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A Primer On Structuring Specialty Finance M&A Deals

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U.S. finance companies, particularly in the mortgage, credit card, student loan and nonprime consumer lending industries, were under stress during the credit crisis, and many of these businesses went bankrupt or were sold, shut down or significantly reorganized. In many cases, the beneficiaries of this shakeout were private equity and hedge funds that specialize in credit opportunities and working out distressed assets and businesses. Moving beyond the crisis, the post-credit crisis era of 2011 to 2013, with its low interest rates and relatively easy access to credit, provided a stable foundation for finance companies to recover, grow and make acquisitions. Recent trends driving specialty finance merger and acquisition transactions will inform the parties' decisions as to how to structure the transaction as discussed below.

Increase in Commercial Banks Selling Finance Company Businesses and Assets

U.S. commercial banks have become some of the most active sellers of finance company businesses and assets, particularly in the mortgage industry, in the post-credit crisis environment. A number of factors have driven this phenomenon:

- ***Increased Regulation and Drive to Divest "Noncore" Businesses and Assets.*** First, bank capital requirements and the Volcker Rule have led banks to focus on their "core" businesses and to seek to shed capital intensive "noncore" businesses and assets. The 10 percent cap on insured deposits and the prohibition in Section 622 of the Dodd-Frank Act on acquisitions where the resulting company would have consolidated liabilities in excess of 10 percent of the aggregate consolidated liabilities of all financial companies has helped encourage divestitures by the largest U.S. commercial banks and has created enormous opportunities for nonbank finance companies. These noncore businesses and assets include asset management businesses, private and corporate investment banking divisions as well as mortgage, credit card and student loan businesses and assets, both distressed and performing. Banks are intensely focused on reputational risk and have been challenged by the huge flood of new regulation and the need to work through litigation generated by the credit crisis. If a business or asset is deemed noncore to a bank or finance company, it will not be worth the regulatory and reputational headaches to keep running the business, and a divestiture, even at a relatively low price, will be preferred.

- ***Some Increased Availability of Financing.*** The financing available for consumer assets strengthened in 2011-2013, although capital markets and bank financing for financial assets such as student loans, mortgage servicing rights (MSRs) and nonagency mortgages remains difficult.

Challenges in the Post-Crisis Environment

The current environment for finance company M&A remains active despite several new complications.

- ***Intense Competition.*** Competition for attractive financial assets and businesses has become more intense, driving up prices and creating fewer opportunities for financial buyers. In the mortgage industry, there is a shrinking pool of nonprime and nonagency assets to buy because very few have been originated since 2008, and a number of the new nonbank servicers are competing for this shrinking pool. Private equity and hedge funds are willing to buy down the credit chain to acquire, for example, subprime auto lenders and student loan portfolios, in the search for yield in the current extremely low interest rate environment.

- ***Regulatory Uncertainty.*** There remains a good deal of uncertainty as to how state and federal consumer financial services regulation will affect finance company businesses, with many new Consumer Financial Protection Bureau regulations and hot buttons and a very active group of state regulators, such as the New York State Department of Financial Services. This regulatory uncertainty affects all consumer finance businesses, and these new concerns are starting to be reflected in the M&A transaction process and the structure and negotiation of acquisition agreements.

Portfolio Sale v. Platform Sale

A threshold issue for many finance company transactions, particularly where the buyer's primary goal is to purchase a large portfolio of loans, leases or other receivables, is whether the transaction will be executed as a portfolio sale or a finance company platform sale. A finance company's "platform" includes the assets needed to operate the business, including employees, facilities and real estate, information technology and contracts. Because the finance company platform assets generally include state licenses, change-of-control consents and other state agency notices and approvals may be required. These approvals can create uncertainty and increase the time required to close the transaction.

Many buyers are already in the finance company business and do not need the facilities, people and information technology assets that may be offered as part of a platform sale along with the loans, leases or other receivables and related rights and loan documents included as part of a loan portfolio. These buyers may only be willing to purchase the platform (other than the licenses) as a reduction to the purchase price for the portfolio or may view the platform as a very small part of a much bigger asset play. This view by buyers is more likely where the seller is a large commercial bank that either cannot offer its information technology assets in the transaction or its information technology assets represent older and less versatile solutions than buyer's existing technology.

M&A Deal or Loan Portfolio Sale?

If a valuable operating platform is being sold along with loan assets, a traditional M&A structure (stock, merger or asset purchase) will typically be used, and the purchase agreement will likely contain customary M&A-style representations, covenants and indemnities. On the other hand, if only or predominantly loans or other financial assets are being sold, the parties may opt for execution of the transaction in a manner that is more typical of a capital markets trade and follow a whole-loan portfolio format as described below.

The decision to structure the sale using an M&A or a loan portfolio sale format may depend as much on the expertise of the deal team executing the transaction as anything else. It may also depend on whether the buyer intends to immediately finance the loans in the capital markets after the purchase, in which case a whole loan portfolio execution may be more desirable for the buyer. Finally, the valuation method being used (whole business versus loan portfolio or assets under management) may lead to a particular type of execution.

Advantages and disadvantages of M&A execution include the following:

- ***Ability to Divest an Entire Business.*** A seller that desires to divest an entire business line may find the M&A-style execution more favorable for avoiding trailing liabilities of the business and allowing a "clean break." If the seller divests only the portfolio of assets (and not the platform that supported the operation of those assets), it will be left with a platform (employees, office leases, etc.) that it no longer needs. The buyer will need to consider what effect its acquisition of the operating platform has on value.

- ***Ability to Limit Indemnification Remedies.*** An M&A indemnity regime may allow the seller to cap certain of the buyer's indemnification remedies to a relatively low threshold, such as 10 percent to 20 percent of the purchase price, and to require a relatively high deductible, such as 1 percent to 3 percent of the purchase price, before certain of the seller's indemnity obligations kick in. This may contrast favorably for the seller with a more typical loan portfolio remedy, which is to repurchase individual loans on a loan-by-loan basis if the seller's representations are breached. The warranty repurchase is a remedy borrowed from capital markets transactions such as securitizations. The buyer may seek a warranty repurchase remedy the terms of which mirror as closely as possible the repurchase remedy imposed on the buyer in the capital markets transaction it executes to finance the loan portfolio purchase. If the seller is divesting an entire business line, it may no longer be able to service repurchased loans or may find it cost prohibitive to do so. These differing indemnity regimes have tended to infiltrate both types of deals, with warranty repurchases cropping up in M&A-style transactions and caps and deductibles cropping up in the warranty repurchase remedy of loan portfolio sales.

- ***Ability to Limit Representations and Warranties.*** M&A representations tend to be more general and qualified as to materiality or a "material adverse effect" and knowledge than representations in a whole-loan transaction. The spectrum of representations that can apply to financial assets ranges from the detailed and numerous representations found in capital markets/securitization transactions (e.g., 20 to 30 representations covering the financial assets being financed) to a medium number of representations in performing whole-loan transactions to very limited "as is, where is" representations contained in nonperforming loan sales to what may only be a single paragraph of loan representations in an M&A transaction qualified by materiality and knowledge. Where the buyer has the ability to do extensive diligence on the loan portfolio, an "as is, where is" or more limited M&A-style execution may be possible.

- ***Risk of Receiving a Lower Purchase Price for the Portfolio.*** A disadvantage that may come hand-in-hand with the limited recourse and limited representations points discussed above is that the buyer may pay a lower price for the portfolio. In effect, the buyer may "price in" the cost of its limited rights.

Advantages and disadvantages of a whole-loan portfolio style of execution include the following:

- ***Faster Execution and Lower Cost.*** Because only financial assets are being purchased in a whole-loan portfolio sale, it is typically quicker and has lower legal and other transaction costs than an M&A-style transaction.

- ***Ability to Quickly Finance or Securitize the Loans.*** Execution as a whole-loan portfolio sale will be preferred if the buyer plans to finance or securitize the loans immediately after or simultaneous with the closing of the purchase. The buyer's goal will be to match to the greatest extent possible the representations and covenants it receives from the seller to those demanded by its underwriters and investors in the capital markets.

- ***Ability to Accommodate a Forward Flow Arrangement.*** The whole-loan portfolio style of execution is better suited to a forward flow arrangement, which is a loan sale program that will involve multiple loan sales over a period of time. The seller may seek a forward flow sale arrangement where it has a large portfolio of financial assets for which it can obtain better value by selling in blocks over time.

- ***Retention of Post-Closing Liabilities for Individual Loans.*** The seller may achieve higher pricing in a whole-loan portfolio sale but it will retain trailing liabilities for the portfolio, typically on a loan-by-loan basis. As discussed above, the buyer in a portfolio sale typically seeks to obtain a warranty repurchase remedy to sell individual loans back to the seller if the seller's representations relating to the loans are breached.

- ***Importance of Data Tape.*** The data tape for the portfolio of loans takes on heightened importance in a loan portfolio execution. The data tape typically is a large Excel spreadsheet that contains hundreds of line items, and it may be difficult to verify the accuracy of each and every line item, particularly for an older pool with multiple servicers and information technology systems over time. On the other hand, the buyer must have a high degree of confidence that its data is accurate if it intends to launch a capital markets deal immediately after or simultaneous with the closing.

Whole Business v. AUM Valuations

The pricing for specialty finance acquisitions falls into two primary categories: (1) pricing based on a valuation of the business as a whole; and (2) pricing based on the "assets under management" or "AUM," which are the loans, leases or other financial assets or rights comprising the bulk of the assets being sold. Some transactions share elements of both the whole business and AUM approach. The whole-business valuation approach is likely to lead to an M&A platform sale execution while an AUM approach lends itself to a whole-loan portfolio execution.

- ***When to Choose a "Whole-Business" Valuation.*** Where a business is thriving and purchasing the entire operation, including hiring substantially all the employees, is attractive to the buyer, a "whole-business" valuation may make sense. The buyer may also be more likely to desire the simplicity of a stock acquisition or merger as opposed to an asset acquisition, and may be willing to assume all the liabilities of the business without cherry-picking assets and liabilities.

- ***When to Choose an AUM Valuation.*** If the buyer of a specialty finance business perceives the business as risky, the buyer will more likely structure the deal as a loan portfolio transaction or as an asset acquisition and refuse to assume specified or unknown liabilities. A typical valuation formula for a loan portfolio or an asset acquisition would be some percentage, e.g., 105 percent or 95 percent, depending on the perceived risk of the financial assets, of the outstanding principal balance of the portfolio of loans, leases or other assets. Similarly, in the acquisition of a servicing business, if the servicer receives a 100 basis point fee in the servicing agreements being assumed, the buyer may offer a price equal to the 100 basis points (or 95 basis points again based on the perceived risk of the servicing rights) times the outstanding principal balance of the loans, leases or other assets being serviced. A finance company asset acquisition may become a loan portfolio purchase that is much more similar to a whole-loan purchase or a securitization than a traditional M&A deal. The buyer may close the transaction in multiple closings for tranches of assets as consents to transfer become available, using a structure that is more akin to a whole-loan flow purchase or a securitization.

- ***Combination Type Valuations.*** Specialty finance acquisitions may combine aspects of both types of valuation methods. For example, a financial buyer like a private equity firm or hedge fund may need the origination and servicing platform to run the target business as well as the financial assets of the business. A financial buyer may initially value the business on a portfolio basis and then add a premium for the whole business and assume various employee, IT and other assets and liabilities, such as litigation tied to the business that may be more effectively handled by the owner of that business after closing. In a distressed situation, a financial buyer may insist on buying the portfolio at a portfolio valuation price and essentially purchase the platform for "free" or even value the platform as a subtraction to the purchase price.

- ***Effect of Valuation Method.*** The decision to value a whole business versus a portfolio will generally affect all the deal terms, including the representations, covenants and of course the purchase price mechanics. For example, a portfolio-based valuation will lead to more extensive representations as to the financial assets being purchased and the financing agreements with customers and lenders related to the financial assets. Operations-based representations, such as, for example, those relating to real property and real property leases, employees and employee benefits or environmental issues of the business, will be less important. Some representations, such as those relating to the financial assets themselves and information technology, will likely be relevant to a finance company business regardless of the valuation method. Similarly, covenants between signing and closing will vary depending on whether the focus is the entire business or the portfolio alone.

Purchase price mechanics will vary depending on the valuation method used in calculating the purchase price. If the purchase price is based on a valuation of a whole business, the purchase price may include a traditional adjustment for changes in the working capital (current assets less current liabilities) or the net assets (total assets less total liabilities) of the business from the last audited balance sheet prepared prior to closing or the balance sheet on which the valuation for the initial offer was prepared.

Where a portfolio valuation method is used, the purchase price will be tied to the fluctuations in the portfolio. Thus, if the purchase price is 105 percent of the aggregate outstanding principal balance of the loans in the portfolio, the price will go up or down based on the size of the portfolio. For a healthy business, new loan originations may equal or exceed the loans being paid down so the purchase price will likely go up. In a distressed situation, the portfolio typically will decline as loans pay down or are written off.

More complicated mechanics may include an audit of the loan portfolio to ensure that the loan amounts are correct and are being properly serviced. Classic areas for dispute may be inadequate or overly generous loan reserves or changes in the collection strategies or advancing practices by the seller or buyer. The seller's compliance with its financing or securitization agreements can also affect the portfolio valuation.

Once the transaction structure (portfolio versus platform sale) and the valuation and pricing method (AUM versus whole business) are determined, the rest of the transaction terms should support the structure and valuation method chosen.

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