PODCAST TRANSCRIPTION SESSION NO. 103-THOMAS SPONHOLTZ & JIM RICCITELLI

Welcome to the Lend Academy Podcast Episode No. 103. This is your host, Peter Renton, Founder of Lend Academy and one of the Co-Founders of LendIt.

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Peter Renton: It's not very often on the podcast that I get to talk about something completely new, something that we've never talked about before but that's the case on today's show. I'm delighted to welcome Thomas Sponholtz and Jim Riccitelli, they are Co-CEOs of Unison. If you haven't heard of Unison, they're a fascinating company, they're in the real estate space and they have introduced a brand new product, an equity-based product for individual homeowners and we will get into this in some depth on the show explaining exactly how it works, how they've been able to do it and the fact that they actually started this just before the financial crisis and they are still in business today which is an amazing story in and of itself. But we talk about the product, how it works, what the benefits are to homeowners and obviously the benefits to investors as well. Hope you enjoy the show!

Welcome to the podcast Thomas and Jim.

Thomas Sponholtz: Thank you, Peter.

Jim Riccitelli: Thanks for having us.

Peter: Okay, so let's get started and give the audience a little bit of personal background about yourself. Why don't we start with you, Thomas.

Thomas: Yeah, thank you. My background is really in consumer finance, capital markets, investment management, most typically in building or managing very large scale consumer finance and investment products. For example, did some of the first securitization of mortgages and assets in Europe, actually built the first CMO in Europe and in the United States built various investment programs for pension funds, endowments and sovereign funds.

The last place I worked prior to starting Unison was at Barclays Global Investors which is now BlackRock where I co-ran the fixed income group which is about a $120 billion fixed income group where we managed again for pension funds, endowments and sovereign funds globally. We also launched the fixed income iShares, we launched the fixed income alternative businesses. Really my career has been spent on innovating on the consumer product side and then turning it either into a capital markets product or an investible product for investors with loan liabilities.

Peter: Okay and where is your accent from?

Thomas: Denmark.

Peter: Denmark, okay, great. Jim, why don't we get some background on you as well.

Jim: Sure, thanks Peter. I have a varied background actually. I was involved with Nomura's commercial real estate business for quite a while, it was the largest commercial lender in the country. I did some venture capital work at Nomura, I ran a venture fund for Nomura that invested in financial services startup businesses so I got to see a lot of innovation and business models by entrepreneurs through that avenue. I ran a residential lending business in Arizona for a while and earlier I did some software development and operations management for financial services as well so all things that come to bear when you're building a company so I think the varied background has been helpful.

Peter: Yeah, sounds interesting, sounds like a pretty good combination there. So then why don't you start, give us a bit of background about the history of the company and what caused you to start Unison?

Thomas: Yeah, I got the idea about 12/13 years ago, again, I was working at that time at Barclays Global Investors again managing large portfolios for really the largest pools of assets against loan liability type investments and we had as a business grown tremendously. We were looking around for large asset classes we could add to our client's portfolio that would be beneficial, an additive to an investment program and the first place I looked was really residential real estate.

Again, we were already invested in fixed income, but residential real estate popped out very quickly because it's the largest asset class, both globally and in the US. It's also housing, and residential housing contributed about 40% of CPI and about 16% of GDP so it's really the biggest component in the US economy and yet our investors had close to zero exposure to the asset class which by itself, it doesn't make any sense because most big and large investors like to have a diversified exposure to the economy which is tied to the liability in their plan so it was pretty obvious that there could be a potential need.

Then we started looking at why didn't they have exposure to the asset class today and the answer very quickly came that there was no way to get efficient exposure to the asset class. When I say asset class i really mean the price exposure to residential real estate as an asset class and nationwide exposure. The only way to do it would really be to go out and buy tens of thousands of homes and renting them out. (Peter laughs).

While that's a good idea when housing is cheap, it also comes with a tremendous amount of administrative cost in maintaining and being a property manager of all these homes which could be a good idea but it didn't match the objective we had which was really to get the inflation component of the US economy related to housing which, again, is the liability that the investment manager is trying to outperform, the kind of investors we were focusing on.

So that was the genesis of the idea and then very quickly we said, well okay, it's pretty obvious that this will be very additive to a large pool of assets to get exposure, but who owns it? And when you look at the consumer...actually, homeowners own the equity in the United States so the asset class itself in America is about $25 trillion, $25 to $30 trillion depending on who's measurement you look at and roughly one third is mortgaged and two thirds is equity owned by individual homeowners. The individual homeowners have no way of getting liquidity for this asset that they own which is typically the largest component of their net worth.

The first idea we came up with was wait a minute, we could be liquidity providers to homeowners so that they could make a partial sale of this equity they own in their home and then we could scale that and then provide exposure to the asset class on the investment management side. That was really the genesis of the idea. Once you build on that, it becomes really interesting because there's so much history and data that you can actually build high quality investment programs to provide this nationwide exposure to investors. And for the consumer, you can create a consumer product that really matches the long term nature of the asset they're selling.

Like the consumer, for example, when they sell equity to us, they don't want us to have any impact on their experience of being a homeowner so they want to own the right to own this or sell this equity to us for as long as they want. And that kind of flexibility we could provide by having very long term patient capital and design highly sophisticated portfolios for these clients on the other side. So that was the genesis and how we came up with the idea and the basic idea is old, it's not new and I say that in the sense that equity financing really exists for corporations…they can obviously finance with debt and equity. Commercial real estate can finance with debt and equity and now what we are bringing to the world is new and adding to the system is that now homeowners can also finance their life as a homeowner with debt and equity. It's additive to the whole system.

Peter: Right.

Thomas: That's really the big idea here.

Peter: Right, and so I believe you launched this...was it back 2005 or 2006 timeframe, is that correct?

Thomas: 2005, correct.

Peter: 2005.

Thomas: That was the start of the company. The first portfolios were built in 2007.

Peter: Right, okay so you launched at an interesting time to have a residential real estate product launching in 2007. Obviously you didn't know what was ahead of you, but...so you launched the product and obviously you're still here, we're talking...how on earth did you...what happened, tell us what happened because we all know the financial crisis was predominantly led by real estate, residential real estate and looks like you guys have survived in some form so talk us through a little bit of the history then from 2007 till getting back into where we are when you sort of…coming out of that period. So what was that like?

Jim: Sure, this is Jim. It was a pretty wild time for us going into the crisis. Let's quickly talk about what had happened in 2007. We experienced a lot of demand for the initial program which as Thomas said is the program that allows an existing homeowner to unlock some of the equity in their home. We were advertising on television in 14 different states and that was our primary means of reaching consumers, TV and radio. We had about 14,000 consumers that had contacted us and were in our pipeline and we were scaling the company up and things were going really, really well and then the crisis hit and real estate started to plunge. It was a very wild ride we were on.

We essentially had to suspend origination, in fact, we actually even considered shutting the company down, but Thomas and I looked at each other and said, this idea is too good, this is something that needs to live in the world, it needs to exist and so we're going to stick it out. We went to our investors and said, would you guys like your money back or would you like to continue to back the company and every one of them said, if you guys are willing to ride through this crisis, we're there with you.

So we spent about a year coming up with a product that we called Reset that was a way for an underwater mortgage to be turned right-side-up. Essentially the idea was that a lender would forgive principal on the mortgage and allowed the homeowner to get a right sized mortgage, a reset if you will, to the current home value. In return for forgiving the principal, the lender would have a share in the upside in the home from today's value and everyone loved that idea. We spent a lot of time talking to people in the industry about it, but no one wanted to set a precedent that it would be okay for a lender to forgive principal. You know, we were doing this back in 2009 and 2010, in the early days of the crisis, and so we couldn't get people to launch that program.

We moved on to launching a fund that invested in inverse IO [Interest Only] Bonds that were significantly mis-priced because the prepayment models used by the various players hadn't been properly recalibrated in the crisis. Our discussions with the banks around the Reset program gave us some insight to prepayment behavior and that funded very well. That was a very good outcome for us and the investors and we spent a lot of time in the crisis improving everything we had built before and thinking about how we would relaunch the business post crisis.

Before the crisis, the business focused on existing homeowners which is the Unison HomeOwner Program and during the crisis we realized that on the other end there would be a great opportunity to repurpose what we had developed for a home purchase and the Unison HomeBuyer Program was born. We came out of the crisis with both of those and raised capital and relaunched the business.

Thomas: This is Thomas, if I may add to what Jim said.

Peter: Sure.

Thomas: What was tremendously powerful in going through the crisis and now after is the fact that we now have a track record, both with the consumer and the investor, of having managed both portfolios of these assets through a crisis, the biggest crisis we have had since the 30's, in residential real estate. We also have a track record with the consumer on how we work together through a crisis as partners. That stress that you put on both the operational capability of the company as well as the portfolio was really very informative for the performance of these assets which was very helpful for investors evaluating an investment. It's also very helpful for the consumer because they saw how we...in many cases, when a consumer during this crisis got into trouble we would be helpful as partners with the consumer.

For example, at times they could take their advances and pay their mortgage debt so that the consumer then would make an orderly sale rather than a distressed sale of the property and thereby the consumer would come out with a clean credit record and some equity. Whereas a typical lender would...if you have a lender relationship which we don't, the lender relationship...well, I'm going to kick you out of the house and you're on your own and I'm going to make a distress sale of the property as long as I get my loan balance back. If you're equity partners, you're in it together with the consumer and the crisis really stressed the importance of partnership with the consumer and the benefits of that to both parties.

Peter: Right, I can see that. So when did you actually reboot then with version two, shall we say. I mean, you rode out the crisis, but when did you reboot and how did you sort of recapitalize the company?

Thomas: The rebooting was about four years ago now and how we recapitalized is really a function of just the amazing shareholders that we had already. The shareholders we started the business with were institutions and high net worth investors that we had worked for in the past or were clients of us in the past. This was not a VC or private equity funded, this was really institutional funding from partners that saw the benefit of what we call "fundamental innovation" to the system and it was very long term patient capital.

It was not an evolutionary innovation, if you will. We're not making it easier for consumers to get a mortgage, this is really adding something brand new to the system that was really important…homeowners and investors should be able to have equity financing in the system much like it exists elsewhere and that fundamental innovation...you don't know the path of growth because it has never been done before. So the kind of capital that we were funded with was patient capital that understood the fundamental innovation path and they also reinvested in the company when we rebooted.

Peter: Right.

Thomas: The same investors.

Peter: Fascinating, fascinating. So I want to dig into the actual product itself because I know...you've mentioned two, you have a homeowners product and you've also launched a homebuyers product. So I just want to be clear on how these products work. Can you maybe run us through an example of each and tell us how your product actually works.

Jim: Sure, we have a new financial product category for both of them, we call them homeownership investments, for either the HomeOwner or the HomeBuyer Program. They're both homeownership investments, it's home financing based on partnership. It’s a lump sum of cash that can be used for up to 30 years with no interest and no payments. As partners, we win and lose together with the homeowner by sharing in the change in value of the home when the homeowner decides to sell. So if the value increases, we share in the appreciation; if it decreases, we share in the loss.

The HomeOwner Program is for an existing homeowner who wants to unlock some of their home equity without borrowing. They can use that money for any purpose, paying off debt, remodeling their home, paying for a child's education, medical expenses, investing for retirement, whatever it might be. With the HomeOwner Program, the money is used as part of the down payment on a home purchase. This lowers the monthly payment by 15% to 20%, makes it a lot easier to income qualify for a mortgage loan, can increase purchasing power by as much as 100%. It can allow the buyer to reserve some of their cash for other important needs and it can help a buyer make a stronger offer and better compete in a tight market. Now you can see some examples on our website, Unison.com, but here's a simple math example. I'll use the HomeBuyer Program because they work the same way so if you understand one, you'll understand both.

Let's imagine we have a million dollar purchase price and a 80% mortgage loan for $800,000 so the buyer needs a 20% down payment or $200,000. We typically provide half the down payment so we and the buyer each contribute $100,000. They own the home, they have all the occupancy rights; we're just an investor alongside them. While they live in the home, they pay the mortgage and the taxes but they don't pay anything to us, so they can use the money for up to 30 years. When they sell, we receive a payment equal to what we originally invested plus 35% of the change in value, up or down. So if the value goes up, we receive 35% of the increase and if it goes down, we're going to incur 35% of the loss.

So imagine this million dollar home rises in value to $1.1 million and they sell it. Our payment is going to equal $135,000 because we invested $100,000 and we're going to have a $35,000 profit, equal to 35% of that change in value. The homeowner will keep 65% of the change in value. It's important to understand that the homeowner also keeps all the equity they create by paying their mortgage loan down over time and if they make home improvements that increase the home value, there's a process by which we adjust for that so we don't share in any value created by improvements either and they can buy us out anytime after three years, based on an appraisal. That's the basic operation of the program and they both work the same way.

Peter: Interesting, and obviously you've got all your regulatory ducks in a row. It sounds like when someone goes along to a bank and in your example say they want to get a $800,000 loan for a million dollar house, they say, oh by the way, we're putting in $100,000 and this other group are putting in a $100,000, I imagine the bank...because you're not a household name yet and the bank probably has never even heard…I imagine many banks have never even heard of this concept so how do you approach those conversations?

Jim: That's part of what we've done in laying the groundwork with the industry over the past several years. The HomeOwner Program is in one sense is a little bit easier to launch into the market because the transaction is only between us and an existing homeowner. In other words, they might have a first mortgage on their property and we're just going to put a second lien position in behind an existing mortgage so we don't really have to get the industry's acceptance in order to do that.

The HomeBuyer Program, we absolutely have to have the acceptance of the industry because we're providing financing that becomes part of a home purchase and is originated alongside the origination of a purchase-money mortgage. So we started at the top of the heap with the regulators, the FHFA; we've been to see the CFPB, the FDIC. Those were very successful review processes and every lender that works with us undertakes a very significant due diligence process with us and gets comfortable with how we operate, our sources of funding, the nature of our agreement with the homeowner and everything you can imagine. In a nutshell, that's part of the building of the groundwork, if you will, to partner with the industry. We've now integrated, for the first time, equity finance into the US housing and mortgage finance system so it's quite a feat to do and it took a lot of effort on our part.

Peter: Right, I know, it's the most mature asset class we have pretty much and it's something brand new which is...it's hard to even imagine that there is something that's a relatively simple concept but hadn't been done before. So I want to ask about duration here because you said it was a minimum of three years, maximum of 30, what are your expectations around the duration on average that each homeowner is going to...your money is going to be tied up?

Thomas: Yeah, this is Thomas, the short answer is ten years. Then the distribution around the ten years is pretty much a normal distribution, meaning that the average is around ten years and then some homeowners, of course, move sooner or sell their house sooner or buy us out and others stay in their home for 10, 20, 30 years. So we don't interrupt or in any way impact how long people stay at their house. We learned that we have the same duration as typical housing on average, that's what we learned by going through the crisis. We don't really impact that, people go on living their lives the way they normally do and by us having a part of the financing of the home does not change that behavior.

Peter: Yeah, that makes sense.

Thomas: Obviously very patient capital again because there's no coupon payments like on a fixed income investment…

Peter: Right.

Thomas: ...there's no cash flow between the time the investor puts the money into a fund and the time they receive cash flows. There's no coupon, there's only run off of the portfolio when houses turnover.

Peter: Right, yeah, that makes sense. So I just want to talk a little bit about underwriting because you've got an interesting product here because you need to underwrite both the property, I imagine, as well as the borrower. Can you tell us how you approach underwriting for each individual deal you do?

Jim: Sure, the property is generally more important to us, but we look at the credit quality of the homeowner as well. We do need to make sure that the homeowner can afford to pay the mortgage and taxes, basically take care of the property, but since there's no monthly payment coming to us we do have more flexibility when thinking about credit underwriting. And generally, like with the HomeBuyer Program, a good rule of thumb is if the mortgage lender is comfortable with their credit decision, we're going to be comfortable with the credit on that client.

For the property, we do single family homes, condos, planned unit developments; we'll soon be doing multi-family, we'll soon be doing rental properties. We haven't introduced those yet, but they are coming. We don't invest in properties that are sold by flippers, but the most important criteria about property underwriting is that the property has to be typical for the neighborhood. The reason is that we want to know that the value of the property can be determined with good precision. Atypical properties can be difficult to value and difficult to sell so you know unusual properties like geodesic domes, log cabins, farm houses, those kind of things will typically not qualify. Some rural properties that are way on the outskirts may not qualify, but in general most properties that are typical in the areas that we operate do qualify for our program.

Peter: And then what about...like how do you approach it because obviously everyone knows real estate is local, what happens...just look at the financial crisis, I live in Denver and while we had certainly a downturn, we bounced back pretty quickly, you've got other...like Vegas or Florida that had some challenges, and Arizona...do you take that into account as well as far as local environment, local economic environment?

Jim: As Thomas mentioned, these are longer term holding periods so local economic conditions can change from time to time, but we're long term investors and we're not really trying to time the markets that we invest in. Over long cycles real estate tends to perform fairly consistently.

Peter: Yeah, okay.

Thomas: If I may add to that, it's important to keep in mind what we're actually offering to the investment community on the other side in order to understand…in order to answer your question, Peter.

The investors that invest with us are expecting us to turn every home into an investment, meaning we've basically taken all the data on an individual house and turn it into an investment much like you would evaluate a stock or bond. So that whole transition is what happens on the investment management side so we can talk about volatility, distribution of return, the pricing. We have a 10-year forecast on every house in America so we have a very sophisticated data infrastructure and pricing structure and what we call turning a house into a security for our portfolio management system so that then goes into building nationwide portfolios for the benefit of the institutional investor.

They are not expecting us to time the markets, they want exposure much like when I built index funds on the fixed income side of iShares. You want exposure to the asset class, you want efficient, diversified exposure with a low cost, with low drag on returns from expenses. That's what the institutional investor wants so we are building nationwide portfolios by looking at every house, what I basically call decomposing into investment characteristics and then reaggregating them up into portfolios and that means that..to answer your question about do we look at local economics, of course, we do. But that just tells us how this investment looks like, much like if you invested in the high tech industry.

If you have an index fund in high tech or in the US, you're not making adjustments about whether tech is cheap or cyclical or expensive. What you're doing is you need to understand every single investment component that you own and then aggregate the portfolio to match these long term liabilities that they have because if the local economics go down in one area that also means the liability goes down. So our job is to outperform the liability by investing in this asset class. It's not to make judgment calls about whether it’s high or low.

Peter: Right, I get that. So you mentioned nationwide, are you open in all states? What states are you open in today?

Jim: We're currently in 13 states, but the states that we are operating in contain most of the largest metro areas in the country so the footprint comprises over 50% of the US housing stock. We're basically in the west coast, you know, the three states on the west coast and then the northeast from Virginia up through Massachusetts and we're also in Arizona and Illinois. We have plans to enter some more states later this year.

Peter: Right, okay. So we're running out of time, but I have a couple more things I'm very curious about. So how are you marketing your offerings? I imagine that it's not like a credit card offer or even a home loan offer that everyone understands what a home loan is, I can explain it to my 8-year old and she would totally get it, how are you marketing?

Jim: We market through partnerships with national lenders and real estate brokers, we've trained thousands of loan officers and realtors on our programs and they're on the frontline seeing deal flow every day and how the program can help and they're introducing the clients to us. We also market direct, direct to consumer, everything you can imagine that might be internet based, we have strategies there, we do direct mail as part of our direct to consumer expansion, we recently launched some amazing instant pre-qual tools on Unison.com that people are enjoying using.

We've been winning some financial innovation awards lately including the Best of Show at Finovate and Benzinga and we get an enormous amount of press so a lot of clients actually come to us after reading about us in the press or seeing us on TV or hearing us on the radio. There's a very strong education component to this and I think that gets to the heart of your question. Education is a key component of our business model. We're very proud to provide all of our clients with a very thorough education, we consider that a key part of being a partner. We have a mandatory education process, it involves video training, other knowledge-based resources. Each client has a program specialist assigned to them for the duration of the transaction and their number one job is making sure the client is properly educated.

We invite all the clients to bring their family and advisers into the education process. Each client goes through a knowledge review process that enables us to assess their understanding of the program features and close any gaps they might have and our clients love this approach. They love the fact that we are not leaving them to their own devices when it comes to a financial product like this and they see it as a breath of fresh air, not something they're used to seeing commonly in financial services. We get a lot of compliments, we get compliments from our lender and realtor partners as well.

Peter: Yeah, okay, that makes sense. I want to talk about the investor side, I mean, who is investing with you guys, what is the vehicle you're using and sort of the scale you guys are at. Can you tell us about that side of the equation?

Thomas: Sure, as we touched on before, it's primarily pension funds and endowments that invest in our funds so they're funds…they're 30-year commingled funds structures so it's a 30-year commitment that investors provide us with. On the origination side of our business it's growing leaps and bounds so it's important to obviously have evergreen demand on both sides of the business, both on the consumer side as well as the investment management side and that's what we've done.

Peter: Right.

Thomas: It's evergreen demand rather than investors that go in and out as they have…you know, if they think real estate is good or bad or high or low, that's one type of investor you can seek, we seek 30-year capital of people that want exposure to the asset class nationwide.

Peter: You couldn't have it any other way really, could you, given the duration of your product so that makes sense.

Thomas: Consumers wouldn't do business with you; here today, gone tomorrow doesn't work.

Peter: Right.

Thomas: And this partnership with originators also doesn't work if you're not constantly ready to fund their consumers.

Peter: Okay, so what's next for you guys? You mentioned potential new products, I mean, are you just consolidating what you've got, I mean, are you expanding into new states, what's on your road map?

Jim: All of that. We're going to continue to lead this category that we started, homeownership investment. We have plans to expand our footprint, the number of lender and realtor partners we have, we're going to move into additional distribution channels and continue to increase origination volume. We have a lot of new programs in the works. We mentioned rental properties and multi-family earlier. We have a couple of other things that are coming soon that are quite revolutionary so keep an eye on Unison.com for more updates. It's an exciting time for us.

Peter: Okay, well it's a fascinating company, fascinating concept. I really appreciate both you guys coming on the show today, thanks a lot.

Thomas: Thank you, Peter.

Jim: Thank you, Peter.

Peter: Okay, see you.

As I said on the show, I think it's really interesting to me that we have such an established asset class and a product like this that really is pretty simple conceptually and is implemented in many other asset classes, this whole concept of equity ownership, and it hasn't happened here in residential real estate. Now I think that the challenge obviously is that until they get an entire industry with 25 competitors all coming in and trying to do something similar and it becomes just a commonly known thing, oh do you want to put all your equity down or do you want to partner with an outside company to join you in putting equity down?

That becomes just a normal part of the conversation when you're buying a house. Obviously, we're not there yet, we're nowhere near that and I think eventually, this either stays a very niche industry that is very small that the major segments don't take up or this will become something that is just commonplace. I tend to think conceptually there are so many advantages for both the homeowner and investor that this could become a very significant segment, sub-segment shall we say, of real estate going forward.

Anyway on that note, I will sign off. I very much appreciate your listening and I'll catch you next time. Bye.

(closing music)