PennyMac Financial Services, Inc.

Second Quarter 2017 Earnings Transcript

August 3, 2017

Introduction

Good afternoon, and welcome to the second quarter 2017 earnings discussion for PennyMac Financial Services, Inc. The slides that accompany this discussion are available from PennyMac Financial's website at www.ir.pennymacfinancial.com. Before we begin, please take a few moments to read the disclaimer on slide two of the presentation. Thank you.

Now I'd like to turn the discussion over to Stan Kurland, PennyMac Financial's Executive Chairman.

Speaker:

Stanford L. Kurland – Executive Chairman

Thank you, Chris.

Let's begin with slide 3.

Slide 3

PennyMac Financial's second quarter results reflect the strength of our platform in a highly competitive market. This quarter we successfully deployed capital from our initial 400 million dollar term note issuance into MSRs resulting from our organic production and into four bulk MSR portfolio acquisitions totaling 16.2 billion dollars in UPB. We also continued to make solid progress building our broker channel, which we will be launching in the fourth quarter.

For the second quarter, PennyMac Financial earned pretax income of 58 million dollars and diluted earnings per share of 44 cents. Book value increased to 16 dollars and 40 cents per share, up from 16 dollars and 1 cent per share at March 31st, and from 13 dollars and 29 cents at June 30th, 2016.

Looking at earnings contribution by segment, our Production segment pretax income was 66.7 million dollars, up 40 percent from the prior quarter and down 36 percent from the second quarter of 2016.

Total production volume for the quarter was 17.6 billion dollars in UPB, up 18 percent from the prior period and up 9 percent from the second quarter of 2016. Total correspondent government and consumer direct locks were 13.5 billion in UPB, up 21 percent from the first quarter and up 4 percent from the second quarter of 2016. These results reflect the strong contribution from both the correspondent and consumer direct channels this quarter.

The Servicing segment recorded a pretax loss of 11.2 million dollars compared to a pretax gain of 13.4 million dollars in the prior quarter and a pretax loss of 21 million dollars in the second quarter of 2016. Second quarter Servicing segment results included a loss attributable to MSR valuation-related changes resulting from a decline in interest rates. Excluding valuation-related changes, pretax income for the Servicing segment was 15.3 million dollars, down 31 percent from the previous quarter, and down 26 percent from the second quarter of 2016.

We also completed the acquisition of four bulk portfolios of Ginnie Mae mortgage servicing rights with a combined UPB of approximately 16.2 billion dollars, including a 4.3 billion dollar portfolio we previously announced.

As a result of strong organic growth and the bulk acquisitions, our servicing portfolio grew to 229 billion dollars in UPB, up 13 percent from March 31st and up 33 percent from a year ago.

Slide 4

Continuing with our highlights on slide 4, the Investment Management segment recorded pretax income of 2.5 million dollars, up from 1.1 million dollars the previous quarter and up from 0.7 million dollars in the second quarter of 2016. Net assets under management were 1.6 billion dollars, essentially unchanged from March 31st and June 30th, 2016.

After quarter end, assets under management in our investment management activities are growing due to a 195 million dollar sale of preferred shares by PMT. This is expected to be partially offset by a sale of the remaining assets from our limited-life Investment Funds, which is expected to reduce assets under management by 145 million dollars once completed.

Also during the quarter, the Board of Directors authorized a stock repurchase program for up to 50 million dollars of outstanding Class A common stock. We believe the repurchases of common stock have the potential to enhance value for our stockholders given the market price of our common stock and our ability to generate after-tax returns on equity that compare favorably, on a risk-adjusted basis, to other investment opportunities available to us.

Now let’s turn to slide 5 and look at the current market environment.

Slide 5

The interest rate volatility experienced in the first quarter continued into the second quarter, with mortgage rates as reported by Freddie Mac's Primary Mortgage Market Survey moving up and down within a relatively narrow range through May, but ultimately ending the quarter down 26 basis points from the end of March. The thirty-year fixed mortgage rate ended the quarter at 3.88 percent, down from 4.14 percent at March 30th. Volatility continued into the third quarter, with the PMMS rate increasing to 3.92 percent at the end of July. For the second quarter, the decline in yields on the ten-year U.S. Treasury bond and Agency MBS were smaller, at just nine basis points and ten basis points, respectively.

Despite the decline in rates and the fact that they remain relatively low from a historical perspective, mortgage refinance activity hovered near multi-year lows in the second quarter, as measured by the Mortgage Bankers Association Refinance Index. In June, the MBA's index reached one thousand three hundred and ninety one, up from one thousand two hundred and seventy one in March, but well below the index average of approximately two thousand over the last five years.

Both new and existing home sales have steadily increased over the past several years, but they have only recovered to levels seen in the early 2000's. Over the same time period, the number of households in the United States has grown by 15 percent. Given this trend, we would expect to see further expansion in home sale activity.

Credit performance of residential mortgages has improved modestly. According to the most recent data available, the Mortgage Bankers Association's delinquency survey showed that total residential mortgage delinquencies fell to 4.71% at March 31st, from 4.77% for the same period a year ago.

Now let's turn to slide 6 and discuss the impact of PennyMac Financial's hedge approach on our second quarter's results.

Slide 6

During the second quarter, changes in the fair value of our MSRs resulted in losses due to lower mortgage rates. As I mentioned earlier, mortgage rates were volatile during the quarter and ultimately declined. This resulted in fair value losses and impairment charges on the MSR asset totaling 36.9 million dollars, driven by higher projected prepayment activity.

The change in fair value of the ESS liability and hedge activity contributed to gains of 5.1 million dollars, partially offsetting the portion of MSR valuation losses.

PennyMac Financial's hedge profile seeks to moderate the impact of interest rate changes through a comprehensive hedge strategy. Our hedge strategy is designed to partially offset MSR value changes associated with significant interest rate movements using hedge instruments, with the remainder of the offset provided by production income that is expected to result from lower mortgage rates. Given the relatively modest interest rate decline over the course of the second quarter, we expect most of the MSR value offset to be provided by future production income.

Now, let's go to slide 7 and discuss the profitability of our Servicing segment excluding the impact of valuation-related changes.

Slide 7

For the second quarter, Servicing segment pretax income excluding valuation changes was 15.3 million dollars compared to 22.3 million dollars in the prior quarter and 20.7 million dollars in the second quarter of 2016. Servicing segment results included a number of moving pieces this quarter.

The quarter-over-quarter decrease in Servicing segment pretax income, excluding valuation changes, was primarily due to an increase in credit losses and provisions for defaulted loans. During the quarter, loans transitioned into defaulted status, resulting in an increase in provisions for defaulted loans and a reduction in provisions for active loans. Combined, the two provisions totaled 15.1 million dollars versus 14.6 million dollars in the prior quarter. The higher provision for defaulted loans is offset when loans transition from active to defaulted status.

This quarter, higher operating revenues were offset by an increase in amortization and realization of cash flows resulting from higher prepayment activity during the quarter and expectations for elevated future prepayment activity. Operating revenues also included an increase in EBO-related revenue resulting from increased early buyout activity, funded, in part, by proceeds from the Ginnie Mae MSR term note. EBO-related revenue included 23.4 million dollars in gains on mortgage loans held for sale from the securitization of performing government-insured and guaranteed loans and 9.1 million dollars of interest income from EBO loans. The increase in EBO revenues was offset by higher interest expense, primarily related to the term notes.

Operating expenses for the Servicing segment increased slightly from the prior quarter but decreased as a percentage of the portfolio. As we grow the servicing asset, we will continue to focus on expense management and take advantage of our scale to drive down unit costs.

Let's go next to slide 8 and discuss our entry into the broker channel.

Slide 8

As mentioned previously, we are preparing to launch our broker channel platform in the fourth quarter.

Today, activity that is directed through mortgage brokers – which is also referred to as the wholesale market – represents approximately ten percent of the total mortgage origination market. Methods of originating and documenting loans, usage of automated underwriting systems and compliance have improved such that the quality of broker production is comparable to retail production.

We feel that the broker market presents an attractive growth opportunity given PennyMac's position as a leader in the mortgage market and our proven ability to profitably produce large volumes of loans. In addition, loan production from the broker channel tends to be weighted towards purchase-money transactions as brokers generally have close connections to their local communities. Purchase-money mortgages help to moderate origination volume fluctuations which occur in the more volatile refinance market.

We have invested considerable time and effort to develop our broker origination platform and enhance the capabilities of our Mortgage Fulfillment Division to support the anticipated volumes. Over the past year, we have worked to create a robust and efficient broker portal that will deliver on our goal of providing a differentiated experience to the broker community. In addition, we are building systems and work-flow routines that will leverage the scale and capabilities of MFD. These investments should have the added benefit of driving enhancements and greater efficiencies in our consumer direct production channel, which are expected to help reduce production costs and improve service levels going forward.

We have a talented team in place to run the broker channel and will carefully and methodically grow this business, with the objective of becoming a leading participant in the channel over time. Again, this initiative is scheduled to launch in the fourth quarter.

This concludes my overview of PennyMac Financial's second quarter performance. Now I'd like to turn the discussion over to David Spector, PennyMac Financial's President and Chief Executive Officer, to review the operational results in each of our businesses.

Speaker:

David Spector – President and Chief Executive Officer

Thank you, Stan.

On slide 9, I would like to begin my remarks by reviewing market share and volume trends across PennyMac Financial's businesses.

Slide 9

PennyMac Financial was the fourth-largest producer of mortgage loans in the United States during the second quarter, according to *Inside Mortgage Finance*, and we estimate that we ended the quarter as the 10th largest servicer.

Correspondent production market share for the second quarter was an estimated 11.19 percent, up from 10.95 percent in the prior quarter. In our consumer direct business, our market share increased slightly to 0.48 percent.

We estimate that the market share of our loan servicing portfolio grew to almost 2.1 percent of all mortgage debt outstanding in the United States. And lastly, net assets under management by our Investment

Management segment was 1.6 billion dollars, essentially unchanged from the prior quarter.

Now let's turn to slide 10 and discuss correspondent production.

Slide 10

Correspondent acquisitions by PMT in the second quarter totaled 16.3 billion dollars in UPB, up 17 percent from the first quarter and up 12 percent year-over-year.

Government loan acquisitions accounted for 64 percent of total correspondent acquisitions, or 10.4 billion dollars in the second quarter, up 12 percent from the prior quarter and up 10 percent from the second quarter of 2016. Conventional conforming acquisitions, for which PennyMac Financial performed fulfillment services for PMT, totaled 5.9 billion dollars in the second quarter, up 28 percent from the prior quarter. Total lock volume for the quarter was 18.2 billion dollars, up 26 percent from the prior quarter.

Seasonally strong home purchase demand was the primary driver of this quarter's correspondent production volume increase. Purchase-money loans accounted for 82 percent of total correspondent production during the second quarter, up from 73 percent in the prior quarter. The purchase-money orientation of our correspondent production volume continues to be an important differentiating factor for PennyMac.

We also continued to grow our seller relationships. At the end of the second quarter, we had 589 seller relationships, up from 557 in the first quarter.

Looking at July volumes, correspondent loan acquisitions totaled 6.1 billion dollars in UPB, while interest rate lock commitments totaled 6.3 billion dollars in UPB.

Now let's turn to slide 11 and discuss consumer direct production.

Slide 11

Consumer direct production volume totaled 1.3 billion dollars in UPB in the second quarter, up 23 percent from the first quarter and down 16 percent year over year. The committed pipeline at the end of the second quarter was 936 million dollars.

Consumer direct volumes benefitted from the lower mortgage rates in the quarter. We also continued to see significant recapture opportunities from our large and growing servicing portfolio of more than 1.1 million customers. As a result, we believe that our portfolio-sourced refinance volume fared better than other consumer direct lenders dependent on the refinance market.

In July, consumer direct originations totaled 497 million dollars in UPB, and interest rate lock commitments were 588 million dollars in UPB. The committed pipeline was 799 million dollars in UPB as of July 31st.

We believe that consumer direct origination volumes will remain predominantly driven by leads from our portfolio, even though growing our non-portfolio volume remains a key priority for us. We doubled our non-portfolio volume quarter-over-quarter, and while still relatively small with respect to total volume, it reflects the emphasis we are placing on this growth. Additionally, our large portfolio of FHA loans represents a significant opportunity as those customers look to refinance their mortgage and move into a conventional loan. The FHA requires mortgage insurance for the life of the loan, and borrowers can potentially realize significant savings in their monthly payment by transitioning into a conventional product where mortgage insurance is not required on loans with loan-to-value ratios below 80 percent. As home equity grows, we expect the portion of borrowers in our portfolio who may benefit from this type of refinance to increase.

Now let’s turn to slide 12 and discuss our loan servicing business.

Slide 12

Our loan servicing portfolio grew to 229 billion dollars in UPB in the second quarter, up 13 percent from the first quarter and up 33 percent from the second quarter of 2016. The significant growth is the result of the four servicing portfolio acquisitions completed this quarter and continued organic growth from our production activities. The acquisitions ranged in size from 2 billion dollars to 5 billion dollars in UPB, amounts that are consistent with our prior acquisitions, and manageable for our servicing transfer operations.

We continued to leverage our expertise in loss mitigation, including growth in successful resolutions for troubled borrowers. In the second quarter, we nearly doubled modification volume to 579 million dollars in UPB, compared to 327 million dollars the prior quarter. Our expertise in loss mitigation enables us to effectively process high transaction volumes, providing much needed payment relief to borrowers and helping them to remain in their homes. Completed modifications also serve as a driver of EBO-related revenue opportunities.

Now let's turn to slide 13 and discuss the Investment Management segment.

Slide 13

As mentioned earlier, net assets under management were 1.6 billion dollars, essentially unchanged from March 31st.

Our investment management segment continues to grow. After quarter end, PMT issued 7.8 million shares of additional preferred stock for gross proceeds of $195 million dollars. During the quarter, our two investment funds entered into agreements to sell their remaining assets. These sales are expected to close in the third quarter and will mark a successful conclusion of these two limited Life funds that were raised in 2008. When completed, we expect a reduction of assets under management of approximately $145 million dollars.

Once all these transactions are concluded, the capital raise by PMT will more than offset the decline in assets under management from the sale of the Funds' assets, resulting in a net gain in assets under management of approximately 50 million dollars.

We also continued to successfully manage the transition of PMT’s capital from distressed whole loans toward MSR and credit risk transfer investments on its conventional correspondent production.

With that I’d now like to turn it over to Andy Chang, PennyMac Financial’s Chief Financial Officer, to discuss the second quarter’s financial results.

Speaker:

Andy Chang, Chief Financial Officer

Thank you, David.

Slide 14

Slide 14 is an overview of PennyMac Financial's results by operating segment. Stan reviewed these figures for the second quarter earlier, and the table shows trends for the last five quarters. Let's now turn to slide 15 and take a closer look at the results of our Production segment.

Slide 15

Production segment revenues were 130 million dollars for the second quarter, up 19 percent from the prior quarter.

Production revenue for PFSI's own account, which includes net gain on mortgage loans held for sale, loan origination fees, net interest income, and other revenue, increased 17 percent from the prior quarter, driven by lock volume growth in both correspondent and consumer direct channels, partially offset by lower margins.

Gross margins, which represent the revenue per lock commitment, were 81 basis points, down from 84 basis points in the prior quarter.

Revenue per consumer direct lock, adjusted for expected fallout, decreased to 198 basis points from 218 in the prior quarter, while revenue per correspondent lock decreased to 50 basis points from 53 in the prior quarter. Production margins remained at the low end of the ranges that we have seen over the past several quarters.

Fulfillment fee revenue was 21.1 million dollars, up 27 percent from the prior quarter, driven by an increase in conventional loan acquisitions by PMT. The weighted average fulfillment fee rate during the quarter was 36 basis points, unchanged from the prior quarter.

Production segment expenses were 63.8 million dollars, a 2 percent increase from the prior quarter.

Let’s turn to slide 16 and review the financial performance of the Servicing segment.

Slide 16

Servicing segment revenues were 64.9 million dollars, a decrease of 27 percent from the prior quarter, primarily resulting from a decrease in net loan servicing fees. Net loan servicing fees totaled 46.9 million dollars for the second quarter, compared with 74.2 million dollars in the prior quarter.

Net loan servicing fees included 134.2 million dollars in loan servicing fees reduced by 55.5 million dollars of amortization and realization of MSR cash flows. Amortization and realization of cash flows increased 14 percent from the prior quarter, driven by portfolio growth and a shorter weighted average life expected for the MSR due to the decline in mortgage interest rates. Net loan servicing fees also included 36.9 million dollars in MSR fair value losses and provisioning for impairment, primarily reflecting higher projected prepayment activity from lower interest rates. In addition, net loan servicing fees included 2.1 million dollars in hedging losses and a gain of 7.2 million dollars due to the change in fair value of the ESS liability. The net loss in MSR value after hedge losses and ESS fair value changes was 31.8 million dollars.

The securitization of reperforming government-insured and guaranteed loans resulted in 23.4 million dollars of revenue in net gains on mortgage loans held for sale at fair value in the second quarter versus 24.1 million dollars in the prior quarter. These loans were previously purchased out of Ginnie Mae securitizations, also known as early buyouts or EBOs, and primarily brought back to performing status through loan modifications. Additionally, net interest expense declined by 3.9 million dollars, driven by higher interest income from EBO loans held on our balance sheet, partially offset by increased interest expense for the term notes and financing of the EBO loans.

Servicing segment expenses for the quarter were 76.1 million dollars, a 1 percent increase from the prior quarter, while the average portfolio size grew by 9 percent from the first quarter.

Now let's turn to slide 17 and discuss the valuation of PennyMac Financial's MSR asset.

Slide 17

MSRs are a significant portion of PennyMac Financial's assets, and their fair value generally increases when interest rates rise and decreases when interest rates fall.

We account for originated MSRs at the lower of amortized cost or fair value, or LOCOM, when the underlying note rate on the loans is less than or equal to 4.5 percent. MSRs related to loans with note rates above 4.5 percent, and all purchased MSRs are accounted for at fair value. PennyMac Financial accounted for 100.5 billion dollars in UPB of its MSRs under LOCOM at June 30th. The fair value of these MSRs was modestly greater than their carrying value on our balance sheet. The remaining 56.8 billion dollars in UPB of MSRs are accounted for at fair value.

A portion of our purchased MSRs are subject to an ESS liability. The UPB of the loans underlying those MSRs totaled 29 billion dollars at June 30thth.

Now let's turn to slide 18 and look at the financial performance of the Investment Management segment.

Slide 18

Investment management revenues were 6.3 million dollars, up 17 percent from the previous quarter. Segment revenues include management fees, comprised of base management fees from PMT and the private Investment Funds, any earned incentive fees from PMT, any carried interest from the funds and Other revenue. The quarter-over-quarter increase in revenue was primarily driven by carried interest of 241 thousand dollars due to performance of the Investment Funds and also included 304 thousand dollars of incentive fees from PMT.

Segment expenses were 3.9 million dollars, a 10 percent decrease from the first quarter, primarily driven by lower compensation expense.

And with that, I would like to turn it back over to Stan for some closing remarks.

Speaker:

Stanford L. Kurland – Executive Chairman

Thank you, Andy.

PennyMac Financial had a profitable second quarter and has consistently demonstrated an ability to operate successfully in various market conditions. We continue to invest in initiatives to enhance our platform, such as the capabilities we are developing to expand into the broker channel. In addition, we continue to focus on capturing efficiencies across our business to maximize our competitive advantage and returns on equity. We remain confident that these activities will help ensure our company's long-term financial and operational success.

Lastly, we encourage investors with any questions to reach out to our Investor Relations team by email or phone.

Thank you.

Operator:

This concludes PennyMac Financial Services, Inc.'s second quarter earnings discussion. For any questions, please visit our website at www.ir.pennymacfinancial.com, or call our Investor Relations department at 818-264-4907. Thank you.