PennyMac Financial Services, Inc.

Third Quarter 2015 Earnings Transcript

November 4, 2015

Introduction

Good afternoon and welcome to the third 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.

Let's begin with slide 3.

Slide 3

PennyMac Financial delivered strong financial performance in the third quarter as a result of continued growth in our loan production and servicing businesses.

For the third quarter, PennyMac Financial earned pretax income of 73.9 million dollars, a decrease of 1 percent from the prior quarter but an 18 percent increase versus the third quarter of 2014. Of pretax income, 77.7 million dollars was from our production segment and 2.2 million came from investment management, partially offset by a loss of 6.1 million dollars from our servicing segment.

Servicing segment results were impacted by 47.9 million dollars of impairment and fair value losses on MSRs driven by higher expected prepayment activity, partially offset by gains of 30.5 million dollars of hedging gains and a 10.3 million dollar gain from the change in fair value of excess servicing spread financing, for a net impairment charge of 7.2 million dollars.

Diluted earnings per share was 58 cents, driven by strong pretax earnings contributions from our Loan Production segment.

Production segment revenues were 135.2 million dollars, up 3 percent from the prior quarter and the highest level in PennyMac Financial's history.

Loan production volumes also reached record high levels during the quarter, totaling 15.5 billion dollars in unpaid principal balance, a 19 percent increase from the second quarter. Of our total production, correspondent production was 14.4 billion dollars in UPB, up 21 percent from the second quarter driven by significant market share gains in our correspondent aggregation business. Consumer direct originations were 1 billion dollars in UPB, down 8 percent from the prior quarter.

Our servicing portfolio grew 14 percent during the quarter to 154.8 billion dollars in UPB, resulting from organic growth in our loan production activities, supplemented by bulk and flow MSR acquisitions totaling 10 billion dollars in UPB. Servicing operating revenues were 106 million dollars, up 17 percent from the second quarter resulting from an increase in servicing fees from a growing portfolio. Net servicing segment revenues were 46.1 million dollars, down 21 percent from the prior quarter, driven by the net MSR impairment.

Investment Management segment revenues were 7.8 million dollars, up 13 percent from the prior quarter, due to an increase in carried interest from the private investment funds. Net assets under management ended the quarter at 1.8 billion dollars.

Now let's turn to slide 4 and discuss the market environment for the second quarter.

<u>Slide 4</u>

During the third quarter, volatility across the capital markets and in overseas markets continued to drive investors to U.S. bonds and keep interest rates low. The 30-year fixed mortgage rate averaged 3.95

percent in the third quarter and has hovered around 3.8 percent in recent weeks. The FHA's 50 basis point reduction in its annual insurance premiums, announced at the beginning of the year, coupled with low rates, continued to drive strong refinance activity in the third quarter. Industry forecasts from Fannie Mae, Freddie Mac and the Mortgage Bankers Association have been revised upward and now predict a 1.6 trillion dollar mortgage origination market for 2015.

While home price appreciation has moderated from the high rates of increase across most areas of the country in recent quarters, housing fundamentals appear stable.

According to the National Association of Realtors, home purchase activity has continued to increase and total existing-home sales reached an annualized rate of 5.6 million units in September, 8.8 percent higher than a year ago.

As you can see from the chart in the lower right-hand portion of the slide, Agency loans and the government-insured and guaranteed programs in particular continue to dominate the mortgage market. Ginnie Mae's share of new MBS issuance reached an all-time high in the third quarter and exceeded the issuance of new MBS guaranteed by either Fannie Mae or Freddie Mac. This result has been driven by the FHA premium reduction, FHA and VA streamlined refinance programs that allow consumers to conveniently benefit from lower interest rates, as well as low down payment requirements for government loans that are meeting the needs of today's borrowers such as first-time home buyers.

Fannie Mae and Freddie Mac have also recently introduced their own low down payment loan programs designed to meet the needs of these homebuyers.

We continue to see changes in mortgage banking regulation that underscore the importance of effective governance, compliance and operating systems. These changes include the new TILA-RESPA Integrated Disclosure Rule, or TRID, that went into effect early in

October, changing the process for new loan origination. FHA and the GSEs have also recently introduced initiatives designed to clarify lender liability and improve confidence in the market. PMT benefits from the focus its service provider and manager, PennyMac Financial, places on governance and operating systems and we believe this distinguishes PMT among mortgage REITs.

Now let's turn to slide 5 and review our earnings growth trajectory.

<u>Slide 5</u>

PennyMac Financial continues to distinguish itself by delivering significant earnings growth. For the first nine months of this year, earnings per share has totaled one dollar fifty-eight cents per share, compared to one dollar thirty-two cents per share for the first nine months of last year, a 20 percent increase. Over this same period, pretax income has grown similarly, up 19 percent. This earnings growth has been driven by substantial top-line growth in our business volumes and revenues. For example, our servicing portfolio has grown by 55 percent over the last twelve months and total loan production has increased by 80 percent.

Our performance reflects the size of the opportunity available to nonbank mortgage specialists in today's market, and the success PennyMac Financial has had in capturing the opportunity.

Now let's turn to slide 6 and discuss the operating profitability of our servicing business.

Slide 6

We seek to enhance the information we provide investors with a focus on the drivers of operating results across our businesses. As a result, we have prepared this analysis of servicing results and separated the components of operating income from fair value changes and non-core items.

Operating income for the servicing segment starts with the operating revenue earned from the servicing portfolio. PennyMac Financial's servicing revenue is unique in that it captures multiple types of revenue from different servicing activities. The servicing revenues from PennyMac Financial's owned MSRs typically range from 25 to 40 basis points per annum on the outstanding principal balance, whereas subservicing revenues on MSRs owned by PMT are approximately 5 basis points per annum. Revenues earned on loans for which PennyMac Financial performs special servicing are typically much greater. Combined, the weighted average revenue during the quarter was 29.2 basis points of average UPB on an annual basis.

Direct expenses include operating expenses, such as payroll, technology development and maintenance, and fees paid to third-party vendors such as our document custodians, as well as expenses related to credit and advance losses. As the owner of MSRs, we absorb costs associated with the non-reimbursability of servicing advances and certain credit losses generally associated with the servicing of government insured and guaranteed loans. Net of direct servicing expenses, operating income during the quarter totaled 15.8 million dollars, or an annualized 4.3 basis points of the average UPB of the servicing portfolio.

After operating income, our servicing business incurs financing costs which result from the excess servicing spread sold to PMT and interest and fees paid to third-party banks on our credit facilities.

Operating income net of these financing costs totaled 3.8 million dollars.

GAAP pretax income for the servicing segment also includes fair value changes and non-core items that are not related to the day-to-day operation of the servicing business.

Fair value changes include the impairment of the MSR asset, hedging gains or losses and changes in the fair value of the ESS liability. In total, these items contributed a net loss of 7.2 million dollars for the quarter.

Non-core servicing expenses include provisioning for future credit losses and losses realized from the early buyout of defaulted government-insured loans from Ginnie Mae pools. These losses are typically associated with increases in value of the remaining MSR. Non-core expenses during the quarter were partially offset by non-core revenues which include gains or losses on the sale of EBO loans to third parties and re-delivery gains on the securitization and sale of reperforming government loans.

The operating profitability of our servicing business continues to grow and capture additional economies of scale. The impact of non-core servicing items on pretax earnings can vary from period-to-period with changes in interest rates and opportunistic EBO transaction activity.

<u>Slide 7</u>

Turning to slide 7, I would like to spend a few minutes reviewing our approach to hedging and managing interest rate risk.

First, it is important to acknowledge that mortgage banking is inherently sensitive to interest rate changes. We seek to moderate the impact of interest rate changes through a comprehensive hedge strategy.

In implementing this strategy, we consider the company wide-impact of interest rate movements on revenue opportunities. For example, lower interest rates generally result in a fair value loss on the MSR asset due to higher expected prepayments in the future.

However, lower interest rates drive increased demand for refinancing which typically leads to higher loan production volumes and revenue. As a result, we choose not to completely offset the non-cash MSR fair value losses with financial hedges, as we expect to capture offsetting production revenue in future periods.

Our overall net exposure today favors an increasing interest rate environment and is designed to capture fair value gains on the MSR asset in excess of the related hedge.

Now let's turn to slide 8 and review the operational capabilities that give PennyMac Financial a competitive edge.

Slide 8

Over the last eight years we have established what we believe is an industry-leading operating platform that continues to distinguish itself, including in the use of technology.

PennyMac Financial has leading technology in place and makes ongoing investments across each of our mortgage banking businesses to automate operational functions, enhance productivity, and provide a superior experience for our customers.

In our loan servicing business, we have in place many customized and proprietary technology applications that provide sophisticated solutions and augment the capabilities of our core loan servicing system. For example, we have developed systems for our customer service departments that organize customer information into an easy to use interface that vastly improves the quality of our borrower interactions. We have also developed loss mitigation technologies and workflows to monitor all aspects of the loan modification process to ensure timelines are met and the process remains on track to completion.

In correspondent production, we have developed a highly automated and scalable loan aggregation system that employs proprietary workflows and systems that drive accuracy and efficiency. We have developed robust checks including in-line quality assurance processes which result in what we believe is among the highest quality loan manufacturing processes in the industry. Additionally, we have also developed best-in-class pricing and margin management systems that allow us to optimize business opportunities and profitability.

Our consumer direct business is leveraging the systems and processes that have made our servicing and correspondent lending businesses into market leaders. We have in place leading technology and webbased tools for loan origination, electronic document signing and transfer, in addition to lead management systems for portfolio refinance and non-portfolio leads.

We have also developed web and mobile technology to facilitate elements of the mortgage transaction and facilitate more efficient borrower communication and interaction.

As we focus greater attention to growing our consumer direct originations, we are leveraging our Mortgage Fulfillment Division and the industry-leading processes and workflows we have developed in our correspondent channel for use in the consumer direct channel.

Both of our production channels also benefit from the state of the art systems we have in place in for pooling, securitization, and secondary marketing activities, which allow us to maximize the profitability of our production business, for example, by identifying the optimal secondary market buyers for specialized pools of loans.

We believe that the technology we have developed, combined with our management team's substantial expertise and the broader capabilities of our operating platform, creates a distinctive competitive edge for PennyMac Financial.

We believe that these capabilities will allow us to capture opportunities in the mortgage market and continue to grow profitability in the coming years.

Now I'd like to turn the discussion over to David Spector, PennyMac Financial's President and Chief Operating Officer, to review the operational results in each of PennyMac Financial's businesses.

Speaker:

David Spector – President and Chief Operating Officer

Thank you, Stan.

Slide 9

On slide 9, I would like to begin my remarks by reviewing market share and volume trends across PennyMac Financial's businesses.

PennyMac Financial ranked as the 4th largest producer of mortgage loans during the third quarter and ended as the 11th largest servicer, according to Inside Mortgage Finance.

Our correspondent loan aggregation business experienced a significant market share gain during the quarter as we effectively executed on opportunities to grow seller relationships and capture additional volume. The growth in market share is also the result of our leading role in the government-insured loan market which as Stan mentioned has grown significantly as a percentage of the total origination market in recent quarters.

Our consumer direct market share remained basically flat during the quarter as we continued to build operating capacity to originate higher volume of loans. We expect to resume market share growth as a result of these initiatives, and we have seen an increase in lock volumes during the third quarter and a significant increase in our pipeline of committed loans in progress at October 31st.

Our loan servicing portfolio has grown as a result of strong production volumes, supplemented by MSR acquisitions completed in recent quarters totaling over 25 billion dollars in UPB. This growth speaks to the ability of our servicing platform to efficiently scale operations for higher transaction volumes while remaining focused on accuracy and compliance.

In our investment management business, net assets under management declined from the prior quarter, primarily due to the planned return of capital and distribution of earnings to investors in the two private funds we manage.

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

Slide 10

Correspondent production totaled 14.4 billion dollars in UPB for the third quarter, a 21 percent increase from the second quarter. Government-insured and guaranteed loan acquisitions accounted for 72 percent, or 10.4 billion dollars of total correspondent acquisitions. Additionally, PennyMac Financial performed fulfillment activities for PMT on 4.1 billion dollars of conventional conforming and jumbo loans during the third 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 increase in production volumes resulted from our ability to execute on the available market opportunity. Our technology-enabled platform provided the ability to significantly increase transaction volumes while maintaining our high production quality standards.

In October, total correspondent loan acquisitions were 3.8 billion dollars in UPB, and interest rate lock commitments were 3.9 billion dollars in UPB.

We continue to focus on growing the number of approved correspondent sellers by approximately 10 percent by year end, while continuing to maximize the business we do with each relationship. We have had success adding new correspondent sellers, which increased to 400 at September 30th from 377 in June.

Another important focus is growing small to medium-sized originators who benefit the most from our operational expertise and risk management capabilities. These sellers accounted for 2.5 billion dollars of lock volume in the third quarter, up 14 percent from the second quarter and we expect these smaller sellers to generate increased volume and become a more meaningful portion of our correspondent business over time.

We also continued to execute on strategic initiatives to grow market share and optimize our business relationships with existing sellers. We have made significant gains in under-represented geographies such as the Midwest where acquisition volumes rose by 23 percent from the second quarter.

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

<u>Slide 11</u>

Consumer direct production volumes in the third quarter totaled 1 billion dollars in UPB, an 8 percent decrease from the second quarter, but nearly double volumes levels a year ago. The number of loans funded, on the other hand, increased 8 percent from the second quarter to 4,226 loans, highlighting our ability to shift to originating lower balance loans. This reflected our strategy designed to capture originations from an underserved portion of the market as interest rates rose toward the end of the second quarter and early in the third quarter.

The slowdown in our origination growth during the third quarter was anticipated given the smaller pipeline of loans in process going into the quarter. We are focused on building additional operational capacity to originate loans, evidenced by the recent increases in our committed pipeline.

In addition, we have added capacity dedicated to the consumer direct business through a significant increase in sales resources.

Lower interest rates in conjunction with these efforts to build capacity resulted in 1.8 billion dollars in lock volume during the third quarter, up 6 percent from the second quarter.

In October, total consumer direct loan production was 357 million dollars and locks totaled 682 million. The pipeline of loan commitments was 628 million dollars in UPB at October 31st, up from 550 million at September 30th.

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

Slide 12

In the third quarter, our loan servicing portfolio grew to 154.8 billion dollars in UPB, up 14 percent from the second quarter. Prime servicing and subservicing saw net growth of 18.8 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 10 billion dollars in UPB of MSRs during the quarter.

We have made significant progress in the development of our Texas operating facility and we now have fully developed operational sites in Ft. Worth, Texas and Moorpark, California.

At the bottom of the page we have included some new metrics to provide insights into the operational performance of our servicing portfolio. For example, the annualized actual constant prepayment rate for our owned MSRs was 15.8 percent for the quarter, and the prepayment rate for the MSRs subserviced for PMT was 9.6 percent. Both prepayment rates declined significantly from the second quarter.

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

Slide 13

Investment Management revenues increased 13 percent from the second quarter due to a 1.3 million increase in carried interest from the investment funds, partially offset by a 500 thousand dollar reduction in management fee revenue from the Investment Funds.

Net assets under management were approximately 1.8 billion dollars at September 30th, down 5 percent from June 30th.

In the third quarter PMT completed its initial GSE risk transfer transaction and entered into a second transaction with Fannie Mae. This unique investment allows PMT to invest in the credit risk of its own high-quality correspondent production. PMT's investment in these initial transactions before financing is expected to total approximately 175 million dollars and we believe that GSE credit risk transfer has the potential to be a major opportunity for PMT to deploy capital over time.

With that I'd now like to turn it over to Anne McCallion, PennyMac Financial's Chief Financial Officer, to discuss the third 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

Pretax income for the third quarter was 73.9 million dollars compared to pretax income of 74.8 million last quarter. Production segment pretax income was 77.7 million dollars, versus 76.3 million dollars in the second quarter. The servicing segment reported a pretax loss of 6.1 million dollars, compared to a pretax loss of 2.4 million dollars from the prior quarter. While pretax income for the Servicing segment has been negative in recent quarters, our servicing business has been profitable on an operating basis excluding fair value changes and non-core items. The growing servicing portfolio has also fueled the growth of our consumer direct originations, the vast majority of which in recent periods have resulted from portfolio-sourced opportunities.

Investment Management segment pretax income totaled 2.2 million dollars for the third quarter, up from 1 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 135.2 million dollars for the third quarter, up 3 percent from the second quarter. The higher revenues were primarily driven by a 21 percent increase in loan origination fees and a 39 percent increase net interest income from higher loan production volumes, partially offset by 6 percent reduction in net gains on mortgage loans held for sale.

During the third quarter, PennyMac Financial acquired 10.3 billion dollars in UPB of Government-insured mortgages through correspondent production, an increase of 24 percent from the second quarter. The Company also originated 1 billion dollars in UPB of loans through consumer direct production, down 8 percent from the second quarter.

Interest rate lock commitments on Government-insured correspondent and consumer direct loans totaled 11.2 billion dollars for the third quarter, a decrease of 3 percent from the second quarter.

The net gains on mortgage loans held for sale as a percentage of Government-insured correspondent and consumer direct interest rate lock commitments were 72 basis points in the third quarter, compared to 75 basis points in the previous quarter.

Loan origination fees as a percentage of Government-insured correspondent and consumer direct loan funding volumes totaled 26 basis points in the third quarter, unchanged from the second quarter. Fulfillment fee revenue increased 14 percent quarter over quarter due to a higher volume of loans fulfilled for PMT in the third quarter. The weighted average fulfillment fee rate in the third quarter was 43 basis points, unchanged from last quarter.

Production segment expenses increased to 57.5 million dollars, a 4 percent increase from the second quarter, primarily driven by the increase in loan production volumes.

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

Slide 16

Servicing segment revenues were 46.1 million dollars in the third quarter, a decrease of 21 percent from the prior quarter. Net loan servicing fees totaled 57.3 million dollars for the quarter, a 16 percent quarter-over-quarter decrease, which included growth in loan servicing fees to 106.1 million dollars reduced by 41.6 million dollars of amortization and realization of MSR cash flows.

Net loan servicing fees also included 47.9 million dollars of impairment and fair value losses on MSRs, driven by higher expected prepayment activity resulting from lower interest rates at quarter end, partially offset by 30.5 million dollars of hedging gains and a 10.3 million dollar gain from the change in fair value of ESS financing.

Servicing segment expenses for the quarter decreased by 8.3 million to 52.2 million dollars, largely due to a reduction in expenses related to the early buyout of loans from seasoned Ginnie Mae pools, lower provisioning charges for unrecoverable servicing advances and a reduction in claims processing activity from elevated levels in the prior quarter. These reductions were partially offset by increased staffing levels for recent MSR portfolio acquisitions and continued portfolio growth.

Now let's turn to slide 17 for a deeper discussion of PennyMac Financial's MSR asset.

Slide 17

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, or those subject to excess servicing spread, are accounted for at fair value. PennyMac Financial accounted for 51.1 billion dollars in UPB of its originated MSRs under LOCOM, with a fair value that was 10.2 million dollars greater than its carrying value at September 30th. We also account for another 2.4 billion dollars in UPB of originated MSRs at fair value, as the note rates on the underlying loans are above 4.5 percent.

We also own purchased MSRs, most of which are subject to excess servicing spread owned by PMT; the UPB related to the loans underlying those MSRs totaled 53.5 billion dollars at September 30, which increased from 46.2 billion dollars at the end of the second quarter.

During the third quarter, PennyMac Financial also completed the sale to PMT of excess servicing spread totaling 84 million dollars.

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 7.8 million dollars, an increase of 13 percent from the second quarter. Segment revenues include management fees, which include base management fees and incentive fees from PMT, in addition to management fees from the Investment Funds.

Management fees decreased 7 percent from the prior quarter, primarily due to a 500 thousand dollar decline in management fee revenue from the private investment funds. Carried interest earned by PennyMac Financial from the private investment funds increased by 1.3 million dollars from the prior quarter resulting from improved performance of the funds during the quarter. No incentive fees were received in the third quarter as a result of PMT's financial performance over the four-quarter period for which incentive fees are calculated.

Segment expenses were 5.6 million dollars, down 6 percent from the second 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 continue to make ongoing investments in PennyMac Financial's leading operating platform to build additional capacity and enhance productivity. Our capabilities in correspondent production and loan servicing are recognized as distinctive in the industry, and we are leveraging these operations to grow our consumer direct lending activities. Our success continues to be driven by our management team's substantial expertise combined with the unique operational capabilities we have developed, including technology, that we believe result in a distinct and sustainable competitive advantage for PennyMac Financial.

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 third 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.