



Five Reasons To Avoid Subprime Bargains

Howard H. Newman 03.28.07, 3:20 PM ET

With the subprime sector bloodied, many contrarian investors are now wondering if it's time to jump back in. While we firmly believe that the subprime mortgage market will ultimately yield attractive investment opportunities, it is not yet "prime time" for subprime. Put simply, the situation is too volatile. The macroeconomic trends and market psychology are still evolving, and it's exceedingly difficult to make responsible investment decisions about subprime assets or companies.

Some institutions with a strong risk tolerance will undoubtedly take advantage of short-term opportunities to acquire deeply discounted assets or companies and trade out of them when valuations permit. Long-term investors, however, should look for certain "mileposts" before committing capital in the current subprime environment. We believe there are at least five issues that must be resolved--or at least clarified--before an institution with a long-term time horizon can invest with confidence in the subprime market:

Excess subprime origination capacity must be destroyed.

Subprime originations jumped from less than \$140 billion in 2000 to roughly \$650 billion in 2006, growing to over 22% of all originations. Today's markets cannot support this level of subprime volume, and the subprime market will not be stable until the surplus origination capacity has been eliminated. The process is underway, with leading subprime originators on the ropes (or worse) and with broad-line originators materially adjusting their underwriting standards for subprime loans. It is far from clear to us, however, what the equilibrium level of subprime mortgage origination capacity may be, particularly because of the potential for material changes in the business as a result of regulatory and other pressures.

The housing market must stabilize.

In the next year or two, many subprime adjustable-rate mortgages (ARMs) will reset. Studies indicate that borrowers with "teaser" rates (over 20% of ARMs issued during the peak of the boom carried teaser rates well under 5% per annum) will face up to a doubling in their monthly mortgage payment. Other borrowers using non-traditional mortgage structures, such as negative amortization loans, will face similar stress. During the boom years, such borrowers could rely on housing price appreciation or a benign interest rate environment to allow them to refinance (often at higher valuations and loan-to-values). That environment no longer exists.

The reset wave is expected to fuel a rise in delinquencies and foreclosures, resulting in additional erosion of home prices, with the potential for cascading further defaults as a result. Housing prices, and the amount of mortgage debt underlying them, must fall until the subprime consumer can service the debt on economic, non-"teaser rate" terms. Until we can better quantify the potential exposure to a downtrend in housing, subprime assets are no bargain.

Subprime paper must be repriced.

While the market for subprime mortgages, mortgage-backed securities and hedging instruments has

stabilized recently, the full impact of the ARM adjustments described above, possible rating agency actions, regulatory changes and other factors is still unknown. In short, the market lacks sufficient information to permit an investor to properly price these securities.

In addition, the supply of capital to purchase subprime mortgage securities is also in flux. During the real estate boom, Wall Street had successfully accessed the global liquidity surplus with a steady stream of mortgage-related products, each incorporating leverage (and, in some cases, leverage on leverage). Many of the holders of this paper have recently faced mark-downs or taken losses, often leading to reduced supply of capital. While opportunistic hedge fund capital may fill some of the shortfall, we would expect that overall supply of capital will decrease, at least until some of the smoke clears, with prices falling accordingly.

The regulators must respond.

The subprime debacle has uncovered various abuses in underwriting, such as failures to disclose “real” costs to borrowers, among other “predatory” activities. We do not yet know how the regulatory authorities will respond to these abuses. Since any new regulatory restrictions could affect the profitability of subprime (or even prime) mortgage products, serious investors should take a “wait and see” attitude.

In addition, there is at least some probability that a regulatory crackdown could drive more capital from the market for subprime mortgages, making it more difficult for borrowers to refinance out of their existing precarious situations and exacerbating the foreclosure wave. Regulation often carries with it unintended consequences.

The impact on the wider economy must be considered.

We have heard reassuring utterances that subprime paper constitutes a fraction of the total mortgage market and, therefore, the current meltdown should not be a major strain on the economy. The fact remains, however, that money is fungible. So, for example, we cannot yet determine the extent to which a tightening of credit for subprime mortgages will spread to other forms of lending (e.g. credit card debt, auto loans) to less-than-creditworthy consumers. It would not surprise us if subprime mortgage-type underwriting looseness had infected other consumer markets.

It is also uncertain which institutions are holding most of the subprime mortgage securities and how their balance sheets will be affected. Another unknown is how seriously the subprime mortgage meltdown will hit the investment banks that have derived substantial fees in recent years from the packaging and sale of subprime paper (and which often retained the riskier elements of those transactions). Without a clear sense of the role of subprime credit in the overall economy, any investment decision is, at best, guesswork.

To be sure, we are already seeing some investors venture into the subprime market, such as the recent \$200 million liquidity infusion provided to Accredited Home Lenders (nasdaq: LEND - news - people) by Farallon Capital Management and the purchase of a \$1.7 billion subprime portfolio by an affiliate of Fortress Investment Group (nyse: FIG - news - people). Such examples aside, I believe it is still early in the game to be making long-term bets on the direction of the battered subprime mortgage market. Investing now, absent a better understanding of the risks and stronger signs of stability, is like trying to catch the proverbial falling knife.

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