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Opportunities in a Volatile Financial Services Investment Environment

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Even during more stable times, investing in financial services requires a specialized understanding of elements unique to the sector. In today's extended global financial crisis environment, many symptoms of the crisis are still exigent and the regulatory environment remains in extreme flux. As a result, private equity investors must remain hyper-focused on understanding and addressing significant environmental risk factors while taking advantage of the volatility and dislocation to acquire and build sustainable businesses.

Two areas of particular interest to private equity financial services specialists are U.S. housing finance and commercial specialty finance, aka "non-bank lending."

Housing Finance

It is hard to argue that the U.S. housing finance market is not dislocated and that it will not remain critical to the U.S. capital markets. It is unclear how the market will be reformulated after the repurposing of Fannie Mae and Freddie Mac, and after the federal government reduces its direct support.

Investing in mortgage origination means betting that current peak origination spread will endure, and requires a belief that the current unprecedented government support for the mortgage market (to reduce rates and make housing affordable) will continue

long enough to justify a high entry price. Wholesale funding also must remain available should another market shock occur. Businesses that hold residential mortgage credit risk while bearing the credit, regulatory, interest rate and funding risks associated with building a mortgage asset balance sheet are difficult to back.

If the goal is to build a sustainable long-term business franchise with access to well-priced long-duration residential mortgage risk, then financing a business that can manage credit risk, flex with the environment and that has significant funding advantages is critical. One method of developing such a franchise requires investing the time and capital to build an underwriting platform using the private mortgage insurance infrastructure to mitigate funding risk, resolving funding risk through regulatory, insurance-based operating leverage. The platform must also be capable of operating effectively in today's federal government-driven environment while being able to pivot with changes in housing finance. Having one's ears and eyes open to political and regulatory changes around housing finance is vital as well.

Commercial Specialty Finance

Specialty lending franchises represent another opportunity. As depository institutions tighten underwriting guidelines, specialty markets are undergoing a transformation. Some loan or security types will be banished for a long time from deposit-funded balance sheets. Others, such as leveraged loans for private equity buyouts or certain types of less liquid asset-backed lending, may have taken a temporary hiatus.

When building specialty loan origination and balance sheet businesses, several questions must be addressed:

a) Can the team and business access enough of the target business on projected terms to pay for overhead and achieve a sufficient return?

b) How will the loans be funded beyond the equity from the private equity sponsor, in particular under duress?

c) Assuming the business can access loans and financing, what is the natural ultimate home for the business? Can the assets belong on the balance sheet of regulated retail deposit-based institutions and therefore attract a premium valuation?

Answering these questions directly and concretely rather than with hopes and history-based expectations is crucial. An informed point of view based on direct market experience and interaction with those who work with bank regulators can help answer questions (a) and (c). When addressing the funding conundrum in (b), arranging wholesale bank-provided financing that can be termed out and where the term matches the life of the assets originated is a requirement. The extra cost of these match term financings must be built into the charge to the borrower.

The financial services private equity investor can count on very little in today's post-financial crisis environment. The dimensions of uncertainty are significant and unparalleled. While daunting, such uncertainty creates significant opportunities for investors with an experienced and balanced perspective—one that comes with being sector and subject experts.

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