PennyMac Financial Services, Inc.

Fourth Quarter 2015 Earnings Transcript

February 3, 2016

Introduction

Good afternoon and welcome to the fourth 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 concluded another record year with strong financial performance in the fourth quarter, demonstrating our balanced mortgage banking model and the earnings contributions from our core businesses of loan production and servicing.

For the fourth quarter, PennyMac Financial earned pretax income of 77.2 million dollars, up 4 percent from the prior quarter and a record quarter for the company. Pretax earnings contributions were 50 million dollars from the Production segment, 28 million from the Servicing segment, and 656 thousand from Investment Management. Diluted earnings per share was 58 cents.

PennyMac Financial's well-designed business model and industry leading operations produced record financial performance despite a reduced origination market due to higher mortgage rates and seasonal factors in the fourth quarter. Our performance across different market environments reflects our focus on operational excellence and interest rate risk management which includes an active hedging program for both the production pipeline and the MSR asset.

Production segment revenues were 104.5 million dollars, down 23 percent from record levels in the prior quarter, driven by a reduction in government-insured correspondent lock volumes during the quarter and tighter margins in the consumer direct lending channel.

Loan production volumes in the fourth quarter totaled 11.1 billion dollars in unpaid principal balance, a 28 percent decrease from the third quarter. Of our total production, correspondent acquisitions totaled 10 billion dollars in UPB, down 30 percent from the third quarter. Consumer direct originations were 1 billion dollars in UPB, a 1 percent decrease from the third quarter.

Our servicing portfolio grew 4 percent during the quarter to 160.3 billion dollars in UPB, primarily as a result of our organic loan production activities. Pretax servicing operating income was 18.9 million dollars, reflecting the core profitability of the business.

Servicing segment revenues were 78.2 million dollars, up 70 percent from the prior quarter, which included an 11.7 million dollar increase in the MSR value net of the performance of the associated hedges and ESS liability.

Investment Management segment revenues were 6.2 million dollars, down 21 percent from the prior quarter, due to a decrease in carried interest from the private investment funds. Net assets under management ended the quarter at 1.7 billion dollars.

Now let's turn to slide 4 and review the trends in PFSI's financial performance and the drivers of future growth.

Slide 4

PennyMac Financial has distinguished itself by delivering substantial earnings growth over its history, with 25 percent year-over-year growth in earnings and book value per share in 2015. This growth has been driven by substantial top-line growth in our business volumes and revenues.

Looking to this year, we believe that PennyMac Financial is poised for further growth. We expect to continue growing market share in each of our production channels, as well as expanding into new activities including wholesale residential mortgage production and multifamily commercial lending.

Today's mortgage market requires strong capabilities and focused processes for Risk Management, regulatory compliance and operational execution. These are core disciplines that PennyMac Financial has developed and put into place. We view our ability to effectively manage these risks as a core competitive advantage and a key factor in our long-term success.

As the company continues to evolve and grow, we are capturing increasing benefits from scale. Going forward, our investments in infrastructure and technology positions us to capture further efficiencies, improve the experience for our customers, and drive higher earnings across our mortgage banking businesses.

Slide 5

Our earnings growth has been driven by top-line growth in our core mortgage banking businesses. Slide 5 highlights the substantial growth in PennyMac Financial's mortgage production volumes and servicing portfolio over the past year.

Mortgage production volumes increased 67 percent from 2014, driven by our industry leadership in correspondent production where PennyMac remains the largest non-bank correspondent aggregator in the U.S. Our consumer direct channel contributed over 4 billion dollars of originations in 2015, a 113 percent increase from last year.

In our servicing business, we successfully transferred and boarded over 32 billion dollars in MSR acquisitions last year, while adding 48 billion dollars from our mortgage production.

Notable among public mortgage companies is that we have a leading business in both mortgage production and servicing. We are now the sixth largest producer of residential mortgages and the eleventh largest mortgage servicer in the U.S.

Now let's turn to slide 6 and review the operating results in our servicing business.

Slide 6

This analysis of results in our Servicing segment aims to isolate the components of operating income from fair value changes and non-core items in the GAAP segment results.

Operating income for the servicing segment increased compared to the third quarter, resulting from growth in operating revenues and a reduction in direct servicing expenses. Operating revenues result from different types of servicing activities. We collect servicing revenues from PennyMac Financial's owned MSRs typically ranging 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 from special servicing activities vary, but are typically much greater. Combined, the weighted average annualized revenue for the quarter was 28.7 basis points of average UPB compared to 29.2 in the prior quarter, reflecting the ongoing mix shift toward owned MSRs and sub-servicing revenue on newly originated prime loans.

Direct servicing expenses include operating expenses and realized credit and advance losses which totaled 11.8 basis points of average UPB compared to 13.4 basis points in the third quarter. Pre-tax operating income during the quarter totaled 18.9 million dollars or an annualized 4.8 basis points of average UPB, which increased from 15.8 million dollars, or 4.3 basis points in the prior quarter.

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, in addition to fair value changes and non-core items that are not related to the day-to-day operations of the servicing business.

Included under the caption of non-core servicing expenses and revenues is the provisioning for future credit losses as well as expenses and gains related to servicing activities and the early buyout of defaulted government-insured loans from Ginnie Mae pools. Non-core expenses were offset by non-core revenues resulting from the securitization of reperforming loans.

The operating profitability of our servicing business continued to grow this quarter 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 the timing of EBO transactions and securitization activities.

Slide 7

During the fourth quarter, anticipation over the eventual Fed Funds rate increase and continued improvement in the U.S. economy drove interest rates higher. The 30-year fixed mortgage rate increased 16 basis points during the quarter, but the increase has more than reversed after quarter end, and mortgage rates are now back to the levels of last April. Volatility has returned to the capital markets on concerns over growth rates in the global economy and falling oil prices, driving investors back to the safety of U.S. Treasury bonds.

In December, the Federal Housing Finance Agency, or FHFA, released its 2016 scorecard to set performance targets for Fannie Mae and Freddie Mac. The scorecard reflects their ongoing central role in the mortgage market and highlights several initiatives for the GSEs, including credit risk transfer. FHFA is now calling for Fannie Mae and Freddie Mac to transfer credit risk on at least 90 percent of the unpaid principal balance of newly acquired, single family mortgages that meet certain criteria. We believe that this is a positive development for the mortgage market by further stabilizing the GSEs and attracting private capital to take on the credit risk of an increasing portion of GSE loans.

Key housing metrics have continued to show steady improvement. We have seen the pace of home sales steadily improve in 2015, with both existing and new home sales posting their best year since the financial crisis. With interest rates at low levels and strong job growth in key home buying age demographics, housing fundamentals appear poised for continued improvement in 2016.

Finally, the industry was faced with new regulation with the TILA-RESPA Integrated Disclosure rule that went into effect in October, changing the disclosure requirements for new loan originations. Originators across the industry experienced varying degrees of difficulty with the rule, which has produced some initial delays and extended closing timelines thus far.

Now let's turn to slide 8 and discuss the mortgage market outlook for 2016.

Slide 8

On slide 8 we take a look at estimates for the residential mortgage origination market, averaging figures from the Mortgage Bankers Association, Fannie Mae and Freddie Mac. 2015 turned out to be a strong origination market that benefitted from continued low mortgage rates and the FHA's mortgage insurance premium reduction in January 2015. Additionally, increasing home sales helped drive robust purchase money volumes.

For 2016, the most recent forecast calls for 966 billion dollars in purchase volume and 486 billion dollars in refinance volume. In recent weeks, refinance applications in the market have increased, suggesting refinance origination volumes may be stronger than forecast in the first quarter. Purchase volumes have the potential to outperform if housing sales continue to improve, and refinance volumes may be stronger than forecast if interest rates remain low.

Now let's turn to slide 9 and discuss initiatives to grow our production businesses in 2016.

Slide 9

Over the last eight years we have established what we believe is an industry-leading operating platform that continues to distinguish itself by profitably growing volumes and market share.

PennyMac's approach to the development and growth of our production channels is different than most of the industry. To be successful in mortgage banking, it is critical to efficiently and effectively leverage technology and processes to achieve scale and operational consistency. As a result, we have built our mortgage fulfillment division to leverage processes and leadership from PennyMac's correspondent business to expand fulfillment capacity in our other production channels. Having a common fulfillment structure reduces cost, improves loan manufacturing quality, and results in consistently excellent customer experience. Specific initiatives to grow our correspondent channel include continued growth in seller relationships, with an emphasis on small and mid-sized originators, and increasing market share in conventional conforming products. We believe that there are many competitors in the correspondent channel that are struggling to achieve scale. As a result, we expect the consolidation that we are beginning to see continue and expect margin pressures to be limited.

In consumer direct, we expect to realize the investments made last year in greater fulfillment capacity to facilitate higher volumes in 2016. Increased fulfillment capabilities will help optimize our recapture rates, with a particular emphasis on improved recapture of conventional conforming loans.

Another key initiative is to significantly enhance the user interface for consumer direct customers. These enhancements are expected to deliver functionality that allows prospective customers to conduct more of the mortgage origination process via their computer or mobile device. The strong purchase market we expect to see in 2016 also represents a significant opportunity for Consumer Direct.

In addition, we are investing in lead management technologies to drive increased pull-through on both portfolio refinance and non-portfolio leads. Today, we are also announcing our entrance into the Wholesale Lending channel and we intend to leverage our investments in correspondent and consumer direct in developing the infrastructure for wholesale. The wholesale channel currently comprises approximately 10 percent of the total mortgage market, and we believe there is a significant opportunity in this channel for a company like PennyMac Financial, with the strong technical expertise and customer service that Brokers value.

We are currently developing the necessary systems and infrastructure and have targeted a full launch for mid-2016. The wholesale channel is a fragmented market, with the top 5 lenders accounting for 30 percent of wholesale volume. Our goal is to work toward a leadership role in the channel over time.

Now let's turn to slide 10 and review what distinguishes PFSI from others in the industry.

Slide 10

PennyMac Financial has delivered and continues to deliver outstanding returns on equity, in contrast to the other pure play public mortgage companies. As I have emphasized throughout PennyMac's history, our performance is attributable to our approach and capabilities that differentiate Pennymac Financial. Our platform is unique and has been built from the ground up, free of legacy issues, and has been designed to address today's regulatory environment.

Our focus on governance and risk management has been instrumental in the development of our mortgage banking business, and is an important component of our ability to deliver consistently strong financial performance across a variety of market environments.

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 11

On slide 11, I would like to begin my remarks by reviewing market share and volume trends across PennyMac Financial's businesses. Looking to the year ahead, we continue to focus on profitably growing market share in our core mortgage banking businesses.

Strong consumer direct production volumes and servicing portfolio growth from our own production volumes led to market share gains for those businesses during the fourth quarter, while our share in correspondent production dropped slightly due to a larger decline in our aggregation volumes versus the overall market reduction.

In our investment management business, net assets under management declined slightly from the prior quarter, driven by the decline in PMT's book value.

Now let's turn to slide 12 and discuss correspondent production.

Slide 12

Correspondent production totaled 10.0 billion dollars in UPB for the fourth quarter, a 30 percent decline from the third quarter, but a 38 percent increase from the fourth quarter of 2014.

The decrease in production volumes was primarily driven by a seasonally smaller origination market, higher rates, and the impact of delays resulting from TRID implementation.

Government-insured and guaranteed loan acquisitions accounted for 65 percent, or 6.6 billion dollars of total correspondent acquisitions. Additionally, PennyMac Financial performed fulfillment services for PMT on 3.5 billion dollars of conventional conforming and jumbo loans during the fourth quarter.

In January, total correspondent loan acquisitions were 3.3 billion dollars in UPB, while interest rate lock commitments were 2.9 billion dollars in UPB.

During the quarter, we continued to grow our correspondent seller relationships, with a continued emphasis on optimizing the business relationships with existing sellers. At the end of the fourth quarter, we reached 432 correspondent seller relationships, up from 400 at the end of the third quarter and 344 going into the new year. We also continued to focus on growing business from 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 fourth quarter, unchanged from the previous quarter, despite a smaller origination market.

Finally, purchase-money loans accounted for 86 percent of our correspondent production, reflecting the strong focus on home purchase financing by our correspondent sellers.

Now let’s turn to slide 13 and discuss consumer direct production.

Slide 13

Consumer direct production volumes in the third quarter totaled 1 billion dollars in UPB, a one percent decrease from the third quarter, but a 51 percent increase from the fourth quarter of 2014.

The fourth quarter marked the third consecutive quarter with origination volumes over one billion dollars in UPB. These strong results were achieved in spite of a smaller origination market and higher mortgage rates, in addition to TRID implementation during the quarter.

As Stan mentioned in his comments, TRID implementation impacted funding timelines industry-wide. In our consumer direct business, these impacts pushed some loan closings into December and also into early 2016.

For the fourth quarter, portfolio-sourced originations totaled 974 million dollars in UPB while non-portfolio originations were 54 million dollars in UPB. In January, total consumer direct loan production was 347 million dollars in UPB, and interest rate lock commitments were 586 million dollars in UPB.

The pipeline of commitments was 592 million dollars in UPB at January 31, down from 691 million dollars in UPB at December 31.

Going forward we are focused on three strategic initiatives within our consumer direct business: building infrastructure, improving recapture rates and increasing the conversion of aggregator leads.

Now let's turn to slide 14 and discuss our Loan Servicing business.

<u>Slide 14</u>

In the fourth quarter, our loan servicing portfolio grew to 160.3 billion dollars in UPB, up 4 percent from the third quarter. Prime servicing and subservicing saw net growth of 5.6 billion dollars in UPB quarter-over-quarter, as we continued to add loans through our consumer direct and correspondent loan production activities.

To support the ongoing growth of our servicing operations we have prudently increased headcount in our servicing business and continued to invest in technology. We are expanding our servicing operations with a third site scheduled to open next quarter in Plano, Texas. This new site will complement our two fully developed operational sites in Ft. Worth, Texas and Moorpark, California.

We have also redesigned our customer facing website PennyMacUSA.com to provide a wide variety of information and tools to better assist our servicing customers. Recent enhancements include responsive technology, e-statements, text notifications and increased customer security protection.

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

Slide 15

Investment Management revenues decreased 21 percent from the third quarter due to a 1.8 million decrease in carried interest from the investment funds.

Net assets under management were approximately 1.7 billion dollars at December 31st, down 1 percent from September 30th.

PMT invested 107 million dollars in its second GSE risk transfer transaction during the fourth quarter. When this transaction is completed, PMT's investment is expected to total 140 million dollars. Credit risk transfer is a unique investment that allows PMT to invest in the credit risk of its own high-quality correspondent production. We believe that we are well positioned for additional investment in GSE credit risk transfer in the future.

With that I'd now like to turn it over to Anne McCallion, PennyMac Financial's Chief Financial Officer, to discuss 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 78.9 million dollars, compared to pretax income of 73.9 million last quarter. Production segment pretax income was 50.3 million dollars, versus 77.7 million dollars in the third quarter. The servicing segment reported pretax income of 27.9 million dollars, compared to a pretax loss of 6.1 million dollars from the prior quarter. Investment Management segment pretax income totaled 700 hundred thousand dollars for the fourth quarter, down from 2.2 million dollars in 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 104.5 million dollars for the fourth quarter, down 23 percent from the third quarter. The decrease was primarily driven by a 19 percent quarter-over-quarter decrease in net gains on mortgage loans held for sale and a 29 percent quarter-over-quarter decrease in loan origination fees. The decrease in net gains on mortgage loans held for sale was driven by a reduction in government-insured correspondent lock volumes from the elevated levels in the third quarter and reduced margins in the consumer direct lending channel. The decrease in loan origination fees was driven by the decrease in government correspondent acquisition volumes.

During the fourth quarter, PennyMac Financial acquired 6.6 billion dollars in UPB of Government-insured mortgages through correspondent production, a decrease of 37 percent from the third quarter. The Company also originated 1 billion dollars in UPB of loans through consumer direct production, down 1 percent from the third quarter.

Interest rate lock commitments on Government-insured correspondent and consumer direct loans totaled 8.8 billion dollars for the fourth quarter, a decrease of 22 percent from the third quarter.

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

Loan origination fees as a percentage of Government-insured correspondent and consumer direct loan funding volumes totaled 28 basis points in the fourth quarter, compared to 26 basis points in the third quarter. Fulfillment fee revenue decreased 27 percent quarter over quarter due to a lower volume of loans fulfilled for PMT in the fourth quarter and a decline in the average fulfillment fee rate to 37 basis points, compared to 43 basis points in the third quarter.

Production segment expenses decreased to 54.2 million dollars, a 6 percent decrease from the third quarter, primarily driven by the decrease in loan production volumes.

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

Slide 18

Servicing segment revenues were 78.2 million dollars in the fourth quarter, an increase of 70 percent from the prior quarter. Net loan servicing fees totaled 77 million dollars for the quarter, a 34 percent quarter-over-quarter increase, which included growth in loan servicing fees to 112.7 million dollars and a 45.5 million dollar gain in MSR fair value driven by lower expected prepayment activity resulting from rising mortgage rates through the fourth quarter. These gains were reduced by 47.4 million dollars of amortization, 27 million dollars of hedging losses and a 6.9 million dollar fair value loss on the ESS financing liability. Servicing segment revenue also included 12.8 million dollars in net gains on mortgage loans held for sale at fair value in the fourth quarter resulting from the securitization of reperforming government-insured loans, versus 1.6 million dollars in the previous quarter.

Servicing segment expenses for the quarter decreased by 1.9 million dollars to 50.3 million, largely due to a decline in credit and advance losses partially offset by a modest increase in direct operating expenses.

Now let's turn to slide 19 for a deeper discussion of PennyMac Financial's MSR asset.

Slide 19

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 56.4 billion dollars in UPB of its originated MSRs under LOCOM, with a fair value that was 14.7 million dollars greater than its carrying value at December 31st. We also account for another 2.8 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 51.4 billion dollars at December 31st, which decreased from 53.5 billion dollars at the end of the third quarter due to prepayment activity.

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 6.2 million dollars, a decrease of 21 percent from the third quarter. Segment revenues include management fees, which include base management fees from PMT and the private investment funds and any earned incentive fees from PMT. Management fee revenue decreased 2 percent from the prior quarter.

Carried interest from the private investment funds decreased by $1.8 million from the prior quarter resulting from the reduced performance of the funds during the quarter. No incentive fees were received in the fourth quarter as a result of PMT's financial performance over the four-quarter period for which incentive fees are calculated.

Segment expenses were 5.5 million dollars, down 2 percent from the third 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.

PennyMac Financial's consistently strong financial performance and outperformance relative to the mortgage industry reflects the significant investments we have made in our operational infrastructure, dedicated approach to risk management, and governance culture. We are building the PennyMac platform for continued growth in mortgage lending and for long-term success. We believe our operational infrastructure is highly scalable and well positioned to respond to market opportunities, including the most recent decline in mortgage rates that could drive higher refinance demand.

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 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.