

PENNYMAC FINANCIAL SERVICES, INC.

Form 10-Q

August 02, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the quarterly period ended June 30, 2018

Or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the transition period from to

Commission file number: 001-35916

PennyMac Financial Services, Inc.

(Exact name of registrant as specified in its charter)

Delaware	80-0882793
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

3043 Townsgate Road, Westlake Village, California	91361
(Address of principal executive offices)	(Zip Code)

(818) 224-7442

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated

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filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes
No

Indicate the number of shares outstanding of each of the registrant’s classes of common stock, as of the latest practicable date.

Class	Outstanding at July 31, 2018
Class A Common Stock, \$0.0001 par value	25,101,553
Class B Common Stock, \$0.0001 par value	45

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PENNYMAC FINANCIAL SERVICES, INC.

FORM 10-Q

June 30, 2018

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SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q (“Report”) contains certain forward looking statements that are subject to various risks and uncertainties. Forward looking statements are generally identifiable by use of forward looking terminology such as “may,” “will,” “should,” “potential,” “intend,” “expect,” “seek,” “anticipate,” “estimate,” “approximately,” “believe,” “predict,” “continue,” “plan” or other similar words or expressions.

Forward looking statements are based on certain assumptions, discuss future expectations, describe future plans and strategies, contain financial and operating projections or state other forward looking information. Examples of forward looking statements include the following:

- projections of our revenues, income, earnings per share, capital structure or other financial items;
- descriptions of our plans or objectives for future operations, products or services;
- forecasts of our future economic performance, interest rates, profit margins and our share of future markets; and
- descriptions of assumptions underlying or relating to any of the foregoing expectations regarding the timing of generating any revenues.

Our ability to predict results or the actual effect of future events, actions, plans or strategies is inherently uncertain. Although we believe that the expectations reflected in such forward looking statements are based on reasonable assumptions, our actual results and performance could differ materially from those set forth in the forward looking statements. There are a number of factors, many of which are beyond our control that could cause actual results to differ significantly from management’s expectations. Some of these factors are discussed below.

You should not place undue reliance on any forward looking statement and should consider the following uncertainties and risks, as well as the risks and uncertainties discussed elsewhere in this Report and the section entitled “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2017, filed with the Securities and Exchange Commission (“SEC”) on March 9, 2018.

Factors that could cause actual results to differ materially from historical results or those anticipated include, but are not limited to:

- the continually changing federal, state and local laws and regulations applicable to the highly regulated industry in which we operate;
- lawsuits or governmental actions if we do not comply with the laws and regulations applicable to our businesses;

- the mortgage lending and servicing-related regulations promulgated by the Consumer Financial Protection Bureau (“CFPB”) and its enforcement of these regulations;
- our dependence on U.S. government sponsored entities and changes in their current roles or their guarantees or guidelines;
- changes to government mortgage modification programs;
- certain banking regulations that may limit our business activities;
- foreclosure delays and changes in foreclosure practices;
- the licensing and operational requirements of states and other jurisdictions applicable to our businesses, to which our bank competitors are not subject;
- changes in macroeconomic and U.S. real estate market conditions;
- difficulties inherent in growing loan production volume;
- difficulties inherent in adjusting the size of our operations to reflect changes in business levels;

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- any required additional capital and liquidity to support business growth that may not be available on acceptable terms, if at all;
- changes in prevailing interest rates;
- increases in loan delinquencies and defaults;
- our dependence on the success of the multifamily market for future originations of commercial mortgage loans and other commercial real estate-related loans;
- our reliance on PennyMac Mortgage Investment Trust (“PMT”) as a significant source of financing for, and revenue related to, our mortgage banking business;
- our obligation to indemnify third party purchasers or repurchase loans if loans that we originate, acquire, service or assist in the fulfillment of, fail to meet certain criteria or characteristics or under other circumstances;
- our ability to realize the anticipated benefit of potential future acquisitions of mortgage servicing rights (“MSRs”);
- our obligation to indemnify PMT and the Investment Funds if our services fail to meet certain criteria or characteristics or under other circumstances;
- decreases in the returns on the assets that we select and manage for our clients, and our resulting management and incentive fees;
- the extensive amount of regulation applicable to our investment management segment;
- conflicts of interest in allocating our services and investment opportunities among ourselves and our Advised Entities;
- the effect of public opinion on our reputation;
- our recent growth;
- our ability to effectively identify, manage, monitor and mitigate financial risks;

- our initiation of new business activities or expansion of existing business activities;
- our ability to detect misconduct and fraud;
- our ability to mitigate cybersecurity risks and cyber incidents;
- our exposure to risks of loss resulting from adverse weather conditions and man-made or natural disasters; and
- our organizational structure and certain requirements in our charter documents.

Other factors that could also cause results to differ from our expectations may not be described in this Report or any other document. Each of these factors could by itself, or together with one or more other factors, adversely affect our business, results of operations and/or financial condition.

Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update any forward-looking statement to reflect the impact of circumstances or events that arise after the date the forward-looking statement was made.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	June 30, 2018	December 31, 2017
	(in thousands, except share amounts)	
ASSETS		
Cash (includes \$152,382 and \$20,765 pledged to creditors)	\$ 189,663	\$ 37,725
Short-term investments at fair value	98,571	170,080
Mortgage loans held for sale at fair value (includes \$2,498,583 and \$3,081,987 pledged to creditors)	2,527,231	3,099,103
Derivative assets	92,471	78,179
Servicing advances, net (includes valuation allowance of \$61,825 and \$59,958; \$94,715 and \$114,643 pledged to creditors)	258,900	318,066
Carried Interest due from Investment Funds pledged to creditors	370	8,552
Investment in PennyMac Mortgage Investment Trust at fair value	1,424	1,205
Mortgage servicing rights (includes \$2,486,157 and \$638,010 at fair value; \$2,333,750 and \$2,098,067 pledged to creditors)	2,486,157	2,119,588
Real estate acquired in settlement of loans	2,300	2,447
Furniture, fixtures, equipment and building improvements, net (includes \$20,656 and \$23,915 pledged to creditors)	29,607	29,453
Capitalized software, net (includes \$1,347 and \$1,568 pledged to creditors)	31,913	25,729
Assets purchased from PennyMac Mortgage Investment Trust under agreements to resell pledged to creditors	138,582	144,128
Receivable from PennyMac Mortgage Investment Trust	19,661	27,119
Receivable from Investment Funds	12	417
Mortgage loans eligible for repurchase	879,621	1,208,195
Other	85,223	98,107
Total assets	\$ 6,841,706	\$ 7,368,093
LIABILITIES		
Assets sold under agreements to repurchase	\$ 1,825,813	\$ 2,381,538
Mortgage loan participation purchase and sale agreements	528,368	527,395
Notes payable	1,140,546	891,505
Obligations under capital lease	13,032	20,971
Excess servicing spread financing payable to PennyMac Mortgage Investment Trust at fair value	229,470	236,534
Derivative liabilities	4,094	5,796
Accounts payable and accrued expenses	114,005	106,716
Mortgage servicing liabilities at fair value	10,253	14,120
Payable to Investment Funds	404	2,427
Payable to PennyMac Mortgage Investment Trust	99,309	136,998

Payable to exchanged Private National Mortgage Acceptance Company, LLC unitholders under tax receivable agreement	46,903	44,011
Income taxes payable	67,357	52,160
Liability for mortgage loans eligible for repurchase	879,621	1,208,195
Liability for losses under representations and warranties	20,587	20,053
Total liabilities	4,979,762	5,648,419

Commitments and contingencies – Note 14

STOCKHOLDERS' EQUITY

Class A common stock—authorized 200,000,000 shares of \$0.0001 par value; issued and outstanding, 25,008,655 and 23,529,970 shares, respectively	3	2
Class B common stock—authorized 1,000 shares of \$0.0001 par value; issued and outstanding, 45 and 46 shares, respectively	—	—
Additional paid-in capital	229,941	204,103
Retained earnings	299,951	265,306
Total stockholders' equity attributable to PennyMac Financial Services, Inc. common stockholders	529,895	469,411
Noncontrolling interest in Private National Mortgage Acceptance Company, LLC	1,332,049	1,250,263
Total stockholders' equity	1,861,944	1,719,674
Total liabilities and stockholders' equity	\$ 6,841,706	\$ 7,368,093

The accompanying notes are an integral part of these consolidated financial statements.

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PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Quarter ended June 30,		Six months ended	
	2018	2017	June 30,	2017
	(in thousands, except earnings per share)			
Revenues				
Net gains on mortgage loans held for sale at fair value:				
From non-affiliates	\$ 46,019	\$ 99,597	\$ 105,047	\$ 188,248
From PennyMac Mortgage Investment Trust	14,927	(1,506)	27,313	(3,201)
	60,946	98,091	132,360	185,047
Mortgage loan origination fees:				
From non-affiliates	22,886	28,303	46,241	52,498
From PennyMac Mortgage Investment Trust	1,542	1,890	2,750	3,269
	24,428	30,193	48,991	55,767
Fulfillment fees from PennyMac Mortgage Investment Trust	14,559	21,107	26,503	37,677
Net mortgage loan servicing fees:				
Mortgage loan servicing fees:				
From non-affiliates	138,871	112,348	274,354	218,815
From PennyMac Mortgage Investment Trust	9,431	10,099	20,450	20,585
From Investment Funds	3	543	3	1,039
Ancillary and other fees	13,637	11,202	27,808	23,068
	161,942	134,192	322,615	263,507
Amortization, impairment and change in fair value of mortgage servicing rights and mortgage servicing liabilities	(47,257)	(94,435)	(84,220)	(152,360)
Change in fair value of excess servicing spread payable to PennyMac Mortgage Investment Trust	(996)	7,156	(7,917)	9,929
	(48,253)	(87,279)	(92,137)	(142,431)
Net mortgage loan servicing fees	113,689	46,913	230,478	121,076
Management fees, net:				
From PennyMac Mortgage Investment Trust	5,728	5,638	11,424	10,646
From Investment Funds	(64)	369	15	735
	5,664	6,007	11,439	11,381
Carried Interest from Investment Funds	(168)	241	(348)	113
Net interest income (expense):				
Interest income:				
From non-affiliates	53,206	32,948	93,845	55,002
From PennyMac Mortgage Investment Trust	1,898	2,025	3,874	3,830
	55,104	34,973	97,719	58,832
Interest expense:				
To non-affiliates	28,706	32,511	61,517	57,338
To PennyMac Mortgage Investment Trust	3,910	4,366	7,844	9,013
	32,616	36,877	69,361	66,351
Net interest income (expense)	22,488	(1,904)	28,358	(7,519)
	108	76	290	215

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Change in fair value of investment in and dividends received from PennyMac Mortgage Investment Trust				
Results of real estate acquired in settlement of loans	13	(119)	(15)	(144)
Other	2,571	1,116	4,443	2,581
Total net revenues	244,298	201,721	482,499	406,194
Expenses				
Compensation	98,540	82,967	200,553	168,207
Servicing	28,490	24,702	54,789	51,545
Technology	15,154	11,581	29,774	22,937
Occupancy and equipment	6,507	5,965	12,884	11,007
Professional services	5,587	4,523	11,325	8,341
Loan origination	5,144	5,116	7,259	9,249
Marketing	2,218	2,483	4,379	4,219
Other	7,960	6,424	13,842	10,697
Total expenses	169,600	143,761	334,805	286,202
Income before provision for income taxes	74,698	57,960	147,694	119,992
Provision for income taxes	6,293	7,214	12,363	14,860
Net income	68,405	50,746	135,331	105,132
Less: Net income attributable to noncontrolling interest	50,568	40,267	100,875	83,774
Net income attributable to PennyMac Financial Services, Inc. common stockholders	\$ 17,837	\$ 10,479	\$ 34,456	\$ 21,358
Earnings per share				
Basic	\$ 0.71	\$ 0.45	\$ 1.41	\$ 0.93
Diluted	\$ 0.70	\$ 0.44	\$ 1.38	\$ 0.91
Weighted average shares outstanding				
Basic	24,959	23,388	24,399	23,006
Diluted	78,825	77,650	78,947	77,641

The accompanying notes are an integral part of these consolidated financial statements.

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PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (UNAUDITED)

	Class A Common Stock				Noncontrolling interest in Private National Mortgage Acceptance Company, LLC	Total stockholders' equity
	Number of shares (in thousands)	Par value	paid-in capital	Retained earnings		
Balance at December 31, 2016	22,427	\$ 2	\$ 182,772	\$ 164,549	\$ 1,052,033	\$ 1,399,356
Net income	—	—	—	21,358	83,774	105,132
Stock and unit-based compensation	—	—	3,450	—	7,256	10,706
Issuance of Class A common stock in settlement of directors' fees	—	—	108	—	61	169
Exchange of Class A units of Private National Mortgage Acceptance Company, LLC to Class A common stock of PennyMac Financial Services, Inc.	1,046	—	16,927	—	(16,927)	—
Tax effect of exchange of Class A units of Private National Mortgage Acceptance Company, LLC to Class A common stock of PennyMac Financial Services, Inc.	—	—	(4,111)	—	—	(4,111)
Balance at June 30, 2017	23,473	\$ 2	\$ 199,146	\$ 185,907	\$ 1,126,197	\$ 1,511,252
Balance at December 31, 2017	23,530	\$ 2	\$ 204,103	\$ 265,306	\$ 1,250,263	\$ 1,719,674
Cumulative effect of change in accounting principle – accounting for all existing classes of mortgage servicing rights at fair value	—	—	—	189	587	776
Balance at January 1, 2018	23,530	2	204,103	265,495	1,250,850	1,720,450
Net income	—	—	—	34,456	100,875	135,331
Stock and unit-based compensation	230	—	7,728	—	8,340	16,068
Issuance of Class A common stock in settlement of directors' fees	—	—	51	—	109	160

Repurchase of Class A common stock	(236)	—	(4,826)	—	—	(4,826)
Exchange of Class A units of Private National Mortgage Acceptance Company, LLC to Class A common stock of PennyMac Financial Services, Inc. by noncontrolling interest unitholders and issued as equity compensation	1,485	1	28,124	—	(28,125)	—
Tax effect of exchange and repurchases of Class A units of Private National Mortgage Acceptance Company, LLC to Class A common stock of PennyMac Financial Services, Inc., net	—	—	(5,239)	—	—	(5,239)
Balance at June 30, 2018	25,009	\$ 3	\$ 229,941	\$ 299,951	\$ 1,332,049	\$ 1,861,944

The accompanying notes are an integral part of these consolidated financial statements.

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PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Six months ended June 30,	
	2018	2017
	(in thousands)	
Cash flow from operating activities		
Net income	\$ 135,331	\$ 105,132
Adjustments to reconcile net income to net cash used in operating activities:		
Net gains on mortgage loans held for sale at fair value	(132,360)	(185,047)
Accrual of servicing rebate payable to Investment Funds	—	100
Amortization, impairment and change in fair value of mortgage servicing rights, mortgage servicing liabilities and excess servicing spread	92,137	142,431
Carried Interest from Investment Funds	348	(113)
Capitalization of interest on mortgage loans held for sale at fair value	(39,390)	(21,615)
Accrual of interest on excess servicing spread financing	7,844	9,013
Amortization of premiums and debt issuance costs	(13,385)	7,122
Change in fair value of investment in common shares of PennyMac Mortgage Investment Trust	(219)	(144)
Results of real estate acquired in settlement in loans	15	144
Stock-based compensation expense	12,235	10,390
Provision for servicing advance losses	12,097	18,030
Loss from disposition of fixed assets and impairment of capitalized software	—	377
Depreciation and amortization	5,647	4,117
Purchase of mortgage loans held for sale from PennyMac Mortgage Investment Trust	(19,267,316)	(21,244,194)
Originations of mortgage loans held for sale	(2,518,992)	(2,353,899)
Purchase of mortgage loans from Ginnie Mae securities and early buyout investors for modification and subsequent sale	(2,002,582)	(1,814,080)
Sale and principal payments of mortgage loans held for sale to non-affiliates	22,832,809	24,497,179
Sale of mortgage loans held for sale to PennyMac Mortgage Investment Trust	1,427,637	40,222
Repurchase of mortgage loans subject to representations and warranties	(12,974)	(11,520)
Settlement of repurchase agreement derivatives	7,478	—
Decrease in servicing advances	47,980	38,821
Collection of Carried Interest	7,834	—
Sale of real estate acquired in settlement of loans	2,130	—
Decrease (increase) in receivable from PennyMac Mortgage Investment Trust	5,873	(1,092)
Decrease (increase) in receivable from Investment Funds	405	(211)
Decrease (increase) in other assets	7,792	(29,492)
Increase (decrease) in accounts payable and accrued expenses	5,349	(30,395)
Decrease in payable to Investment Funds	(2,023)	(5,157)
Decrease in payable to PennyMac Mortgage Investment Trust	(38,580)	(37,650)
Payments to exchanged Private National Mortgage Acceptance Company, LLC unitholders under tax receivable agreement	—	(6,221)
Increase in income taxes payable	12,778	14,824

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Net cash provided by (used in) operating activities	595,898	(852,928)
Cash flow from investing activities		
Decrease (increase) in short-term investments	71,509	(59,476)
Net settlement of derivative financial instruments used for hedging	(126,918)	(30,949)
Purchase of mortgage servicing rights	(30,129)	(159,465)
Purchase of furniture, fixtures, equipment and leasehold improvements	(4,321)	(4,668)
Acquisition of capitalized software	(7,664)	