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SGM - Q3 2015 Stonegate Mortgage Corp Earnings Call

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CORPORATE PARTICIPANTS

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Jim Smith *Stonegate Mortgage Corp - President and COO*

CONFERENCE CALL PARTICIPANTS

Bose George *KBW - Analyst*

Jessica Ribner *FBR - Analyst*

Sam Choe *Credit Suisse - Analyst*

Samuel Ellis *Huntington Management - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Stonegate Mortgage Corporation's third quarter 2015 earnings conference call. My name is Jackie, and I will be your operator today.

At this time, all participants are in a listen-only mode. We will conduct a question and answer session towards the end of this call. Today's call is being recorded.

I would now like to turn the call over to Stonegate Mortgage's Senior Vice President of Finance, Michael McFadden. Please go ahead.

Michael McFadden - *Stonegate Mortgage Corp - SVP of Finance*

Thank you, Jackie, and good morning, everyone. We appreciate you joining us on today's call. Joining me today is Rich Kraemer, Stonegate's CEO; Jim Smith, our President and COO; and Rob Eastep, our CFO.

Financial results that will be discussed on today's call 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 discussed in detail in our documents filed with the SEC, specifically our annual report on Form 10-K, which was filed on March 6, 2015, and any revisions to those risk factors in subsequent filings 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 a recording of this call and accompanying presentation materials can be found on Stonegate Mortgage's Investor Relation website at www.investors.stonegatemtg.com. Please refer to that website for important materials including the Q3 earnings press release.

A replay of this call will also be made available on the website by the end of the day.

At this time, I'd like to turn the call over to Rich Kraemer, Chief Executive Officer of Stonegate Mortgage.

Rich Kraemer - *Stonegate Mortgage Corp - CEO*

Thank you, Mike, and welcome, everyone, to our third quarter 2015 earnings call. Today we will provide an overview of our operating and financial performance for Q3, which I would describe as the beginning of a transitional period for Stonegate.

Joining me on today's call is Jim Smith, our new President and COO who has over 25 years' experience in the mortgage and consumer finance industries, as well as Rob Eastep, our CFO.

Jim and I came aboard in early September, and we spent our time thus far evaluating the Company, its strengths, and weaknesses in an effort to move forward in a positive way to operate more efficiently. We have a good understanding of the operations now but know it is an ongoing exercise, and we will take our time to implement all the efficiency changes.

One area that we moved on quickly was our distributed retail footprint, which will be discussed later in this presentation. Others will take more time. We are acting purposely in order to strengthen the foundation of the Company and position it for enhanced profitability. Jim and I have been working closely with members of our team to create a strategic plan for the remainder of the year and beyond, and we are focused on maximizing shareholder value.

Jim will provide an update later in the call regarding this quarter's operating results, but first I will turn the call over to Rob to discuss our third quarter financial results.

Rob Eastep - *Stonegate Mortgage Corp - CFO*

Thanks, Rich. Let's begin on slide 3 where we provide an overview of our operating and financial performance in the third quarter. We recorded a GAAP net loss of $22.8 million or $0.88 per share in the third quarter. The value of our mortgage servicing right asset decreased $28.1 million during the third quarter primarily due to declining interest rates.

The ten-year Treasury note declined from 2.35% on June 30 to 2.06% on September 30. After adjusting for the fair market value change, stock-based compensation expenses, and other one-time charges recorded during the quarter, adjusted net income was approximately $500,000 or $0.02 per share. One-time charges included $1.6 million of severance expenses due to management and organizational restructuring, $1.2 million for the sale or disposal of certain distributed retail assets, and $221,000 for other non-routine expenses. Additional information on the sale and disposal of the distributed retail assets is included on our Form 10-Q, which will be filed later today.

Our originations adjusted segment income declined by $7.9 million to $3.8 million during the quarter primarily due to the value of our pipeline which is valued based on the actual size of our pipeline and inventory, the margins in those locks in inventory, and assumed pull-through rates based on market conditions as of the end of the quarter. The combination of these factors resulted in a $10.6 million reduction and gain on sale when compared to the second quarter.

In our servicing segment, we recorded an adjusted pre-tax loss of $700,000 compared to a $5.7 million loss in the second quarter, primarily due to higher servicing fees as our ending portfolio was up 5% and lower amortization expenses as prepayment speeds slowed in the third quarter.

The financing segment continues to perform well and contributed $446,000 of pre-tax income during the quarter, up 26% compared to $355,000 in the second quarter. Our outstanding commitments to correspondence grew 7% from Q2, and our funded volume increased 3% to a record $881 million.

Let's turn to slide 4 where we talk about the components of our GAAP revenue during the quarter. Third quarter GAAP revenue of $34.9 million is down 60% from the prior quarter due primarily to the $45.8 million swing in our MSR valuation changes. This includes the $28.1 million negative fair value adjustment to the MSR valuation primarily due to the lower interest rates compared to a $17.8 million positive adjustment last quarter.

Prepayments continue to trend down during the quarter as refinance volume subsides from the recent peak in the first quarter of this year. Higher origination volume during the quarter resulted in increased interest income and loan origination fees.

Gain on mortgage loans held for sale decreased by 22% to $40.3 million primarily as a result of a smaller pipeline at the end of the quarter and lower interest rates at the end of third quarter compared to the second quarter.

On slide 5, we focus on our balance sheet. We maintained an adequate liquidity position in the third quarter with cash and equivalents as of September 30 of $40.5 million or 15.5% of total equity. We continue to free up capital from the servicing assets to reinvest in our originations and financing segments.

In September 2015, we began executing flow MSR sales to provide additional liquidity to fund the business. The flow sales not only provide liquidity for our business; they also result in GAAP and core earnings that are better aligned with the cash flow of the business. We plan to opportunistically ease bulk and flow sales on an ongoing basis to achieve cash flow neutrality.

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

Jim Smith - *Stonegate Mortgage Corp - President and COO*

Thanks, Rob. Turning to originations segment beginning on slide 6, interest rate locks were down 4% over the second quarter and up 4% compared to the prior year. Origination volume was up 1% over the second quarter to $3.5 billion, a relatively strong quarter but down 2% from last year.

As you can see on slide 7, origination segment revenues were down 16% and adjusted pre-tax income was down 67% over the prior quarter. This is primarily due to the decrease in the value of the pipeline at the end of Q3 compared to Q2, which resulted in a negative $12.4 million impact to the gain on sale compared to $1.8 million decrease in the second quarter.

Adjusted segment expenses excluding interest decreased 4% over the prior quarter in total dollars and were down $208 per loan. These expenses exclude the one-time charges associated with originations that Rob discussed earlier, including $456,000 in severance expenses and $1.2 million related to the sale or disposal of long-lived assets.

We believe there continues to be opportunity to further reduce our cost per loan towards our previously stated goal of $350 over the next few quarters by taking full advantage of investments we've already made in our technology platform and by continuing our dedicated efforts to increase efficiency throughout our entire operation. Additionally, our total expense base will be reduced over time as our business mix shifts slightly to incorporate the changes within our distributed retail channel.

Turning to slide 8, our servicing segment produced an adjusted pre-tax loss of $700,000 during the quarter compared to $5.1 million pre-tax loss in the second quarter primarily driven by the increased servicing fees and lower amortization expenses. As expected, our annualized CPR rate continued to trend down during the quarter decreasing to 16% in the third quarter from 24.3% in the second quarter. However, prepayment speeds continue to remain elevated as the 16% compares to a 9.4% annualized rate at this time last year. Our portfolio ended the quarter with $18.2 billion in UPB, a $1 billion over last quarter.

Moving on to slide 9. Our financing segment pre-tax income increased 26% to $446,000 compared to $355,000 in the previous quarter. We believe this segment will continue to provide positive financial results over the next year as it adds more correspondents and participants to the platform.

The financing segment continues to grow funded volume and total commitments during the quarter driving additional fee and net interest income for the business segment. Funded volume came in at approximately 3,900 units and $881 million in the third quarter, up 3% from the prior point. Commitments increased by 7% to $494 million.

Continuing to slide 10, we are committed to maximizing shareholder value by focusing on our core business as an independent mortgage bank. We are refocusing the Company in four key areas producing stable core earnings, continuing to originate high quality loans, increasing overall operational efficiency and productivity, and strengthening our relationships both internally and externally.

We are committed to providing our employees and customers with the tools and resources they need to be successful in today's marketplace. Over the last two months, we made strategic decisions regarding our distributed retail business and have executed plans to improve that channel's ongoing performance. Prior to the strategic changes, our distributed retail channel required a significant amount of cash to finance its operations when compared to its revenues, which resulted in an operating loss year to date.

We closed seven branches during the third quarter and expect to close or sell an additional 67 branch or desk locations by the end of the fourth quarter. These actions, most of which have already been completed, will allow us to refocus our efforts and capital on our core markets and branches.

Going forward, our focus will be to optimize the remaining distributed retail footprint and increase our profitability. The remaining branches represent approximately 40% of our year-to-date distributed retail origination volume and comprised less than 30% of our overall expense base. These branches are also predominantly located in the Midwest where we have longer tenured employees and operation.

As a result of our strategic changes, we recognized a $1.6 million pre-tax expense during the quarter and may incur up to approximately $2.2 million of additional one-time charges in the fourth quarter.

Finally, over the past few months, we have taken action to reduce our expense structure across the board. As a result of these actions, we expect our expense reductions of 15% to 20% by the end of 2016 compared to our current annualized run rate assuming essentially flat origination volume. We are confident that the team we now have in place will be successful in maximizing shareholder value.

With that, we'd like to now open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Bose George, KBW.

Bose George - *KBW - Analyst*

Hey, guys. Good morning. You pointed out what you think you can do on the cost side to help the returns. Assuming all the things that works kind of in line with expectations, what do you think is the return that you can generate from the business, like in terms of a normalized ROE?

Rob Eastep - *Stonegate Mortgage Corp - CFO*

Bose, this is Rob. Yes, I think on a long-term basis, I think our goal would be to get our long-term ROE back in the low double digits similar to what I think we discussed before, but I think that'll be over the next 12 months. That'll take -- as Rich alluded to in his opening commentary, it's going to take us some time to implement those changes, but I think over the next 12 months is what we'd be looking at from an ROE standpoint.

Bose George - *KBW - Analyst*

Okay, great. And then just in terms of any broader, sort of strategic changes, potentially sale of the company, et cetera, are any of those being considered?

Rich Kraemer - *Stonegate Mortgage Corp - CEO*

You know, I think, Bose, we always look enhancing shareholder value and if that were the proper way to do it, and as you understand, this is a public company. We're always for sale daily, so we'd obviously take that into consideration.

Bose George - *KBW - Analyst*

Okay. Great. Thank you.

Operator

Paul Miller, FBR.

Jessica Ribner - *FBR - Analyst*

Good morning. This is Jessica Ribner in for Paul. How are you?

Unidentified Participant

Good.

Unidentified Participant

Hi, Jessica.

Jessica Ribner - *FBR - Analyst*

Just a couple of questions. How can we think about your channel mix if you are kind of getting away from the distributed retail? Are you looking for more correspondent originations or is your focus going to continue to be 25% retail, just not distributed retail?

Jim Smith - *Stonegate Mortgage Corp - President and COO*

Yes. Hi, Jessica. Yes, I would think if you kind of look at our model the way it is today, I mean, if you look at the third quarter, our distributed retail platform really accounted, I think, for about 12% of our volume. The moves that we've made really carve out a segment of our distributed retail platform that as I mentioned in my discussion earlier that really add value to the organization and have an opportunity for us to really develop that model out and develop that footprint. And so, when we look at what our mix looks like kind of going forward, the distributed retail, we had grown it to about 12% of our volume, like I said, in the third quarter, but the changes that we made really have a relatively small effect or impact on that mix. So, as I kind of look forward, we will make up -- I mean, we're looking -- we're basing all of our decisions today not on rising volume; we're basing it on a flat market.

And so there will be a small amount, but it probably overall represents $1 billion or so in our overall volume levels that we will have -- we will make up some of those numbers in our volume levels as we go forward, but I wouldn't see any major shift in our overall market. I mean, we're probably in the 80%/20% now and this probably shifts it to an 85%/15% as we kind of go through the -- start out 2016.

Jessica Ribner - *FBR - Analyst*

Okay. And then just a question on the MSR sales. Did you -- I didn't see in the release any disclosures about sales. Did you sell any MSRs this quarter?

Rob Eastep - *Stonegate Mortgage Corp - CFO*

Yes, we did. We had a flow sale, $225 million, and then a bulk sale that was approximately $1.5 billion. And those are included in the fair value adjustment line. We've consolidated those two lines, and then in the 10-Q we're going to break out those -- break those out. But, on the total of the two sales in the third quarter, we had a net gain of $13,000.

Jessica Ribner - *FBR - Analyst*

Okay. Great. Thank you so much.

Operator

Douglas Harter, Credit Suisse.

Sam Choe - *Credit Suisse - Analyst*

Hi. This is Sam Choe filling in for Doug Harter. Just going back to the channel mix, is it safe to say that your target for retail origination percentage unchanged going forward?

Rob Eastep - *Stonegate Mortgage Corp - CFO*

No. I mean, I think it has minimal impact over what our mix will be as we kind of move forward. We were predominantly -- the breakup in our mix was predominantly, as you know, on the TPO side. So, I would say that -- what I would say is that the impact of our mix is going to be minimally impacted by the moves that we made today and the [re-step]. We're not exiting the distributed retail business. We are -- we have a very -- a platform that we have in place that's a very mature platform. It's located in the Central U.S. and it has brand recognition and we will continue to develop that operation. So, as time moves through and we develop that operation, I would see little impact on our overall mix over time.

Sam Choe - *Credit Suisse - Analyst*

Got it. Thank you.

Operator

(Operator Instructions) Samuel Ellis, Huntington Management.

Samuel Ellis - *Huntington Management - Analyst*

Hi. Thanks for taking my call. I just have a quick question on your thoughts regarding share buybacks with your equity trading for [the] discounted book valued as now versus reinvesting in some of your businesses.

Rob Eastep - *Stonegate Mortgage Corp - CFO*

Sam, this is Rob. The Board looks at share buybacks from time to time, and right now I think the view is that right now is not the right time to do it. We'll continue to evaluate that though as our share price does move around. But it is a discussion that's -- that is held, but right now the Company's not ready to discuss what our position is on that.

Samuel Ellis - *Huntington Management - Analyst*

Okay. And quickly, what is a low -- what is the base value of UPB you need in your servicing business to run that breakeven?

Rob Eastep - *Stonegate Mortgage Corp - CFO*

Sam, can you repeat the question again?

Samuel Ellis - *Huntington Management - Analyst*

I'm not sure I understand like what is a low number in UPB that you need in your servicing business to run that business breakeven.

Rob Eastep - *Stonegate Mortgage Corp - CFO*

Well, I think a lot of it is going to depend on runoff. So, if you look at the servicing business and just look at it on a cash basis excluding the amortization of the MSRs, we are running cash flow positive on the business. But in -- and a little bit higher prepayments that we've seen. You know, obviously you've got to have a higher UPB on that to offset that, but generally I think if you were to look at normal amortization rates we're probably at the breakeven point or a little bit above the breakeven point to where it'd be running profitability now. But, again, if you look on a cash basis, the servicing line of business is profitable at the $18 billion level.

Samuel Ellis - *Huntington Management - Analyst*

Great. Thanks for your time.

Operator

We have no further questions at this time. I'd like to turn the floor back over to Michael McFadden for any additional or closing remarks.

Michael McFadden - *Stonegate Mortgage Corp - SVP of Finance*

Thank you, Jackie. A replay of today's call will be available on the Investor Relations website at www.investors.stonegatemtg.com. Members of the media with additional questions can contact Whit Clay at 212-446-1864, and analysts can contact myself at 317-663-5904. Thank you again to everyone for joining us today.

Operator

Thank you. This concludes today's conference call. You may now disconnect.