PennyMac Financial Services, Inc.

Fourth Quarter 2013 Earnings Transcript

February 5, 2014

Good afternoon and welcome to PennyMac Financial Services' fourth quarter 2013 earnings discussion. The slides that accompany this discussion are available on PennyMac Financial's investor relations 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, PennyMac Financial's Chairman and Chief Executive Officer.

Speaker:

Stanford L. Kurland – Chairman and Chief Executive Officer

Introduction

Thank you, Chris.

PennyMac Financial ended the year with a strong fourth quarter even considering the higher rate environment that created challenges for the mortgage markets. 2013 was a transformational year for the company that included many significant accomplishments: net servicing portfolio growth of 178 percent for the year, loan production growth of 42 percent and total revenue growth of 46 percent. Our growth occurred in an environment of intensified competition and higher interest rates in the second half of the year. Our performance is a testament to PennyMac Financial's diversified businesses in loan production, loan servicing, and investment management and our unique partnership with PennyMac Mortgage Investment Trust ("PMT").

Now let's turn to slide 3 and begin with the highlights of the fourth quarter.

Slide 3

Pretax income for the fourth quarter totaled 41.7 million dollars, a 19 percent increase from the third quarter, and diluted earnings per share totaled 32 cents. Net revenues totaled 90.4 million dollars, up 4 percent from the third quarter, with revenue growth from both of our operating segments, mortgage banking and investment management. Expenses totaled 48.7 million dollars, down 7 percent from the third quarter, reflecting a continued focus on expense management.

While the top lenders reported loan production declines in excess of 35 percent, our declines were smaller and, as a result, we continued to gain share in both correspondent and retail lending. PennyMac Financial's loan production totaled 6 billion dollars for the quarter, a decline of 25 percent. Of that, correspondent loan acquisitions were 5.8 billion dollars and retail originations were 211 million dollars. The company's servicing portfolio reached 78.2 billion dollars, a 48 percent increase from the third quarter, primarily driven by the successful completion of two previously announced bulk MSR portfolio acquisitions that settled and transferred in the fourth quarter. In addition to benefitting our servicing business, these portfolios are expected to provide profitable opportunities for our retail lending business in the form of portfolio refinances and loan modifications.

Net assets under management ended the quarter at 2 billion dollars, down slightly largely due to an acceleration in the timing of PMT's regular dividend.

Now let's turn to slide 4 and look at the potential growth available to PennyMac Financial going forward as a result of opportunities in the U.S. mortgage market.

Slide 4

The U.S. mortgage markets are large and represent a significant portion of financial services in the country. Currently, 10 trillion dollars in mortgage debt is outstanding and that represents loans that need to be serviced. Origination volumes in the market are forecast to be meaningfully smaller this year, but at around 1.2 trillion dollars, significant opportunities remain across the retail, correspondent, and wholesale channels.

Since the financial crisis, we have seen a transformation in the mortgage market as the large banks that dominated the mortgage business have been retreating, due to a combination of increasing capital requirements for mortgage-related assets, a focus on serving their core banking customer relationships and increased regulation. As a result, in just the last three years there have been substantial transfers of existing mortgage assets out of these banks, as well as significant shifts in market share to non-bank firms with the requisite capital and capabilities to capitalize on the opportunities.

For example, three years ago, non-bank firms in the top 20 accounted for only 8 percent of the mortgage origination market, but have increased their share to 13 percent today. The shift has been more pronounced in the servicing market, where the share of non-bank firms in the top 20 has quadrupled to 16 percent in less than three years. The pull-back of the large banks has led to a broader disaggregation of the mortgage markets with more firms outside the top 20 increasing their share in both the origination and servicing markets.

This shift to non-banks is underway, providing many opportunities for firms like PennyMac Financial. We believe these trends will continue over the next several years, providing the market opportunity for PennyMac Financial across its businesses of loan production, loan servicing, and investment management.

Now let's turn to slide 5 and review how PennyMac Financial has developed.

Slide 5

On slide 5 we illustrate some of the major milestones in the organic development of PennyMac Financial's unique capabilities. We believe that our platform, infrastructure, and people are best-in-class, which has led to our current success and laid the foundation for future growth. We have built our business in a prudent and sustainable manner for long-term growth. Our operations were developed organically with a focus on building robust and high-quality systems and processes that are scalable for continued growth. Let me give you an example of our approach. In 2009, we established our Correspondent Lending Group and built the systems and processes for counterparty management, loan fulfillment, and the secondary marketing functionality necessary to appropriately scale this business. We tested our operations extensively before taking on significant growth in our Correspondent lending volume. In 2011 our volumes began to grow, and today we are the largest non-bank correspondent lender in the country.

The same is true in our loan servicing business, where we have built our operations with highly experienced personnel focused on quality and scalability. We now have a vibrant servicing platform at our operations centers in Moorpark and Fort Worth.

We believe that this measured and thoughtful approach will lead to sustainable growth and help us achieve our long-term strategic plan for PennyMac Financial.

Slide 6

Turning to slide 6, you can see that PennyMac Financial has developed the capabilities necessary in all of the functions for a sophisticated mortgage enterprise – across correspondent and retail lending, our credit activities, capital markets capabilities, loan servicing, governance, and our corporate functions. We have taken the time to build the operations, processes, systems, and infrastructure in each area of our business.

We place particular emphasis on our governance functions, including regulatory compliance, internal audit, enterprise risk management, and strategic planning. All of these are critical to successful management of a large mortgage business today.

We now have over 1,300 employees concentrated in California, Florida and Texas, who are led by a highly experienced management team. With great care and planning, we have spent six years developing this best-in-class, legacy-free mortgage platform. I believe this platform is a critical competitive advantage, as it has laid the foundation that allows us to scale all of our businesses, in loan production, loan servicing, and investment management, effectively.

Now let's turn to slide 7 and review the progression of PennyMac Financial's revenues.

Slide 7

2013 was a transformational year for the company. The growth in our servicing portfolio to 78 billion dollars, net assets under management to over 2 billion dollars, and loan production of over 31 billion dollars drove 46 percent year-over-year growth.

More than one third of our revenue for the year came from the relatively more stable Loan Servicing and Investment Management activities. PennyMac Financial earns servicing fees on the MSRs we own, and servicing and subservicing fees from our Advised Entities. Through loan servicing, we also earn ancillary income such as loan-level activity fees, late charges, and interest income on escrow balances. Our loan servicing has grown mostly organically as a result of our loan production activities, supplemented by the opportunistic acquisition of MSR portfolios. Investment Management revenues include base management fees and performance-based incentive fees earned from our Advised Entities.

The growth in revenue from these activities illustrates the ongoing development of PennyMac Financial's business model and its ability to deliver steady revenue growth from diverse sources over the long term.

Slide 8

Turning to slide 8, I'd like to review our outlook across the market in the key areas in which PennyMac Financial participates.

Mortgage rates rose in the second half of 2013 from near historic lows, leading to a significant decline in refinance activity and heightened competition. As we started 2014, industry forecasts were predicting a 1.2 trillion dollar market, with over 60 percent of total volume coming from purchase-money originations. Recent indicators suggest that the purchase-money demand will be supported by broad-based economic improvement across the U.S. and continued home price appreciation. At current interest rate levels, home affordability remains high and housing inventory is low, which point to continued strong demand for homes. In recent weeks, interest rates have declined which may also yield additional refinance activity.

Turning to distressed whole loans, we continue to see opportunities for PMT to deploy capital. In 2013 PMT doubled its investments in distressed loan pools over the prior year, and new sellers and opportunities continue to emerge. Our discussions with sellers and market participants suggest that the distressed whole loan opportunities will remain strong through 2014. There is likely to be continued competition for these assets, including from vehicles established to invest in REO looking to gain ownership of the property through resolution of the loan. With respect to home prices, we remain optimistic regarding future price appreciation; however we expect the rate of home price appreciation to moderate from the robust growth of 2013.

In correspondent lending, the mortgage market contraction is difficult for existing participants, and it continues to create barriers for new participants seeking to enter the market. We see considerable opportunities from smaller originators that can benefit from the broad array of programs and delivery options PennyMac provides. For example, originators that utilize best efforts deliveries to manage interest rate risk can benefit from PennyMac's operational capabilities and service to more effectively manage their pipeline.

Currently the origination markets remain dominated by Agency loan programs, and we do not anticipate any significant near-term changes to conforming loan limits or further clarity regarding the future of GSEs. The majority of today's jumbo mortgage activity is being driven by banks originating or acquiring loans for their balance sheet.

We continue to pursue opportunities to acquire bulk MSR portfolios such as the two Agency portfolio acquisitions we completed in the fourth quarter, with PMT co-investing in the excess servicing spread from these portfolios. We see MSR opportunities from a variety of sellers, and believe that opportunities exist for additional MSR acquisitions and excess servicing spread transactions over the year.

I'd now like to turn it over to David Spector, PennyMac Financial's President and
Chief Operating Officer.

Speaker:

David Spector – President and Chief Operating Officer

Slide 9

Thank you Stan.

Turning to slide 9, I'd like to review the growth trends across PennyMac Financial's businesses.

As Stan stated earlier, we are confident in PennyMac Financial's long-term growth prospects; however, the mortgage origination market continues to face headwinds from higher interest rates. We have been gaining share in both correspondent and retail and have initiatives in place to grow volumes over time. Our retail lending business is focused on maximizing recapture and modification opportunities made possible by our MSR acquisitions and growing its purchase-money business through targeted strategies to increase Realtor and builder lead generation.

The significant growth of our loan servicing portfolio has been driven by the bulk MSR acquisitions in addition to the organic growth of MSRs though government-insured correspondent acquisitions and retail origination activity. PennyMac Financial's special servicing portfolio also saw significant growth in 2013 and we see continued opportunity for growth driven by additional distressed loan investments made by PMT.

Our Investment Management business is driven by our net assets under management, the growth of which has come from PMT, and the performance of all of our Advised Entities. The market opportunity to invest in residential mortgage-related assets remains significant and we anticipate that our investment management activities will grow over time.

Let's turn to slide 10 and review each of PennyMac Financial's businesses, beginning with correspondent lending.

Slide 10

Correspondent acquisitions totaled 5.8 billion dollars in UPB for the fourth quarter, a 25 percent decrease from the third quarter. Of this amount, government-insured loan acquisitions totaled 3.3 billion dollars. Additionally, PennyMac Financial performed fulfillment activities on 2.4 billion dollars of conventional conforming and jumbo loans for PMT. Government-insured loan acquisitions generate revenue for PennyMac Financial primarily in the form of gain on mortgage loans, whereas fulfillment activities generate fulfillment fee revenue.

Our government-insured acquisitions declined 16 percent for the quarter, which was smaller than the declines in origination volume reported by most top lenders and our estimate for the market overall. We believe that this reflects the specialized nature of the government-insured loan programs. There are generally fewer Ginnie Mae issuers than, say, Fannie Mae seller/servicers, resulting in fewer competitors for PennyMac Financial in this market segment.

In January total correspondent loan fundings were 1.7 billion dollars, and interest rate lock commitments were 1.5 billion dollars.

Our Correspondent Lending business is focusing on a variety of strategic initiatives to grow volume and optimize profitability. As Stan mentioned, the changing mortgage origination landscape has shifted volume to smaller originators, creating opportunities to focus on the needs of this underserved market segment. PennyMac offers a broad array of programs and delivery options, including on a best efforts basis. We also have recently started acquiring loans in New England and we are focused on further growing relationships and volumes in the Northeast. Finally, we are focused on initiatives to capture a greater share of volume from our existing relationships.

Let’s now turn to slide 11 and take a look at our retail lending business.

Slide 11

Retail Lending volumes in the fourth quarter totaled 211 million dollars in UPB, a 26 percent decline from the third quarter. Portfolio-sourced originations totaled 103 million dollars, or 49 percent of total originations. Non-portfolio originations totaled 108 million dollars, comprising 51 percent of the total.

Higher mortgage rates have significantly reduced the volume of refinance activity in the U.S. mortgage origination market, increasing the importance of purchase money originations. Our retail lending team is working on a variety of initiatives aimed at growing their share of the purchase market. One of the ways they are doing this is through the launch of Business Development Officers. These individuals are “boots on the ground” to facilitate driving leads from local and regional Realtors and builders to PennyMac Financial’s cost-effective national call center platform.

We are also focused on refinance opportunities that arise from our existing portfolio, including the recent MSR acquisitions. In January, lock volume in our retail lending business was over 200 million dollars, largely driven by portfolio-sourced refinances.

We are pleased about the growth of our retail lending business thus far and our efforts to further develop the consumer direct platform, as well as our ability to successfully execute upon portfolio recapture opportunities.

Now let’s turn to slide twelve and discuss our loan servicing business.

Slide 12

As I mentioned earlier, we completed two bulk acquisitions during the quarter. The transfer of the loans to PennyMac Financial's servicing system occurred successfully as a result of careful planning and close coordination with the selling institutions and Fannie Mae and Ginnie Mae.

These transactions also once again highlight our synergistic partnership with PMT, through that company's ability to co-invest in bulk MSR portfolios with PennyMac Financial, reducing our need for capital. PennyMac Financial gains a competitive advantage from PMT's co-investing in the excess servicing spread, which results from PMT's tax efficiency and lower cost of capital.

Let's now turn to slide 13 and review the results of our Investment Management business in the fourth quarter.

Slide 13

In our Investment Management business, PennyMac Financial provides specialized expertise and investment services to our Advised Entities, which consist of PMT and two private Investment Funds. Our financial results in this segment reflect the ongoing success and strong investment performance of PMT and the Investment Funds. For 2013, PMT generated a return on equity of 15 percent, amid a volatile year in the mortgage markets.

Our Investment Management activities provide us with steady, recurring management fee revenue, as well as performance-based incentive fees from our Advised Entities. Revenues in the fourth quarter were 14.7 million dollars, an increase of 3 percent from the third quarter, primarily due to higher management fees from PMT resulting from its capital raise in the third quarter. Total base management fee revenue for the full year was 27.6 million dollars, a 26 percent increase over 2012. Carried interest from the investment funds and incentive fees from PMT for the year totaled 26.2 million dollars, a 150 percent increase over 2012.

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

Slide 14

Net income for the fourth quarter was 37.3 million dollars on net revenue of 90.4 million dollars, an increase of 19 percent and 4 percent, respectively, from the third quarter and earnings per diluted common share was 32 cents, up 14 percent from the third quarter.

Mortgage Banking segment pretax income for the fourth quarter was 28.9 million dollars, up 28 percent from the third quarter of 2013. Our Investment Management segment pretax income totaled 12.8 million dollars for the fourth quarter, up 4 percent from the third quarter.

Let's turn to slide 15 and look at the Mortgage Banking segment in greater detail.

Slide 15

Mortgage banking revenues were 75.7 million dollars for the fourth quarter, up 4 percent from the third quarter, largely driven by an increase in net servicing fees and higher net gains on mortgage loans, partially offset by lower fulfillment fees due to a decline in correspondent conventional and jumbo funding volumes and a lower weighted average fulfillment fee.

Expenses for the Mortgage Banking segment fell 7 percent in the quarter due to a decline in compensation and marketing expenses, which are included in other expenses. The resulting pretax income for the mortgage banking segment in the fourth quarter was 28.9 million dollars, up 28 percent from the previous quarter.

Let’s now turn to slide 16 and take a look at trends we are seeing in production related revenue.

Slide 16

During the fourth quarter, PennyMac Financial acquired 3.3 billion dollars in government-insured mortgages in its correspondent lending business and originated 211 million dollars of loans through retail lending. From the time of the interest rate lock commitment through the loan’s sale or securitization, PennyMac Financial earned net gains on mortgage loans revenue which totaled 29.5 million dollars in the fourth quarter and 25.9 million dollars in the third quarter. For the same period, interest rate locks, which are the primary driver of net gain on mortgage loans revenue, totaled 3.9 billion dollars and 4.1 billion dollars respectively. As a percentage of interest rate locks, net gain on mortgage loans revenue was 76 basis points in the fourth quarter and 63 basis points in the previous quarter.

Loan origination fees totaled 5.3 million dollars in the fourth quarter compared to 6.3 million dollars in the third quarter. Funding volumes, which totaled 3.6 billion and 4.2 billion dollars in the fourth and third quarters, respectively, drive loan origination fees. As a percentage of funding volumes, loan origination fees totaled 15 basis points, unchanged from the third quarter.

Fulfillment fees totaled 11.1 million dollars in the fourth quarter compared to 18.3 million dollars in the third quarter and the average fulfillment fee for those periods was 46 basis points and 50 basis points, respectively.

Let's turn to slide 17 and take a look at trends in servicing-related revenue.

Slide 17

Servicing fees are becoming an increasingly more meaningful source of revenue for PennyMac Financial as the servicing portfolio continues to grow. The revenue item "net servicing fees" is the summation of several different components related to PennyMac Financial's mortgage servicing activities and amounted to 30.5 million dollars for the fourth quarter.

The first component is the servicing fee revenue. This represents the funds we receive for servicing the loans, primarily represented by our mortgage servicing rights as well as distressed loans serviced under contract for our Advised Entities. Amortization reduces the basis of our MSR asset as servicing fees are received over the life of the loan. The corresponding reduction for our MSRs carried at fair value is shown a few lines down as “change in fair value of MSRs due to realization of cash flows”. The provision for impairment represents adjustments to the value of our MSRs carried at LOCOM, and the changes to the value of our MSRs carried at fair value are also shown separately.

As you can see in the servicing fee roll-forward, the growth in servicing fees in the fourth quarter was largely attributable to an increase in the volume of servicing as our portfolio grows. Moreover, an increase in the rate accounted for approximately one third of the fourth quarter increase. This rate increase resulted from an increase in the weighted average servicing fee of our portfolio due to the addition of government MSRs and distressed loans serviced for PMT.

Let’s now turn to slide 18 and take a look at our other business segment, Investment Management.

Slide 18

Total revenue for the Investment Management segment was 14.7 million dollars, up 3 percent from the third quarter. PennyMac Financial earns a management fee and incentive compensation from its advised entities. Base management fees, incentive fees, and carried interest rose 5 percent quarter-over-quarter largely due to higher management fees from PMT resulting from its equity raise in the third quarter. Segment expenses declined 5 percent from the third quarter from a decline in compensation expense. Pretax income for the segment was up 4 percent for the quarter.

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

Slide 19

As I discussed earlier, the majority of the servicing portfolio growth in the fourth quarter resulted from two bulk MSR portfolio acquisitions that occurred toward the end of the year and are represented in the column "Fair value subject to excess servicing spread".

We described in detail the structure of excess servicing spread transactions in our third quarter earnings presentation. The MSRs in these transactions are carried at fair value, as is the corresponding liability "excess servicing spread financing at fair value". During the fourth quarter, PennyMac Financial completed financing in the form of excess servicing spread totaling 136 million dollars in fair value. This excess servicing spread was acquired by PMT.

We account for originated MSRs at the lower of amortized cost or fair value, or LOCOM, when the underlying note rate on the loans is less than or equal to 4.5 percent. MSRs with note rates on the underlying loans above 4.5 percent, and those subject to excess servicing spread, are accounted for using the fair value method. At the end of the quarter, the fair value of PennyMac Financial's MSR asset carried at LOCOM was 10.7 million dollars greater than its carrying value. This increase in the underlying economic value may result in PennyMac Financial's MSRs generating more income over time than their recorded values indicate.

MSRs are a growing portion of PennyMac Financial's assets and their economic value generally improves in a rising interest rate environment.

And with that I would like to turn it back over to Stan.

Speaker:

Stanford L. Kurland – Chairman and Chief Executive Officer

Thanks Anne.

The opportunities for a non-bank lender and servicer in the U.S. mortgage markets remain substantial. PennyMac Financial remains focused on growing volumes in correspondent and retail lending, driving servicing growth through organic production and additional MSR acquisitions, and increasing the profitability of our businesses. We believe that PennyMac Financial is uniquely positioned with the expertise across mortgage production, servicing, and investment management and operations to successfully and sustainably manage this growth over the long term.

Finally, we encourage investors with any questions to reach out to our Investor Relations group by email or phone.

Thank you.

Operator

This concludes the PennyMac Financial Services fourth quarter earnings discussion. For any questions, please visit our website, at www.ir.pennymacfinancial.com , or call our Investor Relations department, at 818-264-4907.