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# EDITED TRANSCRIPT

## SGM - Q4 2014 Stonegate Mortgage Corp Earnings Call

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## PRESENTATION

**Operator**

Good day ladies and gentlemen and welcome to Stonegate Mortgage Corporation fourth-quarter and full-year 2014 earnings conference call. (Operator Instructions. 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.

I would now like to turn the call over to Stonegate's Chief of Staff, Michael McFadden.

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**Michael McFadden** - *Stonegate Mortgage Corporation - Chief of Staff*

Thank you, Lori, and good afternoon, everyone. We appreciate you joining us on today's call. Joining me today is Jim Cutillo, Stonegate's CEO, and Rob Eastep, Stonegate's 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 14, 2014, which identifies 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 relations website at www.investors.StonegateMPG.com. Please refer to that website for important materials including the Q4 earnings press release. A replay of this call will also be made available on that website by the end of today.

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

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

Thank you, Mike, and welcome everyone to our Q4 2014 earnings call.

Let's begin on slide three which provides a brief overview of our financial and operational performance during Q4. GAAP revenue declined to $26.5 million in the fourth quarter as we produced a GAAP loss of $21.4 million or $0.83 per share. On an adjusted basis, the net loss was $1.2 million or $0.05 per diluted share. The GAAP loss resulted in a book value of $10.87 at the end of 2014.

We provide some context on the following slides that describes the factors that affected our financial performance in the fourth quarter.

On the operational side of our business, originations declined 5% prior quarter of $3.4 billion which is a 41% growth rate from the same period last year. Interest rate locks declined 3% from the prior quarter to $4 billion. The retail channel remained relatively flat on the originations front while locks grew 9%. The launch of Stonegate Direct was a substantial contributor in achieving this growth. We will focus more on this channel a bit later in the presentation.

Our servicing portfolio grew 3% from the end of the prior quarter to $18.3 billion even after closing another $2 billion MSR sale in the fourth quarter. The financing segment also grew its outstanding commitments to $367 million, a 15% growth rate from the prior quarter.

Turning to slide four, we outlined the primary factors that impacted our financial performance in Q4. The interest rate environment made the biggest impact. From the end of the third quarter to the end of the fourth quarter, the 10-year treasury rate declined 35 basis points. Additionally the 2 to 10 spread declined 44 basis points. These two factors resulted in a negative fair market value adjustment, increased payoffs and principal amortization on our MSR asset.

Gain on mortgage loans held for sale was also affected by the interest rate environment as the assumed pullthrough on the pipeline is reduced as market interest rates decline. As you can see on the chart, each of our segments react differently in different interest rate environments. As rates have declined, the immediate result is a reduction in servicing revenue. However, the origination segment is poised to benefit from the lower rates which we have begun to experience in the first quarter.

Per industry sources, the mortgage origination market contracted 13% in the fourth quarter from the third quarter. Given that our origination volume declined less than half of the industry contraction, we were able to continue our growth and market share by 9%. The lower origination volume combined with slightly lower margins resulted in the reduction in origination revenue.

Finally, Company level growth in noninterest expense included a $1.3 million write off of the Crossline trade name as we rebranded the call center under Stonegate Direct. The percentage of origination volume represented by retail increased to 17% in the fourth quarter which typically has a higher expense base. This should be offset by higher revenue produced from this channel in coming quarters but that was also affected by the interest rate environment which we already discussed.

As interest rates declined throughout January, our locks continued to increase up to $79.4 million per day. This was a record month for Stonegate origination segment. Most important was the percentage of locks that came from our retail channel. Retail represented 25% of our total lock volume in January compared to 19% in Q4. Approximately 45% of those retail locks came from our recently launched Stonegate Direct business highlighting the impressive growth that this business experienced in the last four months of its existence.

Secondly, we have signed an LOI to sell approximately $3 billion in Agency MSRs to a strategic buyer. This will enhance our liquidity position and allow us to continue to reinvest back into our origination segment.

Lastly, we continue to see elevated levels of prepayments in the first quarter which provides additional cash for opportunities for Stonegate Direct.

On slide six, we provide an overview of the market environment over the last couple of years. Our investment thesis has been based around the recovery of the housing market. However, based on industry data, the housing market has not recovered at the pace we are originally expected. Market origination volumes have continued to decline as home ownership rates have been lackluster and new and existing home sales have remained depressed. This coupled with increased student loan debt, a reduction in credit availability for self-employed borrowers, borrowers have experienced short sales, foreclosures or bankruptcies during the housing downturn and an uncertain regulatory environment has delayed the housing recovery.

On slide seven, we show a graph of where we see opportunity in the mortgage industry over the next three years. We believe there is approximately 44 million households that have the ability to reenter the housing market over the next three years. These potential households consist of self-employed borrowers, those currently repairing credit and millennials who will seek to buy a home. We are focused on engaging these prospective homebuyers now before they are ready or eligible to reenter the housing market through our retail direct channel utilizing online digital media, radio, social media and proprietary technology and scoring algorithms to determine the timeline for eligibility.

We believe this will position us to become a leading online purchase money originator and offer these prospective homeowners a clear path to their dream home.

On slide eight, we outline the investments we have made over the last two years which we believe will allow us to succeed in any market environment. We have completed three strategic acquisitions to grow our retail and wholesale channels. This has resulted in a much more diversified origination segment as correspondent has declined from 76% of our locks in the first quarter of 2013 to only 57% in the most recent quarter.

A diversified origination business is much more resilient to changes in market dynamics such as competitive pressures from other participants. Crossline Capital, which is now Stonegate Direct, offered us an avenue into the online and call center businesses and has helped complement our distributed retail channel. We can now better serve current and prospective borrowers in the purchase and refinance markets.

Additionally, we launched warehouse lending in July of 2013 following our acquisition of NattyMac in 2012. We have remained focused on developing best-in-class technology to better connect borrowers through investors. We expect Stonegate Connect to evolve into a true mortgage asset market place that offers investors access to invest passively and mortgage asset class with greater transparency and more certainty than traditional origination platforms.

On the investor side of the marketplace, we currently have 17 active investor participants and plan to continue to growth that number. We believe these investments will allow us to improve operating and capital efficiency over the next six to eight quarters.

On the following slide, we describe Stonegate Connect in more detail.

As a participant in the mortgage market, we ultimately create assets by connecting borrowers to investors. These assets range from short-term participations on warehouse lines to whole loans to mortgage servicing rights. Stonegate Connect is proprietary technology designed to facilitate the transaction in an efficient manner. Investors will have the ability to access the marketplace through a single sign-on and participate in warehouse financing, whole loan purchases both Agency and non-Agency MSR purchases, and MSR financing.

Investors will have the ability to target specific asset types, geographic areas and required yields through one platform which is much more efficient for them versus traditional asset acquisition methods.

Given our wide distribution network of retail and third-party originators, we believe we will be able to source assets more efficiently and effectively for our marketplace participants who consist of banks, real estate investment trusts, hedge funds, insurance companies and other financial institutions.

On slide 10, we highlight the different assets that we originate and allow investors to passively invest in. In the current origination market, the vast majority of investors participate through MBS created by agencies. We have the ability to sell whole loans that meet investors' risk appetites for both credit and duration. Our existing MSR asset also allow for investors to capture yield generated by that asset either through purchasing the MSR and allowing Stonegate to subservice the asset for them or extending borrowing against the asset.

Finally, there is an opportunity to take part in the shortest term mortgage asset which is warehouse lending. We operate NattyMac as a fulfillment provider for depositories and other investors to earn yields on excess cash. Each of these assets have different risk and return characteristics and can attract a wide variety of investors. Given the current regulatory environment, we believe this provides a more attractive risk-adjusted return for our investors.

Let's turn to slide 11 where we talk about our origination business. As I stated earlier, we were able to continue our growth in market share in the fourth quarter. Focused on the channel mix of our origination business, you can see that our retail channel outperformed the third-party channel as it only declined by 1.5% from the third quarter. Also you will see on slide five, locks for the fourth quarter were more represented by the retail channel than any period before. A lot of the retail performance can be attributed to the recent launch of our Stonegate Direct business which we will discuss on the next page.

We launched Stonegate Direct on October 1, 2014. In the very short period of time it has been up and running, it has produced strong results. Locks averaged $90.9 million per month in the fourth quarter and jumped to $179.2 million in locks in January. Additionally, we believe there is a lot of opportunity for this channel given the current interest rate environment and the changes to the FHA MIP premiums recently enacted.

As I stated earlier, we are focused on digital marketing, radio and social media to drive prospective homeowners to our site developing a relationship that positions us to gain the mortgage when they reenter the mortgage market. We are also focused on recapture and refinancing of loans from other servicing portfolios specifically targeting borrowers who could benefit given the lower rate environment.

On slide 13, our non-agency product line continues to perform well. Non-agency locks represented 7.4% of our locks in the fourth quarter which was in line with the prior quarter. That figure jumps to 9.3% in January. We plan to continue to add additional investors to this platform and believe the ability to access the market through Stonegate Connect will be a differentiator. We were also able to identify opportunities for investors to expand products that meet the needs of their market.

On slide 14, our financing business continues to grow as operating results such as funded units and total commitments. We believe this will begin to have a bigger impact on our financial results over the next year as it adds lenders and suppliers to the platform.

Funded volume came in at 2016 units and $472.4 million in the fourth quarter. Again, we believe offering the ability for investors which can range from traditional and nontraditional warehouse lenders to access this market through Stonegate Direct will be a differentiator and one that will result in market share and financial gains. This approach also offers us more stability, liquidity and diversification of funding.

Our servicing business grew to $18.3 billion of UPB at the end of the fourth quarter. We closed the sale of our second $2 billion MSR portfolio in the fourth quarter. We plan to look for ways to continue to monetize the MSR asset through strategic (inaudible) potentially flow sales based on current market pricing. Given that this is a capital intensive asset, we believe we can package MSRs that meet the investment criteria of our investors for example specific geographic areas where they may have interest.

We are planning on making this possible through Stonegate Connect marketplace in 2015.

At this point, I will turn the call over to Rob to discuss financial results.

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**Rob Eastep** - *Stonegate Mortgage Corporation - CFO*

Thanks, Jim. GAAP revenue came in at $26.5 million for Q4 which is a 58% reduction from the previous quarter. The primary reasons for the decline in revenues compared to Q3 were one, a $26.3 million higher negative MSR fair value adjustment. Two, a $2.5 million higher MSR pay off and principal amortization. Three, $6.4 million lower gain on mortgage loans held for sale due to lower Q4 volumes and margins. And forth, a $1.2 million attributable to the gain on sale of MSRs that were reported in Q3.

On the following slide, I will provide more context for these changes.

As you can see on slide 17, the primary reason for the GAAP revenue reduction was due to a $28.8 million increase in the combination of both fair market value adjustment and amortization of MSR portfolio driven primarily by the declining and flattening yield curve during Q4 that Jim alluded to earlier. Additionally, gain on mortgage loans held for sale declined $6.4 million on lower volumes and slightly lower margins driven primarily partially by the declining interest rate impact impacting our pullthrough assumptions on the pipeline.

The gain on sale bridge on the bottom right shows the change in the different components that make up gain on mortgage loans held for sale. Each of these would be impacted by the lower lock origination volumes while gain on sale margins as expressed on closings, declined 12 basis points.

Slide 18 shows the quarterly trend in GAAP and adjusted net income for Stonegate. On a GAAP basis, we recorded a net loss of $21.4 million or $0.83 per diluted share. The largest contributor of the net loss was the fair market value changes to the MSR asset of $32.3 million driven again by the lower and flatter yield curve at December 31 compared to September 30.

When computing adjusted net income, we back out the impact of fair market value changes to the MSR asset along with other one-time charges. After making those adjustments, we recorded a net loss of $1.2 million or $0.05 per diluted share compared to a Q3 adjusted net income of $4.1 million or $0.15 per share.

The bridge on the bottom right of this slide provides the primary components of the core net income change from Q3. As you can see, the two items attributable to the servicing asset, amortization and gain on MSR sale, accounted for 36% of the pretax difference. The other primary contributor was the $6.4 million reduction of gain on mortgage loans held for sale.

On the following pages we will take a look at each one of our segment's results. Let's move on to slide 19.

The origination segment produced an adjusted pretax net income of $5.7 million on revenues of $54.4 million. Total dollars of expense remain flat in the fourth quarter compared to the third quarter. Therefore the majority of the income reduction was due to lower volume as well as slightly lower gain on sale margin as discussed earlier.

A declining rate environment in the fourth quarter coupled with increased competitive factors in our correspondent delegated and wholesale channels led to a slightly lower gain on sale margin for the quarter compared to the third quarter. The decline in these channels were slightly offset by the growth in our Stonegate Direct channel which has higher margins and a lower cost structure.

As Jim discussed on slide eight, throughout the last 18 months, we have made significant investments into our origination business that have been recorded through our income statement. We do not anticipate significant incremental investments in our origination infrastructure and are now in a position to see the benefits from our investments. Our primary focus over the next six to eight quarters is maximizing our investments in our origination channels with a dedicated focus on our Stonegate Direct channel which Jim discussed earlier. We expect the results of these current investments to be a reduction in our net costs to originate MSRs.

Our servicing segment financials are highlighted on slide 20. Adjusted revenue and adjusted pretax income for the servicing segment declined to $2.6 million and a loss of $1.4 million respectively for the fourth quarter. There were two primary drivers of this decline.

In the third quarter, we recorded a gain of $1.2 million on the sale of the $2 billion servicing portfolio. In the sale that was executed this quarter, we took a minor loss of $76,000 which includes transaction costs. We continue to plan on monetizing our MSR assets to create liquidity for the origination business. We can accomplish this in two ways, sales and financing. Both of these markets have continued to improve into 2015.

We will continue to evaluate the sales versus financing decisions based on the economics available on the servicing portfolios.

The other primary driver of the financial results in the servicing segment was the increased payoffs. Amortization increased from $6.9 million in Q3 to $9.4 million in Q4. This was a function of the interest rate environment and the additional seasoning of the portfolio. Our current production has lower interest rates and the weighted average coupon rate in our current servicing portfolio which would suggest a more valuable asset if interest rates rose.

We discuss the financing segment on slide 21. Segment revenue net of interest expenses decreased to $807,000, down 3% from the third quarter primarily due to the flattening of the yield curve. This combined with increased amortization expense resulted in a pretax loss of $40,000.

Finally on slide 22, we focus on our liquidity status. Our cash and cash equivalents at December 31 was $45.4 million or 16.2% as a percentage of equity. We feel this is a strong liquidity position. The approximately $3 billion MSR sale that Jim mentioned earlier will enhance our liquidity position further.

As stated during the servicing discussion, we plan to continue to use our MSR assets as the primary source of our liquidity and continue to delever the balance sheet.

With that, I would like to turn the call back over to Jim to wrap up before we open the lines for more questions.

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

Thanks, Rob. To recap our fourth-quarter results, we were significantly impacted by the interest-rate environment as rates dropped at the end of December. Secondly, we have made meaningful investments in our origination financing and servicing businesses. We are very excited about the outlook of our Company given these investments which we believe will allow us to be successful in any mortgage market environment.

Two of the important investments are Stonegate Direct and Stonegate Connect. We also are bullish on our ability to capture a large percentage of prospective homebuyers and get them in a position to buy a home which is not fully tied to the overall housing recovery.

We would now like to open the line up for questions.

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## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions). Bose George, KBW.

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**Bose George** - *Keefe, Bruyette & Woods - Analyst*

Good morning. Just first on the operating expenses, even after taking that $1.4 million write off the expenses are up a fair amount despite roughly flat volume. So can you just discuss that? And also help us think about the potential operating leverage now as your infrastructure is largely in place and we can put more volume through there.

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

So as far as the expenses go, Bose, good morning, I think the expenses are in line with what our expectations were given the fact that we continue to focus more on retail production which in and of itself would increase expenses but also gives us more margin opportunity. If you actually look at our cash gain on sale for example in December of this quarter versus cash in December of last quarter, I think you will see that the retail channel is making an impact on our overall cash position. So we have been very focused on managing cash, managing liquidity, maintaining margins where possible in a contracting market. And then as far as operating leverage goes, we are looking to ensure that the platform is sized and shaped to the current market reality.

So what that means, we will continue to cut operating expenses where necessary, continue to right-size management in certain areas of the Company if necessary. So we are looking at that but at this point given the current trajectory of the market with the refinances and stuff we feel like the operating results will be improved as we go forward here given the investments we have made.

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**Bose George** - *Keefe, Bruyette & Woods - Analyst*

And just in terms of what we need to see to get to whatever double-digit ROE for the Company, is it kind of stability in the market and more volumes or do you need to be hedging either the MSR or the pipeline differently or just curious what kind of framework we need to get to a double-digit return?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

I don't think we need to hedge the pipeline. I think the effectiveness of our hedging strategy with our pipeline has been there. The question of hedging your servicing portfolio always comes up, especially in a declining rate environment. The natural hedge is the production in our origination channels. So our origination channel for example, our Stonegate Direct, is picking up a fair amount of the payoffs and refinances that are coming from our own portfolio through recapture. We are converting those into lower coupons and the economics on that are favorable.

So those things kind of don't happen in the same period and I think that is really what happened here which is we saw the decline in interest rates in Q4 toward the end of December and now obviously you can see the origination franchise responding accordingly in January. And the fact that we are driving more retail should give you some sense that we are not really as focused on driving origination volume as we are driving core earnings and the way that you do that is through more retail, more retail direct.

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**Bose George** - *Keefe, Bruyette & Woods - Analyst*

Okay, great. Thanks.

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**Operator**

Kevin Barker, Compass Point.

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**Kevin Barker** - *Compass Point Research & Trading - Analyst*

Good morning. Thanks for taking my questions. Could you discuss where you are in the first quarter given the change in the mix that is happening and the increase in volume that you are seeing? If you were to sit there and say that what you are seeing in January were to follow through into February and March, can you just give us some idea of what the first quarter is setting up to look like?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

Kevin, good morning. So we are not in the business of providing guidance and probably because of the interest rate volatility. But I think for those that understand our business well and I think you do, you are probably sitting there making the assumption that locks probably are still strong in through February given the current interest rate environment. You can see our focus is more on retail, growing our retail production.

The recent change in the FHA MIP premium has been very positive for the direct group and then some of the other things that we are working on operationally with Stonegate Connect have also been very positive from an operational efficiency perspective.

So I'm not saying expenses are going to go down because we are doing more retail but what I am saying is we are trying to drive our net costs to originate down which is really our cash investment in the asset at the end of the day. And all things being these same, I would say if interest rates remain stable throughout the next couple of weeks, we will probably be set up for a solid Q1.

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**Kevin Barker** - *Compass Point Research & Trading - Analyst*

And when we think about a solid Q1, are we thinking on the magnitude of what you saw in the second quarter of last year or something better?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

You know, I hesitate to say because again if interest rates go to 250 -- the 10-year goes to 250 tomorrow, here is what is going to happen. My locks are going to slow down but I'm going to have a huge fair market value adjustment back the other way in our servicing portfolio. And so then the debate is going to be well, what is that? Is that really true operating performance or not?

So what I can tell you is that we are focused on continuing to drive down our net costs to originate. We are managing liquidity, managing our balance sheet. We are a seller of MSRs in this environment, it is a single-digit asset return. The market is favorable right now for MSR sales and so it gives us the ability to not increase any leverage and maybe even decrease leverage in our balance sheet which we think is a very smart thing to do in this type of environment.

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**Kevin Barker** - *Compass Point Research & Trading - Analyst*

Given the flood of MSRs that have been coming to the market and what is out there for performing MSRs with the fallout from (inaudible) some of the other sources that are coming to the market on MSRs, are you still seeing servicing multiples that were similar to what you saw in the third and fourth quarter?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

The answer is, yes. I will tell you I think one of the reasons why, Kevin, is we are very focused as we indicated on the technology in how we are positioning the origination franchise, our discipline around that, the fact that we are regulatory compliant. So the buyers of our MSRs are very -- in most of these cases have been banks that require clean, solid production with great controls. And we are doing it in a way and I kind of indicated that in my presentation where we are doing it geographically. So they getting the benefit of getting customers in their backyard versus just scattered across the US, not knowing who the originator really originally was. So these are first-party transfers meaning we originated them, we have the reps and warrants on them. We own them and we are targeting financial institutions who have Tier 1 capital capability. I mean so we are doing this proactively with banks and going into them and saying okay, look, this is our business model and we believe we are a great provider of wholesale mortgage related assets to you from both a warehouse, a whole loan, an MSR financing and MSR sale perspective and we have been very well received.

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**Kevin Barker** - *Compass Point Research & Trading - Analyst*

Okay. Thank you for taking my questions.

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**Operator**

Paul Miller, FBR Capital Markets.

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**Paul Miller** - *FBR & Co. - Analyst*

Thank you very much. Jim, a follow-up on Kevin's question. Can you add a little bit more color of what type of MSRs you sold? Were they new production, seasoned production, that type of stuff?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

I think the WAC was just south of 4 so they are kind of I would say middle of the road coupons. We have been holding onto the vintage 3.5s and lower that we have. Nice thing now is that if you think about it, the $4 billion we sold in the third and fourth quarter total would have been a further decline in our MSR value so we actually hit that bid high. And then the sale that we have here in Q1 went off at or above what we had it marked for on our books but it was also a higher coupon. And now that the new coupon we are adding to our servicing portfolio, we would expect the weighted average coupon in our servicing portfolio if the trend continues to actually start to decline.

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**Paul Miller** - *FBR & Co. - Analyst*

And then today, I mean where are mortgage rates today? I know mortgage rates fell probably as low as 3.5 and that is probably where you felt most of your pressure with the refinance speeds. But now the 10 year is back to 2% and are rates right around 3.75% to 4%? Where are they hovering around?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

It really depends. A lot of what we are seeing -- the purchase market is probably 3.58 to 3.75% so the purchase market is a little less sensitive to that. Where we are seeing the most opportunity and I think people missed this in some of our prior communication is we have almost half of our portfolio is Ginnie-Mae and so we have been very successful in going to those especially with the MIP drop. There is a lot of FHA paper out there in the market that we are targeting for refinance through Stonegate Direct. And as you know, the margins in that business are very solid and at the end of the day, the servicing fee income you receive from those assets is very strong as well.

We are being very strategic, very thoughtful about not only how we are monetizing the MSR assets but those MSR assets we are bringing back into the portfolio, how we are bringing them in and ultimately what we are paying for them in cash which is still even today with again where the operating expenses are today I assure you we are producing those assets at less cash investment than we could buy them for on the street. Because we are a seller as well so we know the spread.

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**Paul Miller** - *FBR & Co. - Analyst*

And then NattyMac, I guess that funding went up almost 25% which is I think starting to really work for you there. Can you add some color on your success there and should we continue to see 20% to 25% growth in those fundings?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

Well, what we did is for the first -- we put that into existence back in July of 2013 and we have been ramping that up. We originally tied it more to Stonegate's overall origination volume so it was more focused on capturing correspondent business, capturing wallet share from our correspondent and we are still doing that. That is still a strategy that we are implementing today.

We have had more banks and other financial institutions approach us that in the context of wanting to get into the warehouse business but not having the infrastructure to actually do that. So we have got liquidity coming into the platform from other financial institutions so we are deploying liquidity for them in essence becoming a fulfillment provider on our platform which is very exciting because of course banks don't have a lot of places to put excess capital.

So the structure of that with US Bank as a master custodian, the fact that it is now proven, it is scalable. We are going to continue to grow that and we have kind of taken off the tie to Stonegate and said to Steve Landes who runs that group, look, you grow it because we like the business, we like the returns and we have some really good partners providing liquidity for that platform.

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**Paul Miller** - *FBR & Co. - Analyst*

Can you remind us again what type of fee structures -- because you get a lot of fees off of that, right?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

Relatively speaking a lot, I don't know how you would classify that. But we charge a fee just like most warehouse banks do somewhere between anywhere on the low side maybe $40 and on the high side $100. I think the average runs about $80 and so at the end of the day, we collect the fee income and then we earn spread net interest income spread which is the difference between our borrowing cost and the note rate. We have put out data on that before in prior presentations.

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**Paul Miller** - *FBR & Co. - Analyst*

I know. I just don't think a lot of people -- a lot of people just don't focus on it I think and I think it is one of the bright spots of the Company.

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

When you look at what we are funding, we are becoming a meaningful provider of liquidity in the market for warehouse lending. We are on the radar screen, we are competing with others in that category. And we don't, maybe there is banks that may be in the business that can earn more net interest income spread. We just think that we are in a much better position to source the assets given our distribution network. When you have a number of correspondence we have and the reach that we have, we are in a much better position than a warehouse bank that is tied to a bank to source assets to finance.

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**Paul Miller** - *FBR & Co. - Analyst*

Thanks a lot, Jim.

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**Operator**

Douglas Harter, Credit Suisse.

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**Douglas Harter** - *Credit Suisse - Analyst*

Jim, I was hoping you could sort of walk through the profitability difference Stonegate Direct versus the more traditional retail?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

Yes, good morning. So it is interesting. That is a business that is very scalable both ways, up and down given the current interest rate environment. So a lot of people look at call center as refi driven and I think hopefully I communicated to you guys today that we see that as a tremendous opportunity to gain huge market share in the online purchase origination business. And the way we are looking at that is kind of more as get into the supply chain earlier with those that are looking to buy a year out, two years or three years out determining eligibility and using proprietary algorithms to get there.

That being said, the margin on that business in some cases depending on the product type for example, agency paper may be thinner than distributed retail but our cost infrastructure is significantly less from commissions to just operating expense associated with that, direct costs, fixed costs and other things.

So the trade-off is you give up a little topline revenue and that is why I would caution all you guys that going forward as direct grows, it may have a little different revenue structure on the top line which makes gain on sale a little flatter than what a traditional retail would be but you would see a less expense structure. So right now the trend has been that we see a lower net cost to originate in that channel than we do in other channels meaning that is our most accretive channel, lowest cost to acquire the MSR at this point. And we have just started radio advertising. We are doing media and so again we are putting a big focus on that as we go forward.

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**Douglas Harter** - *Credit Suisse - Analyst*

I guess with that accretive nature, does that change any plans with the more traditional retailers, the pace at which you roll that out or given your commentary also on a slower housing recovery?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

It is interesting. So what Rob alluded to in his script was that we have made some pretty significant investments in 2014 to get our retail platform to what we would call a national footprint in key markets we want to be in. So Chicago and other areas where we see a great opportunity for us to compete and compete very effectively and be profitable. And so for us just to go out and throw retail distributed branches all throughout the country makes no sense. So we are targeting markets only where we see profitability being a leading indicator, high government concentration to make sure that we are getting margin on those loans. So I would say that that platform is in place, the management team is in place and we are still growing it and we have targets to grow that and that is solely focused on purchase.

What we are trying to do on the retail direct side is go into other markets where for example we might not be able to do it on a retail distributed basis but do it on a direct basis and capture share in those markets from online.

What you may not realize is the two are actually connected and here is how they are connected. So the funnel that we show where we are working with prospective borrowers from one to three years out getting them aligned and eligible to buy or build a home, those are in 90% of the case don't have realtors. And so what we are doing is we are setting up and putting ourselves in a position to take that lead and refer that to realtors in our traditional distributed base because that is what they work from. They work from realtors and builders.

And so our ability to capture a renter who wants to buy in a year, incubate that and work with them in our call center and then refer that to a realtor in say Chicago or Philadelphia or in Washington DC, that is very powerful. I think we are going to be in a position to do that here in 2015.

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**Douglas Harter** - *Credit Suisse - Analyst*

Great. Just on that, it sounds like more people are looking at that kind of direct model and addition. I guess how do you view the competition there versus kind of the more traditional retail?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

Well, clearly there is a market leader in that space and I think we all know who that is so we don't really have to talk about who that is per se. But when you look at the traditional call center business model, it is very refinance focused. I'm not suggesting we are not getting our share of refinances because look, if there is $300 billion a year of refinances on a $1 trillion market, I want as much of $300 billion as I can get. The advantage there is because we have scale and we have a brand, we can do effective social media, online leads and we can compete and make money doing that.

The other side of the business though is getting the purchase market going again which we have kind of already talked about. So I think there's people talking about getting into online retail but the question is if you are just going to do it traditionally then you are really kind of limiting yourself you just dealing with retail.

The call center though does give us a nice hedge against a contracting purchase market and vice versa so distributed retail and call center, doing both of those gives us the ability to capture purchase and refinance business whereas if you are just a call center, you only get refinances in most cases.

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**Douglas Harter** - *Credit Suisse - Analyst*

Great, thank you.

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**Operator**

Henry Coffey, Sterne, Agee.

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**Henry Coffey** - *Sterne, Agee & Leach - Analyst*

Good morning, everyone. Let me start with a less philosophical question. Book value was 10.87, what level of intangible should we subtract from that to get tangible book value? I know they are small but I just was --.

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**Rob Eastep** - *Stonegate Mortgage Corporation - CFO*

This is Rob. We have about $6 million in goodwill intangibles. It is a very small number.

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**Henry Coffey** - *Sterne, Agee & Leach - Analyst*

Then on the call center business, everybody knows who number one is, nobody knows who number two is really. As you move this business forward there are a lot of people vying for those top four spots. Do you have the capacity to move the business up that far or is the call center business going to be more of a niche opportunity?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

Henry, don't think it is a niche opportunity. I think it is where the market is going really. I think there is always going to be distributed retail because somebody is going to need to meet with a realtor, a builder, a homebuyer on a street corner or in an office somewhere.

But if you look at the profile, the demographics and this is what we were trying to allude to, if you look at the funnel of potential borrowers that are out there over the next three years, 44 million more households. And you look at how they are going to engage, they are not going to be able to get the information they need today necessarily through a distributed channel or somebody who is a traditional originator because there is additional work required to quote unquote get them in a home and they are kind of doing a lot of research and a lot of education.

So do I think we can scale to get into the top 10 or the top four in call center? And your point is really well taken. I don't know who number two is. A lot of people may claim it. I would tell you that if we are anywhere in the top 10 in call center, it is going to be a meaningful number because obviously we know who number one is.

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**Henry Coffey** - *Sterne, Agee & Leach - Analyst*

What does it take to get there, capital, advertising, technology?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

Look, I think it takes all of that and I think the technology is probably the easiest part. The capital based on what we are building in this marketplace, that is another thing that I think is really important. We are trying to do this in a capital efficient way which says okay, do we really want to invest all of our capital in an MSR that has an 8% return? And the answer is no.

So then the next question is can I finance it at a reasonable rate on an ongoing basis? I think all of you guys know the answer to that is no because the cost of capital for debt financing is probably every bit of 8% given the current market. We have been very fortunate because this market place and the way we structure our business, we have some very attractive short-term interim MSR financing that we are using to hold those assets on an interim basis if you will until we get them strategically placed with a buyer.

So I don't think our capital is going to be the constraint in growth in the call center at all. If anything, I think we will get higher bids from our strategic partners because we will be able to source the asset right in the market they want to be. So if we are selling to a bank and they want to buy loans in Mississippi or in Birmingham, Alabama, we can do radio and TV advertising and get that done in that market if it is a big enough market.

So we see ourselves as an intermediary matching the borrower with the investor and that won't take as much capital as owning the MSR.

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**Henry Coffey** - *Sterne, Agee & Leach - Analyst*

And the business of well-paid retail brokers on the street working with realtors and lawyers and that sort, is that still a viable business? Is that still an area where you want to grow and expand or is that yesterday's market?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

No, I think maybe I didn't say that but I think you have to have both. I think that right now the market, look, not everybody who is buying a home is comfortable going online. So if you want to be an active participant in the purchase market, you have to have some bricks and mortar, you have to do it efficiently and effectively and you have to be in markets that are profitable.

To answer your question, it doesn't work in all markets and so we are being very selective in markets and it doesn't even work in some parts of some markets where it works in others. Like there's areas where we have offices that in large MSAs where we would have it on the north side but on the south side, it is hard to make money because there is a different dynamic.

So you have to be very thoughtful, very prudent and just to go out and roll up retail branches which a lot of people are trying to do, I don't see that as a long-term viable business opportunity especially when you can't really provide the realtor or builder anything more than we are a mortgage company. So what we see a tie between generating online purchase leads that have 90% or more don't have realtors and giving them back through our distributed retail network to get them two real estate agents. It is something we've been working on for years and we have done it on a small scale and now that we have the call center, we plan to do it on a larger scale.

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**Henry Coffey** - *Sterne, Agee & Leach - Analyst*

Can you feed that business into one of the online hopefuls in terms of real estate, people who want to do the whole process of real estate purchase online or do you need to keep working with a realtor?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

Well, there is probably not any realtors on the call but I mean ideally, we would be able to disrupt that market to be honest with you. So we are as you look at our portal and you look at some of the stuff we are doing, we are going to truly a direct. We are connected to them so we are able to display homes for sale to potential homebuyers. So there are things that we are doing and plan to do here in 2015 which will put us in a market leadership position for online purchase.

And the way we are looking at it is, purchase eligibility because there is a lot of people when they come to these sites they get mortgage rates so that doesn't really help them. They need to know if they have enough cash to close, they need to know what their income needs to be. They need to know if their debt ratio is too high. They need to know if they had a foreclosure three years ago or a bankruptcy as a result of -- and were involved in the real estate downturn when they can buy, what date can they buy. They can buy three years from today.

And so then that is what we need to do and they need to know what type of home they can buy responsibly, what the price can be. And so we are changing the way we are educating prospective homebuyers as we go forward than just being an online -- here is your rate and let us get your pay stubs and tell you whether you are prequalified. That doesn't do anybody any good.

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**Henry Coffey** - *Sterne, Agee & Leach - Analyst*

My last question and I think I get the mission. I will tell you more about it when we are off-line. The last question is it has been a struggle to create an acceleration in earnings. I remember Paul Miller's comment, it is really rough working in $1 trillion mortgage market. At what point can we sit back -- and obviously you are never going to be able to perfectly predict earnings but at least see kind of a consistent 10% ROE coming out of this business? What does it take to get there, (multiple speakers) the bottom, not the top?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

Let me tell you, if we get lucky and the market grows great because then everybody will be like wow, you just got lucky and the market grew. We are committed to getting it to that level of return in this market, not in the inflated market we are even seeing today meaning in a $1 trillion market, we believe based on our franchise and the strategies we are deploying we can get there.

And it may require us to cut additional costs out, shrink management, do whatever we need to do, Henry, but at the end of the day, our primary focus is managing and maintaining liquidity. And I think when you look at a lot of others in the market, that is something that they are missing and we don't think being leveraged and going out and chasing volume right now is necessary to get to that level of return.

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**Henry Coffey** - *Sterne, Agee & Leach - Analyst*

Is that a 2015 goal or 2016 goal?

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**Jim Cutillo** - *Stonegate Mortgage Corporation - CEO*

It is a second half of 2015 goal for sure. And again, I mean you kind of asked the question on book value, yes, you know, look, if interest rates or if the 10 year goes to 2.50, my book value is going to go up significantly just based on the asset base that we have. And then people will be arguing you just got lucky and that is not the case at all. We are an asset manager so we are managing these assets, we are managing cash, we are managing liquidity.

And so yes, I think again I think we can get to that level of return even in a tough market based on where we currently have the business positioned. Look, we made some big investments in 2014, cash investments in bringing on a bunch of people early on in the year with Nationstar and Crossline and Medallion and the market contracted by almost 50% from the time we went out the door and did this IPO.

So yes, the results aren't what we had hoped but we have a franchise, we have right-sized it. We are building it the right way to be profitable and sustainable over multiple cycles.

**Henry Coffey** - *Sterne, Agee & Leach - Analyst*

I get it. Thank you.

**Operator**

Ladies and gentlemen, we have reached the allotted time for questions and answers. I will now return the call to management for any additional or closing remarks.

**Michael McFadden** - *Stonegate Mortgage Corporation - Chief of Staff*

Thank you, Lori. Any investors or analysts with additional questions can contact myself at 317-663-5904. Thank you again to everyone for joining us today.

**Operator**

Thank you for participating in Stonegate Mortgage Corporation's fourth-quarter and full-year 2014 earnings conference call. You may now disconnect.