Downturn Will Hit the Tech Sector

We often discuss production volume in this industry. We cover with exacting detail weekly loan application volume, average new loan interest rates and a whole host of other statistics. All of these indexes help us understand the current industry cycle and, we hope, predict where business volume is headed. What often goes unnoticed is how the ups and downs of the mortgage industry impact the mortgage technology firms.

When I ran Contour Software, I saw wild swings in software revenue. The worst periods could be just 20 percent of the best periods—an 80 percent drop in software revenues. I noted that in the good times, mortgage firms had to add seats and buy software licenses. In the bad times, no one was adding loan production capacity by adding seats and thus having to purchase software. Few businesses could ever withstand such volatility.

My experience led me to hold onto a cash hoard. During the good times, our high profits were held onto in anticipation of losses once the inevitable downturn arrived. I also worked hard to bring in revenue that was more stable, such as annual maintenance fees.

There is no doubt the industry's loan volume is dropping. More important, profitability is dropping even faster. The current downturn will have a significant impact on the mortgage technology sector. Make no mistake: There will be a number of firms that go out of business. If your technology vendor is one of these, do you have a contingency plan? Here are some questions you need to ask yourself:

- What is the financial condition of your current vendors?
- Are there other vendors that offer acceptable alternative solutions?
- Do you know which products you would choose in a hurry?
- How would you migrate your existing pipeline data to a new system?
- Would you have the financial resources to purchase a new solution in the midst of a downturn?
- What strain would this place on your information technology (IT) staff?

These are all good questions, and many of them can be planned for ahead of time. The first step I would take is to look at the financial resources of your most important software vendors. What sort of reserves do they have to help them through lean times? Could they handle a 50 percent drop in revenue over the course of 18 months?

Software vendors that are subsidiaries of large publicly traded conglomerates should be fairly safe. In addition, vendors that have a long track record (at least 15 years old) probably know how to get through the bad times. Still, every vendor should be willing to share information on its financial picture so that you can see for yourself. After all, we've just gone through the longest mortgage boom in history so we have to surmise that the downside could get pretty ugly.

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Software pricing typically has a high margin, and it's the software sales that cover the fixed overhead (programmers, technical support, offices and the like) for a typical technology firm. It's typical that for a software firm almost all expenses are fixed costs, and very few are variable costs. This means it doesn't take much of a drop in sales to go from profitability to a substantial loss.

If you have a vendor that could have problems in a sizable downturn, then you must consider some additional steps. One option would be to have the source code placed in escrow. This is a good solution for larger lenders with a staff that could continue to maintain the software code. However, for most companies the ability to maintain someone else's software code would be out of the question. The only remaining option then is to build a contingency plan.

It would be a good idea to have alternative vendors lined up so that you know ahead of time what product you would choose if you needed to make a quick switch. It's always a good idea to stay up on all of the core software offerings that would fit your needs anyway. You could even go so far as performing a complete software evaluation.

Obviously, the more important the software is to your operation, the more thorough the evaluation that's needed. This also means having the financial resources available should you be required to purchase all new licenses and retrain your staff. The reality is that when a software product is discontinued, your entire investment instantly becomes worthless.

It's unfortunate that we must seriously consider these issues, but many, including myself, foresee a large drop in loan volume. I believe this downturn could be the worst on record, and that we'll see a number of technology vendors close their doors with little or no warning. Let's hope I'm wrong—but in case I'm not, let's all make sure we have our bases covered.

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