

PHH CORP
Form 10-Q
March 30, 2007

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2006

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 No. 1-7797

PHH CORPORATION

(Exact name of registrant as specified in its charter)

MARYLAND

(State or other jurisdiction of incorporation or organization)

52-0551284

(I.R.S. Employer Identification Number)

3000 LEADENHALL ROAD
MT. LAUREL, NEW JERSEY
(Address of principal executive offices)

08054
(Zip Code)

856-917-1744

(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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act:

Large accelerated filer Accelerated filer Non-accelerated filer

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

As of March 15, 2007, 53,506,822 shares of common stock were outstanding.

TABLE OF CONTENTS

| Item | Description | Page |
|-----------------------|--|------|
| | <u>Explanatory Note</u> | 2 |
| | <u>Cautionary Note Regarding Forward-Looking Statements</u> | 2 |
| <u>PART I</u> | | |
| <u>1</u> | <u>Financial Statements</u> | 3 |
| <u>2</u> | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 47 |
| <u>3</u> | <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 81 |
| <u>4</u> | <u>Controls and Procedures</u> | 84 |
| <u>PART II</u> | | |
| <u>1</u> | <u>Legal Proceedings</u> | 88 |
| <u>1A</u> | <u>Risk Factors</u> | 88 |
| <u>2</u> | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 93 |
| <u>3</u> | <u>Defaults Upon Senior Securities</u> | 93 |
| <u>4</u> | <u>Submission of Matters to a Vote of Security Holders</u> | 93 |
| <u>5</u> | <u>Other Information</u> | 93 |
| <u>6</u> | <u>Exhibits</u> | 93 |
| | <u>Signatures</u> | 94 |
| | <u>Exhibit Index</u> | 95 |
| | <u>EX-31.1.1: CERTIFICATION</u> | |
| | <u>EX-31.1.2: CERTIFICATION</u> | |
| | <u>EX-32.1: CERTIFICATION</u> | |
| | <u>EX-32.2: CERTIFICATION</u> | |

Table of Contents

Except as expressly indicated or unless the context otherwise requires, the Company, PHH, we, our or us PHH Corporation, a Maryland corporation, and its subsidiaries. During 2006, our former parent company, Cendant Corporation, changed its name to Avis Budget Group, Inc. (see Note 18, Subsequent Events in the Notes to Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 (Form 10-Q)); however, within this Form 10-Q, PHH s former parent company, now known as Avis Budget Group, Inc. (NYSE: CAR) is referred to as Cendant.

EXPLANATORY NOTE

During the preparation of our Consolidated Financial Statements for the year ended December 31, 2005, we determined that it was necessary to restate previously issued financial statements to record adjustments for corrections of errors resulting from various accounting matters. As a result, all amounts as of June 30, 2005 and for the three and six months ended June 30, 2005 and comparisons to those amounts reflect the balances and amounts on a restated basis. Accordingly, some of the data set forth in this Form 10-Q is not comparable to the discussions and data in our previously filed Quarterly Report on Form 10-Q for the three months ended June 30, 2005. For additional information about the effects of the restatement adjustments on the Condensed Consolidated Financial Statements included in this Form 10-Q, see Note 15, Prior Period Adjustments in the Notes to Condensed Consolidated Financial Statements included herein. For additional information about the effects of the restatement adjustments on our Consolidated Financial Statements for the year ended December 31, 2005, see the Explanatory Note and Note 2, Prior Period Adjustments in the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2005 (the 2005 Form 10-K).

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are subject to known and unknown risks, uncertainties and other factors and were derived utilizing numerous important assumptions that may cause our actual results, performance or achievements to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. Investors are cautioned not to place undue reliance on these forward-looking statements.

Statements preceded by, followed by or that otherwise include the words believes, expects, anticipates, intends, projects, estimates, plans, may increase, may fluctuate and similar expressions or future or conditional verbs such as will, should, would, may and could are generally forward-looking in nature and are not historical. Forward-looking statements in this Form 10-Q include, but are not limited to, the following: (i) the beliefs regarding the increasing competition in the mortgage industry and the contraction of margins and volumes in the industry and our intention to take advantage of this environment by leveraging our existing mortgage origination services platform to enter into new outsourcing relationships; (ii) the expected level of savings in 2007 from cost-reducing initiatives implemented in our Mortgage Production and Mortgage Servicing segments; (iii) the expectation that any existing legal claims or proceedings other than the several class actions filed against us as discussed in this Form 10-Q will not have a material adverse effect on our financial position, results of operations or cash flows and our intent to vigorously defend against the several class actions filed against us as discussed in this Form 10-Q; (iv) the expectation that our agreements and arrangements with Cendant and Realogy Corporation (Realogy) will continue to be material to our business; (v) the expectation that our sources of liquidity are adequate to fund operations for the next twelve months; (vi) the expectations regarding the impact of the adoption of recently issued accounting pronouncements on our financial statements and (vii) the expectation that fees and expenses relating to the preparation of our financial results in 2007 will be significantly higher than historical fees and expenses.

The factors and assumptions discussed below and the risks and uncertainties described in Item 1A. Risk Factors could cause actual results to differ materially from those expressed in such forward-looking statements:

- § the material weaknesses that we identified in our internal control over financial reporting and the ineffectiveness of our disclosure controls and procedures;
- § the outcome of civil litigation pending against us, our Directors, Chief Executive Officer, and former Chief Financial Officer and whether our indemnification obligations for such Directors and executive officers will be covered by our Directors and officers insurance;
- § our ability to meet the extended deadlines for the delivery of our quarterly and annual financial statements under our waivers under financing agreements and, if not, our ability to obtain additional waivers under our

Edgar Filing: PHH CORP - Form 10-Q

financing agreements and to satisfy our obligations under certain of our contractual and regulatory requirements for the delivery of our quarterly and annual financial statements;

- § the effects of environmental, economic or political conditions on the international, national or regional economy, the outbreak or escalation of hostilities or terrorist attacks and the impact thereof on our businesses;
- § the effects of a decline in the volume or value of U.S. home sales, due to adverse economic changes or otherwise, on our mortgage services business;

Table of Contents

- § the effects of changes in current interest rates on our Mortgage Production and Mortgage Servicing segments and on our financing costs;
- § the effects of changes in spreads between mortgage rates and swap rates, option volatility and the shape of the yield curve, particularly on the performance of our risk management activities;
- § our ability to develop and implement operational, technological and financial systems to manage growing operations and to achieve enhanced earnings or effect cost savings;
- § the effects of competition in our existing and potential future lines of business, including the impact of competition with greater financial resources and broader product lines;
- § the impact of the proposed merger on our business and the price of our Common stock, including our ability to satisfy the conditions required to consummate the merger, the impact of the announcement of the merger on our business relationships and operating results and the impact of costs, fees and expenses related to the merger;
- § our ability to quickly reduce overhead and infrastructure costs in response to a reduction in revenue;
- § our ability to implement fully integrated disaster recovery technology solutions in the event of a disaster;
- § our ability to obtain financing on acceptable terms to finance our growth strategy, to operate within the limitations imposed by financing arrangements and to maintain our credit ratings;
- § our ability to establish and maintain a functional corporate structure and to operate as an independent organization;
- § our ability to implement changes to our internal control over financial reporting in order to remediate identified material weaknesses and other control deficiencies;
- § our ability to maintain our relationships with our existing clients;
- § a deterioration in the performance of assets held as collateral for secured borrowings, a downgrade in our credit ratings below investment grade or any failure to comply with certain financial covenants could negatively impact our access to the secondary market for mortgage loans and our ability to act as servicer for mortgage loans sold into the secondary market; and
- § changes in laws and regulations, including changes in accounting standards, mortgage- and real estate-related regulations and state, federal and foreign tax laws.

Other factors and assumptions not identified above were also involved in the derivation of these forward-looking statements, and the failure of such other assumptions to be realized as well as other factors may also cause actual results to differ materially from those projected. Most of these factors are difficult to predict accurately and are generally beyond our control.

The factors and assumptions discussed above may have an impact on the continued accuracy of any forward-looking statements that we make. Except for our ongoing obligations to disclose material information under the federal securities laws, we undertake no obligation to release publicly any revisions to any forward-looking statements, to report events or to report the occurrence of unanticipated events unless required by law. For any forward-looking statements contained in any document, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

PART I FINANCIAL INFORMATION

Item 1. *Financial Statements*

Table of Contents

PHH CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In millions, except per share data)

| | Three Months | | Six Months | |
|--|-----------------------|-----------------|-----------------------|-----------------|
| | Ended June 30, | | Ended June 30, | |
| | 2005 | | 2005 | |
| | As | | As | |
| | 2006 | Restated | 2006 | Restated |
| Revenues | | | | |
| Mortgage fees | \$ 35 | \$ 51 | \$ 65 | \$ 95 |
| Fleet management fees | 38 | 37 | 78 | 74 |
| Net fee income | 73 | 88 | 143 | 169 |
| Fleet lease income | 385 | 355 | 753 | 696 |
| Gain on sale of mortgage loans, net | 69 | 56 | 126 | 115 |
| Mortgage interest income | 94 | 71 | 170 | 122 |
| Mortgage interest expense | (69) | (46) | (129) | (88) |
| Mortgage net finance income | 25 | 25 | 41 | 34 |
| Loan servicing income | 124 | 117 | 254 | 241 |
| Amortization and provision for impairment of mortgage servicing rights | | (362) | | (352) |
| Change in fair value of mortgage servicing rights | (3) | | 65 | |
| Net derivative (loss) gain related to mortgage servicing rights | (106) | 279 | (286) | 251 |
| Amortization and valuation adjustments related to mortgage servicing rights, net | (109) | (83) | (221) | (101) |
| Net loan servicing income | 15 | 34 | 33 | 140 |
| Other income | 22 | 26 | 42 | 47 |
| Net revenues | 589 | 584 | 1,138 | 1,201 |
| Expenses | | | | |
| Salaries and related expenses | 89 | 105 | 176 | 199 |
| Occupancy and other office expenses | 20 | 19 | 40 | 39 |
| Depreciation on operating leases | 304 | 295 | 610 | 586 |
| Fleet interest expense | 49 | 31 | 92 | 62 |
| Other depreciation and amortization | 9 | 10 | 18 | 20 |
| Other operating expenses | 94 | 100 | 177 | 194 |

| | | | | |
|--|---------|---------|-----------|---------|
| Spin-Off related expenses | | | | 41 |
| Total expenses | 565 | 560 | 1,113 | 1,141 |
| Income from continuing operations before income taxes and minority interest | 24 | 24 | 25 | 60 |
| Provision for income taxes | 22 | 6 | 35 | 29 |
| Income (loss) from continuing operations before minority interest | 2 | 18 | (10) | 31 |
| Minority interest in income of consolidated entities, net of income taxes of \$(1) | 1 | | | |
| Income (loss) from continuing operations | 1 | 18 | (10) | 31 |
| Loss from discontinued operations, net of income taxes of \$0 | | | | (1) |
| Net income (loss) | \$ 1 | \$ 18 | \$ (10) | \$ 30 |
| Basic earnings (loss) per share: | | | | |
| Income (loss) from continuing operations | \$ 0.01 | \$ 0.34 | \$ (0.19) | \$ 0.59 |
| Loss from discontinued operations | | | | (0.02) |
| Net income (loss) | \$ 0.01 | \$ 0.34 | \$ (0.19) | \$ 0.57 |
| Diluted earnings (loss) per share: | | | | |
| Income (loss) from continuing operations | \$ 0.01 | \$ 0.34 | \$ (0.19) | \$ 0.58 |
| Loss from discontinued operations | | | | (0.02) |
| Net income (loss) | \$ 0.01 | \$ 0.34 | \$ (0.19) | \$ 0.56 |

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

PHH CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In millions, except share data)

| | June 30, 2006 | December 31, 2005 |
|---|--------------------------|----------------------------------|
| ASSETS | | |
| Cash and cash equivalents | \$ 106 | \$ 107 |
| Restricted cash | 649 | 497 |
| Mortgage loans held for sale, net | 2,761 | 2,395 |
| Accounts receivable, net | 464 | 471 |
| Net investment in fleet leases | 4,144 | 3,966 |
| Mortgage servicing rights, net | 2,192 | 1,909 |
| Investment securities | 37 | 41 |
| Property, plant and equipment, net | 69 | 73 |
| Goodwill | 86 | 87 |
| Other assets | 520 | 419 |
| Total assets | \$ 11,028 | \$ 9,965 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Accounts payable and accrued expenses | \$ 503 | \$ 565 |
| Debt | 7,677 | 6,744 |
| Deferred income taxes | 806 | 790 |
| Other liabilities | 490 | 314 |
| Total liabilities | 9,476 | 8,413 |
| Commitments and contingencies (Note 11) | | |
| Minority interest | 33 | 31 |
| STOCKHOLDERS EQUITY | | |
| Preferred stock, \$0.01 par value; 10,000,000 shares authorized; none issued or outstanding at June 30, 2006 or December 31, 2005 | | |
| Common stock, \$0.01 par value; 100,000,000 shares authorized; 53,506,822 shares issued and outstanding at June 30, 2006; 53,408,728 shares issued and outstanding at December 31, 2005 | 1 | 1 |
| Additional paid-in capital | 957 | 983 |
| Retained earnings | 546 | 556 |
| Accumulated other comprehensive income | 15 | 12 |
| Deferred compensation | | (31) |
| Total stockholders equity | 1,519 | 1,521 |

| | | |
|--|-----------|----------|
| Total liabilities and stockholders equity | \$ 11,028 | \$ 9,965 |
|--|-----------|----------|

See Notes to Condensed Consolidated Financial Statements.

5

Table of Contents

PHH CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
Six Months Ended June 30, 2006
(Unaudited)
(In millions, except share data)

| | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income | Deferred Compensation | Total Stockholders Equity |
|--|------------------------|------------------------|----------------------------------|----------------------|---|--------------------------|---------------------------------|
| Balance at December 31, 2005 | 53,408,728 | \$ 1 | \$ 983 | \$ 556 | \$ 12 | \$ (31) | \$ 1,521 |
| Effect of adoption of SFAS No. 123(R) | | | (31) | | | 31 | |
| Net loss | | | | (10) | | | (10) |
| Other comprehensive income, net of income taxes of \$0 | | | | | 3 | | 3 |
| Stock compensation expense | | | 5 | | | | 5 |
| Stock options exercised, net of income taxes of \$0 | 65,520 | | 1 | | | | 1 |
| Restricted stock award vesting, net of income taxes of \$0 | 32,574 | | (1) | | | | (1) |
| Balance at June 30, 2006 | 53,506,822 | \$ 1 | \$ 957 | \$ 546 | \$ 15 | \$ | \$ 1,519 |

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

PHH CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In millions)

| | Six Months Ended June 30, 2005 | |
|--|---|------------------------|
| | 2006 | As Restated |
| Cash flows from operating activities of continuing operations: | | |
| Net (loss) income | \$ (10) | \$ 30 |
| Adjustment for discontinued operations | | 1 |
| (Loss) income from continuing operations | (10) | 31 |
| Adjustments to reconcile (Loss) income from continuing operations to net cash provided by (used in) operating activities of continuing operations: | | |
| Stock option expense related to the Spin-Off | | 4 |
| Capitalization of originated mortgage servicing rights | (218) | (162) |
| Amortization and provision for impairment of mortgage servicing rights | | 352 |
| Net unrealized loss (gain) on mortgage servicing rights and related derivatives | 221 | (251) |
| Vehicle depreciation | 610 | 586 |
| Other depreciation and amortization | 18 | 20 |
| Origination of mortgage loans held for sale | (17,211) | (17,107) |
| Proceeds on sale of and payments from mortgage loans held for sale | 16,858 | 15,994 |
| Other adjustments and changes in other assets and liabilities, net | (24) | (3) |
| Net cash provided by (used in) operating activities of continuing operations | 244 | (536) |
| Cash flows from investing activities of continuing operations: | | |
| Investment in vehicles | (1,413) | (1,365) |
| Proceeds on sale of investment vehicles | 637 | 574 |
| Purchase of mortgage servicing rights, net | (8) | (14) |
| Cash paid on derivatives related to mortgage servicing rights | (12) | (277) |
| Net settlement proceeds for derivatives related to mortgage servicing rights | (212) | 548 |
| Purchases of property, plant and equipment | (13) | (6) |
| Net assets acquired, net of cash acquired and acquisition-related payments | (2) | (4) |
| (Increase) decrease in Restricted cash | (152) | 374 |
| Other, net | 9 | 4 |
| Net cash used in investing activities of continuing operations | (1,166) | (166) |
| Cash flows from financing activities of continuing operations: | | |
| Net increase in short-term borrowings | | 485 |
| Proceeds from borrowings | 11,436 | 3,184 |
| Principal payments on borrowings | (10,512) | (3,260) |
| Issuances of Company Common stock | 1 | |
| Purchases of Company Common stock | | (3) |
| Capital contribution from Cendant | | 100 |

| | | | | | |
|---|--|-----|-----|-----|-----|
| Other, net | | (5) | | (1) | |
| Net cash provided by financing activities of continuing operations | | \$ | 920 | \$ | 505 |

See Notes to Condensed Consolidated Financial Statements.

7

Table of Contents

PHH CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
(Unaudited)
(In millions)

| | Six Months Ended June 30, 2005 | |
|--|---|------------------------|
| | 2006 | As Restated |
| Effect of changes in exchange rates on Cash and cash equivalents of continuing operations | \$ 1 | \$ |
| Cash provided by (used in) discontinued operations: | | |
| Operating activities | | 184 |
| Investing activities | | (30) |
| Financing activities | | (242) |
| Net cash used in discontinued operations | | (88) |
| Net decrease in Cash and cash equivalents | (1) | (285) |
| Cash and cash equivalents at beginning of period: | | |
| Continuing operations | 107 | 257 |
| Discontinued operations | | 88 |
| Total Cash and cash equivalents at beginning of period | 107 | 345 |
| Cash and cash equivalents at end of period: | | |
| Continuing operations | 106 | 60 |
| Discontinued operations | | |
| Total Cash and cash equivalents at end of period | \$ 106 | \$ 60 & |