



Performing Loan Arbitrage Opportunity

November 15th 2022

Since the Federal Reserve began aggressively raising interest rates earlier in 2022, the resulting volatility created in financial markets has had a particular impact on the secondary market for residential whole loan mortgages. In addition to banks and insurance companies, a significant portion of the market demand for pools of recently originated mortgages comes from private equity sponsors using leverage to purchase or from aggregators planning to securitize these pools and sell off securities. Fast moving rates have shut down these industries: there are few securitization bids and leverage buyers can't price their spread when rates are so volatile. It has caused a huge discount in the marketplace currently, one that will continue until volatility levels off, currently projected by many to be Q3 2023. The largest market for must sell performing loans are small pools of Fannie Mae Scratch-n-Dent (repurchases). These are the highest quality loans, short of a fully insured mortgage, and when Fannie kicks these loans back to originators, they become must sell product, especially in an environment of rising rates.

State of the Secondary Market & Recent Case Studies:

Hundreds of millions of dollars of scratch-n-dent performing qualified mortgages are offered every month in the secondary market. We are seeing Seller volume gaining momentum and a re-emergence of previously dormant loan sale platforms specifically catered to sell bank loans.

1. Rocket Mortgage 2nd Quarter Scratch-N-Dent Offering May 2022: 1st signs of dislocation with the Performing SnD bid in the mid-70s UPB, just above NPL trading low 70s
2. Summer 2022 – Elliot Management offered a \$100m 5 WAC RPL pool to market, only five bidders, the highest being JPM at 70. Elliot passed and killed the trade. Elliot expected 85-95% pricing historically.
3. Rocket Mortgage 3rd Quarter Scratch-N-Dent Offering October 1st, 2022: High 60s performing pool, high 70s for the NPL, an even greater spread in the wrong direction. Rocket ended up trading only \$30m (25% of the performing pool) to Citi.
4. Mission Capital Sale October 13th 2022: SW Community Bank, Performing CLEAN conforming loans, WAC 3.35%, must sell seller expecting significant discount, awarded bid is low 70s of UPB, closing mid-November.
5. Since mid-October, only half of the market for scratch-n-dent loans is earning a bid.

Thesis:

This significant dislocation in pricing of performing and performing scratch-n-dent senior lien mortgage loans will only last while rates continue to rise, and the yield curve remains inverted. Once volatility settles, whether it be in six months or six years, aggregators will improve demand and cause a tightening of spreads and reduction of discount expectations in the market, a return to normal pricing. Remember these are 30-year 1st mortgages with high quality borrower credit, one of the safest investments traditionally for global markets.

Action Steps:

Purchase higher quality clean, performing conforming loans as well as scratch-n-dent first lien mortgages subject to criteria we know will meet a future banker buy box as well as borrower credit and collateral quality (i.e., sub 80LTV, 700+FICO, fixable scratches). For QM performing portfolio paper, target anything that can be purchased at 7% or greater actual yield (i.e., 4% WAC purchased at 70% of UPB would provide immediate yield of 5.7% but actual yield closer to 8%, see model A below). For scratch-n-dent, target pools that can be purchased at 8% or greater yield. For reperforming or doc deficient performing pools, target a minimum 9% or greater actual yield. Purchase clean new originations at higher WAC to blend portfolio. Explore opportunities in non-QM and DSCR product that can be purchase mid-teens yield or above.

The Arbitrage:

While securitization aggregators and leveraged loan investors sit on the sideline, it is an equity buyer's dream market, an opportunity to buy high-quality, safe debt at decent return. Rates do NOT need to go down for this arbitrage to work. Rates just need to stabilize enough for securitizations to start up again, which most predict will be 2nd or 3rd quarter 2023. Once the market stabilizes, loans can be resold with significant upside. Payoffs received during ownership further escalate overall return to the portfolio because the loans are being purchased at significant discounts to their par value. Our standard assumption is that we can trade a significant amount of the portfolio for 86% or higher sometime within next 8 years; however, case studies below show how IRR increases if rates decline sooner than 96 months.

IRR ANALYSIS			
Sell Price	90.000%	Annual IRR	9.656%
Balloon/Payoff (months)	96	IRR from Additional Cash	-8.61%
Balloon/Payoff Date	11/10/2030	Total Return On Assets	55.581%
EFF LTV Sale	55.703%	Nominal Yield	4.687%
WA Cpn Adjustment (Duration)	0.00%	WAL (months)	33
WA Max Effective LTV	91.10%	Manual Bid Adjustment	7.000%

IRR ANALYSIS			
Sell Price	90.000%	Annual IRR	11.196%
Balloon/Payoff (months)	60	IRR from Additional Cash	-8.61%
Balloon/Payoff Date	11/10/2027	Total Return On Assets	46.823%
EFF LTV Sale	55.703%	Nominal Yield	4.687%
WA Cpn Adjustment (Duration)	0.00%	WAL (months)	-48
WA Max Effective LTV	91.10%	Manual Bid Adjustment	7.000%

IRR ANALYSIS			
Sell Price	90.000%	Annual IRR	13.963%
Balloon/Payoff (months)	36	IRR from Additional Cash	-8.61%
Balloon/Payoff Date	11/10/2025	Total Return On Assets	39.715%
EFF LTV Sale	55.703%	Nominal Yield	4.687%
WA Cpn Adjustment (Duration)	0.00%	WAL (months)	33
WA Max Effective LTV	91.10%	Manual Bid Adjustment	7.000%

IRR ANALYSIS			
Sell Price	90.000%	Annual IRR	15.862%
Balloon/Payoff (months)	24	IRR from Additional Cash	-8.61%
Balloon/Payoff Date	5/10/2025	Total Return On Assets	38.538%
EFF LTV Sale	55.703%	Nominal Yield	4.687%
WA Cpn Adjustment (Duration)	0.00%	WAL (months)	28
WA Max Effective LTV	91.10%	Manual Bid Adjustment	7.000%

Traditional History of Scratch-N-Dent Arbitrages (strictly confidential)

Our primary loan sale advisor has represented a major US bank with AuM greater than \$50b in a program to purchase and aggregate high quality scratch-n-dent performing loans for several years. Taking advantage of large deal premiums and the fact that many SnD issue loans season themselves into compliance, the bank sold a pool it purchased at an average of 94.25% and resell at 101.5%. The standard pricing for performing scratch-n-dent loans has historically ranged from mid 80s to mid 90s regardless of rates. In addition to the nearly total withdrawal of aggregators and leveraged investors in the secondary market for performing pools, banks have also become more selective and in some cases absent from buying whole loans. With current pricing of "risk off" assets, banks are more inclined to gravitate toward opportunities in MBS

rather than purchasing whole loans (Mortgage Backed Securities maintain a degree of liquidity that whole loan mortgages do not, rising interest rates requires banks to be more liquid).

The Manager:

First Lien Capital, founded by veteran real estate and mortgage investor Bill Bymel, has access to and bidding \$100-200m per week of both bank-owned and privately owned residential seasoned whole mortgage loans. This strategy will focus on a dislocation in the performing loan market wherein we can purchase performing, cash flowing product and non-performing prices, at little downside risk to investor since we are purchasing newly originated loans that were trading at PAR only six months ago, now able to be purchased at 25-30% discounts to face value of the debt. This strategy is the mortgage investor's equivalent of a covered land play deal. Safe steady cash flow, with tremendous upside potential in the near term once the market normalizes. FLC predicts we can acquire \$200-300 million in six months at high single digit average yield.

The Model:

FLC proprietary modelling has been developed for both NPL and Performing Loan product over the course of the last thirteen years. On the performing approach, as imaged below, we account for assumptions regarding state, CDR & CPR rates, HPI, etc. Example below based on actual Rocket Mortgage trade in Summer of 2022.

Seller	Rocket Mortgage				
Indicative/Final Bid	Indicative				
ASSUMPTIONS					
As of Date	10/1/22				
Bid Date	10/6/22				
Settlement Date	11/20/22				
Serv Transfer Date	1/15/23				
First Remit Date	2/4/23				
Pool Type (RPL/BK/SD)	SD				
ADJUSTMENTS					
30-59 Days Delinquent	-10.00%				
Sub Performing	-10.00%				
Modification	0.00%				
FICO >= 680	3.00%				
FICO >= 720	5.00%				
Workout (months)	18.00				
Severity 10% for FHA INS	30.00%				
Severity* UPB/CV	19%				
Duration - Play off	8.00				
Duration - Min Base Price	40.00%				
Duration - Base Coupon	4.00%				
Duration - Max Payup	0.00%				
Duration - Min HH	0.00%				
Prepay Price % BPO	61.89%				
Prepay Price* CV/UPB	100.00%				
Sell Price	86.00%				
Sell LTV	53.23%				
LTV Adjusters	Y				
EFFECTIVE LTV PARAMETERS					
Balance	Effective LTV	Slope			
60,000	50.00%	0.0010000%			
100,000	90.00%				
Max UPB Caps					
Balance	Max Bid Price	Slope			
\$ 40,000.00	50.00%	0.0008889%			
\$ 85,000.00	90.00%				
BROKER FEES					
Source	UPB/Proceeds	Fee (%)			
Internal	PROCEEDS	1.000%			
External	PROCEEDS	0.000%			
CDR/CPR ASSUMPTIONS					
Months	CDR	CPR			
6	5%	2%			
12	5%	3%			
24	8%	5%			
36	8%	5%			
To End	5%	5%			
HPI - State Cap		0.00%			
HPI - WA for Pool		0.0000%			
CASH FLOW COLLECTIONS					
Month	Date	Anticipated CF	Actual CF	Additional CF	Actual/Anticipated
1	2/1/16	756,418.65	-	(756,418.65)	0.000%
2	1/1/16	756,418.65	-	(756,418.65)	0.000%
3	12/1/15	756,418.65	-	(756,418.65)	0.000%
PRICING					
As % of Accruing UPB	66.27%				
Bid Levels	% of Total UPB	Bid Dollars	Effective LTV	Bid + Broker Fee	Bid + Broker Fee (% of UPB)
0.000%	66.173%	102,350,979.44	40.956%	103,374,489.24	66.835%
-10.000%	66.173%	102,346,872.09	45.505%	103,370,340.81	66.822%
-20.000%	66.139%	102,297,620.38	51.168%	103,320,596.58	66.800%
-30.000%	65.886%	101,906,406.93	58.254%	102,925,471.00	66.545%
-40.000%	65.081%	100,661,736.34	67.133%	101,668,353.70	65.732%
IRR ANALYSIS					
Sell Price	86.000%	Annual IRR	10.101%		
Balloon/Payoff (months)	96	IRR from Additional Cash	-8.87%		
Balloon/Payoff Date	11/10/2030	Total Return On Assets	57.720%		
EFF LTV Sale	53.227%	Nominal Yield	4.828%		
WA Cpn Adjustment (Duration)	0.00%	WAL (months)	65		
WA Max Effective LTV	91.10%	Manual Bid Adjustment	5.000%		
DATA SUMMARY					
Number of Loans	533	WA Coupon (accruing balance)	3.227%		
Total UPB	\$ 154,671,275.54	WA FICO	725		
Total Deferred	\$ -	WA FICO Date	3/29/21		
Total Accruing	\$ 154,671,275.54	Remaining Term to Maturity	317		
FLC Reconciled BPO Values AS IS	\$ 249,905,097.44	Remaining Amortization Term	317		
FLC Final Bid Value	\$ 249,905,097.44	Avg Age in Months	16		
Average Loan Size	\$ 290,190.01	Modified Loans %	9.13%		
Average Collateral Value	\$ 468,865.10	Non-Owner Occ %	39.07%		
WA Current LTV	61.89%	Condo Prop Type %	40.47%		
WA Effective LTV	40.96%	WA Days Delinquent	2		
UPB	Count	Total UPB	% of UPB	Effective LTV	
<= 50000	2	84,196	0.05%	44.82%	
<= 100000	52	4,169,701	2.70%	38.62%	
<= 200000	154	22,942,333	14.83%	39.07%	
<= 350000	306	108,545,847	70.38%	40.47%	
> 500000	19	18,929,198	12.24%	47.49%	

Model Assumptions:

1. The Yield Curve will not remain inverted forever.
2. While rates are expected to increase for at least 1 to 2 more quarters, the US cannot continue to raise interest rates ad nauseum.
3. Rates need not decline in order for bid/ask spreads to tighten.



4. The 30-year conforming mortgage (scratch-n-dent or not) is a low-risk, high credit quality, fixed income investment.
5. An average home sells and mortgage pays off in 7-8 years.

Proposed Structure & Terms:

Investor shall own 100% a Delaware Statutory Trust, to be Managed by First Lien Capital. FLC will source, price, contract, oversee due diligence, service transfer, boarding, and provide first year reporting on the aggregated portfolio. A one-time fee of 1% on invested dollars. Manager will be paid an additional 50 basis points management and oversight fee in year two and beyond as long as portfolio hurdles a minimum 8% yield. Manager will oversee liquidation process and share in a promote equal to 30% of net profits above and 110% of initial cost basis.



Industry Color:

From Situs AMC Lead Loan Trader:

In the S&D market today we're definitely seeing a wider range of pricing from different banks these days with the best bids pricing out to high 5s yields but going all the way up to 8%+ yields as different banks have different appetites, capacity, and outlooks. For S&D sellers though, they're ultimately taking losses on these sales so they are very sensitive to overall discounts and we still see a much higher success rates for bids getting awarded when the pricing is in the 60s on the low coupon loans (sub 4%). There are larger S&D pools of loans that trade anywhere from the low to mid 70s but when you look at those pools there are usually a significant amount of loans that don't fit the typical banks buy box so it's hard to compare those pools to the high credit segment of S&D universe that we see as more suited for bank buyers. If they have any questions I'm happy to jump on a call to talk about the S&D market further or how we can help them acquire loans.

We received more color on the large Rocket S&D pool from the other week, on the overall \$155mm of performing loans they put out, Rocket said they had high 60s bids on the entire pool but we heard that they ended up selling about \$30mm to Citi in the low 70s. **We model a high 60s price to be ~9.5 – 10% yield.**

From Mission Capital Lead Loan Trader: (regarding a bank owned portfolio of clean performing QM loans)

S&D volume picked up again last week after a pretty slow week in the week before that but we're not seeing a lot of bids. Last week we only saw bids from five different bidders and of those two of them only bid one loans and really we're only seeing bids on a consistent basis from FNBA. Overall half of the loans we saw last week we didn't have any bids. When talking with some of the sellers out there
