Nationstar Mortgage (NSM): Buy Recommendation

Share Price as of 10/28/2014	$34.35
Market Cap	$3.04 billion
P/E	25.63x
Forward P/E	7.74x
52-Week Range	$24.50 – 55.46
Price/Book	2.81x
Current Ratio	1.08x
EBITD Margin (ttm)	43.46%
Operating Margin (ttm)	23.51%

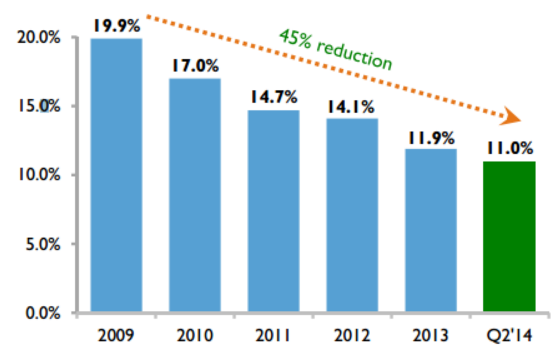
Nationstar Mortgage is a real estate services company engaged in the servicing of residential mortgage loans for others and the origination and selling of single-family mortgage loans to GSEs. It is one of the largest non-bank servicers in the U.S. Its ancillary services business, Solutionstar, provides mortgage and default service offerings. We maintain a buy recommendation on NSM based on its ability to capitalize on industry shifts brought on by new regulation limiting banks' balance sheets, the potential spin-off of Solutionstar and the positive correlation of MSRs with interest rates.

I. Basel III and a Strong MSR Portfolio

Nationstar has capitalized on the low interest rate environment to build a strong servicing portfolio. A $6 billion dollar servicing portfolio in Q2 worked with in-house originations business to contribute to servicing acquisition commitments exceeding $20 billion in Q3 2014, all while keeping a moderate net leverage of 2.1x and pro forma interest coverage of 5.6x. The servicing industry is a low-risk annuity stream with a long earnings tail that Nationstar has been building under favorable interest conditions and rising home prices.

The Company has also been steadily improving the quality of its MSR portfolio. First, the average FICO score for the borrower of a mortgage to which Nationstar owns the MSR is 681, which is both healthy and a significant improvement from an average of 627 in 2011. Second, the Company has been successful in steadily decreasing the sixty-plus day delinquency rate on its MSRs, which is currently at 11.1%. Third, prepayment speed has been lowered to 14.7% from highs of 17.9%, and we expect these to drop further. All of these factors build our confidence in Nationstar's cash flows.

Portfolio Delinquency (60+ Day)



(Nationstar Investor Presentation Q3 2014)

We foresee tailwinds from new regulation, primarily Basel III, which restricts banks' Tier I common equity in mortgage servicing assets to 10%. Banks service over 80% of loans; Basel III encourages the movement of servicing rights to specialized non-bank servicers. To illustrate the effects of that paradigm shift, Nationstar has transitioned from a market share of .1% in 2007 to 4% in 2013, a 390% increase.

> *"Special servicers have become an increasingly attractive option for lenders that don't have the resources or expertise to manage default servicing." – Navigating New Waters in Servicing, KMPG, May 2014*

II. Solutionstar Spin-off

Solutionstar is a full-cycle mortgage consulting service that uses technology-based solutions to streamline processes and engage customers throughout the life of the mortgage. Management has been clear that Solutionstar is a candidate for spin-off, even reporting the financial information for the business segment in recent SEC filings. Because discussions of a spin-off are still preliminary and management has expressed its view that the timing is not yet right, we believe the market has not appropriately priced in the standalone value of Solutionstar into its parent company. Using conservative estimates, we arrived at a per share price of $8.12 and market cap of $731,101.90 for a standalone Solutionstar.

in 000's	1Q14	2Q14	3Q14E	4Q14E	FY14E
Revenue	64,999	83,364	75,000	75,000	298,363
EBT Margin	40%	45%	43%	43%	
# of Property	4,537	5,661	5,000	5,000	
earnings	25,999.60	37,763.89	32,250.00	32,250.00	128,263.49
tax rate	38%	38%	38%	38%	48,740.13
multiple:	15			Mkt Cap	731,101.90
number of sh	90000			Price:	8.12

III. Appreciation of MSR Value with Rising Interest Rates

Because typical residential mortgage loans contain a prepayment option, borrowers often elect to prepay their mortgage loans by refinancing at lower rates in low interest rate environments. Prepayment terminates the stream of cash flows generated from servicing the original mortgage loan. Since the price of a MSR is determined by the value of future expected cash flows, prepayment can greatly harm profitability or even result in a loss when these cash flows are terminated early enough. Prepayment risk is reduced as interest rates rise, since borrowers are less likely to refinance in a more expensive environment. Thus, we view the end of the Federal Reserve's Quantitative Easing program and gradually rising interest rates as a boon to Nationstar's business. Additionally, we believe Nationstar is an appropriate hedge to portfolio positions that share a negative correlation with interest rates.

IV. Risks

Nationstar, as a real estate services company, is greatly exposed to swings in the U.S. housing market. This is partially mitigated by the long earnings tail of its MSR portfolio, but it is still a concern. Moreover, though rising interest rates cause a drop in prepayment risk, they may result in a rise in delinquency rates, in particular on floating rate mortgage MSRs, which would impact Nationstar's profitability.