PennyMac Financial Services, Inc.

Third Quarter 2014 Earnings Transcript

November 5, 2014

Introduction

Good afternoon and welcome to the third quarter 2014 earnings discussion for PennyMac Financial Services, Inc. The slides that accompany this discussion are available from PennyMac Financial Services, Inc.'s website at www.ir.pennymacfinancial.com. Before we begin, please take a few moments to read the disclaimer on slide two of the presentation. Thank you. Now I'd like to turn the discussion over to Stan Kurland, PFSI's Chairman and Chief Executive Officer.

Speaker:

Stanford L. Kurland – Chairman and Chief Executive Officer

Thank you, Chris. PennyMac Financial enjoyed record earnings in the third quarter, driven by continued revenue growth in each of our businesses – loan production, loan servicing, and investment management. We believe that the company's financial performance reflects our solid operational foundation and a culture of strong compliance and governance, which we have worked to build since our formation seven years ago.

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

Slide 3

PennyMac Financial earned pretax income of 62.7 million dollars in the third quarter, up 8 percent from the second quarter, and diluted earnings per share totaled 49 cents. These results represent the largest quarterly income earned by the company in its history thus far.

The third quarter's results included solid pretax earnings contributions from each of our business segments – loan production, loan servicing, and investment management.

Production segment revenues were 71.6 million dollars, an increase of 12 percent from the prior quarter. Loan production totaled 8.6 billion dollars in unpaid principal balance, a 16 percent increase from the second quarter. Of our total production, correspondent acquisitions were 8.1 billion dollars in UPB, up 15 percent from the second quarter. Consumer direct originations were 527 million dollars in UPB, up 31 percent from the prior quarter. Consumer direct is making notable and increasing contributions to the company's production business, driven by success in executing on the recapture opportunities from our growing servicing portfolio.

Servicing segment revenues were 55.7 million dollars, an increase of 4 percent from the prior quarter. The servicing portfolio grew 7 percent during the third quarter and surpassed 100 billion dollars in UPB. PennyMac Financial has expertise in continually boarding new servicing each month on a flow basis, resulting from the volumes of loan production activities as well as from mini-bulk and flow MSR acquisitions which totaled 1.6 billion dollars in UPB during the quarter. We have spent seven years building our servicing platform from the ground up with a focus on addressing the needs of today's mortgage market and regulatory environment. We have in place the core management and infrastructure to continue our growth in loan servicing and expect further economies of scale as we grow.

Investment management segment revenues were 13.3 million dollars, an increase of 4 percent from the prior quarter. Net assets under management ended the quarter at 2.02 billion dollars, down modestly from the second quarter driven by a reduction in our two initial private investment funds and the planned return of capital to those investors.

Let's turn to slide 4.

Slide 4

PennyMac Financial has grown earnings per share in each of the last four quarters during what has been a challenging environment in the U.S. mortgage market. The earnings growth has been driven by significant top-line growth in each of the company's three operating segments.

These trends reflect the company's continued success in driving organic growth through the disciplined execution of our strategic initiatives. Our business model leverages our solid operating platform which enables us to pursue growth in a profitable and controlled manner as well as consider bulk acquisitions on an opportunistic basis.

PennyMac Financial has diverse sources of revenue from a variety of its activities across loan production, loan servicing, and investment management. Nearly half of the company's third quarter revenues came from the relatively more stable servicing and investment management activities. The revenues in these segments are mostly recurring fees and are increasing components of the company's business model.

These revenues are supplemented by loan production revenues from our correspondent and consumer direct channels. Recently, our loan production revenues have benefitted from the increased contributions of our consumer direct activities which have seen steady growth in production volumes over the last year.

Now let's turn to slide 5 and discuss the role of a non-bank mortgage specialist in today's mortgage market.

Slide 5

A mortgage business in the current market and regulatory environment demands focus, expert management, and dedicated resources in order to operate successfully. We believe that a well-managed specialist firm, like PennyMac Financial, can meet the needs of the mortgage market and provide more effective services that are better for consumers than many banks.

A number of banks have re-considered their commitment to the mortgage business in recent years because of the increased regulatory burden, higher capital requirements, and the desire to focus on their core customers and businesses. Large banks have retreated from the residential mortgage business, as evidenced by the significant decline in the top 5 banks' share of the mortgage origination market over the last three years.

This creates significant opportunity for specialist mortgage firms. Unlike large banks, PennyMac Financial lacks the diversion of operating a depository institution and can instead obtain financing through facilities from banks and broker-dealers and by accessing the capital markets. Furthermore, non-bank mortgage lenders are also subject to a considerable amount of external oversight from the likes of regulators such as the CFPB and State agencies; the GSEs; our Bank financing partners; and the ratings agencies.

Now let's turn to slide 6 and review PennyMac Financial's strategy in consumer direct lending.

Slide 6

Our consumer direct activities originate loans through a call center-based model where we capture leads for origination from our servicing portfolio, such as the loans that are eligible for refinance, and originate non-portfolio loans directly to consumers. It's a controlled, centralized, and process-driven origination business that leverages our technology and expertise to deliver effective and efficient service to the consumer and ultimately reduces their cost of borrowing.

Consumers have already adopted the direct channel as the dominant model for other financial service products ranging from investment brokerage to auto insurance. The consumer direct model is becoming favored by borrowers seeking refinance loans, and we believe it will become the channel of choice for all retail mortgage originations, including purchase-money loans.

We drive leads to the call center through a number of corporate-directed strategies.

We develop leads from our servicing portfolio by optimizing the capture of existing customers seeking a refinance or a new purchase loan. We are successfully executing on this strategy as evidenced by recapture rates on recent MSR acquisitions which have been in excess of 50 percent.

Supplementing the recapture strategy are several strategies to drive non-portfolio leads. One initiative is our Business Development Officers, who are strategically located in specific geographic regions to develop and maintain relationships with Realtors and home builders and drive business to our call center. Other lead generation strategies are focused on corporate affinity partnerships, and we continue to build awareness of PennyMac's brand through national advertising which includes broadcast commercials and internet-based strategies.

Additional drivers of success include our increased proficiency in processing larger volumes of loans while maintaining our high standards for customer experience and manufacturing quality, which can be leveraged as we execute on initiatives to grow purchase-money business.

We are making technology investments to enhance the customer experience and maximize lead conversion, as well as developing innovative solutions for purchase-money business such as our Approved Buyer Certificate. The ABC is much stronger than the common pre-approval because it is issued based on the borrower's credit being fully underwritten prior to identifying the property to be purchased. This then allows for a very fast closing to meet the demands of the real estate transaction.

Now let's turn to slide seven and discuss the value of correspondent aggregators in today's mortgage market.

<u>Slide 7</u>

Many small and mid-sized mortgage lenders sell their loans to aggregators, who acquire, pool, and then deliver the loans into the secondary market. Correspondent customers sell to aggregators for a variety of reasons. For instance, they may lack the capital markets expertise to hedge an origination pipeline or the operational capabilities to service the loans or the financial capacity to own and manage the mortgage servicing rights. Aggregators conduct a significant amount of due diligence on the mortgage loans they acquire from these smaller lenders, in addition to devoting significant resources to assess that lenders have the financial wherewithal to stand behind the representations and warranties they make on the loans.

Last year, some 30 percent of the mortgages originated in the United States flowed through the correspondent market. Aggregators such as PennyMac Financial and PMT provide Fannie Mae, Freddie Mac and Ginnie Mae the operational leverage to source loans originated by these smaller lenders. As retail origination costs increase, margins remain under pressure, and lenders lack the capital and liquidity to directly securitize and own the MSR. The correspondent aggregation model has an important role to play in the mortgage market.

Now let's turn to slide 8 and discuss our current perspectives on the market environment.

Slide 8

While mortgage rates trended slightly higher during the third quarter, they remained very low in a historical context which continued to aid refinance activity. Subsequent to the end of the third quarter, mortgage rates declined again which should benefit mortgage production volumes in the fourth quarter. Relatively low rates also help to maintain the attractiveness of purchasing a home compared to renting. Market expectations are for interest rates to remain low through 2015 despite the recent end of the Fed's quantitative easing program, with rates expected to increase over time as economic growth improves.

We have observed a slowdown in the rate of home price appreciation thus far in 2014 and the rate of change appears to be moderating to a more normalized pace across much of the U.S. Further increases in home prices are likely to be driven by the historically low inventory of available homes and improvements in employment and wages. The chart at the lower right depicts the available inventory of new and existing homes as a percentage of all households in the United States, which illustrates the lack of supply in today's housing market. Inventory levels fluctuate but have typically ranged in the past from a low of 2 percent of households to as high as 4 percent. Inventory levels in recent quarters have fallen below 2 percent. One factor behind this decline is that since the financial crisis, new home construction has failed to keep pace with household formations. Although single family housing starts have risen, it will take time for these units to translate into meaningful new supply.

The prime jumbo market has begun to improve relative to the first half of 2014, as evidenced by PMT's increase in its jumbo acquisition volumes and the recent uptick in prime jumbo securitizations from a growing number of issuers.

Another development in the U.S. mortgage market is the growing emphasis that the Federal Housing Finance Agency and the Federal Housing Administration are placing on expanding the availability of mortgage credit to potential borrowers that fall outside of today's strict lending standards. We view this as a positive development and support the efforts of these agencies, but do not yet know how meaningful the impact of these new programs will be.

We continue to see heightened scrutiny of nonbank mortgage companies and discussion about the risks that they may pose, including concerns that they have adequate capital, capabilities and governance systems in place. We believe that PennyMac Financial is distinguished among mortgage companies with its organically built operating platform, strong corporate governance culture, and appropriate levels of capital. Our businesses are subject to considerable external oversight including from regulators, Agencies, and other institutional partners. We believe that a well-managed specialist firm like PennyMac Financial should play an important and increasing role in today's mortgage market.

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

Speaker:

David Spector – President and Chief Operating Officer

Thank you, Stan.

Slide 9

I'd like to begin my remarks on slide 9, and emphasize the growth trends across PennyMac Financial's businesses. Our Correspondent Production, Consumer-Direct and Loan Servicing activities all continued to increase their market share during the quarter through successful execution of our organic growth initiatives.

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

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

Slide 10

Correspondent acquisitions totaled 8.1 billion dollars in UPB for the third quarter, a 15 percent increase from the second quarter. Government-insured loan acquisitions accounted for 54 percent, or 4.4 billion dollars of correspondent acquisitions during the quarter. Additionally, PennyMac Financial performed fulfillment activities for PMT on 3.7 billion dollars of conventional conforming and jumbo loans during the third quarter. Government-insured loan acquisitions generate revenue primarily in the form of gain on mortgage loans, whereas loan fulfillment for PMT generates revenue for PennyMac Financial in the form of fulfillment fees.

In October, total correspondent loan acquisitions were 2.8 billion dollars in UPB, and interest rate lock commitments were also 2.8 billion dollars in UPB.

During the third quarter, we continued to deliver on initiatives to grow the number of seller relationships and deepen our relationships with existing sellers. Our group of approved correspondent sellers increased to 342 lenders at September 30th from 316 at the end of last quarter.

Also notable was the increase in prime jumbo loan acquisition volumes by PMT, which increased by 109 percent from the prior quarter to 169 million dollars. We have emphasized the development and deepening of seller relationships for jumbo loans while focusing efforts on broadening PMT's product menu. These initiatives are showing results and we will continue to focus on profitably growing jumbo acquisition volumes for PMT, which should result in additional revenue streams for PennyMac Financial.

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

Slide 11

Consumer direct production volumes in the third quarter totaled 527 million dollars in UPB, a 31 percent increase from the second quarter. Portfolio-sourced originations were 479 million dollars and non-portfolio originations were 49 million dollars. The high percentage of portfolio-sourced originations during the quarter resulted from the considerable opportunities available from effectively pursuing recapture of the existing servicing portfolio. Our refinance of existing borrowers can reduce potential payment stress and help improve the expected credit performance of the servicing portfolio by providing borrowers with a lower monthly payment.

As consumer direct volumes have grown, we have focused our efforts on developing our loan origination platform in order to make the customer experience easier and more efficient. We are working to develop industry-leading web and mobile interfaces to exceed the expectations of today's consumer through enhanced interaction tools and increased automation. In recent quarters we have focused the majority of our resources towards recapturing loans from the servicing portfolio, but we will be able to leverage these investments in people, systems, and processes as we grow our non-portfolio volumes and execute on our strategic objective of building PennyMac Financial into a leading consumer direct lender.

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 100 billion dollars in UPB, up 7 percent from the second quarter. Prime servicing and subservicing saw net growth of 6.8 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 MSR acquisitions of 16.8 million dollars during the quarter, representing 1.6 billion dollars in UPB, with a 9.3 million dollar co-investment by PMT in the associated excess servicing spread.

During the quarter we reviewed 38 mini-bulk and flow deals in the market, bidding on 7 and winning 3 deals. We remain well positioned to capture larger bulk MSR transactions as these opportunities come to market.

Loan servicing is a scale business which requires a significant investment in systems, infrastructure and people. The need for this up-front investment creates high barriers to entry, and means that servicers must maintain a portfolio large enough to manage their per loan cost to service. PennyMac Financial has developed unique production activities that profitably drive organic MSR generation, which is supplemented by third-party MSR acquisitions. As the servicing portfolio grows, we expect to continue driving operational efficiencies and capture further economies of scale.

Now let’s to turn to slide 13 and discuss the operational results from the investment management segment.

Slide 13

Investment management revenues increased 4 percent from the second quarter due to an increase in base management and incentive fee revenue from PMT partially offset by a decline in carried interest income from the Investment Funds.

Net assets under management decreased modestly to 2.02 billion dollars at quarter-end from 2.14 billion dollars at June 30, 2014, driven by two initial private investment funds which continued their planned return of capital to their investors.

The opportunities to invest in residential mortgage-related assets remain significant. Given our track record in mortgage-related investments, we also believe there are opportunities for PennyMac Financial to raise equity in PMT or other capital vehicles in the future.

PMT continues to pursue a variety of mortgage-related investments which include distressed whole loans; MSRs resulting from correspondent aggregation; excess servicing spread on MSRs; retained interests from prime jumbo securitizations; and Agency and non-Agency MBS. PMT has been a selective buyer of non-Agency securitizations backed by prime jumbo loans and we are encouraged by the potential we see in the non-Agency market going forward. Additionally, we continue to evaluate new investments, such as small-balance commercial mortgages, which align to our core mortgage expertise and have the potential for attractive returns.

With that I'd now like to turn it over to Anne McCallion, PennyMac Financial's Chief Financial Officer, to talk about 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 62.7 million dollars on net revenue of 140.6 million dollars, an 8 percent increase from the second quarter. Diluted earnings per common share was 49 cents, up 9 percent from the second quarter.

Expenses for the third quarter were 77.9 million dollars, also an 8 percent increase from the second quarter.

Production segment pretax income was 39.1 million dollars, up 16 percent from the second quarter, and Servicing segment pretax income was 17.4 million dollars, down 13 percent from the prior quarter. Investment Management segment pretax income totaled 6.2 million dollars for the third quarter, up 16 percent from 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 71.6 million dollars for the third quarter, up 12 percent from the second quarter. The higher revenues were driven by a 10 percent increase in net gains on mortgage loans held for sale and loan origination fee revenue, in addition to a 25 percent increase in fulfillment fees from PMT due to a 23 percent increase in conventional and jumbo correspondent production volumes during the quarter.

During the third quarter, PennyMac Financial acquired 4.4 billion dollars in UPB of Government-insured mortgages through correspondent production and originated 527 million dollars in UPB of loans through consumer direct production, increases of 10 percent and 31 percent, respectively, from the second quarter. Interest rate lock commitments on Government-insured and consumer direct loans totaled 5.6 billion dollars for the third quarter, an increase of 9 percent from the second quarter.

The net gains on mortgage loans held for sale as a percentage of Government-insured and consumer direct interest rate lock commitments was 73 basis points in the third quarter, compared to 74 basis points in the previous quarter. Gains related to consumer direct IRLCs were approximately 305 basis points in the third quarter when adjusted for expected fallout, which is estimated to be approximately 35 percent for consumer direct loans.

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

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

Slide 16

Servicing segment revenues were 55.7 million dollars in the third quarter, an increase of 4 percent from the prior quarter. Net loan servicing fees totaled 53.9 million dollars for the quarter, a 5 percent quarter-over-quarter decrease, which included a 1.8 million dollar decline in servicing fees due to lower activity fees in special servicing, a 3.0 million dollar increase in amortization from a growing servicing portfolio, and a 2.2 million dollar improvement in valuation changes for MSRs and hedges.

Servicing segment expenses increased to 38.3 million dollars, a 13 percent increase from the second quarter, primarily driven by the growth in the servicing portfolio and loss reserves associated with the servicing of 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 33.3 billion dollars in UPB at September 30, 2014, up from 29.5 billion dollars at the end of the second 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 27.2 billion dollars.

MSRs are a growing portion of PennyMac Financial's assets and their fair value generally increases in a rising interest rate environment and decreases when rates fall. We account for originated MSRs at the lower of amortized cost or fair value, or LOCOM, when the underlying note rate on the loans is less than or equal to 4.5 percent. MSRs with note rates on the underlying loans above 4.5 percent, and those subject to excess servicing spread, are accounted for using the fair value option. At the end of the quarter, the fair value of PennyMac Financial's MSR asset was 10.0 million dollars greater than its carrying value.

PennyMac Financial also completed the sale of excess servicing spread during the third quarter, totaling 9 million dollars in fair value. 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 13.3 million, up 4 percent from the second quarter. Management fees, which include base management fees and incentive fees from PMT, and management fees from the Investment Funds increased 3 percent from the prior quarter, primarily due to a 500 thousand dollar increase in incentive fee revenue from PMT resulting from improved performance in recent quarters. Carried interest income from the Investment Funds increased by 100 thousand dollars.

Segment expenses were 7.1 million dollars, down 5 percent from the second quarter primarily as a result of a minor downward adjustment to compensation expense accruals.

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 organic growth of PennyMac Financial is being achieved through the execution of our strategic initiatives through a constantly changing interest rate environment and is not dependent on large acquisitions for success. We have in place the core infrastructure, management, and systems to significantly grow all of our businesses, including loan servicing where our portfolio surpassed 100 billion dollars this quarter. Our company is poised for growth and uniquely positioned because of our operational platform which has been built from the ground up specifically to address the demands of today's mortgage market and regulatory environment.

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