PENNYMAC FINANCIAL SERVICES, INC.
Form 10-Q
May 15, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2014

Or

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

For the transition period from to

Commission file number: 001-35916

PennyMac Financial Services, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**80-0882793**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
6101 Condor Drive, Moorpark, California	**93021**
(Address of principal executive offices)	(Zip Code)

(818) 224-7442

(Registrant s telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act (check one):

Large accelerated filer o	Accelerated filer o
Non-accelerated filer x (Do not check if a smaller reporting company)	Smaller reporting company o

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

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

Class	Outstanding at May 13, 2014
Class A Common Stock, $0.0001 par value	21,196,486
Class B Common Stock, $0.0001 par value	61

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PART I. FINANCIAL INFORMATION

Item 1. ***Financial Statements***

PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

		March 31, 2014		December 31, 2013
		(in thousands, except share data)		
ASSETS				
Cash	$	37,376	$	30,639
Short-term investments at fair value		40,957		142,582
Mortgage loans held for sale at fair value (includes $694,028 and $512,350 pledged to secure mortgage loans sold under agreements to repurchase)		717,476		531,004
Servicing advances (includes $5,564 pledged to secure note payable at December 31, 2013)		171,395		154,328
Derivative assets		21,677		21,540
Carried Interest due from Investment Funds		63,299		61,142
Investment in PennyMac Mortgage Investment Trust at fair value		1,793		1,722
Mortgage servicing rights (includes $246,984 and $224,913 mortgage servicing rights at fair value; $272,115 and $258,241 pledged to secure note payable; and $151,019 and $138,723 pledged to secure excess servicing spread financing)		529,128		483,664
Receivable from Investment Funds		3,062		2,915
Receivable from PennyMac Mortgage Investment Trust		20,812		18,636
Furniture, fixtures, equipment and building improvements, net		11,227		9,837
Capitalized software, net		718		764
Deferred tax asset		58,206		63,117
Loans eligible for repurchase		62,508		46,663
Other		20,911		15,922
Total assets	$	1,760,545	$	1,584,475
LIABILITIES				
Mortgage loans sold under agreements to repurchase	$	567,737	$	471,592
Note payable		48,819		52,154
Excess servicing spread financing at fair value payable to PennyMac Mortgage Investment Trust		151,019		138,723
Derivative liabilities		2,155		2,462
Accounts payable and accrued expenses		49,772		46,387
Payable to Investment Funds		37,106		36,937
Payable to PennyMac Mortgage Investment Trust		85,706		81,174
Payable to exchanged Private National Mortgage Acceptance Company, LLC unitholders under tax receivable agreement		71,671		71,056
Liability for loans eligible for repurchase		62,508		46,663
Liability for losses under representations and warranties		8,974		8,123
Total liabilities		1,085,467		955,271
Commitments and contingencies				

STOCKHOLDERS EQUITY				
Class A common stock authorized 200,000,000 shares of $0.0001 par value; issued and outstanding, 20,879,486 and 20,812,777 shares, respectively	$	2	$	2
Class B common stock authorized 1,000 shares of $0.0001 par value; 61 shares issued and outstanding				
Additional paid-in capital		154,112		153,000
Retained earnings		22,372		14,400
Total stockholders equity attributable to PennyMac Financial Services, Inc. common stockholders		176,486		167,402
Noncontrolling interest in Private National Mortgage Acceptance Company, LLC		498,592		461,802
Total stockholders equity		675,078		629,204
Total liabilities and stockholders equity	$	1,760,545	$	1,584,475

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

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PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Quarter ended March 31,			
	2014		2013	
	(in thousands, except per share data)			
Revenue				
Net gains on mortgage loans held for sale at fair value	$	34,538	$	39,957
Loan origination fees		6,880		5,668
Fulfillment fees from PennyMac Mortgage Investment Trust		8,902		28,244
Net loan servicing fees:				
Loan servicing fees				
From non-affiliates		36,100		9,057
From PennyMac Mortgage Investment Trust		14,591		7,726
From Investment Funds		1,477		2,008
Ancillary and other fees		5,151		2,261
		57,319		21,052
Amortization, impairment and change in estimated fair value of mortgage servicing rights		(13,555)		(5,010)
Net loan servicing fees		43,764		16,042
Management fees:				
From PennyMac Mortgage Investment Trust		8,074		6,492
From Investment Funds		2,035		1,914
		10,109		8,406
Carried Interest from Investment Funds		2,157		4,737
Net interest expense:				
Interest income		4,110		1,742
Interest expense		6,386		3,330
		(2,276)		(1,588)
Change in fair value of investment in and dividends received from PennyMac Mortgage Investment Trust		115		88
Other		1,303		814
Total net revenue		105,492		102,368
Expenses				
Compensation		42,886		35,681
Loan origination		1,417		2,507
Servicing		3,090		1,531
Technology		2,823		1,586
Professional services		2,199		2,288
Other		4,016		3,482
Total expenses		56,431		47,075
Income before provision for income taxes		49,061		55,293
Provision for income taxes		5,523		
Net income		43,538	$	55,293
Less: Net income attributable to noncontrolling interest		35,566		
Net income attributable to PennyMac Financial Services, Inc. common stockholders	$	7,972		
Earnings per share common stock				
Basic	$	0.38		
Diluted	$	0.38		
Weighted-average common stock outstanding				
Basic		20,866		
Diluted		75,952		

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

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PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (UNAUDITED)

	PennyMac Financial Services, Inc. Stockholders						Noncontrolling interest in Private National Mortgage Acceptance Company, LLC	Members equity	Total stockholders equity
	Number of Shares		Common stock		Additional paid-in capital	Retained earnings			
	Class A	Class B	Class A	Class B					
					(in thousands)				
Balance at December 31, 2012								261,750	261,750
Capital:									
Distributions								(9,476)	(9,476)
Unit-based compensation expense								176	176
Net income								55,293	55,293
Balance at March 31, 2013								307,743	307,743
Balance at December 31, 2013	20,813		$ 2		$ 153,000	$ 14,400	$ 461,802	$	$ 629,204
Stock-based compensation expense					555		1,793		2,348
Distributions							(6)		(6)
Net income						7,972	35,566		43,538
Exchange of Class A units of Private National Mortgage Acceptance Company, LLC to Class A stock of PennyMac Financial Services, Inc.	66				563		(563)		
Tax effect of exchange of Class A units of Private National Mortgage Acceptance Company, LLC to Class A stock of PennyMac Financial Services, Inc.					(6)				(6)
Balance at March 31, 2014	20,879		$ 2		$ 154,112	$ 22,372	$ 498,592	$	$ 675,078

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

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PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Quarter ended March 31, 2014	2013
	(in thousands)	
Cash flow from operating activities		
Net income	$ 43,538	$ 55,293
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Net gains on mortgage loans held for sale at fair value	(34,538)	(39,957)
Accrual of servicing rebate to Investment Funds	152	139
Amortization, impairment and change in fair value of mortgage servicing rights	13,555	5,010
Carried Interest from Investment Funds	(2,157)	(4,737)
Accrual of interest on excess servicing spread financing	2,862	
Amortization of debt issuance costs and commitment fees relating to financing facilities	1,213	1,145
Change in fair value of investment in common shares of PennyMac Mortgage Investment Trust	(71)	(45)
Stock and unit-based compensation expense	2,473	176
Depreciation and amortization	286	137
Purchase of mortgage loans held for sale from PennyMac Mortgage Investment Trust	(3,130,530)	(3,548,397)
Purchase of mortgage loans from Ginnie Mae securities for modification and subsequent sale	(26,827)	
Originations of mortgage loans held for sale, net	(317,915)	(268,125)
Sale and principal payments of mortgage loans held for sale	3,292,398	4,060,107
Sale of mortgage loans held for sale to PennyMac Mortgage Investment Trust		990
Repurchase of loans subject to representations and warranties	(1,970)	
Increase in servicing advances	(17,067)	(3,435)
(Increase) decrease in receivable from Investment Funds	(299)	364
(Increase) decrease in receivable from PennyMac Mortgage Investment Trust	(1,493)	2,427
Increase in other assets	(6,664)	(3,507)
Decrease in deferred tax asset	5,520	
Increase in accounts payable and accrued expenses	3,263	6,685
Increase in payable to Investment Funds	169	971
Increase in payable to PennyMac Mortgage Investment Trust	3,747	6,997
Net cash (used in) provided by operating activities	(170,355)	272,238
Cash flow from investing activities		
Decrease (increase) in short-term investments	101,625	(19,500)
Purchase of mortgage servicing rights	(25,866)	
Purchase of furniture, fixtures, equipment and building improvements	(2,084)	(1,531)
Acquisition of capitalized software	(35)	(151)
Increase in margin deposits and restricted cash	(2,462)	5,293
Net cash provided by (used in) investing activities	71,178	(15,889)
Cash flow from financing activities		
Sale of loans under agreements to repurchase	3,161,215	3,485,093
Repurchase of loans sold under agreements to repurchase	(3,065,070)	(3,698,578)
(Decrease) increase in note payable	(3,335)	10,424
Proceeds from issuance of excess servicing spread financing	20,526	
Repayment of excess servicing spread financing	(7,413)	
Decrease in leases payable	(3)	
Distributions to noncontrolling interest	(6)	
Distributions to Private National Mortgage Acceptance Company, LLC partners		(9,476)

Net cash provided by (used in) financing activities		105,914		(212,537)
Net increase in cash		6,737		43,812
Cash at beginning of period		30,639		12,323
Cash at end of period	$	37,376	$	56,135

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

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PENNYMAC FINANCIAL SERVICES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1 Organization and Basis of Presentation

PennyMac Financial Services, Inc. (PFSI or the Company) was formed as a Delaware corporation on December 31, 2012. Pursuant to a reorganization, the Company became a holding corporation and its primary asset is an equity interest in Private National Mortgage Acceptance Company, LLC (PennyMac). The Company is the managing member of PennyMac and operates and controls all of the businesses and affairs of PennyMac subject to the consent rights of other members under certain circumstances and, through PennyMac and its subsidiaries, continues to conduct the business previously conducted by these subsidiaries.

PennyMac is a Delaware limited liability company which, through its subsidiaries, engages in mortgage banking and investment management activities. PennyMac s mortgage banking activities consist of residential mortgage lending (including correspondent lending and retail lending) and loan servicing. PennyMac s investment management activities and a portion of its loan servicing activities are conducted on behalf of investment vehicles that invest in residential mortgage loans and related assets. PennyMac s primary wholly owned subsidiaries are:

- *PNMAC Capital Management, LLC (PCM)* a Delaware limited liability company registered with the Securities and Exchange Commission (SEC) as an investment adviser under the Investment Advisers Act of 1940, as amended. PCM enters into investment management agreements with entities that invest in residential mortgage loans and related assets.

Presently, PCM has management agreements with PennyMac Mortgage Investment Trust (PMT), a publicly held real estate investment trust, and three investment funds: PNMAC Mortgage Opportunity Fund, LLC and PNMAC Mortgage Opportunity Fund, L.P., (the Master Fund), both registered under the Investment Company Act of 1940, as amended; and PNMAC Mortgage Opportunity Fund Investors, LLC (collectively, Investment Funds). Together, the Investment Funds and PMT are referred to as the Advised Entities.

- *PennyMac Loan Services, LLC (PLS)* a Delaware limited liability company that services portfolios of residential mortgage loans on behalf of non-affiliates or the Advised Entities, originates new prime credit quality residential mortgage loans, and engages in other mortgage banking activities for its own account and the account of PMT.

PLS is approved as a seller/servicer of mortgage loans by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and as an issuer of securities guaranteed by the Government National Mortgage Association (Ginnie Mae). PLS is a licensed Federal Housing Administration Nonsupervised Title II Lender with the U.S. Department of Housing and Urban Development (HUD) and a lender/servicer with the Veterans Administration (VA) (each an Agency and collectively the Agencies).

- *PNMAC Opportunity Fund Associates, LLC (PMOFA)* a Delaware limited liability company and the general partner of the Master Fund. PMOFA is entitled to incentive fees representing allocations of profits (Carried Interest) from the Master Fund.

Initial Public Offering and Recapitalization

On May 14, 2013, PFSI completed an initial public offering (IPO) in which it sold approximately 12.8 million shares of its Class A common stock, at a public offering price of $18.00 per share. PFSI received net proceeds of $216.8 million, after deducting underwriting discounts and commissions, from sales of its shares in the IPO. PFSI used these net proceeds to purchase approximately 12.8 million Class A units of PennyMac. PFSI operates and controls all of the business and affairs and consolidates the financial results of PennyMac and its subsidiaries.

The purchase of 12.8 million Class A units of PennyMac has been accounted for as a transfer of interests under common control. Accordingly, the accompanying consolidated financial statements reflect a reclassification of members equity to noncontrolling interests in the Company of $315.5 million. This amount represents the carrying value in the Company of the existing owners of PennyMac on the date of the IPO.

Before the IPO, PennyMac completed a reorganization by amending its limited liability company agreement to convert all classes of ownership interests held by its existing owners to a single class of common units. The conversion of existing interests was based on the various interests liquidation priorities as specified in PennyMac s prior limited liability company agreement. In connection with that reorganization, PFSI became the sole managing member of PennyMac.

After the completion of the recapitalization and reorganization transactions, PennyMac became a consolidated subsidiary of the Company. Accordingly, PennyMac s consolidated financial statements are the Company s historical financial statements. The historical consolidated financial statements of PennyMac are reflected herein based on the historical ownership interests of the then-existing PennyMac unitholders.

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Tax Receivable Agreement

As part of the IPO, PFSI entered into an Exchange Agreement with PennyMac s existing unitholders whereby the existing unitholders may exchange their PennyMac units for PFSI stock. Before 2013, PennyMac made an election pursuant to Section 754 of the Internal Revenue Code which remains in effect. As a result of this election an exchange under the Exchange Agreement results in a special adjustment for PFSI that may increase PFSI s tax basis of certain assets of PennyMac that otherwise would not have been available. These increases in tax basis may reduce the amount of income tax that PFSI would otherwise be required to pay in the future. These increases in tax basis may also decrease gains (or increase losses) on future dispositions of certain assets to the extent a portion of the increased tax basis is allocated to those assets.

As part of the IPO, PFSI entered into a tax receivable agreement with PennyMac s existing unitholders that will provide for the payment by PFSI to PennyMac exchanged unitholders an amount equal to 85% of the amount of the benefits, if any, that PFSI is deemed to realize as a result of (i) increases in tax basis resulting from the exchanges noted above and (ii) certain other tax benefits related to PFSI entering into the tax receivable agreement, including tax benefits attributable to payments under the tax receivable agreement.

The term of the tax receivable agreement will continue until all such tax benefits have been utilized or expired, unless PFSI exercises its right to terminate the tax receivable agreement. In the event of termination of the tax receivable agreement, the Company would be required to make an immediate payment equal to the present value of the anticipated future net tax benefits, which upfront payment may be made years in advance of the actual realization of such future benefits.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in compliance with accounting principles generally accepted in the United States (U.S. GAAP) as codified in the Financial Accounting Standards Board s (FASB) *Accounting Standards Codification* for interim financial information and with the SEC s instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, these financial statements and notes do not include all of the information required by U.S. GAAP for complete financial statements. The interim consolidated information should be read together with the Company s Annual Report on Form 10-K for the year ended December 31, 2013 (the Annual Report). Intercompany accounts and transactions have been eliminated.

The accompanying unaudited consolidated financial statements reflect all normal recurring adjustments necessary to present fairly the financial position, results of operations, and cash flows for the interim periods, but are not necessarily indicative of the results of operations to be anticipated for the full year ending December 31, 2014.

Reclassification of previously presented balances

Certain prior period amounts have been reclassified to conform to the current presentation. Specifically:

• *Interest expense* is included in *Interest income* as a new caption of *Net interest expense* to better reflect results of the Company s portfolio of interest-earning assets. Previously, *Interest expense* was included within *Total expenses.* The reclassification results in the presentation of *Net interest expense*.

Following is a summary of the reclassifications:

	Quarter ended March 31, 2013		
	As reported	As previously reported (in thousands)	Reclassification
Net interest expense (new caption):			
Interest income	$ 1,742	$ 1,742	$
Interest expense	3,330		3,330
	$ (1,588)	$ 1,742	$ (3,330)

Note 2 Concentration of Risk

A substantial portion of the Company s activities relate to the Advised Entities. Fees charged to these entities (comprised of management fees, loan servicing fees net of loan servicing rebates, Carried Interest and fulfillment fees) totaled 35% and 50% of total net revenues for the quarters ended March 31, 2014 and 2013, respectively.

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Note 3 Transactions with Affiliates

Transactions with PMT

Following is a summary of the management fees earned from PMT:

	Quarter ended March 31, 2014		2013	
	(in thousands)			
Management fees:				
Base	$	5,521	$	4,364
Performance incentive		2,553		2,128
	$	8,074	$	6,492

In the event of termination by PMT, the Company may be entitled to a termination fee in certain circumstances. The termination fee is equal to three times the sum of (a) the average annual base management fee, and (b) the average annual (or, if the period is than 24 months, annualized) performance incentive fee earned by the Company, in each case during the 24 month period before termination.

Following is a summary of mortgage loan servicing fees earned from PMT:

	Quarter ended March 31, 2014		2013	
	(in thousands)			
Loan servicing fees:				
Mortgage loans acquired for sale at fair value:				
Base and supplemental	$	17	$	77
Activity-based		26		72
		43		149
Distressed mortgage loans:				
Base and supplemental		4,966		3,875
Activity-based		6,386		1,877
		11,352		5,752
MSRs:				
Base and supplemental		3,148		1,763
Activity-based		48		62
		3,196		1,825
	$	14,591	$	7,726

Following is a summary of correspondent lending activity between the Company and PMT:

	Quarter ended March 31, 2014	2013
	(in thousands)	
Fulfillment fee revenue	$ 8,902	$ 28,244
UPB of loans fulfilled for PennyMac Mortgage Investment Trust	$ 1,919,578	$ 4,786,826
Sourcing fees paid	$ 892	$ 1,010
Fair value of loans purchased from PennyMac Mortgage Investment Trust	$ 3,130,530	$ 3,548,397

Following is a summary of investment activity between the Company and PMT:

	Quarter ended March 31, 2014	2013
	(in thousands)	
Issuance of excess servicing spread	$ 20,526	$
Interest expense from excess servicing spread	$ 2,862	$
Excess servicing spread recapture recognized	$ 1,890	$
MSR recapture recognized	$ 8	$ 133

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Other Transactions

In connection with the IPO of PMT s common shares on August 4, 2009, the Company entered into an agreement with PMT pursuant to which PMT agreed to reimburse the Company for the $2.9 million payment that it made to the underwriters in such offering (the Conditional Reimbursement) if PMT satisfied certain performance measures over a specified period of time. Effective February 1, 2013, the parties amended the terms of the reimbursement agreement to provide for the reimbursement to the Company of the Conditional Reimbursement if PMT is required to pay the Company performance incentive fees under the management agreement at a rate of $10 in reimbursement for every $100 of performance incentive fees earned. The reimbursement of the Conditional Reimbursement is subject to a maximum reimbursement in any particular 12 month period of $1.0 million and the maximum amount that may be reimbursed under the agreement is $2.9 million. The Company received payments from PMT totaling $36,000 during the quarter ended March 31, 2014.

In the event the termination fee is payable to the Company under the management agreement and the Company has not received the full amount of the reimbursements and payments under the reimbursement agreement, such amount will be paid in full. The term of the reimbursement agreement expires on February 1, 2019.

PMT reimburses the Company for other expenses, including common overhead expenses incurred on its behalf by the Company, in accordance with the terms of its management agreement. Such amounts are summarized below:

	Quarter ended March 31,			
	2014		2013	
	(in thousands)			
Reimbursement of common overhead incurred by PCM and its affiliates	$	2,578	$	2,606
Reimbursement of expenses incurred on PMT s behalf		445		1,358
	$	3,023	$	3,964
Payments and settlements during the period (1)	$	18,386	$	33,362

(1) Payments and settlements include payments for management fees and correspondent lending activities itemized in the preceding tables and netting settlements made pursuant to master netting agreements between the Company and PMT.

Amounts due from PMT are summarized below:

	March 31, 2014		December 31, 2013	
	(in thousands)			
Servicing fees	$	8,222	$	5,915
Management fees		8,074		8,924
Allocated expenses		2,764		2,009
Underwriting fees		1,752		1,788
	$	20,812	$	18,636

The Company also holds an investment in PMT in the form of 75,000 common shares of beneficial interest as of March 31, 2014 and December 31, 2013. The shares had fair values of $1.8 million and $1.7 million as of March 31, 2014 and December 31, 2013, respectively.

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Investment Funds

Amounts due from the Investment Funds are summarized below:

	March 31, 2014	December 31, 2013
	(in thousands)	
Receivable from Investment Funds:		
Management fees	$ 2,035	$ 2,031
Loan servicing fees	837	727
Loan servicing rebate	148	136
Expense reimbursements	42	21
	$ 3,062	$ 2,915
Carried Interest due from Investment Funds:		
PNMAC Mortgage Opportunity Fund, LLC	$ 38,838	$ 37,702
PNMAC Mortgage Opportunity Fund Investors, LLC	24,461	23,440
	$ 63,299	$ 61,142

Amounts due to the Investment Funds totaling $37.1 million and $36.9 million represent amounts advanced by the Investment Funds to fund servicing advances made by the Company as of March 31, 2014 and December 31, 2013, respectively.

Exchanged Private National Mortgage Acceptance Company, LLC Unitholders

As discussed in Note 1, the Company entered into a tax receivable agreement with PennyMac s existing unitholders on the date of the IPO that will provide for the payment by PFSI to PennyMac s exchanged unitholders an amount equal to 85% of the amount of the benefits, if any, that PFSI is deemed to realize as a result of (i) increases in tax basis resulting from such unitholders exchanges and (ii) certain other tax benefits related to entering into the tax receivable agreement, including tax benefits attributable to payments under the tax receivable agreement. Based on the PennyMac unitholder exchanges to date, the Company has recorded a $71.7 million liability and it has not made a payment under the tax sharing agreement as of March 31, 2014.

Note 4 Earnings Per Share of Common Stock

Basic earnings per share of common stock is determined using net income attributable to the Company s common stockholders divided by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share of common stock is determined by dividing net income attributable to the Company s common stockholders by the weighted average of shares of common stock outstanding, assuming all potentially dilutive shares of common stock were issued.

The Company applies the treasury stock method to determine the dilutive weighted average shares of common stock represented by the unvested stock based awards and the exchangeable PennyMac Class A units. The diluted earnings per share calculation assumes the exchange of these PennyMac Class A units for shares of common stock. Accordingly, earnings attributable to the Company s common stockholders is also adjusted to include the earnings allocated to the PennyMac Class A units after taking into account the income taxes applicable to the shares of common stock assumed to be exchanged.

The Company did not disclose March 31, 2013 earnings per share amounts as the Company was not publicly traded.

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The following table summarizes the basic and diluted earnings per share calculations:

		Quarter ended March 31, 2014 (in thousands, except per share amounts)
Basic earnings per share of common stock:		
Net income attributable to PennyMac Financial Services, Inc. common stockholders	$	7,972
Weighted-average common stock outstanding		20,866
Basic earnings per share of common stock:	$	0.38
Diluted earnings per share of common stock:		
Net income	$	7,972
Effect of net income attributable to noncontrolling interest, net of tax		21,010
Diluted net income attributable to common stockholders	$	28,982
Weighted-average common stock outstanding		20,866
Dilutive shares:		
PennyMac Class A units exchangeable to common stock		55,051
Shares issuable under stock-based compensation plans		35
Diluted weighted-average common stock outstanding		75,952
Diluted earnings per share of common stock	$	0.38

Note 5 Loan Sales and Servicing Activities

The Company purchases and sells mortgage loans in the secondary mortgage market without recourse for credit losses. However, the Company maintains continuing involvement with the loans in the form of servicing arrangements and the liability under representations and warranties it makes to purchasers and insurers of the loans.

The following table summarizes cash flows between the Company and transferees upon sale of mortgage loans in transactions where the Company maintains continuing involvement with the mortgage loans (primarily the obligation to service the loans on behalf of the loans owners or owners agents):

	Quarter ended March 31,			
		2014		2013
	(in thousands)			
Cash flows:				
Sales proceeds	$	3,298,915	$	4,045,610
Servicing fees received	$	22,184	$	9,299
Net servicing advances	$	(608)	$	(3,736)
Period end information:				
Unpaid principal balance (UPB) of loans outstanding at end of period	$	26,289,208	$	12,485,598
Delinquencies:				
30-89 days	$	362,131	$	119,433
90 days or more or in foreclosure or bankruptcy	$	176,608	$	36,566

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The Company s mortgage servicing portfolio is summarized as follows:

	March 31, 2014		
	Servicing rights owned	Contract servicing and subservicing	Total loans serviced
		(in thousands)	
Agencies	$ 49,201,662	$	$ 49,201,662
Affiliated entities		33,072,540	33,072,540
Private investors	907,981	936	908,917
Mortgage loans held for sale	660,470		660,470
	$ 50,770,113	$ 33,073,476	$ 83,843,589
Amount subserviced for the Company	$ 2,214,554	$ 415,435	$ 2,629,989
Delinquent mortgage loans:			
30 days	$ 872,052	$ 246,218	$ 1,118,270
60 days	407,057	114,867	521,924
90 days or more	1,085,662	1,337,631	2,423,293
	2,364,771	1,698,716	4,063,487
Loans pending foreclosure	187,876	1,861,167	2,049,043
	$ 2,552,647	$ 3,559,883	$ 6,112,530
Custodial funds managed by the Company (1)	$ 654,098	$ 281,921	$ 936,019

	December 31, 2013		
	Servicing rights owned	Contract servicing and subservicing	Total loans serviced
		(in thousands)	
Agencies	$ 44,969,026	$	$ 44,969,026
Affiliated entities		31,632,718	31,632,718
Private investors	969,794	89,361	1,059,155
Mortgage loans held for sale	506,540		506,540
	$ 46,445,360	$ 31,722,079	$ 78,167,439
Amount subserviced for the Company	$ 156,347	$ 582,610	$ 738,957
Delinquent mortgage loans:			
30 days	$ 1,304,054	$ 263,518	$ 1,567,572
60 days	346,912	112,275	459,187
90 days or more	605,555	1,416,498	2,022,053
	2,256,521	1,792,291	4,048,812
Loans pending foreclosure	168,776	1,792,128	1,960,904
	$ 2,425,297	$ 3,584,419	$ 6,009,716
Custodial funds managed by the Company (1)	$ 568,161	$ 246,587	$ 814,748

(1) Borrower and investor custodial cash accounts relate to loans serviced under the servicing agreements and are not recorded on the Company s consolidated balance sheets. The Company earns interest on custodial funds it manages on behalf of the loans investors, which is recorded as part of the interest income in the Company s consolidated statements of income.

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Following is a summary of the geographical distribution of loans included in the Company s servicing portfolio for the top five and all other states as measured by the total UPB:

State	March 31, 2014	December 31, 2013
	(in thousands)	
California	$ 30,959,910	$ 30,320,616
Texas	4,801,408	4,470,123
Virginia	4,300,935	3,769,683
Florida	3,810,018	3,416,274
Washington	3,096,898	2,760,900
All other states	36,874,420	33,429,843
	$ 83,843,589	$ 78,167,439

Certain of the loans serviced by the Company are subserviced on the Company s behalf by other mortgage loan servicers. Loans are subserviced for the Company on a transitional basis for loans where the Company has obtained the rights to service the loans but servicing of the loans has not yet transferred to the Company s servicing system.

Note 6 Netting of Financial Instruments

The Company uses derivative financial instruments to manage exposure to interest rate risk for the interest rate lock commitments (IRLCs) it makes to purchase or originate mortgage loans at specified interest rates, its inventory of mortgage loans held for sale and mortgage servicing rights (MSRs). The Company has elected to net derivative asset and liability positions, and cash collateral obtained from (or posted to) its counterparties when subject to a master netting arrangement that is legally enforceable on all counterparties in the event of default. The derivatives that are not subject to a master netting arrangement are IRLCs.

Following are summaries of derivative assets and related set off amounts.

Offsetting of Derivative Assets

	March 31, 2014			December 31, 2013		
	Gross amount of recognized assets	Gross amount offset in the balance sheet	Net amount of assets in the balance sheet	Gross amount of recognized assets	Gross amount offset in the balance sheet	Net amount of assets in the balance sheet
	(in thousands)					
Derivatives subject to master netting arrangements:						
MBS put options	$ 434	$	$ 434	$ 665	$	$ 665
MBS call options	328		328	91		91

Forward purchase contracts	1,942		1,942	416		416
Forward sale contracts	5,008		5,008	18,762		18,762
Put options on Eurodollar futures	277		277			
Call options on Eurodollar futures	62		62			
Netting		(2,707)	(2,707)		(7,358)	(7,358)
	8,051	(2,707)	5,344	19,934	(7,358)	12,576
Derivatives not subject to master netting arrangements - IRLCs	16,333		16,333	8,964		8,964
	$ 24,384	$ (2,707)	$ 21,677	$ 28,898	$ (7,358)	$ 21,540

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Derivative Assets, Financial Assets, and Collateral Held by Counterparty

The following table summarizes by significant counterparty the amount of derivative asset positions after considering master netting arrangements and financial instruments or cash pledged that do not meet the accounting guidance qualifying for netting.

	March 31, 2014				December 31, 2013			
		Gross amount not offset in the consolidated balance sheet				Gross amount not offset in the consolidated balance sheet		
	Net amount of assets in the balance sheet	Financial instruments	Cash collateral received	Net amount	Net amount of assets in the balance sheet	Financial instruments	Cash collateral received	Net amount
	(in thousands)							
Interest rate lock commitments	$ 16,333	$	$	$ 16,333	$ 8,964	$	$	$ 8,964
Citibank, N.A.	1,330			1,330				
Bank of America, N.A.	880			880	1,680			1,680
Goldman Sachs	781			781	16			16
Daiwa Capital Markets	494			494	1,190			1,190
Credit Suisse First Boston Mortgage Capital LLC	321			321	2,149			2,149
Morgan Stanley Bank, N.A.	157			157	1,704			1,704
Others	1,381			1,381	5,837			5,837
	$ 21,677	$	$	$ 21,677	$ 21,540	$	$	$ 21,540

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Offsetting of Derivative Liabilities and Financial Liabilities

Following is a summary of net derivative liabilities and assets sold under agreements to repurchase and related set off amounts. As discussed above, all derivatives with the exception of IRLCs are subject to master netting arrangements. The assets sold under agreements to repurchase do not qualify for netting.

	March 31, 2014			December 31, 2013		
	Gross amount of recognized liabilities	Gross amount offset in the consolidated balance sheet	Net amount of liabilities in the consolidated balance sheet	Gross amount of recognized liabilities	Gross amount offset in the consolidated balance sheet	Net amount of liabilities in the consolidated balance sheet
	(in thousands)					
Derivatives subject to a master netting arrangement:						
Forward purchase contracts	$ 2,392	$	$ 2,392	$ 6,542	$	$ 6,542
Forward sale contracts	2,327		2,327	504		504
Netting		(4,600)	(4,600)		(6,787)	(6,787