DIAMOND HILL

INVESTED IN THE LONG RUN

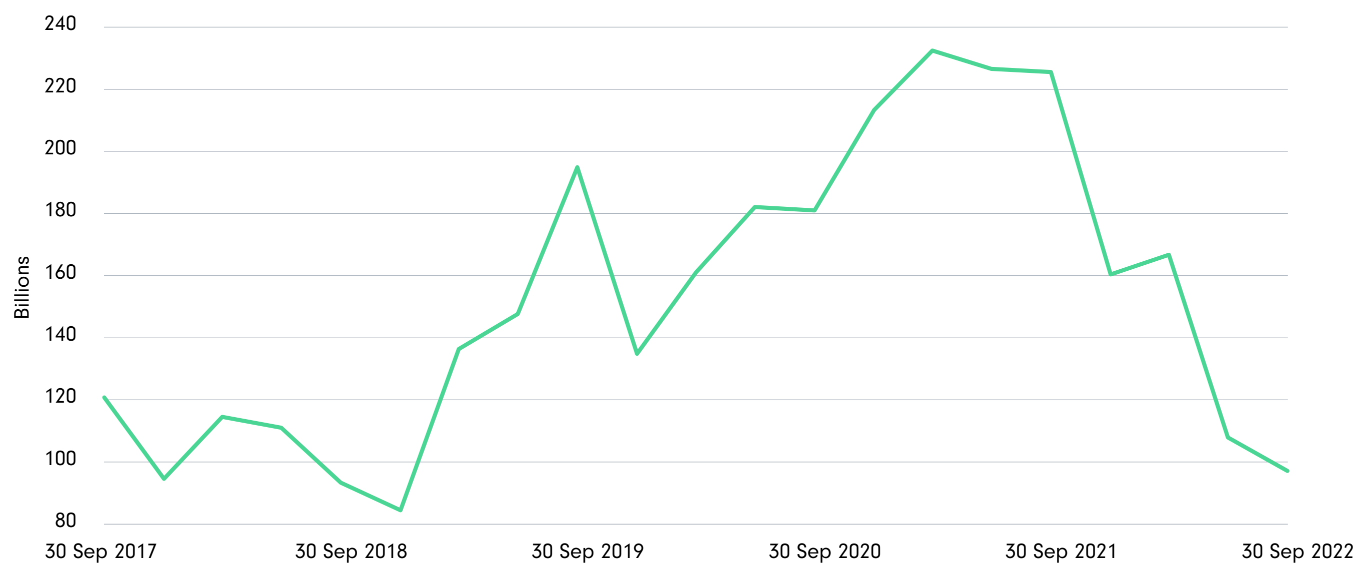
How Mr. Cooper Group Is Flying Under the Radar

Apr 2023

The last 12 months or so have been both a fascinating and challenging time for housing markets. Moving from a period of rapidly rising home prices to one of rising interest rates and cooling demand has been a headwind for both new and existing home sales. Companies that derive profits from housing market transactions have seen earnings fall, including the largest non-bank mortgage servicer in the US, Mr. Cooper Group.

The slowdown in home sales has impacted Mr. Cooper most directly via their mortgage origination segment — in recent quarters it's been earning around $40 million to $50 million, about 10% of levels seen at the peak of the housing boom during the pandemic. This reduction in earnings coupled with a drop in volumes — about 20% compared to peak pandemic levels — is a headwind for the company. But its mortgage-origination segment has never been the whole story for us. Instead, we've focused on overlooked parts of the business that we believe will be more impactful to the long-term value of the franchise, namely the mortgage servicing business and the real estate exchange platform.

Exhibit 1 — New Mortgage Originations ($)



Source: Federal Reserve Economic Data (FRED), large bank consumer mortgage new originations.

As the largest non-bank mortgage servicer in the US, Mr. Cooper services over $800 billion in loans and owns the largest online exchange for foreclosed properties, providing interesting contrasts with the origination segment given the company's exposure to different areas of the market. The profitability of its servicing business is challenged in a low interest rate environment as refinances increase and mortgage originations boom, which we saw play out in 2020 when the servicing segment was essentially at breakeven profitability. Today, however, this segment is earning nearly $150 million a quarter in profits, which will partially offset declining profits in the origination segment due to the recent slowdown in new home purchases and refinance activity.

On the foreclosure side, activity has been nearly non-existent over the past few years given the moratorium on foreclosures during the pandemic. However, as moratoriums are lifted, a record inventory of properties are set to be sold on the exchange, meaning a currently breakeven segment of the company will revert to more normalized profitability of $100 million to $200 million annually.

The management team is also an important part of the story for Mr. Cooper. Smart bolt-on acquisitions and divestiture of non-core assets served to balance exposure to originations and servicing, enabling the company to stay profitable despite volatility over the past few years. As a result, the company has been able to maintain a strong balance sheet and realize some of its deferred tax assets, increasing free cash flow and further increasing value for shareholders via buybacks and organic growth investment. Management has also indicated a desire to sell the foreclosure exchange platform when earnings in the segment normalize, which would monetize a hidden asset and allow them to further utilize deferred tax assets.

We believe Mr. Cooper is a differentiated business model relative to its mortgage market peers and is well-positioned to outperform through the difficult transition to a higher interest rate environment. With its small market capitalization and hidden assets, we believe Mr. Cooper has escaped the view of most investors. As long-term, intrinsic value investors, we've been able to develop a solid understanding and unique perspective of the business and believe their balanced portfolio will continue to prosper through all phases of the mortgage cycle.

As of 31 March 2023, Diamond Hill owned shares of Mr. Cooper Group.