# STONEGATE MORTGAGE CORPORATION

## SECOND QUARTER 2016 EARNINGS CONFERENCE CALL TRANSCRIPT

*AUGUST 4, 2016*

## PARTICIPANTS

**Mike McFadden** *SVP of Finance*

**Jim Smith** *Chief Executive Officer*

**Carrie Preston** *Chief Financial Officer*

## PRESENTATION

**Mike McFadden**

Good day everyone, this is Mike McFadden and thank you all for tuning in to Stonegate Mortgage Corporation's Second Quarter 2016 earnings conference call.

Financial results that will be discussed in this recording and located in the press release are unaudited. Additionally, today's discussion and accompanying materials include forward looking statements, and as such are subject to risk and uncertainty that we have described in detail in our documents filed with the SEC, specifically our annual report on Form 10-K which was filed on March 15, 2016, which identify important risk factors that can cause actual results to differ from the forward looking statements. Finally, the financial results and matters that we will be discussing today contain non-GAAP measures that Stonegate management uses in evaluating company performance. GAAP to non-GAAP reconciliations are located in the press release and appended to the slide presentation. These non-GAAP measures are not intended to be a substitute for our GAAP results.

Please note that the accompanying presentation materials can be found on Stonegate Mortgage's investor relations website at www.investors.stonegatemtg.com. Please refer to that website for important materials including the Q2 earnings press release.

At this time, I would like to turn the call over to Jim Smith, Chief Executive Officer and President of Stonegate Mortgage.

**Jim Smith**

Thank you Mike and welcome everyone to our second quarter 2016 earnings review. Joining me on today's call is Carrie Preston, Stonegate's Chief Financial Officer.

Today, we will provide an overview of our operating and financial performance for the second quarter, but first I want to spend a little time outlining our strategic focus for Stonegate.

Our overarching strategy is to effectively manage the risk profile of the business. There are three key components to this strategy. Enhancing the cash flow and liquidity profile of the business, building a platform capable of delivering sustainable core profitability, and finally, strengthening our balance sheet through prudent debt management. We believe the higher level of control we now have over our expense base lowers our risk of earnings and cash flow volatility in any market environment. Additionally, with the volatility in today's market, we do not believe a highly leveraged MSR asset is justified.

Now, starting on slide 3 of the presentation, I would like to discuss some of the key highlights from the second quarter.

During the quarter, we saw continued volatility within the financial markets primarily driven by economic concerns abroad. In particular, uncertainty around Brexit played a major role related to the instability of interest rates which adversely impacted overall MSR valuations. While this environment presented some challenges related to GAAP earnings, we were pleased with the performance of our business segments and the overall profitability of our core operations.

From a consolidated standpoint, Stonegate made continued progress in the three key areas of focus – Core Earnings Stability, Liquidity Position and Debt Management.

The success of our restructuring efforts and execution of our cost management strategies have positioned us well for future earnings stability. As a result, we posted adjusted core earnings of $1 million this quarter.

Our originations segment posted significant improvement in pre-tax income driven by increases in production and revenues as well as management of our expenses. Overall production and revenues were both up 21% as all channels reported improvement in both areas. We were successful in controlling costs as we as we brought on additional production during the quarter. Our originations expenses were down 21 basis points and we lowered our cost per loan by $335.

Our NattyMac financing segment continued to perform well and posted another record earnings quarter. Net interest income was up 27% and fee income was up 41%.

Servicing fee revenue increased by 2% quarter over quarter. We closed a $5.1 billion MSR sale, which resulted in a $7.1 million realized gain. Government loans now represent 61% of our portfolio and our weighted average coupon is 3.80%, which is 21 basis points lower than last quarter.

I will cover additional details related to our operating performance later, but now, I would like to turn the call over to Carrie for a discussion on our financial results.

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**Carrie Preston**

Thanks, Jim. Turning to slide 4, we provide an overview of our financial performance.

As Jim mentioned, we were pleased with the improved financial results of our segments in the second quarter, specifically on an adjusted basis, which we will discuss in a moment.

On a GAAP basis, we recorded a net loss of $17.2 million or 66 cents per diluted share. The declining interest rate environment, particularly toward the end of the quarter, resulted in a $25.1 million fair market value write-down, which was partially offset by the realized gain on the bulk sale. This sale, in addition to previous bulk sales, has mitigated the balance sheet impact of the recent write-downs and allowed us to make progress on reducing our debt. The 10-year Treasury note rate decreased from 1.78% on March 31st to 1.49% on June 30th.

Additionally, due to the decline in our MSR assets, we continued to have a net deferred tax asset position again this quarter, which led to the recording of an additional valuation allowance against our deferred tax assets in the amount of $6.4 million. This additional amount for the second quarter has resulted in a total valuation allowance of $19.4 million as of June 30, 2016. In the event that we have GAAP earnings in the future, including a write up of the MSR asset, we may reverse some or all of this valuation allowance.

Our second quarter adjusted net income was $1 million or 4 cents per diluted share after adding back the fair market value change in MSRs as well as certain other minor adjustments.

Our adjusted pre-tax income from the Originations segment increased to $5.8 million during the quarter, compared to $500 thousand last quarter, primarily due to higher funded volume and slightly higher gain on sale margins.

In our servicing segment, we recognized an adjusted pre-tax loss of $700 thousand, a decrease of $2.8 million compared to the first quarter of 2016. Payoffs and principal amortization expense was $2.9 million higher in the second quarter, which was the driver of the quarter-over-quarter variance. Without the increase in amortization, our pre-tax income would have remained flat to prior quarter.

The Financing segment continues to perform well and contributed $925 thousand in pre-tax income during the quarter.

Let's now turn to slide 5 where we talk about the components of our GAAP revenue.

Second quarter GAAP revenue of $26.5 million was up significantly from the prior quarter. The primary driver of the increase was the $17.8 million lower MSR write down.

The higher origination volume resulted in increased loan origination fees and interest income.

Gain on sale generated by the originations segment increased due to the higher volume during the quarter. More specifically, as shown on the lower right hand chart, we recorded higher cash gain on sale and capitalized servicing rights. These items were partially offset by the negative change in the valuation of the pipeline. Conventional loans comprised a greater percentage of our pipeline this quarter compared to last quarter, which contributed to the negative change in pipeline valuation.

On slide 6, it is clear we have made significant progress on expense reductions in our efforts to lower the risk profile of the business. Comparing our current year to date annualized total expense base to the annualized expense base for the same period in the prior year demonstrates the progress we have made in this area, lowering expenses by $87 million. Approximately 60% of the $87 million decrease is due to our discontinued retail operations.

In addition to the discontinued operations, our salaries and bonuses expenses were down $30.4 million on an annualized basis compared to last year, and our G&A expenses were down $5.1 million. These reductions, along with reductions in interest expense and occupancy, equipment, and communication expenses, are reflective of our strategic reductions, as well as lower volume through the first half of this year. The only expense category with an increase is depreciation and amortization expense which is a non-cash expense item.

Moving on to slide 7, our liquidity and cash flow position has improved. We maintained an adequate liquidity position in the second quarter, with $30.5 million in cash and equivalents on June 30th, 2016.

The expense reductions I just discussed have had a positive impact on our cash flows, as it reduces the required investment to originate and service MSRs.

The proceeds from the bulk sale were used to pay down a portion of our outstanding MSR debt. Our MSR debt balance at the end of the quarter was $62 million, a decrease of $30.1 million or 33% compared to March 31st.

We also continue to focus on reducing our cash investment in capital assets from last year's annual pace of $16 million. This quarter's investments totaled $1.4 million.

Finally, each of our segments generates fee income, which serves as a steady form of cash inflows for the business. Our servicing segment generated $13.7 million of fee income in the second quarter while our Originations and Financing segments generated a combined $5.5 million.

With that, I'd like to turn the call back over to Jim to discuss our operating results.

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**Jim Smith**

Thanks, Carrie. Turning to our originations segment results beginning on slide 8, interest rate locks of $3.3 billion were up 7% over the first quarter, with purchase volume up 12% and refinance volume up 2%.

Origination volume of $2.3 billion was up 21% compared to the first quarter. Our Retail channel reported a 33% increase in production and accounted for 18% of the additional volume. Our Wholesale channel reported a 31% increase in production and accounted for 33% of the additional volume. And our Correspondent channel reported a 15% increase in production and accounted for 49% of the additional volume.

As you can see on slide 9, Originations segment revenue was up 21% compared to the prior quarter, primarily due to the higher origination volume. The increased revenue combined with only slightly higher expenses resulted in adjusted pre-tax income of $5.8 million compared to $500 thousand last quarter.

Adjusted Segment expenses increased slightly from the prior quarter in total dollars, but were down $335 per loan or 11%.

Turning to slide 10, our Servicing segment reported an adjusted pre-tax loss of $700 thousand during the quarter compared to $2.1 million of income in the first quarter due to the increased amortization as Carrie discussed.

Our portfolio ended the quarter with $14.1 billion in UPB, a $3.9 billion decrease from the end of the first quarter. The closed MSR sale was comprised of conventional loans only; therefore, government loans now make up 61% of our overall servicing portfolio compared to 43% at the end of March. The sold loans had a higher weighted average coupon compared to the overall portfolio. This resulted in a 21 basis point decrease in our weighted average coupon as of June 30th.

Servicing fee revenue increased 2% from the prior quarter and servicing expenses decreased 6%.

Moving to slide 11, we have taken a very methodical and disciplined approach to building out the NattyMac platform and our results clearly continue to validate that strategy. We have been able to capitalize on our strong expertise in the warehouse financing business and both our historical and most recent quarterly results reflect our success.

NattyMac funded volume increased 39% to $1.2 billion and generated pre-tax income of $925 thousand – up 70% from the prior quarter and up 207% from our 2015 quarterly average.

At the end of the second quarter, we had 109 approved NattyMac correspondents of which 98 or 90% were active with us during the quarter. Our outstanding commitments to our correspondents totaled $564 million as of the end of the quarter. In addition, our increased fundings generated 41% more fee income, up from $325 thousand in the first quarter to $459 thousand in the second quarter.

On slide 12, we provide a brief overview of July's origination and lock volume.

Our average lock volume per day was up 20% in July compared to the monthly average in the second quarter, while origination volume per day was down just slightly. Refinance volume comprised 57% of our July lock volume, compared to 49% in the second quarter.

In conclusion, we remain highly focused on optimizing the risk-return profile of our business. During the second quarter, we were successful in generating core profitability, reducing our MSR debt and improving our liquidity position.

We believe that these efforts will improve our overall execution, strengthen our balance sheet and increase shareholder value.

With that, I will turn the call back over to Mike.

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**Mike McFadden**

Thanks, Jim. As a reminder, the materials accompanying today's recording are available on the investor relations website at www.investors.stonegatemtg.com. Thank you everyone for listening in today.