PennyMac Financial Services, Inc.

Second Quarter 2014 Earnings Transcript

August 6, 2014

Introduction

Good afternoon and welcome to the second quarter 2014 earnings discussion for PennyMac Financial Services, Inc. The slides that accompany this discussion are available from PennyMac Financial Services, Inc.'s website at www.ir.pennymacfinancial.com. Before we begin, please take a few moments to read the disclaimer on slide two 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

Thank you, Chris.

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

Slide 3

PennyMac Financial's pretax income was 58 million dollars in the second quarter, up 18 percent from the first quarter, and diluted earnings per share totaled 45 cents.

The second quarter's results included higher revenues and solid pretax earnings contributions from each of our business segments – loan production, loan servicing, and investment management.

Loan production totaled 7.4 billion dollars in unpaid principal balance, or UPB, a 44 percent increase from the first quarter. Of our total production, correspondent acquisitions were 7.0

billion dollars in UPB, up 44 percent from the first quarter. Consumer-direct originations were 403 million dollars in UPB, up 29 percent from the prior quarter as our retail operations continued to demonstrate success executing on the recapture opportunities related to the MSR portfolio acquisitions.

The servicing portfolio grew 12 percent during the second quarter, reaching 93.6 billion dollars in UPB, driven by organic growth resulting from our loan production businesses, supplemented by the acquisition of 5.5 billion dollars in UPB of Agency MSRs.

During the second quarter, we initiated an early buyout or “EBO” program for defaulted loans in Ginnie Mae pools, purchasing 575 million dollars in UPB. The EBO program reduces costs by financing buyouts with lower cost debt or through the early sale of the FHA-insured or VA-guaranteed loans in default, versus advancing the MBS pass-through rate over the resolution timeline of the loans.

In our Investment Management business, net assets under management ended the quarter at 2.14 billion dollars, up modestly from the first quarter driven by an increase in the book value of PMT’s shareholders’ equity.

Now let’s turn to slide 4.

<u>Slide 4</u>

PennyMac Financial’s strategic mission is to be the premier mortgage specialist firm in the U.S. We aim to do so by developing leading businesses in the following areas: consumer-direct and correspondent loan production, 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 capability, mortgage finance.

We continue to see many opportunities to grow and outperform in each of our businesses and measure success in achieving PennyMac Financial's objectives in the following 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.

Let's now turn to slide 5 and further discuss PennyMac Financial's performance in the second quarter.

Slide 5

Turning to slide 5, we show strong trends in PennyMac Financial's earnings and revenues in recent quarters.

PennyMac Financial's growth in EPS reflects its continued success in profitably expanding market share across each of its businesses and organic growth through the disciplined execution of our strategic initiatives.

Our unique business model combines mortgage production revenue streams with more stable fee-based revenue streams from servicing and investment management. Approximately half of second quarter revenues came from the relatively more stable Loan servicing and Investment Management activities, up from just over 30 percent of total revenues last year. PennyMac Financial earns servicing fees on the MSRs we own, and servicing and subservicing fees from our Advised Entities. Through loan servicing, we also earn ancillary income such as loan-level activity fees, late charges, and interest income on escrow balances. Our loan servicing has grown mostly organically as a result of our loan production activities, supplemented by the opportunistic acquisitions of MSR portfolios. Investment Management revenue include base management fees and performance-based incentive fees earned from our Advised Entities. The growth in revenues from these activities illustrates the ongoing development of PennyMac Financial's business model and its ability to deliver steady revenue growth from a variety of sources.

Now let's turn to slide 6 and discuss our current perspectives on the market environment.

Slide 6

During the second quarter, the average rate on the 30 year mortgage declined, helping to drive an increase in refinance activity. By historical standards, mortgage rates remain relatively low, which helps to maintain the attractiveness of purchasing a home compared to renting in many markets across the country. Over the long run, we expect rates to rise as the Fed continues to taper its bond purchases and as signs of economic improvement continue to emerge.

While home prices on a national basis continued to increase, home price appreciation thus far in 2014 has slowed significantly from the rapid pace in 2013. Most industry forecasts expect that moderate home price appreciation will continue in 2014 with price increases likely driven by the improvements in the economy and a tight supply of housing.

In recent months, we have seen signs of improvement in the U.S. economy, most notably in job growth, where more than two million new jobs have been added over the last twelve months. One trend that stands out is job growth in the very important 25 to 34 year old age demographic, which is a key age cohort for first time home buyers. This demographic segment accounted for nearly 34% of total job growth over the past year.

Another factor impacting home prices is the supply of homes available for sale. Inventory of existing home for sale is averaging 5.5 months, which reflects the tight supply in many areas of the country.

To summarize, moderate home price appreciation coupled with a strengthening economy bodes well for both an improving market for housing and the market for the related financing.

During the second quarter we observed increasing prices for distressed loans driven by strong investor demand, and in particular, demand for reperforming loans with clean payment histories. Rising prices are incenting more sellers to bring assets to the market, which we believe will increase the supply of distressed loans available for sale in the future. We continue to believe that opportunities will exist to participate in this market, but it takes patience and diligence to find the right opportunities.

For the foreseeable future the mortgage origination market will remain dominated by the GSEs – Fannie Mae and Freddie Mac – and Ginnie Mae. Recent legislative initiatives aimed at developing an alternative structure to the GSEs have stalled and are not likely to move forward this year. Further, we believe that it is unlikely that we will see a reduction in conforming loan limits. We view the Agencies as essential to the mortgage market, but we believe that a healthy and normally functioning mortgage market should also have an active private label securitization market, which remains limited today and continues to slowly emerge. Opportunities exist in the market for further development of prime non-agency loan products and these opportunities may be a driver of growth in the non-agency market over time.

Recently, there has been increased scrutiny of nonbank mortgage companies and discussion about the risks they may pose. We believe that PennyMac Financial is distinguished among mortgage companies with our organically built operating platform, strong governance culture, and appropriate levels of capital. Our businesses are subject to considerable external oversight including from the GSEs, regulators, and our bank partners. PennyMac Financial's relationship with affiliated entities is limited to its role as the external manager and mortgage services provider for PMT and the Investment Funds. Furthermore, PennyMac Financial does not have any business arrangements with affiliated companies for ancillary real estate-related services.

Slide 7

Turning to slide 7, you can see that each of our businesses continues to grow. Correspondent Production, Consumer-Direct and Loan Servicing continued to increase their 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 increased over the quarter.

We believe that the growth across each of PennyMac Financial's businesses reflects a carefully built operational foundation that will enable us to grow profitably as the mortgage market environment evolves.

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

Speaker:

David Spector – President and Chief Operating Officer

Slide 8

Thank you, Stan.

I would like to begin on slide 8 with our correspondent production business.

Correspondent acquisitions totaled 7.0 billion dollars in UPB for the second quarter, a 44 percent increase from the first quarter. Government-insured loan acquisitions accounted for 57 percent, or 4.0 billion dollars of correspondent acquisitions during the quarter. Additionally, PennyMac Financial performed fulfillment activities for PMT on 3.0 billion dollars of conventional conforming and jumbo loans during second 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.

These acquisition volumes resulted in PMT maintaining its number 3 correspondent aggregator ranking for the second quarter and further market share gains.

In July, total correspondent loan acquisitions were 3.0 billion dollars, and interest rate lock commitments were 2.9 billion dollars.

During the quarter we continued to add seller relationships and build on our strong competitive position in the market for government-insured loan products. By our estimates, PennyMac Financial's share of all government-insured loan originations was 5.8 percent in the second quarter.

During the quarter we increased our group of approved correspondent sellers from 271 at the end of the first quarter to 316 lenders at June 30th, with a target to reach 350 approved sellers by year end. We continue to deliver on initiatives to grow our seller relationships in addition to deepening relationships with existing sellers.

We remain focused on serving the needs of smaller originators, which we believe can benefit from our broad array of programs, delivery options and our proven execution. We believe that these differentiating factors offer a compelling value proposition to these smaller lenders.

We also continue to pursue ways to broaden the product menu, primarily in prime non-agency products, which have the potential to be attractive investments for PMT and generate additional loan fulfillment fees, servicing and investment management revenue for PennyMac Financial.

Now let's turn to slide 9 and discuss consumer-direct production.

Slide 9

Consumer-Direct production volumes in the second quarter totaled 403 million dollars in UPB, a 29 percent increase from the first quarter. Portfolio-sourced originations were 372 million dollars and non-portfolio originations were 31 million dollars. The high percentage of portfolio-sourced originations during the quarter is a result of the emphasis we continue to place on pursuing recapture opportunities from the MSR portfolios we acquired late last year. The recapture rate on these loans during the second quarter was in excess of 50 percent.

In addition, we continued to develop our platform to grow the consumer direct purchase-money business. These initiatives include the ongoing build out of the Business Development Officer initiative which strategically places BDOs in specific geographic regions to develop and maintain relationships with realtors and home builders. Further, we also continue to build awareness of PennyMac's brand through a national advertising campaign including broadcast commercials and internet-based strategies.

Now let's turn to slide 10 and discuss our loan servicing business.

Slide 10

In the second quarter, our loan servicing portfolio grew to 93.6 billion dollars in UPB, up 12% from the first quarter. Prime servicing and subservicing saw net growth of 11.1 billion dollars in UPB quarter-over-quarter as we continued adding loans to our prime servicing portfolio through our consumer-direct and correspondent loan production activities. This organic growth was supplemented by MSR acquisitions during the quarter totaling 5.5 billion dollars in UPB, with a 53 million dollar co-investment by PMT in the associated excess servicing spread. We also initiated an early buyout program for defaulted loans primarily from legacy Ginnie Mae pools, which I'll discuss in greater detail on the next slide.

With regard to strategic objectives for the servicing business, we continue to grow the portfolio organically through our production business and pursue mini-bulk and flow acquisitions to supplement this strategy. Larger bulk MSR transactions are still likely to come to market but on a more intermittent basis. As the servicing portfolio grows, we expect to continue driving operational efficiencies and capturing economies of scale.

Now let's to turn to slide 11 and discuss the details of the benefits of the EBO program that I mentioned a moment ago.

Slide 11

During the second quarter we initiated an early buyout program and purchased 575 million dollars in UPB of loans, primarily from legacy Ginnie Mae MSRs acquired last year. EBO programs help reduce costs and are customarily used by servicers that have the capital and financing necessary to buy out the eligible loans.

The economic benefit of the EBO program is reduced costs by financing with lower cost debt or through the early sale of the FHA-insured or VA-guaranteed loans in default, vs. advancing the MBS pass-through rate through the resolution of the loan.

Let’s now turn to slide 12 and discuss the operational results from the investment management segment.

Slide 12

Investment management revenues increased 2% from the first quarter due to an increase in base management and incentive fee revenue from PMT partially offset by a decline in Carried interest income from the Investment Funds.

Net assets under management increased modestly to 2.14 billion dollars at quarter-end from 2.10 billion at March 31, 2014, due to an increase in the book value of PMT’s shareholders’ equity.

We believe that the opportunities to invest in residential mortgage-related assets remain significant. PMT’s current investments include distressed whole loans; MSRs resulting from correspondent aggregation; excess servicing spread on MSRs; retained interests from prime jumbo securitizations; and agency and non-agency MBS. Given our track record in mortgage-related investments, we believe there is significant opportunity for PennyMac Financial to manage additional capital in assets such as prime non-agency loans and GSE-issued risk transfer securities.

With that I’d now like to turn it over to Anne McCallion, PennyMac Financial’s Chief Financial Officer, to talk about the second quarter’s financial results.

Speaker:

Anne McCallion – Chief Financial Officer

Thank you, David. Let's turn to slide 13 and take a look at the highlights of the quarter's financial performance.

Slide 13

Pretax income for the second quarter was 58.0 million dollars on net revenue of 130.4 million dollars, increases of 18 and 24 percent, respectively from the first quarter. Diluted earnings per common share were 45 cents, up 18 percent from the first quarter.

Expenses for the second quarter were 72.4 million dollars, a 28 percent increase from the first quarter.

Production segment pretax income was 32.8 million dollars, up 26 percent from the first quarter, and Servicing segment pretax income was 20 million dollars, up 17 percent from the prior quarter. Investment Management segment pretax income totaled 5.3 million dollars for the second quarter, down 11 percent from the prior quarter.

Let's now turn to slide 14 and take a closer look at the results of the Production segment.

Slide 14

Production segment revenues were 63.9 million dollars for the second quarter, up 21 percent from the first quarter. The higher revenues were driven by a 10 percent increase in net gains on mortgage loans held for sale and loan origination fee revenue, in addition to a 40 percent increase in fulfillment fees from PMT due to a 56 percent increase in conventional correspondent production volumes during the quarter.

During the second quarter, PennyMac Financial acquired 4 billion dollars in UPB of Government-insured mortgages through correspondent production and originated 403 million dollars in UPB of loans through consumer-direct production, an increase of 37 percent and 29 percent respectively from the first quarter. Interest rate lock commitments on Government-insured and consumer-direct loans totaled 5.2 billion dollars for the second quarter, an increase of 33 percent from the first quarter.

The net gains on mortgage loans held for sale as a percentage of Government-insured and consumer-direct interest rate lock commitments was 74 basis points in the second quarter, compared to 89 basis points in the previous quarter, primarily as a result of a decrease in government-insured correspondent margins during the quarter.

Loan origination fees as a percentage of Government-insured and consumer-direct loan funding volumes totaled 24 basis points in the second quarter compared to 21 basis points in the first quarter. Gains related to consumer-direct IRLCs were approximately 320 bps in the second quarter when adjusted for expected fallout, which is estimated to be 35% for consumer-direct loans. The average fulfillment fee earned from PMT was 42 basis points compared to 46 basis points in the prior quarter.

Let's turn to slide 15 and take a look at the financial performance of the Servicing segment.

Slide 15

Servicing segment revenues were 53.7 million dollars in the second quarter, an increase of 34 percent from the prior quarter. Net servicing fees totaled 57.0 million dollars, a 30 percent increase from the prior quarter. This amount includes a 12.5 million dollar reduction in the fair value of mortgage servicing rights (MSRs) carried at fair value and provisioning for impairment of MSRs carried at the lower of amortized cost or fair value, which was offset by a 10.1 million dollar reduction in the fair value of the excess servicing spread financing liability and 9.6 million dollars in MSR-associated hedge gains.

Servicing segment expenses increased to 33.8 million dollars, up 46 percent from the previous quarter due to servicing portfolio growth, cost associated with the purchase of loans out of the Ginnie Mae pools and higher incentive compensation accruals.

Now let's turn to slide 16 and take a look at the value of our mortgage servicing rights.

Slide 16

PennyMac Financial's originated mortgage servicing rights portfolio grew to 30.1 billion dollars in UPB at June 30, 2014, up from 27.9 billion dollars at the end of the first quarter. PennyMac Financial also owns purchased MSRs, some of which are subject to excess servicing spread owned by PMT with a UPB related to the underlying loans totaling 27 billion dollars.

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.

During the second quarter, PennyMac Financial completed the sale of excess servicing spread totaling 53 million dollars in fair value. This excess servicing spread was acquired by PMT.

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

Slide 17

Investment management revenues were 12.8 million, up 2% from 1Q14. Management fees, which include base management fees and incentive fees from PMT and management fees from the Investment Funds, increased 9 percent from the prior quarter primarily due to a 500 thousand dollar increase in incentive fee revenue from PMT as a result of improved performance. Carried interest income from the Investment Funds declined by 300 thousand dollars.

Segment expenses were 7.5 million dollars, up 15 percent from the first quarter primarily as a result of a higher incentive compensation accrual 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.

We see many opportunities across the residential mortgage market that PennyMac Financial is uniquely positioned to capture. Our servicing portfolio continues to grow organically through loan production and also through bulk and flow acquisitions of MSRs. We continue to enhance our capabilities in our consumer-direct business, which is a growing contributor to PennyMac Financial's revenues. And we continue to profitably grow our correspondent production business. We are well positioned to manage additional investments in mortgage-related assets. In sum, PennyMac Financial is well positioned to grow profitably and sustainably over the long term.

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 second 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.