SPECIAL REPORT

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High-Touch Servicers Carve a Niche in Mortgage Industry

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In this Report

With Basel III looming on the horizon, more and more big banks are exiting the mortgage servicing business—but the transition is only getting under way. The large pool of mortgage servicing assets still on their books poses even more tremendous growth for nonbank specialty mortgage servicers **Nationstar** (NSM) and **Ocwen** (OCN).

As big banks bow out of the mortgage servicing business due to headwinds from regulatory scrutiny, Basel III capital requirements, and persistent litigation issues, nonbank specialty servicers have stepped in to fill the gap. Not an easy task. Several smaller servicers have shut their doors, leaving experienced, major players like **Nationstar Mortgage Holdings** (NSM) and **Ocwen Financial** (OCN) to emerge as best equipped to service distressed loans. Demand for servicing has already propelled both Companies into the top 10 servicers, right there with big banks. Capitalizing on a shift that is still in its infancy, both Companies have already launched complementary services to ensure their profitability beyond this shift, and we view these Companies as attractive prospects for investors looking to enhance long-term positions in the mortgage sector.

Nationstar and Ocwen are experts in high-touch servicing, a process that involves frequent borrower interaction to improve loan performance and reduce loan defaults and foreclosures. These Companies play a crucial role in the nation's massive mortgage market, where consumers owe $10 trillion on their homes. Their role is underscored further in a market environment with elevated numbers of delinquencies, foreclosures, and liquidation proceedings.
Both Companies have grown their respective servicing portfolios considerably by acquiring a large pool of banks' mortgage servicing assets. Though not subject to Basel III capital restrictions, it remains imperative that both Companies maintain due diligence

As of 3/5/2013	Nationstar	Ocwen Financial
Symbol	NSM	OCN
2012 price performance, %	115*	139
P/E ratio	22	31
Market cap (billion)	$3.7	$5.7
Shares outstanding (million)	90	136
3-yr revenue growth rate, %	117	37
3-yr earnings growth rate, %	N/A	27
2011 pretax margin, %	5.5	27.3**
2011 ROE, %	7.8	7.7**
2011 cash flow per share	$0.37	$1.17**
RS rating	98	98
A/D rating	B+	B+
Employees	4,900	7,641

*IPO in March 2012
**2011 data used for comparability. 2012 data available.

in protecting borrowers' rights during the servicing or foreclosure process, or else they will suffer similar regulatory sanctions to those that have plagued big banks. Provided that they remain vigilant in complying with federal, state, and local government regulations, we see considerable growth opportunities for these Companies, as big banks unload more of their mortgage servicing portfolios to focus on brokerage and core banking activities. Nationstar and Ocwen have also developed complementary mortgage services to existing customers to capture multiple revenue streams.

Shift Toward Specialty Servicing[1]

Q3 2011			Q3 2012 (Pro Forma)		
Rank	Servicer	UPB ($ in bil)	Rank	Servicer	UPB ($ in bil)
1	Bank of America	$1,934	1	Wells Fargo	$1,879
2	Wells Fargo	1,814	2	Bank of America[2]	1,157
3	Chase	1,191	3	Chase	1,056
4	Citi	562	4	Citi	472
5	Ally Financial	382	5	Nationstar[3]	425
6	US Bank	227	6	Ocwen[4]	362
7	PHH	178	7	US Bank	260
8	Sun Trust	161	8	Walter Inv. Mgmt[5]	222
9	PNC	134	9	PHH	185
10	OneWest	130	10	Sun Trust	149

UPB - Unpaid principal balance

■ High-touch servicers

1. Source: Inside Mortgage Finance as of 9/30/2012.
2. Pro forma for the sale of $306 billion in UPB to Nationstar and Walter Investment Management.
3. Pro forma UPB includes Q3 2012 end of period UPB, $13 billion BofA closed acquisition in Q4 2012, and $215 billion BofA acquired portfolio announced 1/7/2013.
4. Pro forma includes subservicing. Adjusted to exclude ResCap's master servicing contracts of $46.0 billion.
5. Pro forma includes $50.4 billion of ResCap UPB and $90 billion of BofA acquired portfolio.

Nationstar Mortgage Holdings (NSM)

Nationstar Mortgage Holdings Inc. is a top nonbank residential mortgage servicer with a fully integrated residential loan origination platform that addresses primarily conventional agency, Federal Housing Administration (FHA), and Department of Veterans Affairs (VA) loans. The Company had its IPO in March 2012 but is not a newcomer to the mortgage business. Its roots started in 1994 when it was a division of Centex Homes. The Company is now wholly owned by Fortress Investment Group (FIG) and currently services both prime and subprime loans, traditional and reverse mortgages, and Government-Sponsored Entity (GSE) loans. The Company's Solutionstar business also provides a broad array of services, including brokerage, title insurance, loan settlement, appraisal, and recovery processing services.

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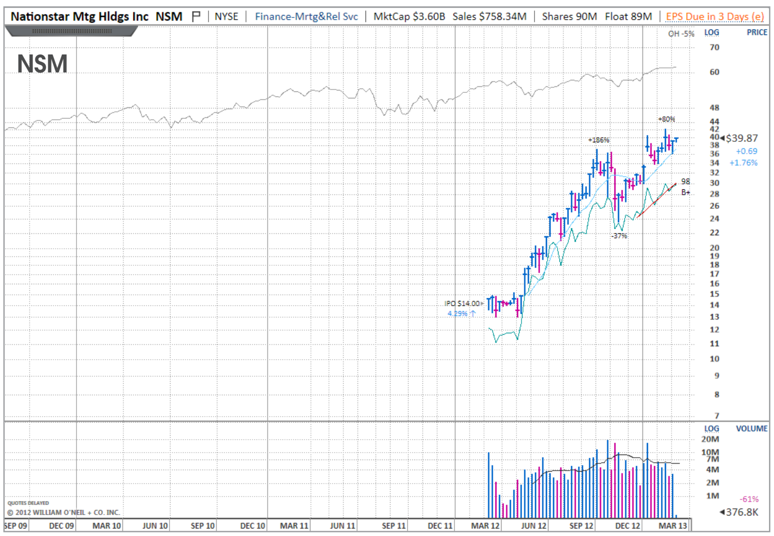
Mortgage Industry Terms

High-Touch Servicing focuses on loss mitigation and frequent interactions with borrowers —via telephone, mail, electronic communications, and other personal contact methods.

Mortgage Servicing Right (MSR) refers to the right to service a loan or pool of loans and to receive a servicing fee. Servicers like OCN and NSM typically receive an annual fee from about 25 to 50 basis points on the average unpaid principal balance of loans serviced.

Compared with other publicly traded specialty servicers, Nationstar has experienced the largest ramp-up in its mortgage servicing rights (MSR) platform. Including its recent Bank of America acquisition of $215 billion in residential MSRs, the Company has acquired more than $300 billion in combined MSRs from banks in the past two years alone. The quick boarding of these MSRs to its servicing platform has enabled Nationstar to achieve 85% growth (year-over-year) in its nine months 2012 servicing revenue — composed of primary servicing, subservicing, and reverse-mortgage servicing income. From 2011 to present, it nearly doubled its number of employees, from 2,599 to 4,900.[1] The Company's fourth quarter and annual 2012 results are due on **March 7, 2013**.



Source: PANARAY

Ocwen Financial Corporation (OCN)

Ocwen specializes in servicing distressed residential and commercial loans. The Company has been servicing residential mortgages for over 20 years and subprime loans for 18 years. Ranked the fourth-largest subprime servicer in 2010, the Company is now the top servicer of subprime loans in the U.S. to date, after a slew of MSR acquisitions in the past several years that included those from JPMorgan Chase, Goldman Sachs, Barclays PLC, Ally Financial, Residential Capital, and Bank of America.[2] Between 2010 and 2011, employee growth has more than doubled, from 2,274 to 5,063 employees.[3] When the Company reported 2012 earnings last week, it clocked its **highest growth in servicing revenue since 2009**. In the past three years, Ocwen's annual servicing revenue increase has accelerated — achieving growth (year-over-year) of 23%, 43%, and 75% (see chart on next page).

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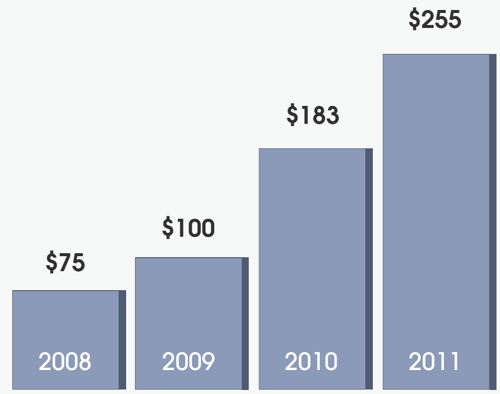
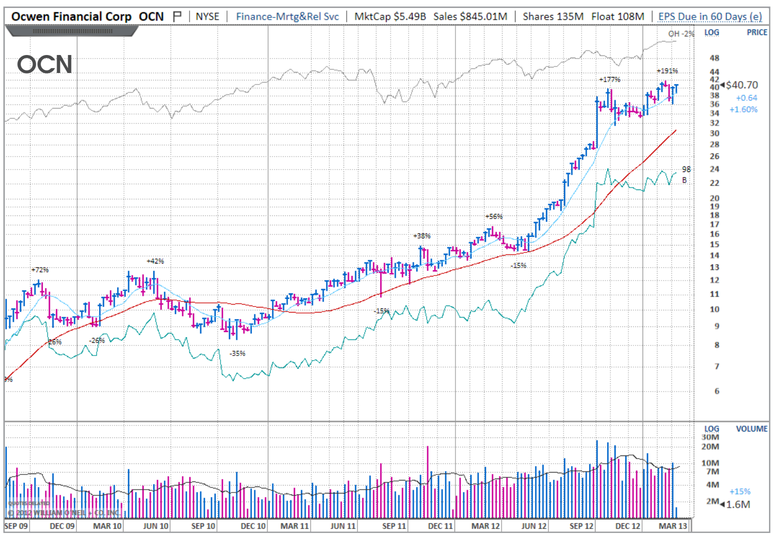
Nationstar Servicing Revenue (in millions)



The efficiency of Ocwen's loss mitigation technology platform and its large offshore operations drive its competitive advantage. It is known as the lowest-cost mortgage servicer in the industry, a quality that has eluded banks and other smaller servicers. Ocwen uses high-tech methods when handling payment collections for non-performing loans and employs a team of 16 social psychologists to write scripts for call-center employees. As employees communicate with borrowers on the phone, they receive bits of dialogue from a computer program that monitors and formulates a response based on homeowner responses.[4] Per its 2012 10-K filing, the Company currently employs 67% of its workforce in India, which includes customer service, collection, and loss mitigation representatives. Ocwen has had operations in India for more than 10 years.



Source: PANARAY

New Regulations Restructure the Servicing Landscape

Big banks have been left reeling from stricter regulations imposed on them as a result of the 2005-2007 financial crisis. The imminent Basel III rules will require banks to either hold more capital for mortgages serviced or reduce the premium placed on the value of their MSRs. In the past, MSRs could account for 100% of equity. Basel III limits that amount to 10% and forces banks to reserve more capital against any excess claims. As a result, larger banks such as Goldman Sachs, Morgan Stanley, and Bank of America have sold their mortgage business units or sold portions of their servicing portfolio to specialty servicers. Bank of America announced last month that it was selling servicing rights on $215 billion mortgage

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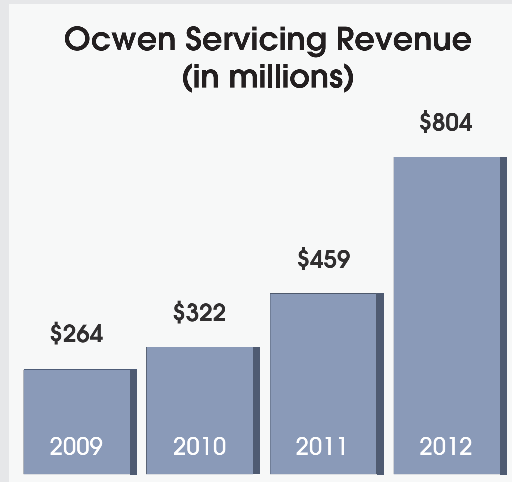

assets to Nationstar with plans to sell another $100 billion more.[5] Bank of America is purported to be leaving the mortgage servicing business entirely in order to focus solely on core banking and brokerage operations.

Banks have also been plagued with a string of legal settlements. Their inability to service the high number of distressed and credit-sensitive loans has led to a high volume of foreclosure cases, which simply overwhelms their mortgage service operations. Last year's $25 billion settlement against five of the largest mortgage servicers, Bank of America, Wells Fargo, J.P. Morgan Chase, CitiMortgage, and Ally Financial (formerly GMAC), is a testament to this. The settlement was a result of unfair and deceptive business practices, including the so-called robo-signing fiasco, an unscrupulous practice that involved servicer staff signing foreclosure related documents outside the presence of a notary public, without verifying if the facts contained in the documents were correct.[6] In early January 2013, banks received another slap on the wrist, as federal regulators finalized a new settlement with 13 banks, worth $9.3 billion, for deficient mortgage servicing practices. The banks included in the settlement were Aurora, Bank of America, Citibank, JPMorgan Chase, MetLife Bank, PNC, Sovereign, Sun Trust, U.S. Bank, Wells Fargo, Goldman Sachs, HSBC, and Morgan Stanley.[7]

With the top four banks alone currently servicing close to 49% of total loans in the nation, a large pool of mortgage servicing assets are still on their books. This presents a tremendous growth driver for specialty servicers like Nationstar and Ocwen. In the wake of Bank of America's sale of some of its high-risk servicing assets and its expected exit from the mortgage servicing business altogether, other big banks are expected to follow suit as Basel III looms closer to implementation.

The MSRs that banks have yet to unload have the potential to provide a substantial source of servicing income for high-touch servicers. In addition, nonbank servicers are exempt from Basel III regulations, which allow them to capitalize on MSR sales. This paradigm shift in the mortgage industry has clearly favored Nationstar and Ocwen, evident in the Companies' climb into the top 10 mortgage servicers in the nation in terms of unpaid principal balance. (see chart on page 2 for reference).

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Adapting to Market Dynamics

Nationstar and Ocwen have modified their respective business models to remain focused on maintaining long-term profitability. Major lenders have all but stopped originating subprime loans, and while big banks still carry a large portion of these distressed loans, acquiring the MSRs to these portfolios alone may not provide an indefinite source of servicing revenue for specialty servicers. Ocwen and Nationstar have anticipated this outcome by providing complementary business services that allow them to efficiently maintain a steady supply of mortgages to service, which can expand profit margins. Due to the capital-intensive nature of owning MSRs, both Companies have also transitioned to a "capital light" approach through subservicing and the co-ownership of MSRs.

Complementary Mortgage Services

Through selective and transformative acquisitions, these Companies provide additional services, such as loan origination, appraisal, title insurance, and settlement. In 2012, mortgage lenders originated $1.273 trillion in conventional conforming mortgages, the highest level since the all-time record of $2.460 trillion was set back in 2003.[8] Ocwen entered the residential loan origination business in October 2012, with its acquisition of Homeward Residential. Homeward's loan origination platform includes correspondent and retail lending, which targets high-quality prime mortgage loans. The platform will provide Ocwen with organic growth and enhance its ability to work with existing borrowers on refinancing opportunities.

Nationstar already has an existing, fully integrated loan origination platform that complements its servicing business. The Company broadened its mortgage business further with its recent acquisition of Equifax Settlement Services Holdings LLC (ESS), a provider of appraisal, title insurance, and settlement services in the U.S. After boarding ESS to its existing Solutionstar platform, the Company estimates that it can generate $16 billion and $20 billion in loan originations in 2013 and 2014, respectively.[9] The chart on page 7 shows a list of businesses that each Company acquired to expand its existing mortgage platform.

Capital Light Approach

MSR ownership is a capital-intensive business, since it requires servicers to front the principal, interest, tax, and insurance (PITI) payments in advance for payments that are late. Nationstar has en-

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tered into a partnership with New Castle Investment Corp. (NCT) wherein MSR ownership is split between the two. This MSR co-ownership with NCT allows Nationstar to grow its servicing portfolio without having to finance the capital to fund 100% of the MSR purchase price. This capital light model is similar to the OCN and affiliate company Home Loan Servicing Solutions (HLSS) model, where MSR ownership is divided between the two firms. HLSS was a spin-off of Ocwen and was created to be an income vehicle. The ultimate goal of such a partnership for both Companies would be to free up capital to acquire and service more loans.

Nationstar and Ocwen have also focused on subservicing contracts with banks and other mortgage owners seeking to improve underperforming loans. Subservicing allows the Companies to operate as a "fee-based servicer" by contracting with the MSR owner to service the mortgage for a fee per loan. These contracts are awarded at a no-cast basis and do not require substantial capital.

Regulatory Risks

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 essentially grants the Consumer Financial Protection Bureau (CFPB) rule-making authority in many of the federal consumer protection laws applicable to mortgage servicers, including the Truth-in-Lending Act (TILA) and the Real Estate Settlement and Procedures Act (RESPA). Ocwen and Nationstar have both grown their respective mortgage business so quickly that it remains crucial for each to maintain the standards set forth by constantly changing regulatory compliance mandates, or else suffer sanctions and elevated costs. In December 2012, a consent order from the New York Department of Financial Services (NY DFS) required Ocwen to hire an independent Monitor, as certain gaps in its operations were found. The Company has agreed and is in the process of selecting one. Fannie Mae (FNMA) and Freddie Mac (FHLMC) have expressed concerns with Ocwen's predominantly offshore operations, but with the closing of the Homeward acquisition, Ocwen will be expanding its U.S.-based operations to address this issue.

In January 2013, the CFPB issued final guidelines governing examination procedures for mortgage servicing to protect consumers, which is expected to take effect in January 2014. This should give mortgage servicers sufficient time to install the proper quality-control measures, if current staffing and infrastructure operations are lacking.

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Business Acquisitions

	OCN	NSM
Reverse Mortgage Origination	✓	✓
OCN - Genworth Financial Inc (Oct 2012)		
NSM - MetLife (Apr 2012), BofA (Dec 2011)		
Appraisal, Title Insurance, and Settlement		✓
NSM - Equifax Settlement Services (Feb 2013)		
Prime Loan Origination	✓	✓
OCN - Homeward Residential (Oct 2012)		
NSM - fully integrated since 2007		

ENDNOTES:

1. Nationstar Mortgage Holdings 2011 S1 filing and February 8, 2013 investor presentation, http://investors.nationstarholdings.com
2. Housing Wire, Ocwen set to become nation's largest subprime servicer, http://www.housingwire.com/news/2011/08/04/ocwen-set-become-nations-largest-subprime-servicer
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9. Housingwire, FBR: Nationstar will capitalize on special servicing, http://www.housingwire.com/news/2013/02/05/fbr-nationstar-will-capitalize-special-servicing

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