PennyMac Financial Services, Inc.

Second Quarter 2015 Earnings Transcript

August 5, 2015

Introduction

Good afternoon and welcome to the second quarter 2015 earnings discussion for PennyMac Financial Services, Inc. The slides that accompany this discussion are available from PennyMac Financial Services, Inc.'s website at www.ir.pennymacfinancial.com. Before we begin, please take a few moments to read the disclaimer on slide two of the presentation. Thank you. Now I'd like to turn the discussion over to Stan Kurland, PFSI's Chairman and Chief Executive Officer.

Speaker:

Stanford L. Kurland – Chairman and Chief Executive Officer

Thank you, Chris.

PennyMac Financial delivered its best quarterly performance in the second quarter, driven by record loan production volumes and servicing portfolio growth.

We have built a strong track record of earnings growth and operational performance over the last several years, evolving into one of the leading mortgage finance specialists in the United States. The successful execution of our growth strategies while remaining focused on quality and governance have been, and remain, the key to our success.

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

Slide 3

For the second quarter, PennyMac Financial earned pretax income of 74.8 million dollars, an increase of 40 percent from the prior quarter. Diluted earnings per share was 59 cents, also an increase of 40 percent from the prior quarter. The quarter's earnings were primarily driven by strong pretax earnings contributions from our Loan Production segment.

Production segment revenues were 131.4 million dollars, up 19 percent from the prior quarter. Loan production volume totaled 13.0 billion dollars in unpaid principal balance, a 47 percent increase from the first quarter. Of our total production, correspondent acquisitions were 11.9 billion dollars in UPB, up 49 percent from the first quarter due to elevated refinancing volume and higher demand for home purchase-related mortgages. Consumer direct originations were 1.1 billion dollars in UPB, up 27 percent from the prior quarter, driven by the successful recapture of loans refinancing from our growing servicing portfolio. Surpassing the 1 billion dollar mark in consumer direct quarterly fundings represents a significant milestone in PennyMac Financial's development and we are pleased with the progress we continue to make in this business.

Servicing segment revenues were 58.1 million dollars, up 191 percent from the prior quarter, driven by higher servicing fee revenue from the portfolio and MSR valuation gains resulting from lower projected prepayment activity and the positive valuation impact of completing early buyouts. The servicing portfolio grew 18 percent during the quarter to 136 billion dollars in UPB, fueled by organic growth from our loan production activities, supplemented by bulk and flow MSR acquisitions totaling 15.4 billion dollars in UPB.

Investment Management segment revenues were 6.9 million dollars, a decrease of 31 percent from the prior quarter, due to a reduction in performance incentive fees from PMT and carried interest from the private investment funds. Net assets under management ended the quarter at 1.8 billion dollars.

After the end of the second quarter, we completed the previously announced acquisition of 8.5 billion dollars in UPB of Agency MSRs, in addition to the sale of the associated excess servicing spread, or ESS, to PMT totaling 75 million dollars.

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

Slide 4

During the second quarter, we saw a robust mortgage origination market and meaningful improvement in home purchase activity. The 30 year fixed mortgage rate remained low through most of the second quarter and has hovered around 4 percent in recent weeks. Low rates coupled with the impact of the FHA's reduction in its annual insurance premiums continued to result in elevated refinance activity, which is expected to decrease in the third quarter. In addition, home purchase demand increased during the quarter.

Existing home sales reached an annualized rate of 5.5 million units, which is the highest pace since February of 2007, according to the National Association of Realtors. Combined with higher refinance activity, industry forecasts from Fannie Mae, Freddie Mac and the Mortgage Bankers Association have been revised upward and now predict a 1.4 trillion dollar mortgage origination market for 2015. The demand for purchase-money loans has also been driven by greater first-time homebuyer participation and a reduction in all-cash transactions. A continued low inventory of homes for sale across many markets has contributed to the continued appreciation in home prices.

Lastly, regulatory actions against non-bank mortgage companies and pending regulation, including the new TILA-RESPA requirements set to take effect later this year, reinforce the importance of effective governance, compliance, and operating systems.

These remain areas of emphasis and ongoing investment for PennyMac Financial and we believe that the quality of PennyMac Financial's efforts in these areas distinguish it versus the industry.

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

Slide 5

We believe that PennyMac Financial has distinguished itself by consistently delivering significant year-over-year earnings growth, and this trend continues thus far this year. PennyMac Financial has earned a dollar, one per share for the first half of this year, compared to 83 cents per share in the first half of last year, a 22 percent increase. Pretax income has grown similarly, up 20 percent versus the first half of last year. Over this same period, PennyMac Financial's servicing portfolio has grown by 46 percent and total loan production has nearly doubled.

Our performance reflects the size of the opportunity available to us in today's mortgage market, as well as the success we have had in capturing the opportunity.

Slide 6

Turning to slide 6, we believe that our outstanding financial performance is a reflection of PennyMac Financial's unique platform. We have built a best-in-class mortgage banking platform, with our operations developed organically – not through acquisitions – which are highly scalable to support continued growth. We have an industry-leading correspondent aggregation business with the scale and systems to grow profitably. At its core are our unique mortgage fulfillment operations which have proven capable of efficiently acquiring, auditing, and securitizing large volumes of loans at the highest levels of manufacturing quality. We have become a leader in mortgage servicing. Our servicing portfolio has grown mostly organically resulting from our loan production volumes.

Where we have acquired MSRs from third parties, we have a track record of successful MSR transfers. We are investing in our consumer direct lending platform, which we believe represents the future of retail mortgage origination. Our consumer direct volumes have more than doubled versus a year ago and are poised for significant future growth. We have a unique partnership with PMT, which is a tax-efficient capital partner that helps reduce the balance sheet requirements of a typical mortgage company. And we have a commitment to strong corporate governance, compliance, and risk management since our inception.

We believe that our platform provides a strong foundation for growth. PennyMac Financial's strategy is to leverage this platform to profitably grow each of our businesses in loan production, loan servicing, and investment management.

Slide 7

On slide 7, I would like to close by reviewing the trends in PennyMac Financial's growth across each of our businesses. Our correspondent and consumer-direct production activities as well as our loan servicing business continued to increase their market share during the quarter through successful execution of our growth initiatives.

Increases in our correspondent and consumer direct production volumes led to market share gains during the second quarter, while the loan servicing portfolio grew as a result of our production activities and recent servicing acquisitions completed during the quarter. PennyMac Financial was the 6th largest producer of mortgage loans during the second quarter and ended as the 12th largest servicer, according to Inside Mortgage Finance. We believe that our carefully built operational foundation and focus on governance enables us to continue growing profitably as the mortgage market environment evolves.

While the assets under management of our investment management business declined quarter-over-quarter as the private investment funds liquidate, we continue to build on several recent accomplishments on behalf of PMT, and see opportunities to manage additional capital over time.

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 8

I'd like to begin my remarks on slide 8, and review the operational results of PennyMac Financial's correspondent production business.

Correspondent production totaled 11.9 billion dollars in UPB for the second quarter, a 49 percent increase from the first quarter and government-insured loan acquisitions accounted for 70 percent, or 8.3 billion dollars of total correspondent acquisitions. Additionally, PennyMac Financial performed fulfillment activities for PMT on 3.6 billion dollars of conventional conforming and jumbo loans during the second quarter. Government-insured loan acquisitions generate revenue primarily in the form of net gains on mortgage loans, whereas loan fulfillment for PMT generates revenue for PennyMac Financial in the form of fulfillment fees.

In July, total correspondent loan acquisitions were 5.6 billion dollars in UPB, while interest rate lock commitments were 4.9 billion dollars in UPB.

Our increase in production volumes was the result of a larger overall origination market and our ability to capture the market opportunity and gain share.

Our correspondent platform was able to effectively scale to the higher demand and maintain service levels while competitors struggled to keep up. This performance reflects our investment in systems, which we believe is one of many significant barriers to entry in the correspondent business. Our correspondent clients need the loans they sell to us processed and funded in a timely manner, so they can clear their warehouse financing lines and make new loans. The ability of our platform, which is largely internally developed, to maintain consistent execution is a key reason for our success and the steadily increasing market share we have achieved over time.

Additionally, the market for whole loans sold to aggregators like us expanded, as private equity buyers for newly originated MSRs backed away from what is known as the co-issue market. This dynamic in particular resulted in additional opportunity in the conventional conforming correspondent market.

During the quarter, we continued to execute on a number of strategic initiatives to grow market share and optimize our business relationships with existing sellers. We have made significant gains in growing our presence in New England, which accounted for approximately 4 percent of our total production volume in the second quarter, and we now believe that we are well-represented in that region. Several other opportunities exist to expand into geographic markets where we are under-indexed, such as the Midwest and Southeast.

We have had success adding new correspondent seller relationships, which reached 377 at the end of June. We continued to add sales resources during the quarter to support our growth initiatives. Our efforts are aided by proprietary technology that enables us to identify seller-specific areas of opportunity.

An important focus of our growth is small to medium-sized originators that can benefit the most from our operational expertise and risk management capabilities.

These sellers accounted for 2.3 billion dollars of lock volume in the second quarter, up from 1.5 billion dollars of lock volume in the first quarter. We expect these relationships to contribute 1 billion dollars per month of lock volume by the second quarter of 2016.

Our goal is to grow our number of approved sellers by approximately 10 percent by year end, while continuing to maximize the business we do with each relationship.

Now let's turn to slide 9 and discuss consumer direct production.

Slide 9

Consumer direct production volumes in the second quarter totaled 1.1 billion dollars in UPB, a 27 percent increase from the first quarter.

Portfolio-sourced originations totaled 1 billion dollars while non-portfolio originations were 134 million dollars in UPB. In July, total consumer direct loan production was 336 million dollars in UPB, and interest rate lock commitments were 572 million dollars in UPB.

The pipeline of loan commitments was 543 million dollars in UPB at July 31, up from 504 million at June 30.

The strong growth in portfolio-sourced originations during the quarter resulted from the successful recapture of borrowers in our servicing portfolio that refinanced their mortgages during the quarter. Production volume was supported by relatively low interest rates for much of the quarter, and the FHA mortgage insurance premium reduction earlier in the year helped keep refinance volumes elevated during the quarter. Our mortgage fulfillment division, MFD, has been able to accommodate the increased volume as a result of our continued investment in systems and people to enable greater processing capacity.

We are also focused on initiatives aimed at growing non-portfolio volumes, including enhancements to our website "PennyMacUSA.com" and growing affinity relationships through corporate partnerships. We now have ten affinity relationships, which accounted for 10 percent of total consumer direct production volume in the second quarter.

Now let's turn to slide 10 and discuss our Loan Servicing business.

Slide 10

In the second quarter, our loan servicing portfolio grew to 136.2 billion dollars in UPB, up 18 percent from the first quarter. Prime servicing and subservicing saw net growth of 21 billion dollars in UPB quarter-over-quarter, as we continued to add loans through our consumer direct and correspondent loan production activities. Additionally, we completed the previously announced acquisition of 15.4 billion dollars in UPB of MSRs during the quarter which added approximately 100 thousand loans to the portfolio.

We continue to pursue opportunities for servicing acquisitions. During the second quarter we reviewed 43 mini-bulk and flow deals in the market, bidding on nine and winning two deals. We remain well positioned to capture larger bulk MSR transactions as those opportunities come to market.

To support the ongoing growth of our servicing operations we have prudently increased headcount in our servicing business and continued to invest in technology. Technology investments have focused on expanding the functionality of our servicing system to reduce vendor expense and to improve the functionality of our customer-facing website. We believe these initiatives are critical to optimizing scale efficiencies and delivering a best-in-class user experience for our borrowers. Today, we now have fully developed servicing sites in California and Texas that provide operational stability, extended customer service hours and support for future growth.

We believe that it is these investments in our business, our people, processes, and governance that differentiate PennyMac Financial, and they are also a key reason why we have been able to successfully acquire and transfer over 30 billion dollars in UPB of bulk and flow MSR acquisitions in the last 12 months.

Now let's turn to slide 11 and discuss the Investment Management segment.

Slide 11

Investment Management revenues declined 31 percent from the first quarter due to a 1.2 million dollar reduction in management fee revenue from PMT and a 1.1 million dollar decrease in carried interest income from the investment funds.

Net assets under management declined to 1.8 billion dollars at June 30th, primarily due to the planned return of capital and distribution of earnings to investors in the two private funds we manage.

Recent initiatives we have completed on behalf of PMT include obtaining additional financing for ESS and MSRs allowing it to grow and achieve its targeted return objectives, as well as obtaining membership in the Federal Home Loan Bank. In addition, the creation of a unique credit risk transfer structure between PMT and Fannie Mae allows PMT to invest in the credit risk on its own high-quality correspondent production. Credit risk transfer has the potential to be a significant new opportunity for PMT to invest and deploy additional capital.

With that I'd now like to turn it over to Anne McCallion, PennyMac Financial's Chief Financial Officer, to discuss the second quarter's financial results.

Speaker:

Anne McCallion – Chief Financial Officer

Thank you, David. Let's turn to slide 12 and take a look at the highlights of the quarter's financial performance.

Slide 12

As Stan noted, pretax income for the second quarter was 74.8 million dollars.

Production segment pretax income was 76.3 million dollars, up from 67.4 million dollars in the first quarter. The servicing segment reported a pretax loss of 2.4 million dollars, compared to a pretax loss of 18.1 million dollars from the prior quarter. Investment Management segment pretax income totaled 1 million dollars for the second quarter, down from 3.9 million dollars in the prior quarter.

Additionally, first quarter 2015 segment results were updated to reflect a change in the amount of incentive compensation for executive management and shared services allocated to each segment. Incentive compensation for executive management and shared services is now allocated to each segment based on its contribution to earnings rather than on usage of such executive management and shared services.

Let's now turn to slide 13 and take a closer look at the results of the Production segment.

Slide 13

Production segment revenues were 131.4 million dollars for the second quarter, up 19 percent from the first quarter. The higher revenues were primarily driven by a 12 percent increase in net gains on mortgage loans held for sale and a 46 percent increase in loan origination fee revenue.

During the second quarter, PennyMac Financial acquired 8.3 billion dollars in UPB of Government-insured mortgages through correspondent production, an increase of 63 percent from the first quarter. The Company also originated 1.1 billion dollars in UPB of loans through consumer direct production, up 27 percent from the first quarter. Interest rate lock commitments on Government-insured and consumer direct loans totaled 11.6 billion dollars for the second quarter, an increase of 49 percent from the first quarter.

The net gains on mortgage loans held for sale as a percentage of Government-insured and consumer direct interest rate lock commitments were 75 basis points in the second quarter, compared to 99 basis points in the previous quarter. Production gains, which include net gains on mortgage loans held for sale, loan origination fees, and net interest income, increased 20% quarter over quarter, driven by higher lock and funding volumes, partially offset by reduced margins in our consumer direct business.

Loan origination fees as a percentage of Government-insured and consumer direct loan funding volumes totaled 26 basis points in the second quarter, down from 28 basis points in the first quarter. Fulfillment fee revenue increased 19 percent quarter over quarter due to a 24 percent increase in loans fulfilled for PMT, partially reduced by a lower weighted average fulfillment fee rate in the second quarter. The average fulfillment fee earned from PMT was 43 basis points, down from 45 basis points the prior quarter.

Production segment expenses increased to 55.1 million dollars, a 28 percent increase from the first quarter, primarily driven by increased headcount to support higher volumes of consumer direct production and higher production-related incentive compensation.

Let's turn to slide 14 and take a look at the financial performance of the servicing segment.

Slide 14

Servicing segment revenues were 58.1 million dollars in the second quarter, an increase of 191 percent from the prior quarter. Net loan servicing fees totaled 68.5 million dollars for the quarter, a 156 percent quarter-over-quarter increase, which included growth in loan servicing fees to 91 million dollars, and a 44.4 million dollar gain in MSR fair value driven by lower expected prepayment activity resulting from higher mortgage rates through the end of the second quarter, as well as the positive valuation impact of completing early buyouts. These were reduced by 31.4 million dollars of amortization, 28.3 million dollars of hedging losses and a 7.1 million dollar loss on ESS financing.   Additionally, MSR fair value gains were tempered by higher than expected actual prepayment speeds, particularly for MSRs related to government-insured loans.

Servicing segment expenses increased by 22 million dollars quarter over quarter to 60.5 million dollars, largely due to 10 million dollars of expense related to increased early buyout activity, whereby defaulted loans are purchased out of primarily seasoned Ginnie Mae pools. This was largely offset by an improvement in MSR values, as forecasted future costs are reduced by removal of the loans from MSR pools. We also incurred 5 million dollars of additional expense related to servicing portfolio growth, including staff hired in anticipation of large servicing acquisitions that boarded in May through July. Lastly, we incurred 7 million dollars in other expenses, including increased claims processing activity during the quarter.

Now let's turn to slide 15 for a deeper discussion of PennyMac Financial's MSR portfolio.

Slide 15

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 42 billion dollars in UPB of MSRs under LOCOM, with a fair value that was 15.7 million dollars greater than its carrying value at June 30th.

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 46.2 billion dollars at June 30, which increased from 33.1 billion dollars at the end of the first quarter.

PennyMac Financial also completed the sale of excess servicing spread totaling 141 million dollars during the second quarter. This excess servicing spread was acquired by PMT.

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

Slide 16

Investment management revenues were 6.9 million dollars, down 31 percent from the first 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 declined 18 percent driven by PMT's reduced financial performance in recent quarters. Carried interest earned by PennyMac Financial from the private investment funds declined by 1.1 million dollars from the prior quarter.

Segment expenses were 6.0 million dollars, down 2 percent from the first 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 achieved several significant milestones in the second quarter, including record earnings, record total production volumes and over one billion dollars in production from consumer direct lending. These results are a direct result of the investments we have made to achieve sustainable success across our businesses.

Our focus on operational excellence and disciplined execution distinguishes PennyMac Financial and positions us to capitalize on the significant opportunities in the mortgage market. We incurred higher expenses during the quarter as a result of higher transaction volumes and our ongoing investments in people, infrastructure and technology to develop greater operational capacity. We expect to leverage these investments going forward to continue capturing greater economies of scale and profitability.

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 second 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.