# Altisource Asset Management (AAMC) – A $2 Billion Dollar Parasite

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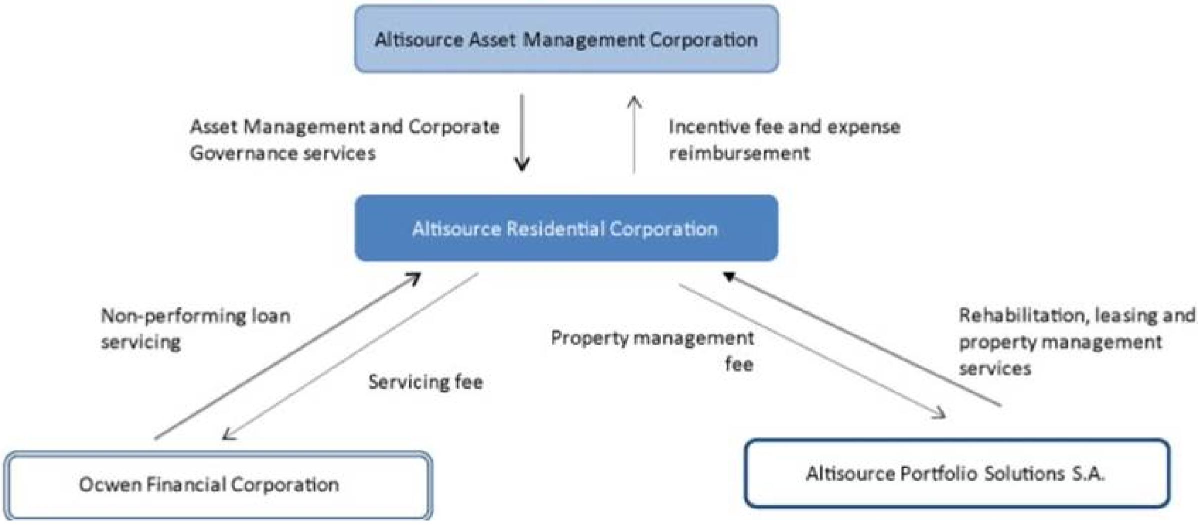
Bill Erbey's empire is a complicated web of companies with inter-related interests. The history first:

- Ocwen Financial Corp (OCN) – is a mortgage servicer and asset manager that Bill Erbey started in 1988. Interestingly, Ocwen is Newco spelled backwards. Could it be that Bill has been planning this tangled web for 16 years?
- OCN spun-out Altisource Portfolio Solutions (ASPS) in Aug-09.
- ASPS then created, capitalized and spun-out 2 different companies: (1) Altisource Residential (RESI) was capitalized with $100MM and began trading on 24-Dec-12 and (2) Altisource Asset Management (AAMC) was capitalized with $5MM and spun-out on the same day as RESI.
- RESI is a single-family property REIT shell that outsources all of its work to related party entities. It has no employees.
- AAMC is the management company of RESI. AAMC is contractually not allowed to offer its services to anyone else besides RESI so long as RESI maintains "average of $50MM of capital available for investment over the previous two fiscal quarters." AAMC has 7 employees.




## The Host-Parasite Relationship between RESI & AAMC

The focus here is on RESI and AAMC's parasitic relationship – here's how it works:

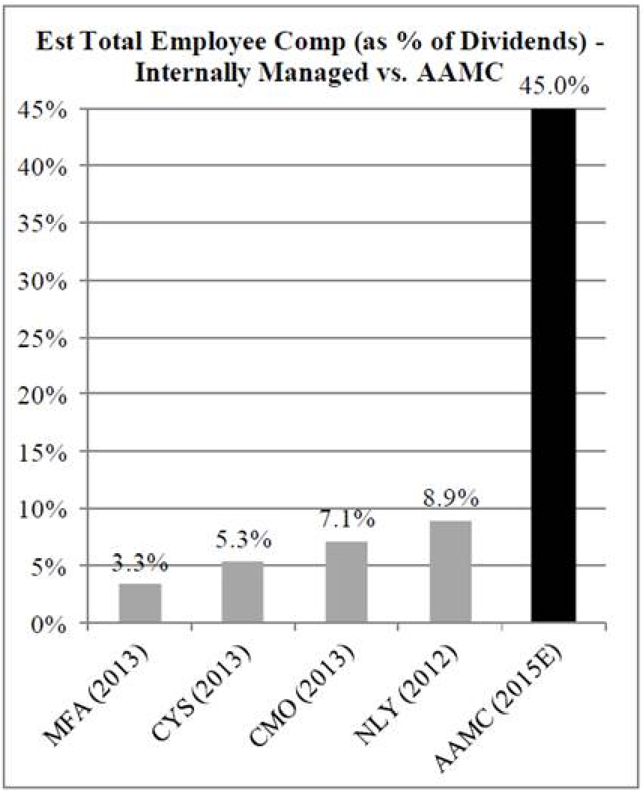
- RESI is a shell that holds single-family home assets and AAMC manages the book.
- AAMC does not service the loans nor manage RESI's properties, and has only 7 employees, no assets and virtually no infrastructure.
- RESI pays the salaries and all operating expenses of AAMC. AAMC has effectively no costs save its stand-alone public company costs.
- RESI pays AAMC incentive fees on cash distributions based on a tiered formula – the math leaves you scratching your head as AAMC is entitled to somewhere between 35% - 50% of the realized gains.

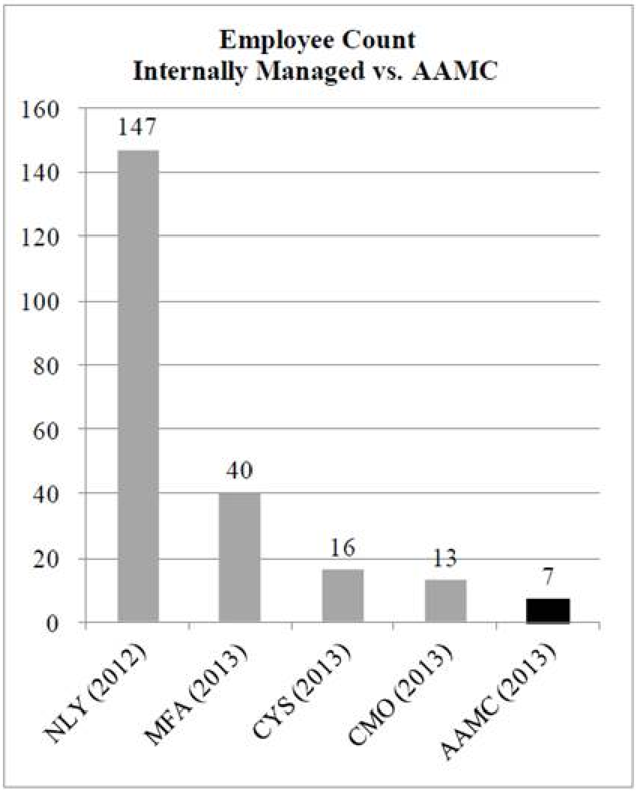
With shared upside, no bills and no downside, the question is:

**Is AAMC disproportionately benefitting at the expense of RESI shareholders?**

The conclusion from Glaucus Research is an emphatic **YES. RESI massively overpays AAMC.**

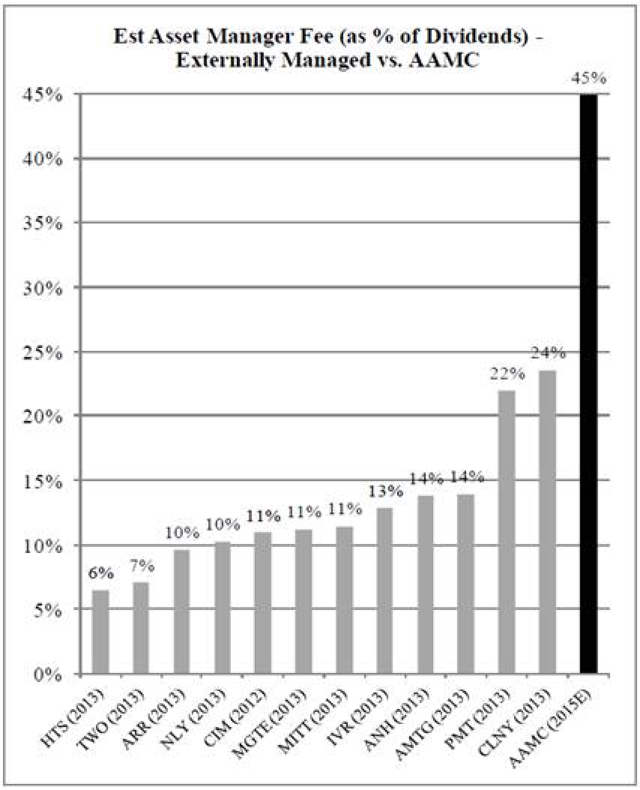
RESI pays AAMC **over 7x** what similarly situated mortgage REITs are paying for **internal asset management**.

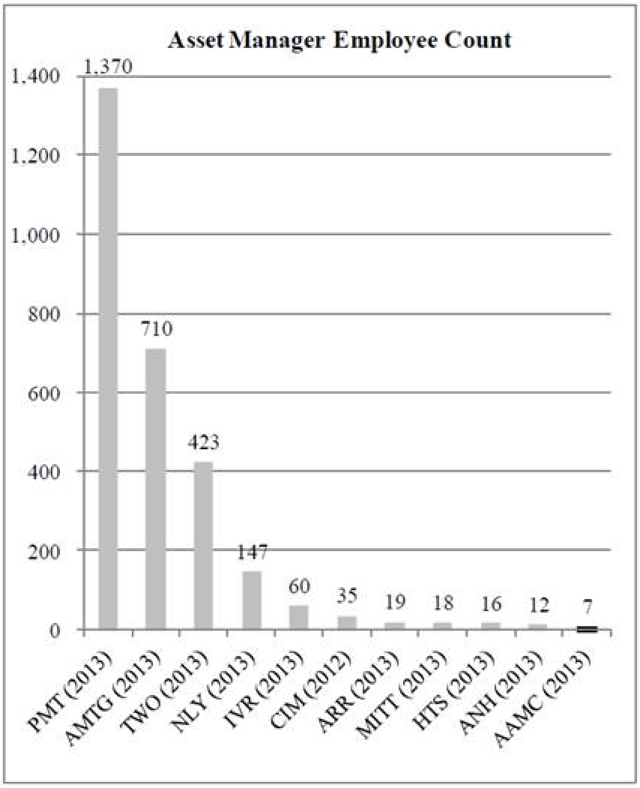



Source: [Glaucus Research]

If you widen the comp set to include twelve externally managed mortgage REITS, RESI pays AAMC around **4x more** than the amount paid to **external asset managers**.




Source: Glaucus Research

Looking at these charts, it should be clear to you that AAMC is unjustly benefitting at the expense of RESI shareholders. What's interesting is that not only has **Bill Erbey** been getting away with it, but as the largest shareholder of both companies he's **been a massive beneficiary as the sell-side plays buffoon**. The valuation of these companies makes no sense **- I'd go so far as to say AAMC is one of the biggest mispricings I have ever seen, internet bubble included**. Take a look at the numbers and decide for yourself:

- RESI is valued at approximately NAV ($2.2BN EV, $1.6BN equity + $700MM debt - $48MM cash), roughly in-line with comps.
- AAMC is valued at $1.9BN, a multiple of 26x est. 2014 incentive fees.
- If you assume that RESI-AAMC were 1 entity, the combined P/NAV would be 1.8x, suggesting an overvaluation of nearly $2BN.
- If you look at the multiples of Apartment REITS (a business model that's been proven over multiple cycles), we've never seen a P/NAV over 1.2x.

**Table 9: Market cap weighted price-to-NAV for selected asset classes**

| | Total REITs | Apartments | Shopping Centers | Regional Malls | Office (1) | Industrial | Self Storage |
|---|---|---|---|---|---|---|---|
| Dec-97 | 126% | 114% | 127% | 105% | 140% | 139% | 128% |
| Dec-98 | 103% | 98% | 94% | 107% | 106% | 101% | 108% |
| Dec-99 | 78% | 85% | 67% | 75% | 76% | 80% | 79% |
| Dec-00 | 90% | 97% | 92% | 78% | 97% | 97% | 79% |
| Dec-01 | 97% | 105% | 114% | 95% | 97% | 92% | 104% |
| Dec-02 | 98% | 91% | 109% | 110% | 87% | 98% | 99% |
| Dec-03 | 119% | 111% | 121% | 133% | 112% | 119% | 113% |
| Dec-04 | 114% | 112% | 118% | 114% | 111% | 122% | 113% |
| Dec-05 | 101% | 100% | 106% | 101% | 99% | 101% | 108% |
| Dec-06 | 108% | 107% | 114% | 102% | 107% | 114% | 108% |
| Dec-07 | 83% | 78% | 87% | 81% | 75% | 98% | 90% |
| Dec-08 | 114% | 108% | 115% | 94% | 114% | 113% | 150% |
| Dec-09 | 106% | 107% | 105% | 106% | 104% | 109% | 108% |
| Mar-10 | 96% | 96% | 100% | 95% | 94% | 67% | 102% |
| Jun-10 | 96% | 95% | 92% | 96% | 99% | 91% | 103% |
| Sep-10 | 101% | 101% | 97% | 100% | 100% | 97% | 111% |
| Dec-10 | 99% | 102% | 96% | 101% | 96% | 102% | 103% |
| Mar-11 | 102% | 101% | 102% | 100% | 100% | 108% | 106% |
| Jun-11 | 110% | 120% | 104% | 108% | 106% | 115% | 115% |
| Sep-11 | 96% | 104% | 96% | 96% | 101% | 89% | 102% |
| Dec-11 | 93% | 92% | 90% | 95% | 90% | 91% | 105% |
| Mar-12 | 99% | 94% | 100% | 97% | 100% | 103% | 104% |
| Jun-12 | 94% | 94% | 94% | 94% | 93% | 90% | 95% |
| Sep-12 | 100% | 94% | 104% | 102% | 99% | 105% | 104% |
| Dec-12 | 95% | 89% | 98% | 97% | 94% | 97% | 101% |
| Mar-13 | 100% | 91% | 107% | 100% | 101% | 102% | 104% |
| **Apr-13** | **102%** | **94%** | **109%** | **106%** | **96%** | **100%** | **106%** |

Source: [Bank of America Merrill Lynch]

The numbers tell the story: the market is – arguably – fairly valuing the host (RESI) and it's – rather remarkably – rewarding the parasite (AAMC).

So we have a **strange public market situation where 2 interrelated companies are engaged in a massive siphoning of money from one (RESI) to the other (AAMC) while overvaluing the pair by $2 billion.** Ok, good to know. But what's the catalyst for shorts? Well, absent the market miraculously waking up from its stupidity-induced coma, there's one other catalyst on the horizon: June 24th. You see, Glaucus has written letters to independent RESI board members attempting to get the current Asset Management Agreement replaced with an at-market rate (thereby eliminating the massive value transfer from RESI to AAMC) and June 24th is the last date the independent directors must give notice to terminate or replace the contract.

If they are successful at achieving even a 50% decrease in AAMC's incentive fees (which would still leave its overall compensation structure significantly above market for an asset manager), AAMC's stock price will likely get cut in half – and that assumes AAMC continues to trade at an absurd and unsustainable multiple ([Glaucus est]).

But what if they aren't successful? Then you still have a combined RESI-AAMC pair trading at an internet bubble-like valuation and a blood sucking parasite (AAMC) realizing 35% - 50% of the gains from RESI's portfolio.

And so I propose a slightly modified pair trade from the one Glaucus mentions in their report: **short them both**. If the management contract gets ripped up and replaced, AAMC will tumble dramatically and you'll lose some money as RESI rises. Net-net, you likely win.

If the management contract doesn't get torn up, RESI will likely fall (why should RESI be priced at NAV considering they are giving away 35% - 50% of the ups to another company?) while AAMC may remain extremely overvalued. Net-net, you likely win.

Either way Bill Erbey remains a diabolical genius.

**Critical Questions for Management**

- Why can't anyone on the sellside or buyside model AAMC's incentive fees correctly? What does that say about AAMC's disclosures?
- Why can't anyone other than 4 sell-side analysts ask questions on earnings calls?
- Why is it that when you call AAMC you get… Ocwen?
- How can AAMC's 7 employees buy better pools of loans than SWAY who has 545 employees?
- Does AAMC have the right acquisition strategy (spray-and-pray versus sharpshooter)?
- Does the single-family home REIT model work over a full cycle?
    - Sam Zell has spoken out against it: "I just don't think that the logistics produce real positives." (0:24 to 1:12 of this video)
    - Moss Adams Capital: "others who are converting to perpetual owners and are continuing to buy believe in the operating property model. That's the model that's unproven at scale." (source)
    - "The institutional wave has passed." - Jonathan Gray, global head of real estate for Blackstone (source)
- What was the motivation for the $250MM capital raise / $300MM buyback in mid-March?

**Addendum: Thoughts on the recent capital raise**

In March, existing investors gave the company $250MM which the company is using to buy back $300MM in shares (source). This is strange to me… why would AAMC institute a buyback program given that it's a brand new spin-off trading at an internet bubble-like valuation and is beginning to face negative headwinds from a no-longer-severely-distressed single family home market (see Blackstone's comments here)?

This transaction smells funny to me. Why would existing investors put in new capital given the above? Is it to buy them enough time to get out of their positions? I'd love to be a fly on the wall at AAMC, but here's a scenario to ponder… funds like Luxor, Long Pond, and SAB all got their shares in the Dec-12 ASPS spin and have lucked into a large fortune. They get a massive drawdown in 1Q13 (AAMC was down big intra-quarter) impacting their performance so before the quarter ends they propose this deal with the Company, making their quarter look better. This wouldn't surprise me one bit. And with management's restricted stock grants tied incredulously to AAMC's share price, AAMC is equally incentivized to do everything they can to keep their share price high (hence the buyback announcement).

The investors that bought into this deal got convertible preferred stock that has free upside and no downside (they can put these shares back to the company at par and get upside if they convert over $1,250 / share). This is a risk-free trade to participating investors with principal protection. And the simultaneous buyback announcement creates the perception that there is a floor under the shares. At its core, for investors that sell their non-convert stock holdings (we'll see over the coming months whether or not they start selling), **this is merely an exchange of "at risk" money for principal protected money with a 6 year lock-up. A trade I'd do any day especially if I thought my shares were worth 90% less than what they were trading at.**

One final note: If Glaucus is successful in getting the management agreement torn up, the buyback could be moot (there’s ~$260MM left) as AAMC may have to keep a lot of that cash to cover the "put" held by convert holders.