PennyMac Financial Services, Inc.

First Quarter 2016 Earnings Transcript

May 5, 2016

Introduction

Good afternoon and welcome to the first quarter 2016 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

During the first quarter, financial markets experienced significant volatility driven by concerns over growth in overseas economies which also led to lower interest rates. As a result, mortgage rates fell to their lowest levels in two years, driving higher prepayment activity and expectations, which adversely impacted the value of our, mortgage servicing rights, or MSR asset this quarter. Conversely, the decline in mortgage rates significantly improved the momentum for the mortgage production business.

For the first quarter, PennyMac Financial earned pretax income of 30.1 million dollars, a 61 percent decrease from the fourth quarter of 2015. And diluted earnings per share were 23 cents. The decline in earnings resulted from 47.7 million dollars in non-cash valuation losses on MSRs, net of hedges and valuation gains on excess servicing spread liabilities, driven by the significant decline in mortgage rates this quarter. We estimate that this impact adversely affected first quarter earnings per common share by 37 cents. Book value reached 12 dollars and 59 cents per share, up from 12 dollars and 32 cents per share at December 31st.

Pretax earnings contributions from the Production segment were 68.4 million dollars, a 36 percent increase from the fourth quarter, driven by growth in the higher margin consumer direct production channel. Total loan production volumes in the first quarter were 10.9 billion dollars in unpaid principal balance, or UPB, a 2 percent decrease from last quarter, reflecting smaller production pipelines entering the quarter. Total locks were 12.6 billion dollars in UPB, up 1 percent from the fourth quarter.

The Servicing segment had a pretax loss of 39.5 million dollars, versus pretax income of 27.9 million dollars last quarter. The loss was driven the 125.9 million dollar decrease in MSR value, partially offset by 78.2 million dollars in gains from hedges and valuation gains on the excess servicing spread liability. Pretax servicing operating income was 13.8 million dollars, reflecting the underlying operating profitability of the business excluding market driven and non-operational impacts. Our servicing portfolio grew 3 percent during the quarter to 164.9 billion dollars in UPB, which resulted from our organic loan production activities.

Investment Management pretax income was 1.1 million dollars, up 74 percent from the prior quarter, driven by higher carried interest revenue resulting from improved performance in the private Investment Funds. Net assets under management ended the quarter at 1.6 billion dollars.

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

Slide 4

During the first quarter, financial markets worldwide experienced considerable volatility as concerns over a global economic slowdown and the collateral impact from lower oil prices in the energy sector weighed on investor sentiment. These concerns drove a flight to quality in U.S. Treasuries, driving the 10-year bond yield to its lowest level in two years and credit spreads wider. As a result, 30-year fixed mortgage rates declined by over 26 basis points during the quarter, resulting in a significant increase in refinancing activity. While lower rates are likely to benefit mortgage origination volumes and margins in future periods, they adversely impact the value of mortgage servicing rights as the mortgages underlying these assets experience higher actual and projected future prepayment activity.

As the quarter progressed, we saw credit spreads begin to tighten as investor fears began to ease. One segment of the market that widened and did not rebound was mortgage credit, in particular the first loss tranches of GSE credit risk transfer transactions. We believe that this widening resulted from technical factors and the lack of liquidity in these securities, while the fundamental performance of these transactions remain strong.

In contrast to the volatility in the financial markets, housing fundamentals continued to show strength in existing sales, home prices, single family housing starts this quarter, and in continued improvement in employment data for key home buying age demographics. Increased focus by homebuilders in the construction of starter homes, coupled with greater availability of low down payment mortgage products, are expected to drive more homebuyers into the market and propel continued strength in the purchase market as we enter the spring/summer home buying season.

The mortgage business is a highly regulated industry and a company's approach to, and execution of, effective governance, compliance and operating systems is critical in today's environment. We've seen numerous recent examples in the industry of what can happen when controls are not effective. We believe that the quality of PennyMac's efforts in this regard, and the focus we place on ensuring robust governance and operational controls, continues to distinguish us versus the industry and will remain integral to our continued future success.

Slide 5

Turning to slide 5, I would like to spend a few minutes reviewing our approach to hedging and managing interest rate risk.

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

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

However, lower interest rates drive increased demand for refinancing which typically leads to higher loan production volumes and revenue.

We choose not to completely offset the non-cash MSR fair value losses with financial hedges, as we expect to capture offsetting production revenue in future periods. Our overall net exposure today favors an increasing interest rate environment and is designed to capture fair value gains on the MSR asset in excess of the related hedge. The chart on the slide shows the changes in our MSR value for each of the last three quarters before and after taking into account our hedges and valuation changes in the excess servicing spread liability.

Now let's turn to slide 6 and discuss the impact of lower interest rates on the mortgage production business.

Slide 6

On slide 6 we take a look at forecasts for the residential mortgage origination market, averaging figures from the Mortgage Bankers Association, Fannie Mae and Freddie Mac from January compared to the most recent published estimate.

Over the quarter, the forecast for the mortgage origination market has risen by over 150 billion dollars, driven by estimates for increased refinance activity, on top of already strong purchase activity.

The most recent forecasts call for 978 billion dollars in purchase volume and 627 billion dollars in refinance volume. The refinance component has risen 29 percent from the estimate three months earlier. These estimates forecast the majority of the increase in the second and third quarters, implying continued strong origination activity for the next several months.

Now, let's turn to slide 7 and discuss the increased income in PennyMac Financial's production business, driven by the growth in our consumer direct channel.

Slide 7

Production segment pretax income rose 36 percent from the fourth quarter, driven by solid performance from both our correspondent and consumer direct channels, but in particular, the greater percentage of higher margin consumer direct production volumes in the overall mix.

Consumer direct production and locks increased to 1.2 billion dollars and 2.2 billion dollars, from 1 billion dollars and 1.8 billion dollars in the fourth quarter. We attribute this volume growth to the investments in our origination platform and fulfillment capabilities that allowed the business to efficiently scale capacity. That focus allowed us to increase originations during the quarter and capture additional volume as rates declined. This resulted in a record level of 1,963 consumer direct loan units originated in March and nearly 5,000 loan units originated for the quarter – also a record.

Our platform now affords the operational capabilities to pursue a much broader set of growth opportunities: from product and channel-focused initiatives to drive greater recapture volume from our servicing portfolio, to innovative strategies for capturing purchase money volume from the PennyMac customer base, and the acquisition of new customers for both purchase and refinance transactions.

Throughout this year, we will continue the build-out of our financial technology solutions to further enhance the experience of our borrowers, including new tools to allow customers to conduct more of the mortgage origination process themselves via their mobile devices and computers, while continuing to innovate back end processes in our mortgage fulfillment division.

Now let's turn to slide 8 and review the operating results in our servicing segment.

Slide 8

In the first quarter, the weighted average annualized operating revenue was 28.3 basis points of the average servicing portfolio UPB compared to 28.7 basis points last quarter. Our average operating revenue in basis points tends to be lower than other mortgage servicers, partly driven by the 28 percent of our portfolio that is prime subservicing, which has lower revenue but is more capital efficient.

Pre-tax operating income during the quarter totaled 13.8 million dollars or an annualized 3.4 basis points of average UPB, a decrease from 18.9 million dollars or an annualized 4.8 basis points last quarter. The decline was driven by an increase in direct servicing expenses, which include operating expenses and realized credit and advance losses. These expenses totaled 12.7 basis points of average servicing portfolio UPB in the first quarter, compared to 11.8 basis points in the fourth quarter. The increase primarily reflects a higher volume of claims processed during the quarter, which tend to fluctuate from quarter to quarter. Our direct servicing expenses are lower than our mortgage servicing peers.

Pre-tax operating income has ranged from 1.1 basis points to 4.8 basis points over recent quarter.

The largest input on GAAP pretax income was the MSR value reduction, partially offset by PennyMac Financial's interest rate risk management strategies, which include the gains from our hedges and the ESS liability.

Included under the caption of non-core servicing expenses is the provisioning for future credit losses and transaction expenses related to the early buyout of defaulted government-insured loans from Ginnie Mae pools, which totaled 10.3 million dollars, compared to 5.9 million in the fourth quarter. Higher non-core expenses were offset by non-core gains related to the sale of reperforming early buyout loans and interest income of 16.4 million, compared to 14.1 million in the fourth quarter. 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.

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 our businesses.

Speaker:

David Spector – President and Chief Operating Officer

Thank you, Stan.

Slide 9

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

Strong consumer direct production volumes and servicing portfolio growth resulting from our own production led to market share gains in those areas during the first quarter, while our correspondent market share dropped slightly. PennyMac Financial was the 6th largest producer of mortgage loans during the first quarter and ended as the 11th largest servicer, according to Inside Mortgage Finance.

In our investment management business, net assets under management declined slightly from the prior quarter, driven by PMT's share repurchases and the ongoing pay-down of the private Investment Funds.

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

<u>Slide 10</u>

Correspondent production totaled 9.7 billion dollars in UPB for the fourth quarter, a 3 percent decline from the fourth quarter. On a year-over-year basis, our correspondent production volumes increased 21 percent from the first quarter of 2015.

The modest decrease in production volumes was in line with the overall origination market and reflects seasonal factors due to the purchase-money focus on PMT's correspondent production.

Government-insured and guaranteed loan acquisitions accounted for 66 percent, or 6.4 billion dollars of total correspondent acquisitions in the first quarter. Additionally, PennyMac Financial performed fulfillment services for PMT on 3.3 billion dollars of conventional production during the quarter.

The decline in mortgage rates has led to increased demand for refinancing and a robust origination market. In April, total correspondent loan acquisitions were 4 billion dollars in UPB, while interest rate lock commitments were 4.6 billion dollars in UPB. April acquisitions represent a 24 percent increase from the average of 3.2 billion dollars per month during the first quarter.

During the quarter, we continued to grow our correspondent seller relationships. At the end of the first quarter, we reached 437 correspondent seller relationships, up from 432 at the end of the prior quarter and up from 356 a year ago. Additionally, purchase-money loans accounted for 72 percent of our correspondent production. Our high concentration of purchase-money volume continues to position us well as we enter the Spring / Summer home buying season that will be aided by improved affordability resulting from the recent decline in mortgage rates.

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

Slide 11

Consumer direct production in the first quarter totaled 1.2 billion dollars in UPB, a 17 percent increase from the fourth quarter, and a 35 percent increase from the first quarter of 2015.

The first quarter marked the fourth consecutive quarter with origination volumes over one billion dollars in UPB and represented the highest quarterly funding volumes for our Consumer Direct channel. These strong results were driven by our successful efforts to optimize recapture from our servicing portfolio and capitalize on the scale in our platform to address market-driven opportunities.

Portfolio-sourced originations totaled almost 1.2 billion dollars in UPB in the first quarter while non-portfolio originations were 48 million dollars in UPB. Lower interest rates have contributed to strengthening momentum for consumer direct. In April, total consumer direct loan production was 441 million dollars in UPB while interest rate lock commitments were 814 million dollars in UPB.

The committed pipeline was 816 million dollars in UPB at April 30.

Going forward we are focused on continuing investments in financial technology enhancements to further improve the customer experience and expand our call center functionality. In addition, our new Plano, Texas facility will be devoted to non-portfolio growth initiatives focused on optimizing lead conversion and purchase-money business.

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

Slide 12

In the first quarter, our loan servicing portfolio grew to 164.9 billion dollars in UPB, up 3 percent from the fourth quarter. Prime servicing and subservicing saw net growth of 4.6 billion dollars in UPB quarter-over-quarter, as we continued to add loans through our consumer direct and correspondent loan production activities.

We have experienced success in driving adoption of self-service technology by our loan servicing customers through our recently redesigned servicing portal. The expanded functionality allows customers convenient access to a wide array of information, while driving greater scale efficiencies for us. At quarter end, 58 percent of our servicing customers were registered with PennyMacUSA.com and 79 percent of all payment processing was conducted electronically, compared to 64 percent a year ago.

We continue to focus on outcomes that keep our customers in their homes, and during the quarter we completed over 1,400 modifications. This activity drove income from the securitization of modified government loans as well as growth in PMT's performing loan portfolio. Additional operational metrics can be found in the table on the bottom left hand portion of the slide.

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

Slide 13

Net assets under management were 1.6 billion dollars at March 31st, down 6 percent from December 31st, driven by the planned return of capital to investors in the private Investment Funds and PMT's share repurchase program. PMT's book value per share increased to twenty dollars and fifty nine cents, up from 20 dollars and 28 cents at December 31st.

Investment Management revenues increased 5 percent from the fourth quarter due to a 600 thousand dollar increase in carried interest from the private Investment Funds versus a 300 thousand dollar decrease in the fourth quarter, resulting from improved performance in the private Investment Funds. Additionally, we did not receive incentive fees in the first quarter as a result of PMT's financial performance over the four-quarter period for which incentive fees are calculated.

As PMT's manager, PennyMac Financial is focused on executing strategic initiatives that are designed to enhance PMT shareholder value, such as managing the repurchase of PMT's common shares at a discount to book value and identifying and selling lower yielding investments. We are also focused on allocating capital to investments that result from PMT's unique correspondent production business, such as GSE credit risk transfer and mortgage servicing rights.

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

Speaker:

Anne McCallion – Chief Financial Officer

David, Thank you. Let's turn to slide 14 and take a look at the highlights of the quarter's financial performance.

Slide 14

To recap, pretax income for the first quarter was 30.1 million dollars, compared to pretax income of 78.9 million dollars in the fourth quarter 2015. Production segment pretax income was 68.4 million dollars, versus 50.3 million dollars last quarter. The servicing segment reported a pretax loss of 39.5 million dollars, compared to pretax income of 27.9 million dollars for the fourth quarter. Investment Management segment pretax income totaled 1.1 million dollars for the first quarter, up from 700 hundred thousand dollars in the prior quarter.

Let's now turn to slide 15 and take a closer look at the results of the Production segment.

Slide 15

Production segment revenues were 117.3 million dollars for the first quarter, up 12 percent from the fourth quarter. The increase was primarily driven by a 19 percent quarter-over-quarter increase in net gains on mortgage loans held for sale and a 7 percent quarter-over-quarter increase in loan origination fees. The increase in net gains on mortgage loans held for sale was driven by a significant increase in originations and lock volumes in the consumer direct channel, which tend to have higher margins than the correspondent channel. The increase in loan origination fees was also driven by an increase in consumer direct originations.

During the first quarter, PennyMac Financial acquired 6.4 billion dollars in UPB of Government-insured mortgages through correspondent production, a decrease of 2 percent from the fourth quarter. The Company also originated 1.2 billion dollars in UPB of loans through consumer direct production, up 17 percent from the previous quarter, and interest rate lock commitments on Government-insured correspondent and consumer direct loans increased 1 percent from the fourth 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 87 basis points in the first quarter, compared to 75 basis points in the previous quarter.

Loan origination fees as a percentage of consumer direct and Government-insured correspondent loan funding volumes totaled 29 basis points in the first quarter, compared to 28 basis points in the fourth quarter. Fulfillment fee revenue was largely unchanged from last quarter, as an increase in the average fulfillment fee rate to 40 basis points, from 37 basis points in the prior quarter, was offset by the reduction in conventional corespondent loan acquisitions.

Production segment expenses decreased to 48.9 million dollars, a 10 percent decrease from the fourth quarter, primarily driven by reductions in direct and allocated discretionary and equity-based compensation pertaining to the first quarter's financial results.

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

Slide 16

Servicing segment revenues were 19.6 million dollars in the first quarter, a decrease of 75 percent from the prior quarter. Net loan servicing fees totaled 17.5 million dollars for the quarter, a 77 percent quarter-over-quarter decrease, which included growth in loan servicing fees to 114.9 million dollars reduced by 49.7 million dollars of amortization and realization of MSR cash flows. Net loan servicing fees also included 125.9 million dollars of fair value losses and impairment provisioning related to MSRs, partially offset by 58.7 million dollars of related hedging gains and 19.4 million dollars of gains due to the change in fair value of the ESS financing. MSR fair value losses and impairment provisioning in the first quarter resulted from expectations for higher future prepayment activity due to the significant decline in mortgage rates during the quarter.

Servicing segment expenses for the quarter increased by 8.8 million dollars to 59.1 million dollars, as a result of increased realized credit and advance losses totaling 3 million dollars, higher expenses related to the early buyout of loans from seasoned Ginnie Mae pools of 2.7 million dollars and additional credit loss provisioning of 1.7 million dollars. The securitization of modified and reperforming government insured loans also resulted in 13.3 million dollars of revenue in net gains on mortgage loans held for sale at fair value in the first quarter, versus 12.8 million dollars in the fourth quarter. Now let's turn to slide 17 for a deeper discussion of PennyMac Financial's MSR asset.

Slide 17

MSRs are a significant 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, and all purchased MSRs, including those subject to excess servicing spread, are accounted for at fair value. PennyMac Financial accounted for 60.9 billion dollars in UPB of its originated MSRs under LOCOM, with a fair value that was 400 thousand dollars greater than its carrying value at March 31st. We also account for another 14.5 billion dollars in UPB of MSRs at fair value, because either the note rates on the underlying originated loans are above 4.5 percent or the MSRs were purchased and are not subject to excess servicing spread.

Most of our purchased MSRS are subject to excess servicing spread owned by PMT and the UPB related to the loans underlying those MSRs totaled 37.4 billion dollars at March 31st. This is a decrease from 51.4 billion dollars at the end of the fourth quarter due to the retirement in February of a portion of the ESS financing related to Fannie Mae and Freddie Mac MSRs. As a result, the outstanding ESS financing at March 31, 2016 only relates to Ginnie Mae MSRs.

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 6.4 million dollars, an increase of 5 percent from the fourth quarter. Segment revenues include management fees, comprised of base management fees from PMT and the private Investment Funds and any earned incentive fees from PMT. Management fee revenue decreased 7 percent from the prior quarter due to PMT share buybacks and the return of capital to investors in the private Investment Funds. Carried interest from the private investment funds increased by 863 thousand dollars from the prior quarter resulting from improved performance by the Funds’ investments. No incentive fees were received in the first quarter as a result of PMT’s financial performance over the four-quarter period for which incentive fees are calculated.

Segment expenses were 5.3 million dollars, down 4 percent from the fourth 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.

While significant interest rate volatility such as that seen in the first quarter can adversely impact near-term results, we are pleased with our underlying profitability and the ongoing growth of our businesses. For example, our consumer direct production channel continues to scale, a result of the investments we have made in our operational infrastructure, and is delivering increasingly meaningful contributions to PennyMac Financial's earnings. In particular, we believe that we are poised to capitalize on the opportunities presented by the current low interest rate environment to continue growing the company and delivering strong returns on equity for our shareholders.

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 first quarter 2016 earnings discussion. For any questions, please visit our website, at www.ir.pennymacfinancial.com, or call our Investor Relations department, at 818-264-4907.