PennyMac Financial Services, Inc.

First Quarter 2014 Earnings Transcript

May 7, 2014

Introduction

Thank you, Chris.

Let's begin with slide 3 and review the highlights of the first quarter.

Slide 3

PennyMac Financial had a strong quarter with significant increases in revenue and income. Our performance reflects how the company's operating platform and business model are well positioned for a more normalized mortgage market.

PennyMac Financial's pretax income was 49.1 million dollars in the first quarter, up 18 percent from the fourth quarter, and diluted earnings per share totaled 38 cents. Net revenue totaled 105.5 million dollars, up 17 percent from the fourth quarter, driven by strong revenue growth in loan production and servicing. Expenses totaled 56.4 million dollars, a 16 percent increase from the fourth quarter.

Our first quarter loan production totaled 5.1 billion dollars in UPB, a 14 percent decline from the fourth quarter. Of our total production, correspondent acquisitions were 4.8 billion dollars in UPB, down 16 percent from the last quarter. Retail originations were 314 million dollars in UPB, up 49 percent from the last quarter as our retail operations demonstrated success executing on the recapture opportunities related to the MSR portfolios we acquired late last year. While our origination volumes declined, we continued to gain market share in correspondent lending and retail lending.

The servicing portfolio grew 7 percent during the first quarter, reaching 84 billion dollars in unpaid principal balance, driven by organic growth resulting from our loan production businesses supplemented by the acquisition of 2.4 billion dollars in UPB of Agency MSRs. Since the end of the quarter, we have entered into agreements to acquire an additional 3.7 billion dollars in UPB of Agency MSRs through a combination of mini-bulk and flow transactions that we expect to settle in the second quarter. We also elected to sell 900 million dollars in UPB of non-core MSRs from a private-label securitization, and we expect that this transaction will also settle in the second quarter.

Net assets under management ended the quarter at 2.1 billion dollars, up 4 percent from the fourth quarter driven by the 80 million dollars in equity raised by PMT during the quarter.

Finally, PennyMac Financial's float increased by approximately 47 percent as the result of a previously planned sale of shares by one of the company's existing stockholders, which should improve the liquidity of our common stock.

Now let's turn to slide 4.

Slide 4

PennyMac Financial's overarching objective is to be the premier mortgage specialist firm in the U.S. We aim to do so by developing leading businesses in four areas: consumer-direct lending, correspondent aggregation, loan servicing, and investment management. This is and has been our strategy since the company's founding over six years ago and remains our strategy for 2014 and beyond. Notably, our growth strategy does not depend on extending into business activities outside of our core capabilities in residential mortgage management.

We see many opportunities to grow and outperform in each of these four business areas. Although we have been successful in growing our mortgage portfolio and platform to date, our servicing portfolio today still represents less than one percent of all residential mortgages outstanding in the U.S. We will elaborate on the specific initiatives we are pursuing to grow each of these businesses later in the presentation.

We measure success in achieving PennyMac Financial's objectives in several ways. First, through financial performance – namely, we look to deliver strong returns on equity and earnings growth over time. We also seek to achieve the highest compliance and quality ratings, as measured by our internal review mechanisms and by outside third parties. Finally, we hope to enjoy loyalty and recognition from our customers, investors, employees and other stakeholders.

Slide 5

Turning to slide 5, we believe that PennyMac Financial stands alone in being well positioned to be the premier specialist firm in the new mortgage market. We have built an industry leading platform through careful organic development over more than six years, as opposed to cobbling together operations through various acquisitions and attempting to revamp platforms built by someone else in a different regulatory environment. We believe that our approach is superior for many reasons, not the least of which is that PennyMac Financial is free from the distractions of legacy issues.

We also believe that a strong compliance culture and corporate governance are imperative to our success, as well as the heightened requirements of a changing market. We have built the core systems for the company to grow in a responsible and controlled manner. PennyMac Financial's governance starts with our distinguished board of directors which has nine members, seven of whom are independent. Within our executive management, we have a robust governance structure with 10 management-level committees that are responsible for overseeing the key risks and controls within the company. We believe that our governance processes are a strength which enhances our credibility with regulators and other outside parties.

We have the optimal structure in place to compete as a non-bank, with the operational activities of PennyMac Financial partnered alongside the investment vehicle PMT. PMT is a leading mortgage REIT that invests in residential mortgage-related assets on a tax-advantaged basis. Our partnership with PMT provides access to a lower cost of capital and reduces the balance sheet constraints on growth, which is important given the capital-intensive nature of mortgage origination, servicing, and investment.

Lastly, we have in place distinctive expertise and the full range of capabilities required for a leading mortgage enterprise. We have all of the capabilities across functions including loan production and fulfillment; credit areas including underwriting and quality control; capital markets; loan servicing; and all of the requisite corporate functions. We have over one thousand four hundred employees led by what we believe is the most experienced management team in the mortgage business today.

As the mortgage market evolves, PennyMac Financial is well positioned to reach our objective to be the premier mortgage specialist firm in the U.S.

Next I'd like to turn to slide 6 and discuss the market environment and how it impacts the businesses in which we participate.

Slide 6

Mortgage rates remain relatively low even though they have risen over the past year from historically low levels. This has helped to maintain the attractiveness of purchasing a home compared to renting in many markets across the country. Improvements in the overall U.S. economy remain modest; however, recent indicators, such as the latest Fannie Mae Homeownership survey, provide optimism that home purchase demand is strengthening as we enter the traditional home buying season.

While home prices on a national basis have risen significantly from year ago levels, we have seen the rate of appreciation slow in recent months, some of which appears to be a result of severe winter weather experienced in many parts of the country during the first quarter. However, most industry forecasts suggest that home price appreciation will continue in 2014, albeit at a slower pace than last year.

Industry forecasts also predict that the mortgage origination market in 2014 will reach 1.2 trillion dollars, compared to 1.9 trillion dollars in 2013. Agency and Government-insured loan products are expected to continue to comprise the vast bulk of mortgage originations, with activity in non-agency products remaining largely limited to bank originations and acquisitions of jumbo loans for their own balance sheets. With the decline in refinance activity due to higher interest rates, over 60 percent of origination volume this year is expected to be purchase-money originations.

The contraction in the U.S. mortgage origination market has increased competition but also presents opportunities. When origination margins were wider in 2012 and early 2013, it was easier for many smaller originators to retain MSRs as the net capital outlay required was lower than it is today. What we're seeing now is a shift by these lenders toward both selling the MSRs they had been retaining in order to raise capital, and selling more of their loans servicing released to correspondent aggregators such as PMT.

There has been a lot of discussion recently about GSE reform with a new director leading FHFA, the regulator of the GSEs, and the recently proposed Johnson-Crapo bill in the Senate. We do not see a high likelihood of any significant changes in the role of the GSEs occurring in the near term. While we believe that over the long term a healthy and normally functioning mortgage market should consist of a combination of private label and Agency originations, with private label mortgage originations comprising a greater percentage of total originations than current levels. Nevertheless, we view the Agencies as essential components of the U.S. mortgage finance system with a significant ongoing role to play. As a result, we expect that the Agencies will remain strong and important business partners for PennyMac Financial and PMT into the future.

The non-agency origination market remains limited today, but the recent spread tightening in Agency and private-label mortgage-backed securities leads us to feel more optimistic. Spread tightening helps make private-label securitization of prime jumbo loans more competitive with banks that originate and acquire loans for their balance sheets. Also, we see the potential for additional prime loan products outside the definition of a Qualified Mortgage, or what are being called non-QM loans, that are likely to emerge in order to satisfy consumer demands that are not currently being met in the market.

The market for MSRs remains active, with many smaller bulk and flow transactions occurring in the market and there continues to be intermittent opportunities to acquire large bulk portfolios. I will elaborate on the nuances of this market in greater detail in a moment.

Finally, we continue to see opportunities to acquire distressed whole loans and PMT remains a selective buyer of these assets where the transactions meet its targeted returns.

Now let's turn to slide 7 and further discuss the opportunity in MSR acquisitions.

Slide 7

PennyMac Financial continues to pursue opportunities to acquire MSRs such as the mini-bulk and flow acquisitions it completed this quarter, in addition to larger acquisitions such as the two bulk portfolios it acquired in the fourth quarter. Given the recent discussions in the industry over the viability of this market and activities by competitors, we wanted to provide you our perspective on the current market and where we see opportunities.

I'd like to begin with the fundamentals of why companies are selling MSRs. Larger banks are selling MSRs due to a combination of continuing operational pressures, higher regulatory capital requirements and a desire to shed non-core customers, such as those that lack cross-sell potential. As I mentioned earlier, independent mortgage lenders are increasingly selling MSRs in order to raise capital as origination volumes have declined abruptly, and with reduced margins, many face operational losses.

Given these different motivations to sell, MSR transactions come to market in different ways. Larger bulk transactions by nature tend to be intermittent. These transactions require considerable amounts of coordination among the various parties involved and can take months to complete. There is attention on these transactions from regulators, the Agencies, and the selling banks, and the capabilities of the acquiring servicer have become increasingly important.

There is what we call a mini-bulk market that consists of smaller MSR portfolios which we expect to be a more consistent market throughout the year. In addition, there are flow transactions which occur on a monthly basis. These are typically MSRs sold by larger independent mortgage originators who deliver their loans directly to the Agencies and simultaneously sell the MSRs. MSRs acquired by PennyMac Financial on a flow basis currently range between 100 and 150 million dollars in UPB per month.

Not all MSRs available in the market are attractive co-investments for PennyMac Financial and PMT. For example, we tend to like GSE and Ginnie Mae MSR portfolios, where we believe PennyMac Financial has a distinctive expertise, versus private-label MSRs in which there are often large delinquency-related advances which could lead to misalignment with bond investors and borrowers. There have been transactions in the market where the financial MSR asset is sold but the loans remain subserviced either by the seller or another third-party. We are most interested in portfolios where there is operational transfer of the servicing to PennyMac Financial, due to the importance of the operational capabilities on performance and ability to recapture. Lastly, PennyMac Financial is concerned about taking on undue liability to repurchase loans as a result of MSR acquisitions, as originator representation and warranty liability can be significant. As a result, we tend to focus on so-called bifurcated transactions, in which the origination liability remains with the seller in the case of Fannie Mae and Freddie Mac portfolios, and Ginnie Mae MSRs where such liability is limited. We also conduct significant due diligence, which can be very resource intensive, in order to mitigate our exposure to liability.

As MSR transactions come to market, we believe that PennyMac Financial is uniquely positioned to be a successful acquirer, working with the selling institutions, Agencies and regulators. It has a proven track record of transferring and boarding complex MSR transactions and numerous portfolios of distressed whole loans over the past six years. PennyMac Financial has an industry leading operating platform, with the physical capacity in California and Texas – including space, infrastructure, and processes – to service more than 200 billion dollars in UPB versus a portfolio of 84 billion dollars in UPB today. Lastly, our synergistic partnership with PMT provides access to efficient capital through co-investment by PMT in the excess servicing spread on MSR acquisitions.

Slide 8

So how do we measure progress in executing on our growth strategy? Turning to slide 8, you can see that each of our businesses has grown over the last two years. Our Correspondent Lending, Retail Lending and loan servicing businesses each grew market share during the quarter. And in the bottom right portion of the slide we have net assets under management for the investment management business, which also grew in the quarter.

Our strategy is to grow each of these businesses in a normalizing mortgage market as well as in a profitable manner over time, and this remains our focus.

Now I'd like to turn to slide 9 and review the specific initiatives we have in place to continue growing each of our businesses, starting with correspondent and retail lending.

Slide 9

Our Correspondent Lending business is focused on a variety of strategic initiatives to grow volume and optimize profitability.

We are growing the number of seller relationships and deepening our relationships with existing sellers. We are particularly focused on serving the needs of smaller originators, which represents a considerable portion of the existing market. We think that our broad array of programs, including deliveries on a best efforts basis, offers a compelling value proposition to these lenders.

During the quarter we increased our group of approved correspondent sellers from 229 to 271 lenders and we expect additional growth throughout 2014, with a target of 350 approved sellers by year end. We have also seen progress in our initiatives to grow seller relationships and volumes in the Northeast, with approximately 40 percent of the new sellers added during the quarter coming from that region. In addition to our strategic initiatives, further growth in the correspondent aggregation market may come as originators deliver fewer loans directly to the GSEs.

In retail lending, our efforts are directed toward successfully executing on portfolio recapture opportunities, while continuing to develop the consumer direct platform for non-portfolio business.

It is worth noting that refinance activity still remains an important part of the market, and many borrowers, for example those in smaller balance loans, have been underserved by originators. This is one reason we believe that we have been successful in refinancing borrowers from our recent MSR acquisitions, even in a higher interest rate environment.

We are also developing the consumer direct platform to serve the growing purchase-money origination market. One of the ways we are doing this is through our Business Development Officers, or BDOs, who develop institutional relationships with local and regional Realtors and builders for PennyMac Financial's centralized call center platform.

Finally, as I mentioned earlier, we believe that there are meaningful opportunities in prime non-QM mortgage products to satisfy consumer demands that are not currently being met in the market, which could benefit both our correspondent and retail lending businesses.

Slide 10

Turning to slide 10, our strategy to grow our loan servicing business is to continue adding loans to our prime portfolio through the company's retail and correspondent loan production activities, and to supplement this organic growth with MSR acquisitions. We expect that the steadiest opportunity is in mini-bulk and flow MSR acquisitions, and we expect to see larger bulk MSR transactions like the two portfolios we acquired in the fourth quarter on a more intermittent basis.

In addition to portfolio growth, we expect the contribution of loan servicing to PennyMac Financial's profitability to grow in a few ways. First, the economic value of servicing varies depending on interest rates and we expect prime servicing to produce more value when interest rates are higher. This value increase not only results from an expectation for lower prepayments, but also through increased value of the float from custodial accounts.

Second, we believe that there are opportunities to drive operational efficiencies and improved economics with the larger servicing portfolio. Servicing is an operationally intensive business that benefits from economies of scale, and our platform is reaching a level where we expect to realize more of these efficiencies.

Now let's talk about the growth strategies for our Investment Management business.

Through the growth in PMT's capital base, we believe that the opportunities to invest in residential mortgage-related assets remain significant. Our primary focus is growing the capital base in PMT and the existing investments include distressed whole loans; MSRs resulting from correspondent aggregation; excess servicing spread on MSRs; retained interests from jumbo securitizations; and agency and non-agency MBS. As the mortgage market evolves, new opportunities are also emerging that drive a need for investment capital, such as risk-sharing transactions on GSE loans and prime non-QM loans.

As you can see, PennyMac Financial has specific initiatives that we are pursuing to grow each of our businesses.

Now I'd now like to turn it over to David Spector, PennyMac Financial's President and Chief Operating Officer to review the highlights in each of our businesses during the first quarter.

Speaker:

David Spector – President and Chief Operating Officer

Slide 11

Thank you, Stan.

I will begin my comments on slide 11 with the correspondent lending business. Correspondent acquisitions totaled 4.8 billion dollars in UPB for the first quarter, a 16 percent decrease from the fourth quarter. Of this amount, government-insured loan acquisitions totaled 2.9 billion dollars, a decline of 13 percent from last quarter. Additionally, PennyMac Financial performed fulfillment activities on 1.9 billion dollars of conventional conforming and jumbo loans for PMT during the first quarter. Government-insured loan acquisitions generate revenue for PennyMac Financial primarily in the form of gain on mortgage loans, whereas fulfillment activities generate revenue in the form of fulfillment fees.

Our volumes in correspondent were strong this quarter relative to the total mortgage origination market, which declined 23 percent from the fourth quarter. Our volumes resulted in market share gains, and PMT maintained its ranking as the number 3 correspondent aggregator in the country.

In April, total correspondent loan fundings were 2.2 billion dollars, and interest rate lock commitments were 2.5 billion dollars.

We continued to build on our strong competitive position in the market for government-insured loan products. By our estimates, our correspondent business' share of all government-insured loan originations represented 5.7 percent during the quarter. We believe that PennyMac Financial has competitive advantages in the specialized market for government-insured loan programs.

Let's now turn to slide 12 and look at our retail lending business.

Slide 12

Retail Lending volumes in the first quarter totaled 314 million dollars in UPB, a 49 percent increase from the fourth quarter. Portfolio-sourced originations were 285 million dollars, or 91 percent of our originations. Non-portfolio originations were 29 million dollars, or 9 percent of the total. The high percent of portfolio-sourced originations during the quarter is the result of the emphasis we placed on pursuing recapture opportunities from the recent MSR portfolio acquisitions. So far, the recapture has been running at approximately 49 percent.

In addition, we continued to develop our platform for purchase-money business including our BDO initiative which Stan mentioned earlier. We continue to grow this initiative methodically, and we hired new BDOs and key management positions in the first quarter to help drive this initiative forward.

Now let's turn to slide 13 and discuss our loan servicing business.

Slide 13

PennyMac Financial's servicing portfolio grew to 83.8 billion dollars in UPB at the end of the first quarter, up 7 percent from 78.2 billion at the end of the prior quarter. The portfolio grew primarily organically, supplemented by smaller bulk and flow MSR acquisitions which totaled 2.4 billion dollars in UPB. PMT co-invested in these bulk and flow MSR acquisitions by acquiring excess servicing spread valued at 21 million dollars.

We have continued to develop our Fort Worth facility to support the growth in our servicing portfolio. Our Fort Worth facility's servicing operations now mirror most of the capabilities of the platform located in our Moorpark headquarters. This provides not only scalability for future growth, but also redundancy for the Moorpark platform and expanded customer service hours. As Stan mentioned in his remarks, we believe that we have in place the physical capacity to service 200 billion dollars in UPB, and the Fort Worth facility provides us a way to scale the servicing platform outside of California.

Let's now turn to slide 14 and review the results of our Investment Management business in the first quarter.

Slide 14

PennyMac Financial provides specialized expertise and investment services to our Advised Entities, which consist of PMT and two private Investment Funds. We ended the quarter with combined net assets under management of approximately 2.1 billion dollars, an increase of 4 percent from December 31 2013, which was driven by PMT raising 80 million dollars through share offerings during the quarter to support its continued growth.

Our Investment Management activities provide relatively steady, recurring management fee revenue, as well as performance-based incentive fees from our Advised Entities. Revenues in the first quarter were 12.5 million dollars, a decrease of 13 percent from the fourth quarter, primarily due to lower incentive fees from PMT and a decline in carried interest from the Investment Funds.

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

Speaker:

Anne McCallion – Chief Financial Officer

Thank you David. Let's turn to slide 15 and take a look at the highlights of the quarter's financial performance.

Slide 15

Pretax income for the first quarter was 49.1 million dollars on net revenue of 105.5 million dollars, increases of 18 and 17 percent, respectively, from the fourth quarter. Earnings per diluted common share were 38 cents, up 19 percent from the fourth quarter.

Expenses for the first quarter totaled 56.4 million dollars, a 16 percent increase from the fourth quarter, driven by a quarter-over-quarter increase in incentive compensation and higher servicing expenses from a growing portfolio.

Beginning this quarter we have enhanced our reporting by separating our mortgage banking activities into two segments: Production and Servicing.

Production segment pretax income was 26.0 million dollars, up 14 percent from the fourth quarter, and Servicing segment pretax income was 17.1 million dollars, up 94 percent from the prior quarter. Investment Management segment pretax income totaled 6.0 million dollars for the first quarter, down 41 percent from the prior quarter.

Let's now turn to slide 16 and drill down into the results of the Production segment.

Slide 16

Production segment revenues were 52.7 million dollars for the first quarter, up 10 percent from the fourth quarter. These higher revenues were driven by a 17 percent rise in net gains on mortgage loans held for sale and higher loan origination fees, partially offset by lower fulfillment fees from PMT due to a decline in conventional correspondent production volumes during the quarter.

During the first quarter, PennyMac Financial acquired 2.9 billion dollars in Government-insured mortgages through correspondent lending and originated 314 million dollars of loans through retail lending. Interest rate lock commitments on Government-insured and retail loans totaled 3.9 billion dollars for the first quarter, flat from the prior quarter. Interest rate lock commitments are the primary driver of net gain on mortgage loans held for sale.

The net gains on mortgage loans held for sale as a percentage of Government-insured and retail interest rate lock commitments was 89 basis points in the first quarter compared to 76 basis points in the previous quarter.

Loan origination fees as a percentage of Government-insured and retail loan funding volumes totaled 21 basis points in the first quarter compared to 15 basis points in the fourth quarter and the average fulfillment fee earned from PMT was 46 basis points for both quarters.

Let's turn to slide 17 and take a look at the financial performance of the Servicing segment.

Slide 17

Pretax income for the Servicing segment was 17.1 million dollars for the first quarter, an increase of 94 percent from the fourth quarter. Net servicing fees amounted to 43.8 million dollars for the first quarter, a 43 percent increase from the prior quarter. This included a 3 million dollar reduction in fair value of mortgage servicing rights carried at fair value and a 400 thousand dollar provision for impairment of MSRs carried at lower of amortized cost or fair value, both driven by expectations for higher prepayment speeds as a result of lower interest rates at quarter end. The MSR valuation adjustments were partially offset by a 4.8 million dollar decrease in the fair value of the liability for excess servicing spread sold to PMT. Segment revenues also included 2.9 million dollars in liquidation fees from PMT from the previously announced sale of a performing whole loan portfolio in January. Segment expenses were 23.1 million dollars for the first quarter, up from 19.4 million dollars in the previous quarter.

As you can see in the box on the slide for the servicing fee roll-forward, the majority of the growth in servicing fees during the first quarter was attributable to an increase in the volume as our servicing portfolio grows, while rate-driven increases accounted for a relatively small percentage of servicing fee growth.

Now let's turn to slide 18 and take a look at the current value of our mortgage servicing rights.

Slide 18

MSRs are a growing portion of PennyMac Financial's assets and their fair value generally increases in a rising interest rate environment and decreases when rates fall.

We account for originated MSRs at the lower of amortized cost or fair value, or LOCOM, 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, and those subject to excess servicing spread, are accounted for using the fair value option. At the end of the quarter, the fair value of PennyMac Financial's MSR asset carried at LOCOM was 9.4 million dollars greater than its carrying value.

During the first quarter, PennyMac Financial completed the sale of excess servicing spread totaling 21 million dollars in fair value. This excess servicing spread was acquired by PMT.

Let's now turn to slide 19 and take a look at the financial performance of the Investment Management segment.

Slide 19

Pretax income for the Investment Management segment was 6 million dollars, a decline of 41 percent from the fourth quarter. Management fees, which include base management fees and incentive fees from PMT and base management fees from the Investment Funds, declined 8 percent from the prior quarter primarily due to an 800 thousand dollar decline in incentive fee revenue from PMT. Carried interest income from the Investment Funds declined 900 thousand dollars driven by lower gains in their distressed loan investments during the quarter.

And with that I would like to turn it back over to Stan for some closing remarks.

Speaker:

Stanford L. Kurland – Chairman and Chief Executive Officer

Thank you Anne.

As demonstrated by our performance in the first quarter and the strategic initiatives we are pursuing, we see many opportunities for PennyMac Financial to grow and outperform, even in a smaller mortgage origination market. While we have been successful in growing our mortgage servicing portfolio and platform, our servicing portfolio today represents less than one percent of all residential mortgages outstanding in the U.S. We have significant opportunities across our businesses of correspondent aggregation, consumer-direct lending, loan servicing, and investment management. Our company is uniquely positioned with the expertise and industry-leading capabilities required to continue growing in a responsible and sustainable manner. We believe that PennyMac Financial is well on the way toward achieving our objective of being the premier mortgage specialist firm in the U.S.

We appreciate your support of PennyMac Financial. Finally, we encourage investors with any questions to reach out to our Investor Relations team by email or phone.

Thank you.

Operator

This concludes the PennyMac Financial Services first quarter earnings discussion. For any questions, please visit our website, at www.ir.pennymacfinancial.com , or call our Investor Relations department, at 818-264-4907.