PennyMac Financial Services Inc.

Second Quarter 2013 Earnings Discussion Transcript

August 8, 2013

Good morning and welcome to the second quarter 2013 PennyMac Financial Services, Inc. earnings discussion, the company's first reporting period following our IPO in May 2013. The slides that accompany this discussion are available on PennyMac Financial's investor relations website at www.ir.pennymacfinancial.com. Before we begin, please take a few moments to read the disclaimer on slide one of the presentation. Thank you. Now I'd like to turn the discussion over to Stan Kurland, PFSI's Chairman and Chief Executive Officer.

Speaker:

Stanford L. Kurland – Chairman and Chief Executive Officer

Introduction

Thank you, Chris.

I am pleased to speak with you today on the inaugural earnings release for PennyMac Financial. I'd like to start on slide 2 with a brief overview of the company and its structure. PennyMac Financial is an organization that we built over the last five and a half years into one of the leaders in the U.S. mortgage market, and a company that is poised for substantial growth as the mortgage industry evolves and continues to undergo significant change.

Today we have in place an organization, operations, and management that we believe are the best in the mortgage industry, and a company that is able to support many times our current volumes of business activity. We have developed PennyMac's operations organically to create a first-class mortgage platform free from legacy issues.

Our business is organized under two segments: Mortgage Banking and Investment Management. PennyMac Loan Services, or PLS, is our mortgage company and houses our loan servicer, consumer direct retail business, and correspondent lending business. PNMAC Capital Management, or PCM, is an SEC registered Investment Adviser. PCM is the external manager to a publicly traded mortgage REIT, PennyMac Mortgage Investment Trust, or PMT, and two Investment Funds, which collectively we call our Advised Entities. Together, PCM has approximately 1.8 billion dollars of equity under management, for which we earn management fees and performance-based incentive fee revenue. PLS also provides loan servicing for mortgage investments held by the Advised Entities, as well as certain other mortgage banking activities on a fee-for-service basis.

Moreover, PennyMac has a unique partnership with PMT. PMT is a leading investor in mortgage-related assets, but as an investment vehicle, it has no employees of its own. We provide investment management and mortgage-related services for PMT, such as loan fulfillment, subservicing, and special servicing. PMT, in turn, is a long-term, investment vehicle with access to efficient capital. We view this relationship as a significant competitive advantage.

Slide 3

On slide 3 we provide an overview of the different ways in which PennyMac Financial earns revenue. The company's business falls into three main areas: Loan Production and Loan Servicing – both of which are part of the Mortgage Banking Segment and Investment Management. I'd like to briefly describe the revenue sources in each area, which shows the diverse businesses in which we participate and how they position the company well in today's changing mortgage market.

Loan production operations consist of our correspondent and retail lending businesses. All correspondent loans are acquired from external originators by PMT. PFSI purchases the Government-insured loans from PMT, then pools and delivers the loans into a Ginnie Mae securitization and earns gains on the mortgage loans, retains the mortgage servicing rights, or MSRs, and earns servicing fees over the life of the loans. For conventional and jumbo loans, PMT securitizes the loan itself and retains the resulting MSR. PFSI receives a fulfillment fee for all of the activities for conducting this correspondent lending activity, including reviews of loan data; documentation and appraisals to assess loan quality and risk; the approval of correspondent sellers and monitoring of their ongoing performance; and the subsequent sale and securitization of loans in the secondary mortgage markets for PMT.

In our Retail Lending business, all loans are originated by PFSI. In general, PFSI earns gains on the sale of the mortgage loans, retains the MSRs, and earns servicing fees over the life of the loans. Jumbo loans are sold to PMT, which provides PFSI with a ready market; however, instead of these loans being sold to an Agency, they will be pooled in an eventual non-agency securitization through PMT.

In Loan Servicing, we earn servicing fees on the MSRs we own. We also earn servicing and subservicing fees from our Advised Entities which continue to grow from their acquisitions of whole loans as well as the growth in PMT's MSRs, primarily generated from its correspondent production. Ancillary income includes loan-level activity fees, late charges, and interest income on escrow balances. For example, when a distressed loan owned by one of our Advised Entities is modified, or goes through the short-sale process, PFSI earns activity fees.

Finally, PFSI earns investment management fees for managing our Advised Entities. For both PMT and the Investment Funds, we earn a base management fee plus incentive fees or carried interest based on their financial performance. Our Advised Entities invest in complex strategies which require specialized expertise and resources, including those in sourcing of investments, valuation and analysis, and due diligence activities.

As you can see, PennyMac Financial's revenues are a combination of traditional mortgage banking and fee-for-service activities. More than half of PennyMac's revenues, including those related to conventional correspondent production, are fee-based cash revenues that are driven by business volumes.

Let's turn to slide 4 and review our outlook for the markets PFSI participates in.

Slide 4

I'd like to turn to slide 4 and discuss our outlook on the markets in which we participate and the implications for PennyMac Financial.

The recent rise in mortgage rates has caused refinance activity to slow considerably, which is adversely impacting industry origination volumes and margins. While PFSI's correspondent and retail lending businesses remain attractive, we expect margins to continue to decline from what were historically elevated levels as the origination market contracts. Despite the challenges in the market, we expect to continue capturing new business and remain disciplined in our pricing to drive profitable returns. Also, for the correspondent lending business, we believe that the decline in the overall origination market is somewhat offset by increased flow through aggregators.

We remain optimistic in our outlook for the housing market going forward, as it appears that there are sound underlying fundamentals supporting its recovery. Demand from homebuyers and investors is strong, housing inventory is tight, helping to drive price appreciation, and home affordability remains high despite the recent jump in mortgage rates. Our own experience through the sale of REO tells us that demand for residential real estate remains strong - which bodes well for continued growth in purchase-money originations. Despite the higher mortgage rates, we expect these trends to continue.

Jumbo originations have also been affected by the recent rise in rates, and a widening in the spreads of mortgage-backed securities has affected the economics of securitization. In the short term, this has resulted in a somewhat diminished jumbo opportunity. However, over the long term we remain optimistic that there is a considerable opportunity for jumbo loans, which should benefit PennyMac Financial in our retail lending business, correspondent lending fulfillment, loan servicing, and investment management for PMT.

PMT, our largest Advised Entity, is a leading investor in the distressed whole loan market which remains robust. PMT has seen more supply and invested in more distressed loan pools this year so far than in all of 2012. All indications suggest that the distressed whole loan opportunity will remain strong through at least 2014. PMT continues to pursue new distressed loan investments which will drive a need for additional capital over time.

We continue to see opportunities to acquire mortgage servicing rights with co-investment by PMT. We expect to see several large legacy MSR portfolios in the market this year. We have been developing a structure for PMT to co-invest in MSR acquisitions alongside PFSI, which would take the form of an I/O strip owned by PMT. During the second quarter, we negotiated $450 million in UPB of smaller acquisitions for such a structure and have been working through the technical issues along with the GSEs. We would expect to apply the same technology and structure in a potential acquisition of a large bulk MSR portfolio as well.

Slide 5

Now let's turn to slide 5 and discuss the recent shifts in the mortgage origination market and our expectations going forward. The rate on the 30 year fixed rate mortgage increased more than a full percentage point from early May to the end of June. The sudden increase in mortgage rates has taken many borrowers out of the market for refinancing. On the positive side, we expect home purchase activity to rise with the improving trends in housing as I discussed on the previous slide, but not enough to offset the lower refinance volumes. As a result we think it's likely that the market origination volumes in the second half of 2013 will be down more than 30 percent from the first half of the year.

We also expect to see an increase in demand for adjustable rate and fixed-period adjustable rate mortgages or "hybrid" products, which have become a more attractive alternative relative to fixed rate loans. For example, sophisticated home buyers can utilize ARM and Hybrid products to lower their payments. Even though home prices have risen in most areas of the country, they are still generally far below their peak levels, and homeownership still compares favorably versus renting in many markets.

The shifts in the origination market present challenges for our loan production and fulfillment activities, without a doubt. However, PennyMac's share of the correspondent lending market remains approximately 6 percent, and our retail lending market share is well below 1 percent, and we believe that we have continued opportunities to capture additional business in a declining market. For example, we are continuing to add new sellers to our correspondent network and optimizing that group to ensure that we have the right sellers to prosper in this market. David Spector will go into our initiatives in greater detail.

I'd now like to turn it over to David Spector, PennyMac Financial's President and Chief Operating Officer.

Speaker:

David Spector – President and Chief Operating Officer

Slide 6

Thank you Stan.

On slide 6, I'd like to discuss the continuing growth across PennyMac Financial's businesses. As Stan described earlier, our loan production includes correspondent and retail lending activities. We have steadily grown volume over the past year in both channels. In correspondent lending, we are focused on disciplined initiatives to capture additional market share in a profitable manner, even as origination volumes decline. Our retail lending continues to build out operations, marketing initiatives, and technology to drive continued growth over the long-term. Presently, both the correspondent and retail production businesses have a relatively small share of the total origination market, and we believe we can prudently and profitably capture additional share, even as mortgage origination volumes decline.

Our loan servicing business has grown consistently, primarily due to the growth in our and PMT's loan production activity. This growth is also supplemented by the growth of our specialty servicing portfolio through the distressed whole loan acquisitions completed by PMT.

Investment management is driven by our net assets under management and the performance of our Advised Entities. Net assets under management have grown as PMT has raised additional capital to deploy in new investment opportunities. We expect PMT to expand its participation in distressed investments and the other opportunities it pursues and continue to grow its balance sheet as appropriate.

Now I would like to review the operational results and outlook for each of our businesses, starting with our correspondent lending business on slide 7.

Slide 7

Correspondent acquisitions totaled $8.6 billion in UPB in the second quarter, a slight increase from the first quarter. Of this, government-insured loan acquisitions totaled $4.3 billion, generating gains on sale of mortgage loans for PFSI. Additionally, PFSI performed fulfillment activities on $4.3 billion of conventional conforming and jumbo loans for PMT, generating fulfillment fee revenue.

In July total correspondent loan fundings were $3.2 billion, of which 49 percent were government-insured loans; and total interest rate lock commitments were $2.5 billion, of which 51 percent were government-insured loans.

As I discussed on the previous slide, there is a lot of room to capture market share and there is a large gap between PennyMac and the largest correspondent lenders. Our initiatives include expanding the active seller relationships, especially in markets where we are underpenetrated such as the Northeast. In the second quarter, we continued to expand the network of correspondent sellers to 220, up from 179 at the end of the first quarter. We also expect increased contribution from new and recently introduced products such as VA loans and fixed-period adjustable rate mortgages, or hybrid ARMs, such as the 5/1, 7/1, and 10/1 products. As Stan stated earlier, while fixed rates have increased, we believe that adjustable rate products should experience growth in demand. Even with our growth initiatives, which we expect to expand market share over time, at this moment, we expect our correspondent volumes to decline in proportion to the overall market.

Let's now turn to slide 8 and take a look at our retail lending business.

Slide 8

Our retail lending business is a consumer direct business that originates loans through a centralized call center-based model. We capture leads for origination from our servicing portfolio, such as the recapture of loans eligible for refinance activity, or purchase-money loans to finance REO and short sales in the distressed portfolio. We also market through the Internet and direct mail to generate leads.

As the graph indicates, we have grown this business steadily but it remains in the early stages of its growth. Retail volumes increased 29 percent in the second quarter to $343 million in UPB. Of that amount, consumer direct originations, or those not generated from our portfolio, grew 93 percent.

We have built the infrastructure for a national call center-based model with technology that can deliver superior service and process efficiencies. Our retail business is closely integrated with our servicing business, which optimizes recapture opportunities. There are substantial opportunities for PennyMac to grow volume. Our rapidly growing servicing portfolio will provide more leads for retail originations. The government's HARP refinance program for underwater borrowers has been extended through 2015. And we are focused on targeted marketing and strategies to drive purchase-money business with the improving housing market.

Slide 9

Turning to slide 9, our servicing portfolio ended the second quarter at $44.4 billion in UPB, a 22 percent increase from the end of the first quarter. Most of this growth came from $8 billion in organic loan production generated from our retail and our and PMT's correspondent activities. Our special servicing portfolio continues to add UPB through the acquisition of distressed whole loans by PMT. We also added $450 million in UPB through what we call mini-bulk and flow MSR acquisitions, which we have begun aggregating pending a planned co-investment by PMT.

As I said, we expect substantial long-term organic growth from the continued production volume generated by the correspondent and retail businesses. In addition, there are also opportunities to grow servicing through MSR portfolio acquisitions in partnership with PMT. All of these growth opportunities will help drive further economies of scale over time, which have the potential to improve servicing margins.

Switching from our Mortgage Banking segment to Investment Management, let's turn to slide 10.

Slide 10

Our Investment Management activities provide us with steady, recurring management fee revenue, as well as performance-based incentive fees from all of our Advised Entities. Net assets under management remained at $1.8 billion during the second quarter, with revenues declining slightly to $13.5 million. Incentive fees and carried interest were $6.7 million, driven by the strong performance of our Advised Entities.

PMT is actively investing in multiple opportunities including opportunities in distressed whole loans, mortgage servicing rights, and non-agency securitizations. PMT is a permanent capital vehicle that has repeatedly demonstrated its ability to access the capital markets as its investment portfolio grows. PMT raised capital in the second quarter, issuing $250 million of 7-year exchangeable notes. While this offering does not result in additional base management fee to PFSI in the near term, the new capital is expected to be accretive to PMT's financial performance.

To talk about the second quarter's financial results, I'd like to turn it over to Anne McCallion, PennyMac Financial's Chief Financial Officer.

Speaker:

Anne McCallion – Chief Financial Officer

Thank you David. Let's turn to slide 11 take a look at the highlights of the quarter's financial performance.

Slide 11

Net income attributable to PFSI common stockholders reflecting the post-IPO period of May 9 through June 30 was $2.8 million, or $0.22 per diluted share. The full-quarter equivalent earnings per diluted share was $0.38.

Pretax income for the full quarter was $50.2 million, on total net revenues of $110.8 million. Both of our business segments exhibited strong top-line performance, with our Mortgage Banking segment producing revenue of $97.2 million, up 6 percent from the first quarter of 2013 and over 178 percent from the same period a year ago.   Investment management revenue was down slightly from the first quarter, but up over 76 percent from the same period a year ago.

As David described earlier, loan production activity maintained volumes totaling $8.9 billion in UPB in the second quarter, helping the servicing portfolio to exceed $44 billion in UPB as of June 30, 2013, an increase of 23 percent from the first quarter.

Let's turn to slide 12 and examine the financial statements in greater detail.

Slide 12

As I said, revenue was $110.8 million, up 5 percent from the previous quarter, driven by a 38 percent increase in net servicing income, a 24 percent increase in management fees, and a 7 percent increase in net gains on mortgage loans, offset by a decrease of 22 percent in fulfillment fees. Carried interest from the Investment Funds declined in the second quarter as the funds' first quarter performance outpaced second quarter results.

Expenses for the second quarter were $60.5 million, up 20 percent from the first quarter, largely driven by increased compensation expenses. As a financial services company, this will be our largest recurring expense and should vary commensurately with our operations. The second quarter's increase in compensation expense resulted from headcount growth and the accrual of certain incentive compensation expenses above first quarter levels.

This resulted in pretax income for the second quarter of $48.2 million. As Stan noted early in his comments, PennyMac Financial is a holding company whose sole investment is a minority interest in Private National Mortgage Acceptance Company. The financial statements represent the consolidation of Private National. The noncontrolling interest that is deducted from net income represents the portion of earnings attributable to Private National's other owners. This results in after-tax net income for PFSI stockholders of $2.8 million and earnings per diluted share of $0.22 for May 9th to June 30th, the period of time in which PFSI owned an interest in Private National.

Let's turn to slide 13 and look at income by Operating Segment.

Slide 13

Mortgage banking revenues were $97.2 million for the second quarter, up 6 percent from the prior quarter, and 178 percent over the same period a year-ago. Net gain on mortgage loans, fulfillment fees, and net servicing fees all drove the strong quarterly performance. Net gain on mortgage loans was $42.7 million, a 7 percent increase over the prior quarter, driven by strong correspondent lending volume of government-insured loans. Fulfillment fees were $22.1 million for the second quarter, down 22 percent from the prior quarter primarily due to the reduction in funding volume, but up 186 percent from the same period a year ago. Net servicing fees increased 38 percent in the second quarter to $22.1 million, which was an increase of 188 percent from the same period a year ago.

These revenues were partially offset by compensation expenses of $39.3 million, which increased 18 percent from the prior period due to increased headcount and the accrual of certain incentive compensation expenses above first quarter levels. This resulted in pretax income for the mortgage banking segment of $39.9 million, down 9 percent from the previous quarter, but up over 700 percent from the same period a year ago.

Investment management revenues for the second quarter were $13.5 million, down 3 percent from the prior quarter, but up over 76 percent from the same period a year ago. Investment management revenues were driven by strong management fees, incentive fees, and carried interest from the Investment Funds. Offsetting this revenue was compensation expenses of $3 million. Pretax income for investment management was $10.3 million, down 10 percent from the prior quarter but up over 111 percent from the same period a year ago.

Let's turn to slide 14 and briefly review our balance sheet.

Slide 14

Total assets at June 30, 2013 were $1.3 billion, an increase of 85 percent from the first quarter. Mortgage loans held for sale at fair value consist primarily of the correspondent inventory of government-insured loans that have yet to be sold. At quarter-end, the inventory was $656 million, an increase of over 200 percent from the first quarter, largely due to an increase in fundings at the end of the quarter. The other important asset I want to mention is the $200 million of mortgage servicing rights, which is the combination of the mortgage servicing rights held at fair value and those held at the lower of cost or fair value. This asset is largely the result of our sales of government-insured correspondent loans. We believe that these are valuable assets, especially given the historically low mortgage rate environment in which most of these loans were originated. I will be discussing this asset, and its value, in a moment.

Of the Company's $725 million in total liabilities at the end of the second quarter, $500 million was related to the financing of our mortgage loan inventory, primarily correspondent loans under repurchase agreements. The amount of this debt outstanding should vary with the change in our inventory of correspondent government-insured and retail mortgage loans.

I would now like to turn to slide 15 and take a greater look at the embedded value of our mortgage servicing rights.

Slide 15

PFSI's mortgage servicing rights portfolio continued to grow, ending the second quarter at 18.8 billion dollars in UPB, up from 14.6 billion dollars in UPB at the end of the prior quarter.

MSRs are a growing portion of PFSI's long-term investments and their economic value generally improves in a rising interest rate environment. The chart on slide 15 shows some of the key metrics of PFSI's MSR portfolio and highlights the difference between the carrying value of PFSI's MSRs and their fair value.

We account for originated MSRs at the lower of amortized cost or fair value when the underlying note rate on the loans is less than or equal to 4.5 percent. MSRs with note rates on the underlying loans above 4.5 percent are accounted for using the fair value method. Given that the vast majority of the loans underlying PFSI's servicing portfolio have note rates below 4.5 percent, most of the MSR asset is accounted for under the lower of amortized cost or fair value accounting method or LOCOM. At the end of the quarter, the carrying value of PFSI's MSR asset was 18 million dollars less than its fair value. This increase in the underlying economic value should result in PFSI's MSRs generating more income over time than initially expected.

And with that I would like to turn it back over to Stan.

Speaker:

Stanford L. Kurland – Chairman and Chief Executive Officer

Thanks Anne. As the origination market slows down and shifts to a purchase-money market, we are taking a close look at the pace of growth in our operations. The shifts in the mortgage market, however, underscore the power of PennyMac Financial's business model, with contributions from loan production, loan servicing, and investment management, and a significant percentage of our revenues from recurring fees.

Our servicing portfolio continues to grow rapidly through organic production, and we have significant opportunities to continue profitable market share gains in our correspondent and retail lending business. PMT, the REIT that we manage, has been very active putting capital to work in multiple opportunities including distressed whole loans, jumbo loans, and its correspondent lending activities, which helps grow our servicing portfolio and increase investment management revenues over time. While we expect some variability in our results and the pace of our growth as the mortgage market evolves, we believe PennyMac Financial is well positioned to drive substantial profitability and earnings growth over the long-term.

Finally, we encourage investors with any questions to reach out to our Investor Relations group by email or phone.

Thank you.