PennyMac Financial Services, Inc.

First Quarter 2015 Earnings Transcript

May 6, 2015

Introduction

Good afternoon and welcome to the first quarter 2015 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 delivered strong earnings in the first quarter, driven by higher volumes and revenue from our loan production business. The opportunity in mortgage production is substantial, driven by continued low mortgage rates, the FHA's reduction of its mortgage insurance premium, and limited origination capacity in the market. While this opportunity also results in higher prepayment activity, which negatively impacted our loan servicing segment during this quarter, we believe that PennyMac Financial is well positioned for continued success in this vibrant market.

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

Slide 3

For the first quarter, PennyMac Financial earned pretax income of 53.2 million dollars and diluted earnings per share totaled 42 cents. The first quarter's earnings were primarily driven by pretax earnings contributions from our Loan Production segment.

Production segment revenues were 110.8 million dollars, up 53 percent from the prior quarter. Loan production volume, including loans that have not yet transferred from PMT as of March 31, 2015, totaled 8.9 billion dollars in unpaid principal balance, a 12 percent increase from the fourth quarter. Of our total production, correspondent acquisitions were 8 billion dollars in UPB, up 10 percent from the fourth quarter due to higher mortgage production volume resulting from lower mortgage rates and the FHA's mortgage insurance premium reduction. Consumer direct originations were 897 million dollars in UPB, up 31 percent from the prior quarter, due to recapture opportunities from our servicing portfolio.

Servicing segment revenues were 19.5 million dollars, down 66 percent from the prior quarter. Higher actual and forecast prepayments driven by refinance opportunities resulted in a reduction of MSR value. The servicing portfolio grew 9 percent during the quarter, to 115.2 billion dollars in UPB, driven by organic growth that resulted from our loan production activities, supplemented by mini-bulk and flow MSR acquisitions totaling 6.4 billion dollars in UPB during the quarter.

Investment management segment revenues were 10 million dollars, a decrease of 4 percent from the prior quarter, resulting from a reduction in performance-based incentive fees. Net assets under management ended the quarter at 2 billion dollars.

Let's turn to slide 4 and review the activity after quarter end.

Slide 4

After the end of the first quarter, we completed the acquisition of 15 billion dollars in UPB of Agency MSRs which we previously announced. We also completed the sale of the associated excess servicing spread, or ESS, to PMT totaling 136 million dollars.

During the first quarter, we worked on several potential bulk MSR acquisition opportunities and subsequent to the end of the quarter, PennyMac Financial entered into a letter of intent to acquire approximately 9 billion dollars in UPB of Ginnie Mae MSRs, with co-investment by PMT in the related ESS. David Spector will discuss this pending acquisition in more detail later in the presentation.

Also, we worked with Credit Suisse to amend our Ginnie Mae MSR financing facility to allow for the financing of ESS by PMT.

Let's turn to slide 5 and review several trends in the mortgage market that are affecting our businesses.

Slide 5

During the first quarter, 30 year fixed mortgage rates declined to their lowest quarterly average level since mid-2013. In addition to declining interest rates, the FHA's 50 basis point reduction in its annual insurance premiums paid by borrowers on new FHA loans increased the incentive for many FHA borrowers to refinance and lower their mortgage payments. As a result of these factors, the industry experienced a significant increase in refinance activity during the first quarter. The average of industry forecasts from Fannie Mae, Freddie Mac and the Mortgage Bankers Association now predict a 1.3 trillion dollar mortgage origination market for 2015.

As you can see from the chart in the lower right hand portion of the slide, home prices have been stagnant on a not-seasonally-adjusted basis since last summer. This year, home prices are forecast to rise at a pace that is closer to the average home price appreciation rate over the last 30 years of 4.1 percent. We continue to believe that home price gains going forward will be driven by macroeconomic improvement and tight housing inventory in certain regions.

Lastly, recent regulatory actions against large non-bank mortgage companies reinforce the importance of effective governance, compliance, and operating systems. These have all been areas of emphasis for PennyMac since our inception and we remain committed to investing in these areas as we grow.

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

Slide 6

PennyMac Financial earned 42 cents per share in the first quarter, compared to 41 cents per share in the fourth quarter, a total net revenue decreased 1 percent from the fourth quarter.

The first quarter's results included increased earnings from Loan Production, which was partially offset by a loss in Loan Servicing and lower earnings from Investment Management.

This quarter's results highlight the effectiveness of PennyMac Financial's business model where the reduction in servicing revenue due to the reduction in MSR values was offset by higher production revenues driven by increased production in correspondent and strong portfolio recapture by consumer direct lending.

Slide 7

On slide 7, I would now like to discuss some of the strategic initiatives that PFSI is pursuing.

The ability to capture increasing economies of scale is critical to our long term success as it results in cost efficiencies over time and improves the Company's competitive position in the marketplace. Growth in our servicing portfolio has been key to capturing economies of scale. Our portfolio will approach 140 billion dollars in UPB with the completion of the recent and pending acquisitions. Additionally, as the portfolio has grown, the percentage of prime quality loans has also increased and is now over 95 percent of the portfolio. This growth has been a catalyst for the expansion of our servicing and consumer direct businesses in the Fort Worth area, where we have developed an operations center that now mirrors the full functionality of our California operations. The high-quality nature of our portfolio also makes possible strategic investments in technology focused on enhancing the efficiency and productivity of our customer interactions.

We are also pleased to announce that we have recently established a new mortgage fulfillment division, or MFD, to leverage the high-volume processes and expertise of our correspondent aggregation business for consumer direct lending. This new division is focused on developing additional operating capacity, improving efficiency through enhanced processes, and making technology investments to improve the loan origination experience for the borrower.

Finally, we are continuing to develop the platform for our new Commercial Real Estate Finance business. We have been focused on building the production sales force and developing our operational resources and infrastructure. We have completed the implementation of the credit and pricing policies and processes, and continue to develop commercial loan servicing capabilities. We expect the initial funding of newly originated loans to occur in the second quarter of 2015, with these loans to be acquired and aggregated for securitization by PMT.

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 8

I'd like to begin my remarks on slide 8, and review the trends across PennyMac Financial's businesses. Our loan servicing and consumer-direct activities continued to increase their market share during the quarter through successful execution of our growth initiatives.

Increases in our consumer direct production volumes and servicing UPB led to market share gains during the first quarter, while our share in correspondent production dropped slightly as we maintained pricing discipline in a competitive environment.

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 9 and review the operational results in each of PennyMac Financial's activities, starting with correspondent production.

Slide 9

Correspondent production totaled 8.0 billion dollars in UPB for the first quarter, a 10 percent increase from the fourth quarter. Government-insured loan acquisitions accounted for 64 percent, or 5.1 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 first 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.

In April, total correspondent loan acquisitions were 3.6 billion dollars in UPB, and interest rate lock commitments were 4.6 billion dollars in UPB. During the quarter, we continued to execute on a number of strategic initiatives to grow market share and optimize the business relationships with existing sellers. We have made significant gains in growing our presence in New England, which now accounts for approximately 7% of our total lock volume. Additionally, we initiated a new program with a large bank to acquire and securitize their government-insured loan production on a flow basis.

To support our geographic expansion and grow our book of correspondent seller relationships, we hired additional correspondent sales managers in the first quarter. Their goal is to help the business achieve its target of 480 seller relationships by year end, and to also maximize the business we do with each relationship. An important aspect of this initiative is to continue building what we call our “development book” which typically consists of smaller originators. These sellers tend to deliver their loans on what’s known as a “best efforts” basis, and we believe that these relationships can benefit from our operational expertise and risk management capabilities. Our development book accounted for 1.5 billion dollars, or roughly 15 percent of lock volume in the first quarter, up from less than 2 percent of lock volume in the first quarter of 2014 and it will remain a key strategic focus for the correspondent sales team going forward. Finally, we are making use of proprietary technology to optimize our margin opportunity by product and geography, allowing us to more effectively manage the economics of each transaction we execute.

Now let's turn to slide 10 and discuss consumer direct production.

<u>Slide 10</u>

Consumer direct production volumes in the first quarter totaled 897 million dollars in UPB, a 32 percent increase from the fourth quarter. Portfolio-sourced originations were 834 million dollars and non-portfolio originations were 63 million dollars. The high percentage of portfolio-sourced originations during the quarter resulted from the recapture opportunities available in our servicing portfolio, supported by the low interest rate environment and the FHA mortgage insurance premium reduction.

In April, total consumer direct loan production was 330 million dollars in UPB, and interest rate lock commitments were 638 million dollars in UPB. The high volume of refinance opportunities available is continuing in the second quarter thus far. Our newly announced pending MSR acquisition, which I will go over in a moment, is expected to result in additional portfolio recapture opportunities over the next several quarters.

While we are focused on and reacting to the considerable opportunity in today's market, we continue to invest in initiatives that will drive long-term growth of our consumer direct business. As Stan mentioned earlier, we have established a centralized mortgage fulfillment division to extend our high-volume processes and expertise to consumer direct. Our technology investments include a new customer experience at PennyMacUSA.com and enhancements for new rules such as the TILA-RESPA integrated disclosure.

We also continue to invest in developing the purchase-money business for our consumer direct platform. These initiatives include growing affinity relationships through corporate partnerships, our use of Business Development Officers in key geographic markets across the country, and sourcing leads from our servicing call centers.

Now let's turn to slide 11 and discuss our Loan Servicing business.

Slide 11

In the first quarter, our loan servicing portfolio grew to 115.2 billion dollars in UPB, up 9 percent from the fourth quarter. Prime servicing and subservicing saw net growth of 9 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 6.4 billion dollars in UPB of MSRs during the quarter.

During the quarter we reviewed 55 mini-bulk and flow deals in the market, bidding on 10 and winning 3 deals. We remain well positioned to capture larger bulk MSR transactions as those opportunities come to market, as evidenced by our pending acquisition of an additional 9.3 billion dollars of Agency MSRs.

Our servicing portfolio continues to grow through a combination of organic growth and MSR acquisitions. As Stan mentioned, to support our growth, we are continuing to expand our operating platform, and we now have full scale operations in both California and Forth Worth, Texas. We view the Fort Worth metro area as a strategic location for our second operations center, primarily due to its talented and deep labor pool and central time zone that provides better coverage for our consumers across the United States. Two operations centers provide disaster recovery benefits to ensure our ability to serve customers amidst any interruption in either location. We have also made recent technology enhancements to improve customer self-service capabilities through the use of interactive voice response, and a new website.

Now I'd like to turn to slide 12 and elaborate on our new bulk MSR acquisition.

Slide 12

Subsequent to quarter end, PFSI invested 62 million dollars net of ESS sold to PMT in 15 billion dollars in UPB of Agency MSRs. This transaction was announced in the fourth quarter earnings release.

We are also pleased to announce that PennyMac Financial has entered into a letter of intent to acquire MSRs totaling 9.3 billion dollars in unpaid principal balance. Upon closing this transaction, PennyMac Financial expects to sell the excess servicing spread associated with this portfolio to PMT.

This portfolio consists of seasoned government insured loans with recapture potential. The portfolio has a weighted average note rate of 4.73 percent, and 5.65 percent of the loans are delinquent. The weighted average servicing fee for the portfolio is 35.4 basis points. We anticipate creating an excess servicing spread investment of approximately 22.9 basis points which would represent an investment of approximately 75 million dollars by PMT.

We believe that this pending transaction reflects our commitment to operational excellence and our track record of closing and transferring these types of MSR portfolios successfully.

Now let's turn to slide 13 and discuss the Investment Management segment.

Slide 13

Investment Management revenues declined 4 percent from the fourth quarter primarily due to a 1.4 million dollar reduction in management fee revenue from PMT, partially offset by a 1 million dollar increase in carried interest income from the investment funds.

Net assets under management remained at 2 billion dollars at March 31, 2015. 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, investments in Agency and non-Agency MBS, credit risk transfers on its own correspondent production and small balance commercial real estate loans.

New initiatives that PMT has put in place, including FHLB membership and financing for ESS and MSRs, are strengthening its ability to grow and generate attractive returns on equity which is important to us as PMT's manager. The unique risk share transaction with Fannie Mae that PMT has announced provides another opportunity to invest and deploy additional capital over time.

With that I'd now 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 14 and take a look at the highlights of the quarter's financial performance.

Slide 14

As Stan noted, pretax income for the fourth quarter was 53.2 million dollars.

Production segment pretax income was 70.7 million dollars, up from 37.8 million dollars in the fourth quarter. The servicing segment reported a pretax loss of 18.5 million dollars, compared to pretax income of 11.4 million dollars from the prior quarter. Investment Management segment pretax income totaled 1.1 million dollars for the first quarter, down from 2.6 million dollars in the prior quarter.

Let's now turn to slide 15 and take a closer look at the results of the Production segment.

Slide 15

Production segment revenues were 110.8 million dollars for the first quarter, up 53 percent from the fourth quarter. The higher revenues were primarily driven by a 72 percent increase in net gains on mortgage loans held for sale and a 33 percent increase in loan origination fee revenue due to a higher rate on fulfillment fees paid by PMT during the quarter.

During the first quarter, PennyMac Financial acquired 5.1 billion dollars in UPB of Government-insured mortgages through correspondent production, an increase of 16 percent from the fourth quarter. The Company also originated 897 million dollars in UPB of loans through consumer direct production, up 31 percent from the fourth quarter. Interest rate lock commitments on Government-insured and consumer direct loans totaled 7.8 billion dollars for the first quarter, an increase of 34 percent from the fourth quarter.

The net gains on mortgage loans held for sale as a percentage of Government-insured and consumer direct interest rate lock commitments were 99 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 consumer direct loan funding volumes totaled 28 basis points in the first quarter, up from 25 basis points in the fourth quarter. The average fulfillment fee earned from PMT was 45 basis points, up from 41 basis points the prior quarter.

Production segment expenses increased to 40.1 million dollars, a 16 percent increase from the fourth quarter, primarily driven by increased headcount to support higher volumes of consumer direct production.

Let's turn to slide 16 and take a look at the financial performance of the servicing segment.

Slide 16

Servicing segment revenues were 19.5 million dollars in the first quarter, a decrease of 66 percent from the prior quarter. Net loan servicing fees totaled 26.8 million dollars for the quarter, a 57 percent quarter-over-quarter decrease, which included 72.9 million dollars in servicing fees reduced by 24.1 million dollars of amortization and 46.7 million dollars of impairment and fair value losses driven by lower mortgage rates during the first quarter and the FHA's unanticipated Mortgage Insurance Premium reduction. These were partially offset by a 7.5 million dollar benefit from the change in excess servicing spread financing and 17.1 million dollars of hedging gains.

Servicing segment expenses decreased to 38.1 million dollars, an 18 percent decrease from the fourth quarter, primarily driven by a decrease in loss provisions on claims to the government agencies related to defaulted loans and fewer buyouts of delinquent Ginnie Mae loans.

Now let's turn to slide 17 and take a look at the value of our mortgage servicing rights.

Slide 17

PennyMac Financial's originated mortgage servicing rights portfolio grew to 39.2 billion dollars in UPB at March 31, up from 36.6 billion dollars at the end of the fourth 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 33.1 billion dollars at March 31, which increased from 28.2 billion dollars at the end of the fourth 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 interest 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 8.8 million dollars greater than its carrying value.

PennyMac Financial also completed the sale of excess servicing spread totaling 46 million dollars during the first quarter. This excess servicing spread was acquired by PMT.

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

Slide 18

Investment management revenues were 10.0 million dollars, down 4 percent from the fourth 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 earned by PennyMac Financial from the private investment funds increased 1 million dollars from the prior quarter as a result of increases in the fair value of reperforming loans in the investment funds. Management fees declined 15 percent driven by PMT's reduced financial performance.

Segment expenses were 8.9 million dollars, up 15 percent from the fourth quarter primarily due to an increase in corporate overhead allocation, consistent with the activities and efforts completed on PMT's behalf, such as FHLB membership, the Fannie Mae credit risk transfer transaction and execution of new financing facilities.

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 opportunities available to PennyMac Financial are substantial, both in today's vibrant market and in the mortgage markets over time. We are capturing increasing economies of scale with higher volumes in loan production and the significant growth of our loan servicing portfolio. We have made significant progress putting in place several key initiatives for PMT, our primary managed entity. We continue to invest in our operations, systems, and management for sustainable success across our businesses. Together, we believe that these initiatives will drive continued growth in revenue and earnings for our shareholders.

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 2015 earnings discussion. For any questions, please visit our website, at www.ir.pennymacfinancial.com , or call our Investor Relations department, at 818-264-4907.