PENNYMAC FINANCIAL SERVICES, INC.
Form 10-Q
August 02, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2018

Or

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 (State or other jurisdiction of incorporation or organization)	80-0882793 (IRS Employer Identification No.)

3043 Townsgate Road, Westlake Village, California (Address of principal executive offices)	91361 (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 No

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 No

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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 July 31, 2018
Class A Common Stock, $0.0001 par value	25,101,553
Class B Common Stock, $0.0001 par value	45

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PENNYMAC FINANCIAL SERVICES, INC.

FORM 10-Q

June 30, 2018

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SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q (“Report”) contains certain forward looking statements that are subject to various risks and uncertainties. Forward looking statements are generally identifiable by use of forward looking terminology such as “may,” “will,” “should,” “potential,” “intend,” “expect,” “seek,” “anticipate,” “estimate,” “approximately,” “believe,” “ “predict,” “continue,” “plan” or other similar words or expressions.

Forward looking statements are based on certain assumptions, discuss future expectations, describe future plans and strategies, contain financial and operating projections or state other forward looking information. Examples of forward looking statements include the following:

- projections of our revenues, income, earnings per share, capital structure or other financial items;
- descriptions of our plans or objectives for future operations, products or services;
- forecasts of our future economic performance, interest rates, profit margins and our share of future markets; and
- descriptions of assumptions underlying or relating to any of the foregoing expectations regarding the timing of generating any revenues.

Our ability to predict results or the actual effect of future events, actions, plans or strategies is inherently uncertain. Although we believe that the expectations reflected in such forward looking statements are based on reasonable assumptions, our actual results and performance could differ materially from those set forth in the forward looking statements. There are a number of factors, many of which are beyond our control that could cause actual results to differ significantly from management’s expectations. Some of these factors are discussed below.

You should not place undue reliance on any forward looking statement and should consider the following uncertainties and risks, as well as the risks and uncertainties discussed elsewhere in this Report and the section entitled “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2017, filed with the Securities and Exchange Commission (“SEC”) on March 9, 2018.

Factors that could cause actual results to differ materially from historical results or those anticipated include, but are not limited to:

- the continually changing federal, state and local laws and regulations applicable to the highly regulated industry in which we operate;

- lawsuits or governmental actions if we do not comply with the laws and regulations applicable to our businesses;

- the mortgage lending and servicing-related regulations promulgated by the Consumer Financial Protection Bureau ("CFPB") and its enforcement of these regulations;

- our dependence on U.S. government sponsored entities and changes in their current roles or their guarantees or guidelines;

- changes to government mortgage modification programs;

- certain banking regulations that may limit our business activities;

- foreclosure delays and changes in foreclosure practices;

- the licensing and operational requirements of states and other jurisdictions applicable to our businesses, to which our bank competitors are not subject;

- changes in macroeconomic and U.S. real estate market conditions;

- difficulties inherent in growing loan production volume;

- difficulties inherent in adjusting the size of our operations to reflect changes in business levels;

- any required additional capital and liquidity to support business growth that may not be available on acceptable terms, if at all;
- changes in prevailing interest rates;
- increases in loan delinquencies and defaults;
- our dependence on the success of the multifamily market for future originations of commercial mortgage loans and other commercial real estate-related loans;
- our reliance on PennyMac Mortgage Investment Trust ("PMT") as a significant source of financing for, and revenue related to, our mortgage banking business;
- our obligation to indemnify third party purchasers or repurchase loans if loans that we originate, acquire, service or assist in the fulfillment of, fail to meet certain criteria or characteristics or under other circumstances;
- our ability to realize the anticipated benefit of potential future acquisitions of mortgage servicing rights ("MSRs");
- our obligation to indemnify PMT and the Investment Funds if our services fail to meet certain criteria or characteristics or under other circumstances;
- decreases in the returns on the assets that we select and manage for our clients, and our resulting management and incentive fees;
- the extensive amount of regulation applicable to our investment management segment;
- conflicts of interest in allocating our services and investment opportunities among ourselves and our Advised Entities;
- the effect of public opinion on our reputation;
- our recent growth;
- our ability to effectively identify, manage, monitor and mitigate financial risks;

- our initiation of new business activities or expansion of existing business activities;
- our ability to detect misconduct and fraud;
- our ability to mitigate cybersecurity risks and cyber incidents;
- our exposure to risks of loss resulting from adverse weather conditions and man-made or natural disasters; and
- our organizational structure and certain requirements in our charter documents.

Other factors that could also cause results to differ from our expectations may not be described in this Report or any other document. Each of these factors could by itself, or together with one or more other factors, adversely affect our business, results of operations and/or financial condition.

Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update any forward-looking statement to reflect the impact of circumstances or events that arise after the date the forward-looking statement was made.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	June 30, 2018	December 31, 2017
	(in thousands, except share amounts)	
ASSETS		
Cash (includes $152,382 and $20,765 pledged to creditors)	$ 189,663	$ 37,725
Short-term investments at fair value	98,571	170,080
Mortgage loans held for sale at fair value (includes $2,498,583 and $3,081,987 pledged to creditors)	2,527,231	3,099,103
Derivative assets	92,471	78,179
Servicing advances, net (includes valuation allowance of $61,825 and $59,958; $94,715 and $114,643 pledged to creditors)	258,900	318,066
Carried Interest due from Investment Funds pledged to creditors	370	8,552
Investment in PennyMac Mortgage Investment Trust at fair value	1,424	1,205
Mortgage servicing rights (includes $2,486,157 and $638,010 at fair value; $2,333,750 and $2,098,067 pledged to creditors)	2,486,157	2,119,588
Real estate acquired in settlement of loans	2,300	2,447
Furniture, fixtures, equipment and building improvements, net (includes $20,656 and $23,915 pledged to creditors)	29,607	29,453
Capitalized software, net (includes $1,347 and $1,568 pledged to creditors)	31,913	25,729
Assets purchased from PennyMac Mortgage Investment Trust under agreements to resell pledged to creditors	138,582	144,128
Receivable from PennyMac Mortgage Investment Trust	19,661	27,119
Receivable from Investment Funds	12	417
Mortgage loans eligible for repurchase	879,621	1,208,195
Other	85,223	98,107
Total assets	$ 6,841,706	$ 7,368,093
LIABILITIES		
Assets sold under agreements to repurchase	$ 1,825,813	$ 2,381,538
Mortgage loan participation purchase and sale agreements	528,368	527,395
Notes payable	1,140,546	891,505
Obligations under capital lease	13,032	20,971
Excess servicing spread financing payable to PennyMac Mortgage Investment Trust at fair value	229,470	236,534
Derivative liabilities	4,094	5,796
Accounts payable and accrued expenses	114,005	106,716
Mortgage servicing liabilities at fair value	10,253	14,120
Payable to Investment Funds	404	2,427
Payable to PennyMac Mortgage Investment Trust	99,309	136,998

Payable to exchanged Private National Mortgage Acceptance Company, LLC unitholders under tax receivable agreement	46,903	44,011
Income taxes payable	67,357	52,160
Liability for mortgage loans eligible for repurchase	879,621	1,208,195
Liability for losses under representations and warranties	20,587	20,053
Total liabilities	4,979,762	5,648,419
Commitments and contingencies – Note 14		
STOCKHOLDERS' EQUITY		
Class A common stock—authorized 200,000,000 shares of $0.0001 par value; issued and outstanding, 25,008,655 and 23,529,970 shares, respectively	3	2
Class B common stock—authorized 1,000 shares of $0.0001 par value; issued and outstanding, 45 and 46 shares, respectively	—	—
Additional paid-in capital	229,941	204,103
Retained earnings	299,951	265,306
Total stockholders' equity attributable to PennyMac Financial Services, Inc. common stockholders	529,895	469,411
Noncontrolling interest in Private National Mortgage Acceptance Company, LLC	1,332,049	1,250,263
Total stockholders' equity	1,861,944	1,719,674
Total liabilities and stockholders' equity	$ 6,841,706	$ 7,368,093

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

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PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Quarter ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
	(in thousands, except earnings per share)			
Revenues				
Net gains on mortgage loans held for sale at fair value:				
From non-affiliates	$ 46,019	$ 99,597	$ 105,047	$ 188,248
From PennyMac Mortgage Investment Trust	14,927	(1,506)	27,313	(3,201)
	60,946	98,091	132,360	185,047
Mortgage loan origination fees:				
From non-affiliates	22,886	28,303	46,241	52,498
From PennyMac Mortgage Investment Trust	1,542	1,890	2,750	3,269
	24,428	30,193	48,991	55,767
Fulfillment fees from PennyMac Mortgage Investment Trust	14,559	21,107	26,503	37,677
Net mortgage loan servicing fees:				
Mortgage loan servicing fees:				
From non-affiliates	138,871	112,348	274,354	218,815
From PennyMac Mortgage Investment Trust	9,431	10,099	20,450	20,585
From Investment Funds	3	543	3	1,039
Ancillary and other fees	13,637	11,202	27,808	23,068
	161,942	134,192	322,615	263,507
Amortization, impairment and change in fair value of mortgage servicing rights and mortgage servicing liabilities	(47,257)	(94,435)	(84,220)	(152,360)
Change in fair value of excess servicing spread payable to PennyMac Mortgage Investment Trust	(996)	7,156	(7,917)	9,929
	(48,253)	(87,279)	(92,137)	(142,431)
Net mortgage loan servicing fees	113,689	46,913	230,478	121,076
Management fees, net:				
From PennyMac Mortgage Investment Trust	5,728	5,638	11,424	10,646
From Investment Funds	(64)	369	15	735
	5,664	6,007	11,439	11,381
Carried Interest from Investment Funds	(168)	241	(348)	113
Net interest income (expense):				
Interest income:				
From non-affiliates	53,206	32,948	93,845	55,002
From PennyMac Mortgage Investment Trust	1,898	2,025	3,874	3,830
	55,104	34,973	97,719	58,832
Interest expense:				
To non-affiliates	28,706	32,511	61,517	57,338
To PennyMac Mortgage Investment Trust	3,910	4,366	7,844	9,013
	32,616	36,877	69,361	66,351
Net interest income (expense)	22,488	(1,904)	28,358	(7,519)
	108	76	290	215

Change in fair value of investment in and dividends received from PennyMac Mortgage Investment Trust				
Results of real estate acquired in settlement of loans	13	(119)	(15)	(144)
Other	2,571	1,116	4,443	2,581
Total net revenues	244,298	201,721	482,499	406,194
Expenses				
Compensation	98,540	82,967	200,553	168,207
Servicing	28,490	24,702	54,789	51,545
Technology	15,154	11,581	29,774	22,937
Occupancy and equipment	6,507	5,965	12,884	11,007
Professional services	5,587	4,523	11,325	8,341
Loan origination	5,144	5,116	7,259	9,249
Marketing	2,218	2,483	4,379	4,219
Other	7,960	6,424	13,842	10,697
Total expenses	169,600	143,761	334,805	286,202
Income before provision for income taxes	74,698	57,960	147,694	119,992
Provision for income taxes	6,293	7,214	12,363	14,860
Net income	68,405	50,746	135,331	105,132
Less: Net income attributable to noncontrolling interest	50,568	40,267	100,875	83,774
Net income attributable to PennyMac Financial Services, Inc. common stockholders	$ 17,837	$ 10,479	$ 34,456	$ 21,358
Earnings per share				
Basic	$ 0.71	$ 0.45	$ 1.41	$ 0.93
Diluted	$ 0.70	$ 0.44	$ 1.38	$ 0.91
Weighted average shares outstanding				
Basic	24,959	23,388	24,399	23,006
Diluted	78,825	77,650	78,947	77,641

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

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PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (UNAUDITED)

	Class A Common Stock				Noncontrolling interest in Private National Mortgage	Total
	Number of shares (in thousands)	Par value	Additional paid-in capital	Retained earnings	Acceptance Company, LLC	stockholders' equity
Balance at December 31, 2016	22,427	$ 2	$ 182,772	$ 164,549	$ 1,052,033	$ 1,399,356
Net income	—	—	—	21,358	83,774	105,132
Stock and unit-based compensation	—	—	3,450	—	7,256	10,706
Issuance of Class A common stock in settlement of directors' fees	—	—	108	—	61	169
Exchange of Class A units of Private National Mortgage Acceptance Company, LLC to Class A common stock of PennyMac Financial Services, Inc.	1,046	—	16,927	—	(16,927)	—
Tax effect of exchange of Class A units of Private National Mortgage Acceptance Company, LLC to Class A common stock of PennyMac Financial Services, Inc.	—	—	(4,111)	—	—	(4,111)
Balance at June 30, 2017	23,473	$ 2	$ 199,146	$ 185,907	$ 1,126,197	$ 1,511,252
Balance at December 31, 2017	23,530	$ 2	$ 204,103	$ 265,306	$ 1,250,263	$ 1,719,674
Cumulative effect of change in accounting principle – accounting for all existing classes of mortgage servicing rights at fair value	—	—	—	189	587	776
Balance at January 1, 2018	23,530	2	204,103	265,495	1,250,850	1,720,450
Net income	—	—	—	34,456	100,875	135,331
Stock and unit-based compensation	230	—	7,728	—	8,340	16,068
Issuance of Class A common stock in settlement of directors' fees	—	—	51	—	109	160

Repurchase of Class A common stock	(236)	—	(4,826)	—	—	(4,826)
Exchange of Class A units of Private National Mortgage Acceptance Company, LLC to Class A common stock of PennyMac Financial Services, Inc. by noncontrolling interest unitholders and issued as equity compensation	1,485	1	28,124	—	(28,125)	—
Tax effect of exchange and repurchases of Class A units of Private National Mortgage Acceptance Company, LLC to Class A common stock of PennyMac Financial Services, Inc., net	—	—	(5,239)	—	—	(5,239)
Balance at June 30, 2018	25,009	$ 3	$ 229,941	$ 299,951	$ 1,332,049	$ 1,861,944

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

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PENNYMAC FINANCIAL SERVICES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Six months ended June 30,	
	2018	2017
	(in thousands)	
Cash flow from operating activities		
Net income	$ 135,331	$ 105,132
Adjustments to reconcile net income to net cash used in operating activities:		
Net gains on mortgage loans held for sale at fair value	(132,360)	(185,047)
Accrual of servicing rebate payable to Investment Funds	—	100
Amortization, impairment and change in fair value of mortgage servicing rights, mortgage servicing liabilities and excess servicing spread	92,137	142,431
Carried Interest from Investment Funds	348	(113)
Capitalization of interest on mortgage loans held for sale at fair value	(39,390)	(21,615)
Accrual of interest on excess servicing spread financing	7,844	9,013
Amortization of premiums and debt issuance costs	(13,385)	7,122
Change in fair value of investment in common shares of PennyMac Mortgage Investment Trust	(219)	(144)
Results of real estate acquired in settlement in loans	15	144
Stock-based compensation expense	12,235	10,390
Provision for servicing advance losses	12,097	18,030
Loss from disposition of fixed assets and impairment of capitalized software	—	377
Depreciation and amortization	5,647	4,117
Purchase of mortgage loans held for sale from PennyMac Mortgage Investment Trust	(19,267,316)	(21,244,194)
Originations of mortgage loans held for sale	(2,518,992)	(2,353,899)
Purchase of mortgage loans from Ginnie Mae securities and early buyout investors for modification and subsequent sale	(2,002,582)	(1,814,080)
Sale and principal payments of mortgage loans held for sale to non-affiliates	22,832,809	24,497,179
Sale of mortgage loans held for sale to PennyMac Mortgage Investment Trust	1,427,637	40,222
Repurchase of mortgage loans subject to representations and warranties	(12,974)	(11,520)
Settlement of repurchase agreeement derivatives	7,478	—
Decrease in servicing advances	47,980	38,821
Collection of Carried Interest	7,834	—
Sale of real estate acquired in settlement of loans	2,130	—
Decrease (increase) in receivable from PennyMac Mortgage Investment Trust	5,873	(1,092)
Decrease (increase) in receivable from Investment Funds	405	(211)
Decrease (increase) in other assets	7,792	(29,492)
Increase (decrease) in accounts payable and accrued expenses	5,349	(30,395)
Decrease in payable to Investment Funds	(2,023)	(5,157)
Decrease in payable to PennyMac Mortgage Investment Trust	(38,580)	(37,650)
Payments to exchanged Private National Mortgage Acceptance Company, LLC unitholders under tax receivable agreement	—	(6,221)
Increase in income taxes payable	12,778	14,824

Net cash provided by (used in) operating activities	595,898	(852,928)
Cash flow from investing activities		
Decrease (increase) in short-term investments	71,509	(59,476)
Net settlement of derivative financial instruments used for hedging	(126,918)	(30,949)
Purchase of mortgage servicing rights	(30,129)	(159,465)
Purchase of furniture, fixtures, equipment and leasehold improvements	(4,321)	(4,668)
Acquisition of capitalized software	(7,664)	(7,719)
Net change in assets purchased from PMT under agreement to resell	5,546	—
Increase in margin deposits	(3,774)	(12,071)
Net cash used in investing activities	(95,751)	(274,348)
Cash flow from financing activities		
Sale of assets under agreements to repurchase	20,763,584	13,332,610
Repurchase of assets sold under agreements to repurchase	(21,319,387)	(12,046,244)
Issuance of mortgage loan participation certificates	12,486,542	10,491,796
Repayment of mortgage loan participation certificates	(12,485,880)	(10,919,650)
Advances on notes payable	650,000	435,000
Repayment of notes payable	(400,000)	(153,073)
Advances of obligations under capital lease	—	10,298
Repayment of obligations under capital lease	(7,939)	(7,081)
Repayment of excess servicing spread financing	(24,309)	(28,910)
Payment of debt issuance costs	(9,788)	(11,059)
Issuance of common stock pursuant to exercise of stock options	3,833	316
Repurchase of common stock	(4,826)	—
Net cash (used in) provided by financing activities	(348,170)	1,104,003
Net increase (decrease) in cash and restricted cash	151,977	(23,273)
Cash and restricted cash at beginning of period	38,173	99,642
Cash and restricted cash at end of period	$ 190,150	$ 76,369
Cash and restricted cash at end of period are comprised of the following:		
Cash	$ 189,663	$ 75,978
Restricted cash included in Other assets	487	391
	$ 190,150	$ 76,369

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

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PENNYMAC FINANCIAL SERVICES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1—Organization

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 consolidates the financial results of PennyMac and its 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 loan production and mortgage loan servicing. PennyMac's investment management activities and a portion of its mortgage 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 a management agreement with PennyMac Mortgage Investment Trust ("PMT"), a publicly held real estate investment trust ("REIT"). Previously, PCM had management agreements with PNMAC Mortgage Opportunity Fund, LLC (the "Registered Fund") and PNMAC Mortgage Opportunity Fund, L.P. (the "Master Fund"), both formerly registered under the Investment Company Act of 1940, as amended, an affiliate of these registered funds, and PNMAC Mortgage Opportunity Fund Investors, LLC (the Private Fund") (collectively, the "Investment Funds"). Together, the Investment Funds and PMT are referred to as the "Advised Entities." In 2017 and through the six months ended June 30, 2018, the Investment Funds sold or liquidated all of their remaining investments. The Registered Fund and the Master Fund obtained orders of de-registration on July 25, 2018, and the management agreements with the Registered Fund, the Master Fund and the Private Fund expired or were otherwise terminated on or before August 2, 2018. PCM expects to complete liquidation of the Investment Funds during 2018.

· PennyMac Loan Services, LLC ("PLS") — a Delaware limited liability company that services portfolios of residential mortgage loans on behalf of non-affiliates and PMT, purchases, originates and sells 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”) and U.S. Department of Agriculture (“USDA”) (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.

Note 2—Basis of Presentation and Accounting Changes

Basis of Presentation

The accompanying consolidated financial statements have been prepared in compliance with accounting principles generally accepted in the United States ("GAAP") as codified in the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") 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 GAAP for complete financial statements. This interim consolidated information should be read together with the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

The accompanying unaudited consolidated financial statements reflect all normal recurring adjustments necessary to present fairly the financial position, income, and cash flows for the interim periods, but are not necessarily indicative of income to be anticipated for the full year ending December 31, 2018. Intercompany accounts and transactions have been eliminated.

Preparation of financial statements in compliance with GAAP requires management to make judgments and estimates that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and revenues and expenses during the reporting period. Actual results will likely differ from those estimates.

Accounting Changes

During the six months ended June 30, 2018, the Company adopted changes to the accounting principles used in the preparation of its financial statements summarized below.

Mortgage Servicing Rights

Effective January 1, 2018, the Company has elected to change the accounting for the classes of mortgage servicing rights ("MSRs") it had accounted for using the amortization method through December 31, 2017, to the fair value method as allowed in the Transfers and Servicing topic of the FASB's ASC. The Company determined that a single accounting treatment across all MSRs is consistent with lender valuation under its financing arrangements and simplifies the Company's hedging activities. As the result of this change, the Company recorded an adjustment to increase its investment in MSRs by $848,000, an increase in its liability for income taxes payable of $72,000 and in increase in stockholders' equity of $776,000.

Revenue Recognition

In May 2014, the FASB issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers (Subtopic 606) ("ASU 2014-09"), which supersedes the guidance in the Revenue Recognition topic of the ASC. Effective January 1, 2018, the Company adopted ASU 2014-09 as amended using the modified retrospective method. The adoption of ASU 2014-09 did not require the Company to record a cumulative effect adjustment to its beginning retained earnings.

The Company's revenues from contracts with customers that are subject to ASU 2014-09 include fulfillment fees, management fees, Carried Interest and certain reimbursed overhead costs. Other revenue and income streams are not subject to ASU 2014-09 as they are financial instruments or other contractual rights and obligations accounted for under the Receivables, Investments and Debt and Equity Securities, Transfers and Servicing, Financial Instruments and Derivatives and Hedging topics of the ASC.

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Fulfillment Fees

Fulfillment fees represent fees the Company collects for services it performs on behalf of PMT in connection with the acquisition, packaging and sale of mortgage loans. Fulfillment fee amounts are based upon a negotiated fee schedule and the unpaid principal balance of the mortgage loans purchased by PMT. The Company's obligation under the agreement is fulfilled when PMT completes the sale or securitization of a mortgage loan it purchases. Fulfillment fees are generally collected within 30 days of purchase by PMT, although a portion of the fulfillment fees may not be collected until 30 days following sale or securitization to the extent such sale or securitization does not occur in the month of purchase. Fulfillment fee revenue is recognized in the month the fee is earned. Fulfillment fees receivable contract assets are disclosed in Note 4—Transactions with Affiliates.

Management fees

Management fees represent compensation to the Company for its management services provided to the Advised Entities. Management fees are earned based on the Investment Funds' net assets and PMT's shareholders' equity amounts and profitability in excess of specified thresholds, and are recognized as services are provided and are paid to the Company on a quarterly basis within 30 days of the end of the quarter. Management fees receivable contract assets are disclosed in Note 4—Transactions with Affiliates.

Carried Interest

The Company's Carried Interest arrangements with the Investment Funds represent capital allocations to the Company. As a result, the Company has concluded as part of its assessment of the effect of the adoption of ASU 2014-09 that its Carried Interest represents an equity method investment subject to the Investments – Equity Method and Joint Ventures topic of the ASC. Therefore, effective January 1, 2018, the Company recharacterized its Carried Interest as financial instruments under the equity method of accounting. Carried Interest balances are disclosed in Note 9—Carried Interest Due from Investment Funds.

Expense reimbursements

Under the Company's management agreement with PMT, PMT is required to pay its pro rata portion of rent, telephone, utilities, office furniture, equipment, machinery and other office, internal and overhead expenses of the Company and its affiliates required for PMT's and its subsidiaries' operations. These expenses are allocated based on the ratio of PMT's proportion of gross assets compared to all remaining gross assets managed by the Company as calculated at each fiscal quarter end. Before the adoption of ASU 2014-09, the Company accounted for such reimbursements as reductions to expenses. With the adoption of ASU 2014-09, the Company is required to include such expense reimbursements in its net revenues. As a result of the adoption of ASU 2014-09, certain overhead reimbursement amounts were reclassified from the following expense line items to Other revenue as summarized below:

Income statement line	Quarter ended June 30, 2018	Six months ended June 30, 2018
	(in thousands)	
Occupancy and equipment	$ 647	$ 1,236
Technology	302	522
Compensation	120	240
Other	227	419
Total expense reimbursements included in Other revenue	$ 1,296	$ 2,417

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Cash Flows

During the six months ended June 30, 2018, the Company adopted ASU 2016-18, Statement of Cash Flows (Topic 230) – Restricted Cash ("ASU 2016-18"). ASU 2016-18 requires that a statement of cash flows explain the change during the reporting period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the consolidated statement of cash flows. Accordingly, the Company retrospectively changed the presentation of its consolidated statements of cash flows to conform to the requirements of ASU 2016-18. For the purpose of reporting statement of cash flows, the Company has identified tenant security deposits relating to rental properties owned by PMT and managed by the Company as restricted cash. The tenant security deposits are included in Other asset on the Company's consolidated balance sheets. As the result of adoption of ASU 2016-18, the Company's consolidated statements of cash flows for the six months ended June 30, 2017 changed as follows:

	As previously reported	Effect of adoption of ASU 2016-18	As reported
	(in thousands)		
Cash flow from operating activities	$ (853,044)	$ 116	$ (852,928)
Cash and restricted cash at quarter end	$ 75,978	$ 391	$ 76,369

Note 3—Concentration of Risk

A substantial portion of the Company's activities relate to the Advised Entities. Revenues generated from these entities (generally comprised of gains on mortgage loans held for sale, mortgage loan origination fees, fulfillment fees, mortgage loan servicing fees, change in fair value of excess servicing spread financing ("ESS"), management fees, Carried Interest, net interest charged to these entities and change in fair value of investment and dividend received from PMT) totaled 18% and 21% of total net revenue for the quarters ended June 30, 2018 and 2017, respectively, and 16% and 19% for the six months ended June 30, 2018 and 2017, respectively.

Note 4—Transactions with Affiliates

Transactions with PMT

Operating Activities

Mortgage Loan Production Activities and Mortgage Servicing Rights (“MSR”) Recapture

The Company sells newly originated loans to PMT under a mortgage loan purchase agreement. Historically, the Company has used the mortgage loan purchase agreement for the purpose of selling to PMT prime jumbo residential mortgage loans. Beginning in the quarter ended September 30, 2017, the Company also sells non-government insured or guaranteed mortgage loans to PMT under the mortgage loan purchase agreement.

Pursuant to the terms of an amended and restated MSR recapture agreement, effective September 12, 2016, if the Company refinances mortgage loans for which PMT previously held the MSRs, the Company is generally required to transfer and convey cash in an amount equal to 30% of the fair market value of the MSRs related to all the mortgage loans so originated. The MSR recapture agreement expires, unless terminated earlier in accordance with the agreement, on September 12, 2020, subject to automatic renewal for additional 18-month periods, unless terminated earlier in accordance with the terms of the agreement.

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The Company provides fulfillment and other services to PMT under an amended and restated mortgage banking services agreement for which it receives a fulfillment fee. Pursuant to the terms of mortgage banking services agreement, the monthly fulfillment fee is an amount that shall equal (a) no greater than the product of (i) 0.35% and (ii) the aggregate initial unpaid principal balance (the "Initial UPB") of all mortgage loans purchased in such month, plus (b) in the case of all mortgage loans other than mortgage loans sold to or securitized through Fannie Mae or Freddie Mac, no greater than the product of (i) 0.50% and (ii) the aggregate Initial UPB of all such mortgage loans sold and securitized in such month; provided, however, that no fulfillment fee shall be due or payable to the Company with respect to any mortgage loans underwritten to the Ginnie Mae Mortgage Backed Securities ("MBS") Guide. PMT does not hold the Ginnie Mae approval required to issue Ginnie Mae MBS and act as a servicer. Accordingly, under the agreement, the Company currently purchases mortgage loans underwritten in accordance with the Ginnie Mae MBS Guide "as is" and without recourse of any kind from PMT at PMT's cost less an administrative fee plus accrued interest and a sourcing fee ranging from two to three and one-half basis points, generally based on the average number of calendar days mortgage loans are held by PMT before being purchased by the Company.

In consideration for the mortgage banking services provided by the Company with respect to PMT's acquisition of mortgage loans under the Company's early purchase program, the Company is entitled to fees accruing (i) at a rate equal to $1,500 per year per early purchase facility administered by the Company, and (ii) in the amount of $35 for each mortgage loan that PMT acquires thereunder. The mortgage banking services agreement expires, unless terminated earlier in accordance with the agreement, on September 12, 2020, subject to automatic renewal for additional 18-month periods.

Following is a summary of mortgage loan production activities and MSR recapture between the Company and PMT:

	Quarter ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
	(in thousands)			
Net gain (loss) on mortgage loans held for sale at fair value:				
Net gain on mortgage loans held for sale to PMT	$ 15,863	$ —	$ 29,674	$ —
Mortgage servicing rights and excess servicing spread recapture incurred	(936)	(1,506)	(2,361)	(3,201)
	$ 14,927	$ (1,506)	$ 27,313	$ (3,201)
Sale of mortgage loans held for sale to PMT	$ 646,311	$ 18,692	$ 1,427,637	$ 40,222
Fulfillment fee revenue	$ 14,559	$ 21,107	$ 26,503	$ 37,677
Unpaid principal balance of mortgage loans fulfilled for PMT subject to fulfillment fees	$ 5,396,370	$ 5,918,027	$ 9,622,001	$ 10,549,933
Sourcing fees paid to PMT	$ 2,891	$ 3,204	$ 5,532	$ 6,065
Unpaid principal balance of mortgage loans purchased from PMT	$ 9,639,495	$ 10,641,243	$ 18,487,368	$ 20,215,960

Tax service fees received from PMT included in Mortgage loan origination fees	$ 1,542	$ 1,890	$ 2,750	$ 3,269
Early purchase program fees earned from PMT included in Mortgage loan servicing fees	$ —	$ 1	$ —	$ 6

Mortgage Loan Servicing

The Company has a mortgage loan servicing agreement with PMT ("Servicing Agreement"). The Servicing Agreement provides for servicing fees of per loan monthly amounts based on the delinquency, bankruptcy and/or foreclosure status of the serviced mortgage loan or the real estate acquired in settlement of loans ("REO"). The Company also remains entitled to customary ancillary income and market-based fees and charges relating to mortgage loans it services for PMT. These include boarding and deboarding fees, liquidation and disposition fees, assumption, modification and origination fees and a percentage of late charges.

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- The base servicing fee rates for distressed whole mortgage loans range from $30 per month for current loans up to $85 per month for loans where the borrower has declared bankruptcy. The base servicing fee rate for REO is $75 per month.

- To the extent the Company facilitates rentals of PMT's REO under its REO rental program, the Company collects an REO rental fee of $30 per month per REO, an REO property lease renewal fee of $100 per lease renewal, and a property management fee in an amount equal to the Company’s cost if property management services and/or any related software costs are outsourced to a third-party property management firm or 9% of gross rental income if the Company provides property management services directly. The Company is also entitled to retain any tenant paid application fees and late rent fees and seek reimbursement for certain third-party vendor fees.

- Except as otherwise provided in the MSR recapture agreement, when the Company effects a refinancing of a mortgage loan on behalf of PMT and not through a third-party lender and the resulting mortgage loan is readily saleable, or the Company originates a loan to facilitate the disposition of a REO, the Company is entitled to receive from PMT market-based fees and compensation consistent with pricing and terms the Company offers unaffiliated parties on a retail basis.