PennyMac Financial Services, Inc.

Fourth Quarter and Full-Year 2017 Earnings Transcript

February 8, 2018

Introduction

Good afternoon, and welcome to the fourth quarter and full-year 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 delivered strong results for the fourth quarter, reflecting solid earnings contributions from both our Production and Servicing segments.

For the fourth quarter, PennyMac Financial earned pretax income of 121.8 million dollars and diluted earnings per share of 2 dollars and 44 cents. Book value increased to 19 dollars and 95 cents per share, up from 17 dollars and 20 cents per share at September 30th, and from 15 dollars and 49 cents a year ago.

The enactment of new federal tax law resulted in the re-measurement of tax-related items which contributed 32 million dollars to our pretax income and 1 dollar and 79 cents to diluted earnings per share.

Our Production segment pretax income was 55.3 million dollars, down 20 percent from the prior quarter and down 41 percent from the fourth quarter of 2016, when we experienced record production levels. Our production business delivered good results this quarter, despite the typical fourth quarter decline in origination volumes. Our ability to sustain strong profitability reflects the strength of our market-leading platform.

Total production volume for the quarter was 17 billion dollars in UPB, down 10 percent from the prior quarter and down 23 percent from the fourth quarter of 2016. Total correspondent government and consumer direct locks for our own account were 11.8 billion dollars in UPB, down 11 percent from the prior quarter and down 20 percent from the fourth quarter of 2016.

The Servicing segment recorded pretax income of 32 million dollars, up 31 percent from the prior quarter and down 9 percent from the fourth quarter of 2016.

These results were driven by strong operational performance, valuation-related gains, and growth in our servicing portfolio, which totaled 245.8 billion dollars in UPB, up 3 percent from September 30th and up 27 percent from December 31st a year ago.

Excluding valuation-related items, pretax income for the Servicing segment was 28.2 million dollars.

Valuation-related gains totaled 11.8 million dollars, which included a 28 million dollar increase in MSR values, a 4.6 million dollar gain due to changes in the fair value of the excess servicing spread liability, and 20.8 million dollars decline from hedging activities.

Also during the quarter, PennyMac Financial entered into an agreement to acquire a bulk portfolio of Ginnie Mae and conventional MSRs with UPB of approximately 3.6 billion dollars.

Slide 4

Continuing with our highlights on Slide 4, the Investment Management segment recorded pretax income of 1.5 million dollars. Net assets under management were 1.6 billion dollars, down 4 percent from the prior period and up 2 percent from December 31st, 2016.

After quarter-end, we launched our Broker Direct channel. This channel allows us to access approximately 10% of the U.S. mortgage market that we previously didn't address. By leveraging PennyMac's market-leading capabilities in mortgage production, we are now offering mortgage brokers access to our state-of-the-art portal called POWER(SM), which we spent more than a year to develop.

Now let's turn to Slide 5 and look at PennyMac Financial's track record of book value growth and profitability.

Slide 5

Our book value increased to nearly 20 dollars per share at the end of 2017, which is nearly 2.5 times book value per share at the end of 2013, our first year as a publicly-traded company.

We have also achieved substantial growth in earnings since our IPO, delivering strong financial performance over multiple years, while growing PennyMac Financial into an industry leader in its primary businesses of residential mortgage production and servicing.

Now let’s turn to Slide 6 and look at the current market environment.

<u>Slide 6</u>

Mortgage rates increased steadily throughout the fourth quarter, rising 16 basis points to 3.99 percent at quarter end. Rates have continued to rise since the end of last year, with the 30-year fixed-rate mortgage reaching 4.22 percent last week, its highest level in nearly a year.

Refinance activity, as measured by the average of the MBA’s refinance application index, declined 14 percent from the prior quarter in response to rising rates.

Home sales showed renewed strength in the fourth quarter, after slowing from robust levels during the2017 spring and summer buying season. Macroeconomic fundamentals underlying the housing market remain positive and mortgage market origination estimates are forecasting multi-year growth in purchase-money mortgages, driven by continued strong consumer demand for homes.

Credit performance of residential mortgages generally continues to be strong. According to Black Knight Financial Services, the total U.S. loan delinquency rate for loans 30 days or more past due was 4.7 percent at the end of December versus 4.4 percent at the end of September. We believe the increase in delinquencies is attributable to recently experienced natural disasters, primarily Hurricanes Harvey and Irma, and typical seasonal factors in the fourth quarter. We expect delinquencies to decrease from these levels in the first half of the year.

Now, let's turn to Slide 7 to discuss the implications of the Tax Cuts and Jobs Act on the housing market and PennyMac.

Slide 7

We expect the new tax law to provide a stimulus to the economy and help drive continued economic growth. Historically, a strong economy has supported home price appreciation, driven by robust demand for homes, and elevated home sales activity. Many households should see an increase in their disposable income, which is supportive of increased homeownership levels longer term. However, there may be a mixed impact on home prices in the near term as a reduction in the maximum mortgage interest deduction and the cap on state and local tax deductions could have a negative impact on high-cost areas such as California and the Northeastern states.

Looking at the mortgage industry impact, the reduction in the federal corporate income tax rate to 21 percent should significantly improve the after-tax profitability for industry participants organized as corporations, including PennyMac Financial.

While the lower mortgage interest deduction cap may affect the jumbo mortgage market, it does not affect the Agency market for government and conventional conforming loans, which make up 80 percent of all U.S. mortgage loan production – and essentially 100 percent of PennyMac's production. Improved after-tax profitability for the industry may affect competition and production margins over time, but the impact at this point is uncertain.

We also believe that the new tax law is a positive for our synergistic partnership with PMT. The new 20 percent deduction for REIT dividends increases the attractiveness of PMT's stock.

Now, let's turn to Slide 8 to discuss the key initiatives for PennyMac Financial's business in 2018.

<u>Slide 8</u>

Our key initiatives for 2018 include leveraging our platform and significant customer reach to drive greater volumes and profit opportunities through our expansion into new channels and products. We will also continue to harness technology to achieve greater workflow efficiencies and cost savings.

In Correspondent Production, we expect to maintain our market leadership with existing and new customers. We are well-positioned for the evolving market environment, given our emphasis on purchase-money loans, which represented 79 percent of Correspondent acquisitions last year. In this channel we will reintroduce a prime jumbo offering. Our unique relationship with PMT and its strategy of investing in GSE credit risk transfer and MSRs is a positive aspect of our participation in the conventional conforming market.

In Consumer Direct Production, we remain focused on driving increased accuracy and faster loan processing at lower costs by re-engineering fulfillment workflows and focusing on incorporating parallel processing capabilities. In addition to increasing cash-out refinancing loans, we are working on the introduction of a HELOC product.

In our new Broker Direct channel launched last month, PennyMac's state-of-the-art POWER(SM) platform offers mortgage brokers seamless integration with our centralized sales and fulfillment functions. We plan to ramp up production volume in a controlled manner throughout this year, with a focus on attractive market segments such as purchase-money and prime jumbo loans.

And in the Loan Servicing business, servicing returns should benefit from a strong economy and a higher interest rate environment, which reduces prepayment activity and increases the value of our custodial deposits. We are continuing our emphasis on technology investments in Servicing, which are designed to produce greater efficiencies and cost savings as we deploy 68 system enhancement modules this year. We expect the profitability of our Servicing business to benefit from greater economies of scale and efficiencies resulting from our technology investments and the growth of our loan portfolio.

With that, I would now like to turn the discussion over to David Spector, PennyMac Financial's President and Chief Executive Officer, to drill down into the performance of each of our businesses during the fourth quarter.

Speaker:

David Spector – President and Chief Executive Officer

Thank you, Stan.

On Slide 9, let's begin with a review of market share and volume trends across PennyMac Financial's businesses.

Slide 9

PennyMac Financial was the 4th largest producer of mortgage loans in the United States for the fourth quarter and we were the 8th largest servicer at quarter-end, according to *Inside Mortgage Finance*.

Correspondent market share declined in the fourth quarter due primarily to increased competition in the conventional market while consumer direct market share increased, driven by our higher recapture activity.

With the growth of our servicing portfolio, we estimate that we serviced 2.31 percent of all mortgage debt outstanding in the United States at quarter end. And in our investment management business, net assets under management were 1.6 billion dollars, essentially unchanged from the prior year.

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

Slide 10

Correspondent acquisitions by PMT in the fourth quarter totaled 15.4 billion dollars in UPB, down 12 percent from the third quarter and down 23 percent from the prior year.

Government loan acquisitions accounted for 62 percent of total correspondent acquisitions, or 9.5 billion dollars in UPB in the fourth quarter, down from 10.9 billion dollars in UPB in the prior quarter and 12.5 billion dollars in UPB in the fourth quarter of 2016.

Conventional conforming acquisitions, for which PennyMac Financial performed fulfillment services for PMT, totaled 5.9 billion dollars in UPB in the fourth quarter, down 10 percent from the prior quarter while down 21 percent year-over-year. The weighted average fulfillment fee in the fourth quarter was 33 basis points, down from 36 basis points in the prior quarter, reflecting discretionary reductions to facilitate the successful completion of certain loan transactions by PMT.

Total lock volume for the quarter was 15.9 billion dollars in UPB, down 9 percent from the prior quarter and 17 percent year-over-year. Government locks totaled 9.6 billion dollars in UPB in the fourth quarter, down 13 percent from the previous quarter and 22 percent year-over-year.

The decline in acquisition and lock volumes resulted from increased competition, primarily in the conventional conforming market, and seasonal factors. We remained disciplined in our pricing and benefited from our optimization of financing arrangements.

The purchase-money percentage of our correspondent acquisition volume was 76 percent in the fourth quarter, which positions us well for the forecasted growth in purchase market origination volumes.

We also continued to grow our seller relationships, with a total of 613 at the end of the fourth quarter, versus 604 at the end of the previous quarter.

Looking at January production volumes, total correspondent loan acquisitions were 4.8 billion dollars in UPB, while interest rate lock commitments totaled 4.4 billion dollars in UPB.

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

Slide 11

Consumer direct production volume totaled 1.6 billion dollars in UPB in the fourth quarter, up 8 percent from the third quarter while down 20 percent year over year. The committed pipeline at the end of the fourth quarter was 777 million dollars.

Consumer direct volumes benefited from improved recapture from our large and growing servicing portfolio of more than 1.2 million customers.

In January, consumer direct originations totaled 509 million dollars in UPB, while interest rate lock commitments were 662 million dollars in UPB. The committed pipeline was 659 million dollars in UPB as of January 31st.

The increase in pull-through that we experienced in the third quarter continued in the fourth quarter. Our projected pull-through rate was 67 percent compared to 66 percent in the prior quarter.

Revenue per fallout adjusted consumer direct lock increased to 370 basis points from 363 basis points in the prior quarter.

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

Slide 12

Our loan servicing portfolio grew to 245.8 billion dollars in UPB in the fourth quarter, up 3 percent from the third quarter and up 27 percent from the fourth quarter of 2016. This quarter's portfolio growth was achieved organically, resulting from our strong production activities.

Mortgages 60 days or more past due were 3.5 percent of our portfolio, up from 2.5 percent in the previous quarter, due to typical seasonal trends and the recent natural disasters, and we expect these effects to be transitory.

While completed modifications decreased during the quarter, the pipeline of modifications in process increased as a result of disaster-related modification activity initiated this quarter.

Next, let's turn to slide 13 to review the Investment Management segment.

Slide 13

As mentioned earlier, net assets under management were 1.6 billion dollars, down 4 percent from September 30th. The reduction in net assets under management quarter-over-quarter reflects PMT's common share buyback activity. During its most recent purchase window, PMT repurchased approximately 5.2 million shares at a cost of 83 million dollars. In December, the PMT Board of Trustees approved an increase in the share repurchase program from 200 million dollars to 300 million dollars. The repurchase program allows PMT to acquire its common shares at a discount to book value and enhance equity returns, which we believe aids PMT's long-run success.

Now I'd like to turn the discussion over to Andy Chang, PMT's Chief Financial Officer, to review the fourth quarter's results.

Speaker:

Andy Chang – Chief Financial Officer

Thank you, David.

I will highlight some of the key trends and factors in our financial results on the next few slides beginning with slide 14, but we encourage you to read the press release on fourth quarter earnings for further details.

Slide 14

Slide 14 summarizes the earnings contributions of PennyMac Financial's two major business segments, Production and Servicing, over the past three years. The Production segment historically contributed most of PennyMac Financial's pretax income. Our business profile, however, has become more balanced as the servicing portfolio has grown and Servicing segment income has become more meaningful. Servicing segment income excluding valuation-related changes has grown substantially, from 15 million dollars two years ago to 103 million dollars in 2017. We expect this trend to continue as the servicing portfolio continues to grow and we benefit from scale economies and other initiatives to increase the profitability of servicing.

Now let's turn to slide 15 and take a look at the impact of our hedging approach on fourth quarter earnings.

Slide 15

Our hedging strategy is designed to moderate the impact of volatility in interest rates on our financial results.

As Stan mentioned earlier, mortgage rates increased during the fourth quarter. Fair value gains and reversal of impairment charges on the MSR asset totaled 28 million dollars, which were due to a combination of higher mortgage rates and lower discount rates on government MSRs. The lower discount rates reflect improved market liquidity for Ginnie Mae MSRs and the reduced risk profile of our MSR portfolio resulting from the buyout of severely delinquent loans.

These MSR value gains were partially offset by value declines in our hedge instruments. In addition, the value of the ESS liability was reduced as a result of yield curve flattening and higher than expected prepayment activity during the quarter.

Now, let’s go to slide 16 and review the profitability of the Servicing segment.

<u>Slide 16</u>

Pretax income from Servicing in the fourth quarter was strong and benefited from the valuation-related gains I discussed on the previous slide.

Servicing segment pretax income excluding valuation-related changes was 28.2 million dollars versus 37.1 million dollars in the prior quarter, primarily driven by a significant increase in early buyout transactions in the fourth quarter.

The increase in operating revenue reflects portfolio growth and increased ancillary revenue. Ongoing improvements in operating expense efficiency were offset by temporary increases in staff needed to assist borrowers affected by the recent natural disasters.

EBO-related revenue in the fourth quarter was 38.6 million dollars versus 39.4 million dollars in the prior quarter. These results were driven by strong reperformance of previously delinquent loans including those that were modified to help borrowers get back into performing status. EBO transaction-related expenses increased quarter-over-quarter due to the significant increase in buyout volume during the fourth quarter. This was due in part to higher delinquencies as a result of the natural disasters that occurred in the third quarter. We expect future period income to benefit from these buyouts through reduced costs and the resale of reperforming loans.

Financing expenses increased quarter-over-quarter driven by the issuance of a second Ginnie Mae MSR term note during the third quarter and higher short-term interest rates.

Overall, the performance of our servicing portfolio remains strong. The increased provision for credit losses reflects expected levels of delinquencies resulting from portfolio seasoning and disaster-related loans.

Now let's turn to slide 17 to review the impact of the new tax law on our fourth quarter results.

Slide 17

As Stan mentioned previously, in the fourth quarter the new tax law resulted in a 32 million dollar benefit to pretax income, and a 1 dollar and 79 cent benefit to diluted earnings per share. This was a result of the re-measurement of tax-related items on PennyMac Financial's balance sheet. First was our net deferred tax liability, which includes a deferred tax liability related to originated MSRs, as well as a deferred tax asset resulting from the exchange of Private National Mortgage Acceptance Company, LLC unitholders into PFSI Class A common stock. Second were amounts payable to exchanged Private National Mortgage Acceptance Company, LLC unitholders under a tax receivable agreement. The schedule on this slide shows the impact on the income statement of these items for the fourth quarter.

Now let's turn to slide 18 and discuss certain changes to the accounting of PennyMac Financial's mortgage servicing rights that we are making in 2018.

<u>Slide 18</u>

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.

Through December 31st, 2017 we accounted for a portion of our originated MSRs at the lower of amortized cost or fair value when the underlying note rate on the loans was less than or equal to 4.5 percent. MSRs related to loans with note rates above 4.5 percent, and all purchased MSRs, were accounted for at fair value.

Beginning January 1st, 2018, all of PennyMac Financial's MSRs will be carried at fair value. This will result in a single accounting treatment for all MSRs, the carrying value of our MSRs will be consistent with how MSRs are valued under our financing arrangements, and our hedging activities will be simplified.

PennyMac Financial accounted for 114.4 billion dollars in UPB of its MSRs at lower of amortized cost or fair value at December 31st. The fair value of these MSRs was 0.8 million dollars in excess of their carrying value on our balance sheet.

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.

We remain focused on long-term initiatives to help ensure PennyMac Financial's growth and success. We continue to make progress on process redesigns that will benefit our consumer direct and broker direct channels, while in our servicing business we are making additional technology investments in new servicing modules to drive workflow and increased efficiencies. We also launched our Broker Direct channel which gives us access to an additional 10 percent of the U.S. mortgage market. While the effects of different aspects of the new tax law are uncertain, we believe a strong economy and the stimulus provided by the tax bill bodes well for housing and PennyMac Financial's businesses.

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 fourth 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.