



PennyMac Financial Services, Inc.

Fourth Quarter 2014 Earnings Transcript

February 4, 2015

Introduction

Good afternoon and welcome to the fourth 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.

PennyMac Financial continued to grow its core mortgage banking businesses during the fourth quarter with strong performance in consumer direct originations and loan servicing portfolio growth. The mortgage origination market is gaining momentum with the low interest rate environment, and the FHA's recent reduction to its annual mortgage insurance premiums makes mortgage financing more affordable for many borrowers. Industry forecasts expect these factors to lead to an increase in refinance and home purchase activity, and we believe that PFSI is well positioned to capture these opportunities.

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

Slide 3

For the fourth quarter, PennyMac Financial earned pretax income of 53.2 million dollars, down 15 percent from the third quarter, and diluted earnings per share totaled 41 cents. The fourth quarter's earnings in particular were driven by pretax earnings contributions from our loan production segment.

Production segment revenues were 72.4 million dollars, up 1 percent from the prior quarter. Loan production totaled 8 billion dollars in unpaid principal balance, a 7 percent decline from the third quarter. Of our total production, correspondent acquisitions were 7.3 billion dollars in UPB, down 10 percent from the third quarter, driven by a competitive environment and a seasonal decline in the purchase money market which has represented more than 70 percent of our correspondent production volumes. Consumer direct originations were 682 million dollars in UPB, up 30 percent from the prior quarter. Our increasing volumes in consumer direct are driven by ongoing success in executing on the recapture opportunities from a growing servicing portfolio.

Servicing segment revenues were 57.6 million dollars, an increase of 3 percent from the prior quarter. The servicing portfolio grew 6 percent during the quarter, to 106 billion dollars in UPB, due to organic growth resulting from our loan production activities, supplemented by mini-bulk and flow MSR acquisitions totaling 1.7 billion dollars in UPB during the quarter.

Investment management segment revenues were 10.4 million dollars, a decrease of 22 percent from the prior quarter driven by a reduction in performance-based fees. Net assets under management ended the quarter at 2 billion dollars.

During the fourth quarter, we worked on several potential bulk MSR acquisition opportunities. Subsequent to the end of the quarter, PennyMac Financial has entered into letters of intent to acquire approximately 21 billion dollars in UPB of Agency MSRs from multiple selling institutions, and we expect to sell the excess servicing spread associated with these portfolios to PennyMac Mortgage Investment Trust (PMT). David Spector will discuss these pending acquisitions in more detail later in the presentation.

Let's turn to slide 4 and review several trends in the mortgage market that are affecting our businesses.

Slide 4

Mortgage rates continued to trend lower during the fourth quarter and are currently at their lowest levels since mid-2013.

In addition, the Federal Housing Administration announced in January that it would reduce its annual mortgage insurance premiums paid by borrowers on new FHA loans by 50 basis points. As you can see from the chart in the lower right hand portion of the slide, this action results in annual FHA mortgage insurance premiums that are now significantly lower than the levels for new loans originated over the last four years. The lower premiums should help reduce the cost

of homeownership. In addition, this change will increase the ability of many FHA and other borrowers to refinance and lower their mortgage payments.

As a result of the lower interest rates and the policy change, the industry has seen an increase in refinance activity. More broadly, we believe these changes will have a meaningful impact on mortgage origination volumes in the near term. Forecasts for 2015 origination volume from Fannie Mae, Freddie Mac and the Mortgage Bankers Association have increased, on average, by approximately 10 percent as a result.

Over the last several months we have seen home price appreciation across the U.S. moderate. Home price gains are estimated to be approximately 6 percent on a national basis for 2014, which is a significant decline from the double-digit home price appreciation seen in 2012 and 2013. This year, home prices are forecast to rise by 4.9 percent nationally, which is much closer to the average home price appreciation rate over the last 30 years of 4.1 percent. Our expectation is that price gains going forward will be driven more by underlying economic fundamentals than a rebound from housing crisis levels.

Lastly, we continue to see regulatory scrutiny of nonbank mortgage companies, which in our view highlights the importance of operational excellence, governance, and compliance systems. These have been areas of heavy emphasis for PennyMac Financial since our inception. It is also important for mortgage companies to maintain adequate levels of capital, and we view the expansion of minimum financial requirements for mortgage seller / servicers proposed by FHFA last week as a positive development. PennyMac Financial currently operates with capital levels well above these proposed minimums.

Slide 5

On slide 5, I would like to take a moment to review our business model and why today's market environment is particularly attractive to PennyMac Financial. The company is organized in three operating segments: Loan Production, Loan Servicing and Investment Management.

Our loan production business consists of our correspondent activity, aggregating loans originated by third-party sellers, and our consumer direct originations of loans to facilitate the purchase of a home or refinancing of an existing mortgage. In correspondent, PennyMac Financial aggregates the government-insured loans, the majority of which are FHA-insured loans which I discussed on the previous slide. These government-insured loans are then pooled into Ginnie Mae securities; PennyMac Financial earns a gain on mortgage loans and retains an investment in the resulting MSR. In consumer direct, PennyMac Financial originates and securitizes government-insured loans, as well as conventional loans which are typically delivered to Fannie Mae or Freddie Mac. Through our correspondent and consumer direct production, PennyMac Financial is a major participant in the government-insured lending market and has become the second-largest issuer of Ginnie Mae securities.

In loan servicing, the majority of our business is prime servicing and subservicing for loans in Fannie Mae, Freddie Mac, and Ginnie Mae securities. We also conduct special servicing for distressed loans owned by PMT and the private Opportunity Funds managed under our investment management business.

In addition to our business model, our platform has been strategically developed to be in a position to capture the broad array of opportunities in the mortgage market. Mortgage banking is a complex and highly regulated business that requires deep expertise and operational excellence. Our distinctive platform has been built from the ground up and we have developed legacy-free operations focused on scalability and sustainability, with a commitment to strong corporate governance, compliance, and risk management processes. As a result, we believe that PennyMac Financial is uniquely well positioned for continued growth in this market and regulatory environment.

Now let's turn to slide 6 and review the fourth quarter's performance in greater detail.

Slide 6

PennyMac Financial's earnings per share in the fourth quarter were 41 cents per share, compared to 49 cents per share in the third quarter. Total revenue increased 1 percent from the third quarter.

The fourth quarter's results included increases in revenue from Loan Production and Loan Servicing. In Loan Production, the strong performance from consumer direct lending was offset by lower fulfillment fee revenue in correspondent production due to a 21 percent decline in conventional conforming acquisition volumes by PMT. In Loan Servicing, higher net servicing fee revenue was partially offset by a reduction in gains from the sale of early buyout loans. Investment Management revenue decreased, as carried interest from the investment funds

declined by 1.6 million dollars and incentive fees from PMT decreased by 1.1 million dollars from the third quarter.

Total expenses during the fourth quarter rose 14 percent. The increase was driven by headcount growth in the consumer direct, servicing and correspondent production businesses to support increasing levels of activity. Servicing expense rose due to increased losses and loss provisions on claims to the government agencies on defaulted loans, including loans purchased out of government agency pools.

Now let's turn to slide 7 and discuss how we're building PFSI's platform to address current and prospective opportunities.

Slide 7

PennyMac Financial continued to invest in its businesses during the fourth quarter to address the considerable opportunities we see in today's mortgage market and to prepare for future growth.

PennyMac is in a strong position to capitalize on the opportunities presented by the low interest rate environment as well as the FHA's recent reduction in annual mortgage insurance premiums. The low interest rates are already resulting in higher loan application volume industry-wide. Borrowers who entered into mortgages over the last eighteen months, in particular, could benefit from refinancing at the prevailing low mortgage rates, which we expect will drive increased activity for PennyMac Financial's production businesses. The change in the FHA mortgage insurance premiums will not only increase overall refinance and purchase money

mortgage origination activity, which benefits our correspondent production volumes, but we also believe it will result in an increase in refinance opportunities for our existing customers as well as supporting non-portfolio growth for our consumer direct lending.

The pending bulk MSR acquisitions that I mentioned earlier should also create new opportunities for PennyMac Financial, including servicing fee revenue, added economies of scale, and additional recapture potential.

During the quarter, we continued to invest in our consumer direct origination activities to enhance our portfolio recapture capabilities and further develop our non-portfolio growth strategies. These initiatives resulted in current period investments in headcount and technology. We invested in growing our call center and processing capabilities and continued to build and develop our affinity and business development officer strategies aimed at growing our consumer direct market share. We also continued to invest in information technology and additional loan servicing infrastructure necessary to support long-term future growth.

Now I would like to turn to slide 8 and discuss our new initiatives in commercial real estate finance in more detail.

Slide 8

PennyMac Financial recently launched PennyMac Commercial Real Estate Finance, or PCREF, a new division focused on loans for multifamily, office, retail and mixed-use properties, with a typical loan balance between 1 and 10 million dollars.

The origination market for small balance commercial real estate loans is highly fragmented, with the top 15 lenders in the country estimated to account for less than a quarter of the total market. Annual originations are approximately 160 billion dollars, and we expect this market to grow as the economy continues to improve and as borrowers of commercial real estate address upcoming loan maturities over the next few years.

PennyMac Financial plans to originate conventional, mini perm, bridge and Agency multifamily commercial real estate loans. PMT is expected to purchase and aggregate these newly originated commercial loans for eventual securitization. We intend to focus our commercial lending footprint in the nation's 50 largest MSAs. In addition to new originations, PMT plans to pursue opportunities to acquire legacy performing and sub-performing loans from banks and other commercial loan owners. PennyMac Financial expects to develop the special servicing capabilities necessary for the resolution of nonperforming commercial real estate loans on behalf of PMT.

PennyMac Financial has attracted a team of seasoned industry professionals, who we believe have the industry knowledge and expertise necessary to successfully penetrate the commercial mortgage market and build PCREF into a significant market participant over time. The commercial real estate lending business complements our existing businesses in residential mortgages and has the potential to deliver attractive returns for PennyMac Financial and PMT. We are currently focused on building our operating capabilities, and as a result, we do not expect profitability from PCREF before the fourth quarter of this year.

Now I'd like to turn the discussion over to David Spector, PennyMac Financial's President and Chief Operating Officer.

Speaker:

David Spector – President and Chief Operating Officer

Thank you, Stan.

Slide 9

I'd like to begin my remarks on slide 9, and review the trends across PennyMac Financial's businesses. Looking to the year ahead, we continue to focus on profitably growing market share in our production businesses as well as in our servicing portfolio. Increases in our consumer direct production volumes and servicing UPB led to market share gains during the fourth quarter, while our share in correspondent production dropped slightly as we maintained pricing discipline in the face of heightened competition.

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

Now let's turn to slide 10 and review the operational results in each of PennyMac Financial's activities, starting with correspondent production.

Slide 10

Correspondent acquisitions totaled 7.3 billion dollars in UPB for the fourth quarter, a 10 percent decline from the third quarter. Government-insured loan acquisitions accounted for 60 percent, or 4.4 billion dollars of correspondent acquisitions, during the quarter. Additionally, PennyMac Financial performed fulfillment activities for PMT on 2.9 billion dollars of conventional conforming and jumbo loans during the fourth quarter. Government-insured loan acquisitions generate revenue primarily in the form of net gains on mortgage loans, whereas loan fulfillment for PMT generates revenue for PennyMac Financial in the form of fulfillment fees. The fourth quarter presented a challenging operating environment as aggressive competitor pricing, coupled with the traditional seasonal slowdown in purchase-money volumes, drove the decline in conventional conforming acquisition volumes at PMT.

In January, total correspondent loan acquisitions were 2.3 billion dollars in UPB, and interest rate lock commitments were 2.4 billion dollars in UPB.

Throughout 2014, we continued to deliver on initiatives to grow the number of seller relationships and deepen our relationships with existing sellers. Our group of approved correspondent sellers has grown considerably over the last year, reaching 344 at the end of 2014, up from 229 at the end of 2013, with a goal of reaching 480 sellers by the end of 2015. In addition to adding new sellers, we are focused on growing volumes from smaller sellers as well as improving market share in specific geographic markets and states where we are under-represented. We also remain focused on growing our activities in jumbo loan aggregation, a market in which we see opportunity for PennyMac Financial and PMT.

Now let's turn to slide 11 and discuss consumer direct production.

Slide 11

Consumer direct production volumes in the fourth quarter totaled 682 million dollars in UPB, a 30 percent increase from the third quarter. Portfolio-sourced originations were 603 million dollars and non-portfolio originations were 79 million dollars. The high percentage of portfolio-sourced originations during the quarter resulted from the considerable opportunities available from effective recapture of the existing servicing portfolio, supported by the rollout of certain government-insured loan programs in our consumer direct channel.

We believe that the current low rate environment, combined with the recent mortgage insurance premium reduction will increase our recapture activity and drive increased non-portfolio refinance opportunities. Our pending bulk MSR acquisitions, which I will go over in a moment, should add to the portfolio recapture opportunities over the next several quarters.

We also continue to invest in initiatives to develop purchase-money business for our consumer direct platform. These initiatives include growing affinity relationships through corporate partnerships and continuing to expand our program of Business Development Officers in geographic markets across the country.

Now let's turn to slide 12 and discuss our Loan Servicing business.

Slide 12

In the fourth quarter, our loan servicing portfolio grew to 106 billion dollars in UPB, up 6 percent from the third quarter. Prime servicing and subservicing saw net growth of 5.8 billion dollars in UPB quarter-over-quarter as we continued to add loans through our consumer direct and correspondent loan production activities. This organic growth was supplemented by the acquisition of 1.7 billion dollars in UPB of MSRs during the quarter. PMT's coinvestment in ESS related to purchased MSRs during the quarter amounted to 17.1 million dollars.

During the quarter we reviewed 36 mini-bulk and flow deals in the market, bidding on 5 and winning 1 deal. We remain well positioned to capture larger bulk MSR transactions as these opportunities come to market.

Our servicing portfolio continues to grow through a combination of organic growth and MSR acquisitions, such as the pending transactions we're announcing today. As the portfolio grows, we expect to continue driving operational efficiencies and capture further economies of scale. While servicing expenses can fluctuate from quarter-to-quarter, we expect them to grow on a dollar basis as the portfolio grows. Over the long run, expenses as a percentage of the average servicing UPB should decline.

Now I'd like to turn to slide 13 and elaborate on our pending bulk MSR acquisitions.

Slide 13

We are pleased to announce that PennyMac Financial has entered into letters of intent to acquire MSRs totaling approximately 21 billion dollars in unpaid principal balance from multiple

third-party sellers. Upon closing these transactions, PennyMac Financial expects to sell the excess servicing spread associated with these portfolios to PMT. These pending acquisitions will be important additions to PennyMac Financial's growing servicing portfolio.

Underlying the MSRs in these pending acquisitions are seasoned high-quality Agency loans. The portfolios combined have a weighted average note rate of 3.86 percent, and four and a quarter percent of the loans are delinquent. The weighted average servicing fee for the portfolios is 33.4 basis points. We anticipate creating an excess servicing spread of approximately 17.5 basis points which would represent an investment of approximately 175 million dollars by PMT.

Our best-in-class operational platform is highly scalable with the capabilities, processes and systems in place to acquire and board these types of bulk MSR portfolios in addition to being well-positioned for future growth. We believe that these pending transactions reflect our commitment to operational excellence and reflect our track record of closing and transferring these types of MSR portfolios successfully.

Now let's turn to slide 14 and discuss PennyMac's approach to interest rate risk management and protecting the value of our mortgage servicing rights.

Slide 14

At PennyMac Financial, we employ a comprehensive interest rate risk management approach to protect the value of our interest rate risk sensitive assets, among the largest is our mortgage servicing rights.

We use a variety of financial instruments to implement our strategy. These include forward sale contracts, mortgage options and other derivatives such as swaptions. Our objective is to protect the embedded value of the MSR asset from movements in interest rates, while also considering the company-wide revenue impacts of a particular change. For example, when bonds rally and interest rates decline, we generally expect lower interest rates to result in higher prepayments in our loan servicing portfolio. The projection of higher prepayment speeds impacts the value of the mortgage servicing rights; however, the lower rates that drive this higher prepayment expectation also typically result in an increase in refinance activity, recapture opportunities for our consumer direct channel, and higher refinance volumes for correspondent production. However, while the increased origination activity associated with lower rates takes place in future periods, the MSRs experience an immediate reduction in value. To counter the adverse impact to the MSR's value, we use financial hedges that correspondingly rise in value when interest rates decline.

During the fourth quarter, the gains in our servicing hedges more than offset the amortization and fair value declines in the MSR asset. Anne will discuss these results later in the presentation.

Now let's turn to slide 15 and discuss the operational results of the Investment Management segment.

Slide 15

Investment Management revenues declined 22 percent from the third quarter due to lower carried interest income from the Investment Funds and a decline in incentive fee revenue from PMT.

Net assets under management decreased modestly to 2 billion dollars at quarter-end from 2.02 billion dollars at September 30th, driven by lower book value at PMT. Despite the book value decline, PMT continued to make attractive new investments in MSRs and ESS, and made its first sizable acquisitions of distressed loans since early 2014.

PMT continues to pursue a variety of mortgage-related investments which 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. Newer opportunities may include investments in commercial real estate loans and GSE risk transfers on PMT's production, both of which have the potential for attractive returns and align with PennyMac Financial's expertise of managing mortgage investments.

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

Speaker:

Anne McCallion – Chief Financial Officer

Thank you, David. Let's turn to slide 16 and take a look at the highlights of the quarter's financial performance.

Slide 16

Pretax income for the fourth quarter was 53.2 million dollars on net revenue of 141.7 million dollars, down 15 percent from the third quarter. Diluted earnings per common share was 41 cents, a 16 percent decrease from the third quarter.

Expenses for the fourth quarter were 88.5 million dollars, a 14 percent increase from the third quarter and were driven by higher compensation and servicing expenses.

Production segment pretax income was 37.8 million dollars, down 3 percent from the third quarter, and Servicing segment pretax income was 11.4 million dollars, down 34 percent from the prior quarter. Investment Management segment pretax income totaled 2.6 million dollars for the fourth quarter, down 58 percent from the prior quarter.

Let's now turn to slide 17 and take a closer look at the results of the Production segment.

Slide 17

Production segment revenues were 72.4 million dollars for the fourth quarter, up 1 percent from the third quarter. The higher revenues were driven by a 7 percent increase in net gains on

mortgage loans held for sale and higher loan origination fee revenue, partially offset by a 23 percent decline in fulfillment fees from PMT due to lower conventional and jumbo correspondent production volumes during the quarter.

During the fourth quarter, PennyMac Financial acquired 4.4 billion dollars in UPB of Government-insured mortgages through correspondent production, unchanged from the third quarter. The Company also originated 682 million dollars in UPB of loans through consumer direct production, up 30% from the third quarter. Interest rate lock commitments on Government-insured and consumer direct loans totaled 5.9 billion dollars for the fourth quarter, an increase of 5 percent from the third quarter.

The net gains on mortgage loans held for sale as a percentage of Government-insured and consumer direct interest rate lock commitments was 76 basis points in the fourth quarter, compared to 73 basis points in the previous quarter.

Loan origination fees as a percentage of Government-insured and consumer direct loan funding volumes totaled 25 basis points in the fourth quarter, up from 24 basis points in the third quarter. The average fulfillment fee earned from PMT was 41 basis points, down from 42 basis points the prior quarter.

Production segment expenses increased 6 percent quarter over quarter, primarily due to headcount growth to support increased consumer direct production capacity through increased staffing in loan fulfillment, call center and sales support personnel.

Let's turn to slide 18 and take a look at the financial performance of the Servicing segment.

Slide 18

Servicing segment revenues were 57.6 million dollars in the fourth quarter, an increase of 3 percent from the prior quarter. Net loan servicing fees totaled 62.3 million dollars for the quarter, a 16 percent quarter-over-quarter increase, primarily due to an 8 percent increase in servicing fees, in addition to hedge gains. The 162 thousand dollar net loss on mortgage loans held for sale during the quarter resulted from a reduction in economics related to early buyout loan, or EBO sales in the fourth quarter, compared to 6.8 million of gains in the third quarter. Despite the net loss on the sale, it is important to mention we conduct EBO transactions when we believe that the cost savings of not advancing at the MBS pass-through rate exceeds both the expenses and costs that are recorded at the time of the buyout and any financing expenses we may incur in the future on the EBO loans.

Servicing segment expenses increased to 46.1 million dollars, a 21 percent increase from the third quarter, primarily due to a rise in losses and loss provisions on claims to the government agencies on defaulted loans, largely related to legacy bulk MSR acquisitions. These expenses are generally contemplated in the purchase price of MSR acquisitions.

Now let's turn to slide 19 and take a look at the value of our mortgage servicing rights.

Slide 19

PennyMac Financial's originated mortgage servicing rights portfolio grew to 36.6 billion dollars in UPB at December 31, 2014, up from 33.3 billion dollars at the end of the third 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 28.2 billion dollars at December 31, 2014, which increased from 27.6 billion dollars at the end of the third quarter.

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 at fair value. At the end of the quarter, the fair value of PennyMac Financial's MSR asset was 11.4 million dollars greater than its carrying value.

PennyMac Financial also completed the sale of excess servicing spread during the fourth quarter, totaling 17 million dollars in fair value. This excess servicing spread was acquired by PMT.

Let's now turn to slide 20 and take a look at the financial performance of the Investment Management segment.

Slide 20

Investment management revenues were 10.4 million, down 22 percent from the third quarter.

Segment revenues include management fees, which include base management fees and incentive fees from PMT, in addition to management fees and carried interest from the Investment Funds.

Carried interest paid to PennyMac Financial from the private investment funds declined 86 percent from the prior quarter, due to a smaller portfolio of assets and reduced financial performance from the distressed loans. Incentive fees from PMT declined by 1.1 million dollar from the third quarter as a result of PMT's reduced financial performance in the fourth quarter.

Segment expenses were 7.7 million dollars, up 9 percent from the third quarter primarily due to higher incentive compensation.

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.

The mortgage banking business is one that requires high levels of expertise and operational capabilities. Since our inception over seven years ago, we have continually invested in our operating platform and enterprise risk-management capabilities to ensure we have best-in-class compliance, governance and operational functionality. Our highly scalable and legacy-free operating platform has the ability to support future growth and deliver further economies of scale as we grow.

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 fourth quarter 2014 earnings discussion. For any questions, please visit our website, at www.ir.pennymacfinancial.com , or call our Investor Relations department, at 818-264-4907.