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SGM - Q2 2015 Stonegate Mortgage Corp Earnings Call

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PRESENTATION

Operator

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

(Operator Instructions)

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 Corporation - SVP, Finance*

Thank you, Brandy, and good morning, 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 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 Relations website, at www.investors.stonegatemtg.com. Please refer to that website for important materials, including the Q2 earnings press release. A replay of this call will also be made available on the website by the end of today.

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

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

Thank you, Mike, and welcome everyone to our Q2 2015 earnings call.

Let's begin on slide 3, where we provide an overview of our operating and financial performance in the second quarter.

GAAP net income was $11.1 million, or $0.43 a share, in the second quarter.

The value of our investment in mortgage servicing rights increased during the quarter as interest rates rose, resulting in a positive $20.8 million pretax fair market value adjustment to the MSR.

After adjusting for the fair market value change in stock-based compensation, we recorded an adjusted net loss of approximately $900,000, or $0.04 per share.

Payoffs and principal amortization, the other non-cash item associated with the MSR asset, remained elevated during the quarter, at $11.3 million.

This translates to a CPR of 24.3%, which is significantly higher than the long-run average CPR of around 10%. We estimate that a 1% change in CPR rate translates into approximately $0.01 of EPS.

The adjusted net loss also includes a $3.1 million loss on MSR sales recognized during the quarter, which we will explain in more detail later in this presentation.

Our originations segment performed as expected during the quarter, as locks in the pipeline at the end of Q1 turned into fundings. The increased fundings resulted in higher interest income, origination fees, and origination expenses, while the decline in locks this quarter resulted in a $1.8 million lower fair market value of pipeline compared to Q1. The combination of these factors resulted in a pretax income of $11.7 million.

In our servicing segment, we realized a pretax loss of $8.1 million, compared to a $4.8 million loss in Q1 and a $2.9 million pretax income in Q2 of 2014. The decline was primarily due to the loss on MSR sales and lower servicing fees due [in the] quarter to a smaller average portfolio size. We also experienced higher than normal levels of amortization, which contributed to the pretax loss during the quarter and the variance to the prior year.

Our payoffs and principal amortization of $11.3 million was 143% higher than the same period last year. The prepayment speed is beginning to slow, as July total payoffs were down 11.5% from the monthly average in Q2.

We executed a $1.8 billion MSR sale during the quarter, which combined with our new production during the quarter resulted in our servicing UPB increasing only $300 million, or 2% overall, from the end of Q1.

We have monetized over $80 million of invested capital from our servicing segment in the past 12 months, which demonstrates the liquidity of this asset at current market multiples and also shows our commitment to freeing up equity to invest in our originations and financing segments.

The financing segment continues to perform well and contributed $355,000 in pretax income during the quarter, up 209% compared to the $115,000 in the first quarter. Our outstanding commitments to correspondents grew 14% in Q1, and our funded volume increased 34% to a record $857 million.

At this point, I'd like to turn the call over to Rob Eastep, who will review the financial results.

Rob Eastep - *Stonegate Mortgage Corporation - CFO*

Thanks, Jim.

Let's turn to slide 4, where we talk about the components of our GAAP revenue during the quarter. Second quarter GAAP revenue of $87.4 million was up 97% from the prior quarter. This includes the $20.8 million positive adjustment to the MSR valuation, primarily due to higher interest rates.

Higher origination volume during the quarter resulted in increased interest income and loan origination fees.

Gain on mortgage loans held for sale decreased by 3%, to $51.3 million, primarily as a result of a smaller pipeline at the end of the quarter partially offset by the higher cash gain on sale and capitalized servicing rights during the quarter, as Q1 locks began to flow through as fundings.

In the appendix, we provide more details around the gain on mortgage loans held for sale line item. The thing to note is the growing contribution from cash gain on sale. Cash gain on sale has grown from five basis points to 37 basis points over the past four quarters.

The loss on MSR sale resulted in a $3.3 million variance in revenue to the prior quarter, which is explained in more detail on the following slide.

On slide 5, shows the components of the $3.1 million loss on MSR sales we recorded during the quarter. We accepted a bid on April 1 that was slightly higher than the book value of the portfolio at that time, which would have resulted in an approximately $100,000 gain, excluding deal costs and estimated prepayment reserves.

However, since GAAP accounting requires that the portfolio remain on our books for the period of time between the bid date and close date, we have to mark the portfolio to fair value until the asset is derecognized on the close date. This results in additional fair market value change during that period.

In this case, the 10-year Treasury increased from 1.87% on the bid date to 2.05% on the close date. This resulted in our recording a fair market value write-up on that specific portfolio of $1.2 million on April 30 and a subsequent loss on MSR sales based on the new market value and higher basis in that asset.

If interest rates had remained flat during the period between the bid date and the close date, there would not have been the $1.2 million fair value write-up or the associated loss on MSR sale.

This combination of these two is neutralized in the P&L but does create geography noise.

Additionally, we recognized $2.1 million associated with the sale of the MSR asset for transaction costs and prepayment protection. The prepayment protection is for loans that pay off over a specified time of period after close, such as 60 to 90 days. Therefore, had we not sold the asset, the expense would have just been recorded as amortization expense on actual prepayments instead of in the loss on MSR line item.

The take-away is we have liquidity in our MSR asset at our book value. Interest rate changes are out of our control, and we remain committed to investing our capital in parts of our business which provide the best risk/return tradeoff.

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

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

Thanks, Rob.

Turning to our originations segment, on slide 6, locks were down 7% over the first quarter and 3% compared to the prior year. The $4.5 billion of locks was comprised of 23% retail, 14% wholesale, and 63% correspondent.

Origination volume was up 21% over the first quarter, to $3.4 billion. A very strong lock volume for the last quarter rolled through as fundings.

Our retail channel continues to grow, comprising 23% of our locks and 22% of fundings during the quarter. We continue to take a balanced approach to retail with our focused on both our distributed retail and direct-to-consumer models, as we believe this allows us to maintain volume in any market environment.

Segment expenses excluding interest increased 14% over the prior quarter in total dollars but were down $320 per loan. This is primarily attributable to a greater number of fundings during the quarter, which spreads our fixed costs across a greater number of loans.

As you can see on slide 7, segment revenue was up 1%, but pretax income was down 35% over prior quarter. This is primarily due to the decrease in interest rate locks during the quarter, which resulted in a $1.8 million smaller pipeline value at the end of the period, compared to a $15.6 million increase in the first quarter of 2015.

As we've discussed in the past, one of the key performance metrics for our originations segment is net cost to originate, or NCO, because it excludes the impact of change in the value of the pipeline and represents our cash cost basis in the MSR asset.

Our NCO was 96 basis points in the second quarter, down 17 basis points from the first quarter primarily due to the increase in cash gain on sale and lower expenses in basis points.

From the gain on sale appendix on slide 20, you can see the MSR we originated this period was capitalized at 135 basis points. This translates to an MSR spread of 39 basis points. Therefore, the second quarter we invested 96 basis points into an asset that is fair valued at 135 basis points. This equated to an unlevered pretax return on investment of approximately 41%.

While the higher loan count this period resulted in a reduction in the cost per loan from $3,611 to $3,291, or $320 per loan, we believe we have an opportunity to reduce our cost per loan up to an additional $350 through overhead reductions and by leveraging technology.

Turning to slide 8, our servicing segment produced a pretax loss of $8.1 million during the quarter, compared to a $2.9 million pretax income in the second quarter of 2014, primarily driven by the loss on MSR sale as Rob discussed earlier and the elevated prepayment rates we have experienced during the quarter.

We expect the prepayments will revert back to historical levels through the remainder of 2015. This could result in a meaningful improvement to our servicing profitability.

Our portfolio ended the quarter at $17.2 billion in UPB, a slight increase over last quarter, as we added newly originated loans while also completing another MSR sale of $1.8 billion in UPB during the quarter.

Moving on to slide 9, segment pretax income more than doubled, to $355,000, compared to $115,000 in the previous quarter. We believe this segment will have an even greater impact on our financial results over the next year as it adds more correspondents and participants to the platform.

Our NattyMac platform continues to drive additional volume from our corespondent originators, increasing wallet share with those customers. TPO customers with a NattyMac warehouse line sell nearly four times more to Stonegate on average than those without a NattyMac line.

The financing segment continued to grow volume and total commitments during the quarter, driving additional fee and net interest income for this segment.

Funded volume came in at 3,691 units and $856.8 million in the second quarter, up 34% for the prior quarter. Commitments increased by 14%, to $462 million.

We believe there continues to be opportunity to improve the financial performance of this segment by leveraging technology. [Stonegate Connect] will offer investors access to the net interest spread generated by warehouse financing, which could result in lower cost to fund opportunities for NattyMac and our own inventory.

On slide 10, we focus on our balance sheet. We maintained a strong liquidity position in the first quarter, with cash and cash equivalents at June 30 of $48.5 million, or 17.2% of total equity. Our book value increased to $10.93 per share at the end of the quarter, with a $20.8 million write-up of the MSR asset.

We continue to focus on freeing up capital from servicing assets to reinvest in origination and financing segments.

In conclusion, we are focused on maintaining a healthy balance sheet through ongoing MSR sales. However, and more importantly, we are focused on making the proceeds we receive from the MSR sales go further. We can accomplish this through reducing our cost per loan in our originations segment. We believe there is an opportunity to reduce costs by up to $350 per loan, while growing our retail and wholesale originations by leveraging technology and reducing expenses over the next nine to 12 months.

Finally, we have taken action to reduce overhead expenses that we expect will result in annualized savings of $2.5 million to $3 million per year beginning in fourth quarter of 2015.

We'd now like to open the call up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jeremy Campbell, Barclays.

Jeremy Campbell - *Barclays - Analyst*

I just wanted to touch a little bit on that MSR sale. Of that $2.1 million of deal cost and prepaid protection, how much of that was the, quote, synthetic amortization and how much of that was actual deal cost?

Rob Eastep - *Stonegate Mortgage Corporation - CFO*

Jeremy, the deal costs were approximately $700,000.

Jeremy Campbell - *Barclays - Analyst*

So, if you agree to sell at like a $100,000 gain and you're going to have a deal cost of $700,000, isn't that always going to be a loss?

Rob Eastep - *Stonegate Mortgage Corporation - CFO*

In that type of situation, you're right. It would be. That would result in a GAAP loss. You're right.

Jeremy Campbell - *Barclays - Analyst*

Okay. I'm just trying to think about that monetization strategy, if you're going to have that much of a deal cost versus --.

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

Jeremy, this is Jim. You wouldn't have a loss if your bid price was one basis point above the carrying value. So, historically, we've not been that close or that on top of the bid price. So, we factor that into the bids when we look to monetize the asset.

Jeremy Campbell - *Barclays - Analyst*

Okay.

Rob Eastep - *Stonegate Mortgage Corporation - CFO*

Jeremy, in the first three deals that we did, the bid price was two or three basis points higher than the valuation price on it. And this was a Ginnie Mae sale that we did. So, it was a little bit tighter execution on it. But the expectation on a go-forward basis would be that you'd have a little bit higher spread between the valuation and the bid price.

Jeremy Campbell - *Barclays - Analyst*

Gotcha. So, I'm just wondering why -- did you need the liquidity to funnel back into the origination side? Is that why you executed here at this kind of price? I was just --. If you're not going to get a strong enough bid to cover your deal costs, it would seem logical just to kind of retain that?

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

Well, the answer is, yes. We want to maintain a strong liquidity position. And as we indicated on the slide, we have done that.

And so, we believe the liquidity is actually more important and don't believe with all the interest rate volatility that levering up or borrowing money against an MSR asset is a smart business decision.

Jeremy Campbell - *Barclays - Analyst*

Got it. And then, just why the pullback in the wholesale channel this quarter from your earlier part of the year run rate?

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

I think it's just seasonality. Just the conversion from refis to now purchase. They go through kind of an adjustment period, if you will. I think the brokers were running predominantly refinances. And now, obviously, the market has shifted over to purchase and people just had to reset and go after that.

Jeremy Campbell - *Barclays - Analyst*

And how is lock volume and wholesale shaping up relative to where it was in 2Q?

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

It's up.

Jeremy Campbell - *Barclays - Analyst*

Okay. Great.

Operator

Bose George, KBW.

Chas Tyson - *Keefe, Bruyette & Woods North America - Analyst*

This is Chas Tyson on for Bose. I just wanted to ask on the $350 per-loan savings that you are trying to target from a cost-per-loan perspective, what line items should we see that flow through? And is there -- can you give us kind of a ballpark range in what that should equate to annually? Running quick math, it seems like kind of mid-single millions, a couple of million, $5 million-ish, something like that? Does that sound right?

Rob Eastep - *Stonegate Mortgage Corporation - CFO*

Yes, that's -- once we get that $350 -- or, up to $350 fully baked in, that would be -- the numbers you're [quoting] are about what our expectations would be.

And where you're going to see that flow through on the P&L is kind of a combination of your G&A expenses, (inaudible) equipment and communication expense line item, and to some extent some sales commission benefit line items, too. So, it will kind of spread itself throughout all those particular line items.

Chas Tyson - *Keefe, Bruyette & Woods North America - Analyst*

Okay. And you guys mentioned and alluded to it, but how do you think about saving -- cutting down the cost per loan as you increase higher-cost-to-originate channels, like retail and wholesale?

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

Well, I think we factored that into our number that we put out there. We have some internal technology strategies, even with the pending [trid] implementation that we believe will result in those savings.

So, a lot of this has to do with creating more internal efficiency, as well as we've made some recent cuts in various areas of the Company from a headcount perspective which drove the $2.5 million, or so, worth of annual savings as well.

So, we're going to continue to right size the organization for the current origination market as well as continue to drive efficiency with technology.

Chas Tyson - *Keefe, Bruyette & Woods North America - Analyst*

Got it. For the headcount cuts that you made, the $2.5 million of savings, was there any severance in the quarter related to that?

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

No.

Rob Eastep - *Stonegate Mortgage Corporation - CFO*

No, there wasn't.

Chas Tyson - *Keefe, Bruyette & Woods North America - Analyst*

No severance. Okay. And then, lastly, just curious about the mix of originations this quarter. If you can kind of break out maybe what the government or FHA origination percentage was and how you're seeing that market shaping up?

Rob Eastep - *Stonegate Mortgage Corporation - CFO*

The mix was primarily 55% FHA, VA, or Ginnie Mae, and then 45% conforming. And we're kind of seeing on a go-forward basis about that same level of mix. We're not seeing a dramatic change either way on that.

Chas Tyson - *Keefe, Bruyette & Woods North America - Analyst*

Okay.

Operator

Kevin Barker, Compass Point.

Kevin Barker - *Compass Point - Analyst*

Regarding the servicing profitability and what the prepaid fees that you're already seeing in July, can you give us an idea of [whether] you expect to return to profitability in the third quarter, given prepaids fees just thus far this quarter?

Rob Eastep - *Stonegate Mortgage Corporation - CFO*

We're looking at -- on the servicing channel with our prepayments fees slowing down and excluding any impact of a transaction of MSR sales, we are looking at the servicing channel getting back to that profitability level in Q3 and having a little bit of a positive impact in Q4, again excluding any impact that you would see on MSR sales.

Kevin Barker - *Compass Point - Analyst*

Are you still on target to hit your goal of retail origination percentages by year-end 2015?

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

I believe we are. With the change in rate environment and more purchase focused, obviously the numbers get a little harder to achieve, especially going into Q3 and Q4. But we are seeing progress in both our distributed and in our direct channels.

Kevin Barker - *Compass Point - Analyst*

Okay. Outside of general efficiency cuts that you've talked about here, is there any other initiatives that you can do in order to lower your expense base to increase pretax margins?

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

Well, whenever you're increasing your retail and wholesale production, your expenses are going to go up. It really comes down to a cost-per-loan basis and the margin in the retail and wholesale channel being greater than the margin in delegated.

But we intend to grow both our third-party channel and our retail channels for the balance of the year and obviously into 2016. So, we're going to continue to make cuts where necessary and drive down expenses where necessary. So, it's just going to be an ongoing effort quarter over quarter.

Kevin Barker - *Compass Point - Analyst*

Okay.

Operator

Paul Miller, FBR Capital Markets.

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

On slide 9, talking about NattyMac, it continues to grow at a very nice pace. I was just wondering, I notice that you broke it out in revenues versus net profit and the margin went up significantly. Is that a good margin to model that out? And is 30% growth something that we'll be able to get for the next couple of quarters? Or, will it slow down a little bit?

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

Well, we continue to add new correspondents. So, our application volume for new warehouse lines has picked up. We've also increased the size of the lines we're offering correspondents. So, we've picked up some larger correspondents which are driving the larger number of units being funded as well as volume. And then, we're working very aggressively with the current funding sources to lower our cost of funds.

So, we see opportunity there to reduce, as well, our cost per funded loan. We see opportunity to increase our interest income, our spread, and drive more outstandings, which is really where the opportunity is.

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

And can you talk a little bit about what type of points and fees go along with these type of loans?

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

Well, there aren't -- it's really, Paul, two things. We charge a transaction fee for funding the loan to the correspondent. So, whoever is funding the loan pays a funding fee. And then, we basically earn the net interest income spread during the period of time that it's on the warehouse line before it's sold to an investor.

And obviously, Stonegate is one of the investors. But we sell -- NattyMac funds loans and ultimately ends up transferring those or selling those to pretty much all the correspondents in the market. We have a wide array of investors, including the tier one banks, that ultimately we deliver these loans to on behalf of our correspondents.

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

And then, going back to the -- do you guys have your CPR rate? I don't see it here. I guess I can calculate it. But on slide 8, you talk about how the amortization rate on the servicing rights have been elevated. And I think they've been elevated not just with you guys, but across the industry.

And what the CPR rates were? And then, you said get back to a more normal level compared to your historical levels. What type of level do you think that CPR rate is going to drop to?

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

Well, to answer your first question, the CPR rates are in the Q. So, you should have that. You can look that up, obviously.

And we I think in here reference more like 10%, which has kind of been our historical norm, if you go back and look at kind of the performance of our servicing portfolio.

So, the thing I think everybody needs to keep in mind is in Q1 not only did we have rates drop, which would have pushed CPR rates up, but we had the change in the MIP premium on the FHA loans, which put a whole bunch of loans in the money, if you will, to refinance.

And that's, really, another reason why on the sale of the MSR is we sort of got impaired a little bit on the prepayment protection, because those loans were paying off at a much faster pace than when we originally cut that deal. And so, it kind of -- we got double-hit on that side of it, as well.

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

Okay. So, I guess -- I'm not trying to put words in your mouth, Jim. So, you think that you can get the CPR rates down to closer to 10%. And you think you can get that there this year? Because I know -- I don't know what you guys --.

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

I don't have any control over the CPR.

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

I know you don't.

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

Obviously, the interest rate environment controls that.

I would point you towards the current Fannie/Ginnie securities market to look at prepayment speeds based on WAC. So, you really have to look at our servicing portfolio's weighted average coupon. You can go out to the board and get a proxy for what they've run historically, what they're currently running now. And I would use those to make adjustments to your amortization expense estimates for our portfolio. And keep in mind, half of our portfolio is Ginnie and the other half is agency, Fannie and Freddie.

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

Okay.

Rob Eastep - *Stonegate Mortgage Corporation - CFO*

Paul, the CPR rate in the first quarter is approximately 24%.

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

Okay.

Operator

Doug Harter, Credit Suisse.

Doug Harter - *Credit Suisse - North America - Analyst*

Jim, could you talk about what is the need for liquidity? What is the right level? Does it need to be at 17%? And if not, --? I guess we'll leave it at that, first.

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

Well, of course we have covenants we need to maintain with our funding sources who provide repurchase lines for us. And so, those -- the liquidity requirement is not only for us, but other non-banks, whether you're public or private.

Those have increased over the last couple of years due to the financial crisis. The historical norms of what a company would need to maintain in the way of liquidity have changed drastically, or dramatically.

And so, then what we've done is we have kind of put a sizable buffer on top of that.

And then, as we look at ways in which we want to invest our capital, the question would be, why would we want capital in the MSR asset if we can move it into origination and financing, where we have higher return on invested capital?

And so, we want to have additional capital available for investment in our origination and financing businesses. So, we are opportunistically monetizing that asset in order to invest in origination and financing.

And so, this event that occurred in Q1 on the MSR sale, although it's unfortunate, having that cash now available to invest in origination and financing is going to provide better return dynamics on a go-forward basis.

And I think I mentioned this before. We're not a fan of creating debt and levering up this asset when you see all the volatility associated with it from an interest rate perspective. So, we're probably erroring more on the side of conservative on making sure that we have enough cash for any type of instance, including a margin call that could happen in the event of a rapid rate move in the market, as well.

Doug Harter - *Credit Suisse - North America - Analyst*

Right. I think that all makes sense. I guess I'm just trying to understand whether -- what the right level is and what level of excess you have and as to whether --. I guess that's what I'm just trying to understand, whether there is excess cash that could be used to grow all of the options at one point.

Jim Cutillo - *Stonegate Mortgage Corporation - CEO*

Well, we don't believe that we have excess cash. We believe that we're maintaining an adequate level given the market environment and the covenants that we have in our facilities. If we were to have excess cash, obviously we would invest that in further originations and financing.

Doug Harter - *Credit Suisse - North America - Analyst*

Okay.

Operator

There are no further questions at this time. I would now like to turn the floor back over to Mr. McFadden for any closing or additional comments.

Michael McFadden - *Stonegate Mortgage Corporation - SVP, Finance*

Thank you, Brandy. 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, for everyone attending today.

Operator

Thank you. That does conclude today's conference call. You may now disconnect.
