosophy is to be diversified."

In keeping with this policy, Konrath explains the firm not only sells loans into the secondary market where the loans are often securitized, but Accredited has been increasingly securitizing loans in its own name since 2002, just completing a $500 million deal in February. "Securitization is a bigger part of our business, and we believe it's a basis for steady income," he notes. "The demand for securitization has been strong and consistent for some time."

Given Konrath's observation that the window for securitization is wide open, and analyst opinion that the barriers to entry are so low, is there a risk of the market overheating? Will too many firms jump in and underwrite too aggressively?

Remarkably, says Valentin, the froth is not too abundant. "Competition for loan production and account executives remains intense but rational," he says. "Competitors are increasingly willing to accept lower weighted-average coupons to originate incremental volume. To date, however, the effect of increased competition has been limited to WACs. Broker premiums remain unchanged. This highly competitive environment has not caused any account executive retention issues at Accredited. In our opinion, Accredited, with its hybrid operating model, [its use of securitization] and unique profit-based culture will continue to thrive in this marketplace. Given the overall size of this market and its reasonably fragmented nature, we expect that further consolidation will occur in the industry over the next several years."

FBR's Valentin does note, however, that Accredited has come through a very good year with a lot of debt on its balance sheet, something the company was looking to remedy when it met with investors in March. "Management is evaluating a number of different capital-raising alternatives and corporate structures," he says. "Management is considering straight equity, convertible preferred equity and the REIT structure. With leverage at 16x, the high end of our comfort level, a modest capital raise makes sense in order to grow the on-balance-sheet portfolio. In our opinion, the REIT structure enhances risk-adjusted returns from the portfolio with tax savings."

Valentin says that Accredited's balance sheet is highly liquid and loans could be immediately sold at a premium without any undue financial stress, but, "we believe the increased leverage increases the risk of funding in a more difficult operating environment." And there are other external risks. Fannie Mae and Freddie Mac have increased their penetration in the nonconforming residential lending market in the last few years. If the GSEs elect to expand more aggressively, origination volumes and earnings could be pressured, Valentin says.

Any increase in economic weakness means there could be a decline in real estate values and demand for consumer credit. A decline in real estate values reduces the ability of borrowers to use home equity to support borrowings, since the drop negatively impacts loan-to-value ratios. Additionally, due to the nature of borrowers, the actual rate of delinquencies, foreclosures and losses on these loans could be higher during these periods.

Finally, the mortgage lending industry is highly regulated. Loan originations and purchases are subject to the laws and regulations of each state in which business is conducted. Meaningful changes in local, state, or federal regulations could impact production volumes and earnings. In addition, the Federal Parity Act and several state regulations are being introduced that will require compliance by Accredited and other lenders.

*—Michael Sisk*

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