PennyMac Financial Services, Inc.

Third Quarter 2018 Earnings Transcript

November 1, 2018

Introduction

Good afternoon, and welcome to the third quarter 2018 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 2 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 third quarter results demonstrate the earnings power of our comprehensive mortgage banking platform against the backdrop of a rising rate environment and heightened competition among industry participants adjusting capacity to a smaller origination market.

I am also pleased to announce today that we completed our corporate reorganization simplifying our corporate structure, with the conversion of all equity ownership to a single class of publicly-traded common stock. I will expand on the benefits and key implications a bit later in my presentation.

For the third quarter, our Production segment results increased from the prior quarter, along with solid earnings contributions from Servicing and Investment Management.

PennyMac Financial earned pretax income of 61.7 million dollars and diluted earnings per share of 57 cents. Book value per share increased to 21 dollars and 47 cents, from 21 dollars and 19 cents per share at June 30th. Pro forma for the company's reorganization, book value was 20 dollars and 67 cents per share.

Our Production segment pretax income was 25.7 million dollars, up 35 percent from the prior quarter and down 63 percent from the third quarter of 2017. Acquisition and origination volume totaled 17.9 billion dollars in UPB, up 12 percent from the prior quarter and down 6 percent from the third quarter of 2017. Total correspondent government and direct lending locks were 11.1 billion dollars in UPB, down 6 percent from the prior quarter and 16 percent from the third quarter of 2017.

The Servicing segment recorded pretax income of 33.6 million dollars, down from 54.6 million dollars in the prior quarter and up from 24.5 million dollars in the third quarter of 2017.

Excluding valuation-related items, pretax income for the Servicing segment was 29.9 million dollars, down 17 percent from the prior quarter and 19 percent from the third quarter of 2017.

Valuation-related items for the third quarter included a 60.9 million dollar increase in MSR fair values, partially offset by a 53 million dollar decrease from associated hedging activities, and a 1.1 million dollar decrease due to the change in fair value of excess servicing spread liability.

Furthermore, in August we refinanced 500 million of MSR secured term notes and issued an additional 150 million dollars for a total of 650 million dollars of five-year secured term notes at more favorable terms. We expect the transaction to reduce annual interest expense by nearly 7 million dollars after recognizing a one-time debt redemption cost of 4.6 million dollars this quarter.

We continued to grow our servicing portfolio, which totaled 284.5 billion dollars in UPB at quarter-end, up 8 percent from June 30th and

19 percent from September 30th, 2017. Contributing to this growth was the completion of 11.6 billion dollars in UPB of previously announced bulk MSR portfolio acquisitions.

Slide 4

Turning to slide 4, our Investment Management segment delivered pretax income of 2.5 million dollars, up from 1.1 million dollars in the prior quarter and 700 thousand dollars in the third quarter of 2017. Net assets under management were 1.6 billion dollars, up 1 percent from the prior quarter-end and down 5 percent from September 30th, 2017 as we completed the wind down of the two private Investment Funds.

After quarter-end, PennyMac Financial completed the acquisition of additional bulk Ginnie Mae MSR portfolios with a UPB of approximately 3.2 billion dollars, which David will discuss in more detail later in the presentation.

Turning to slide 5, I would like to take a moment to review our corporate reorganization and the key benefits of the transaction.

Slide 5

Effective today, all equity ownership of the Company has been converted into a single class of publicly-traded common stock which continues to trade on the New York Stock Exchange under the ticker "PFSI."

This completed transaction simplifies our financial reporting and eliminates the allocation of income and equity between different classes of stockholders, and all equity holders are now represented by a single class of common stock.

The reorganization also has the potential to expand the investor universe and demand for the Company's stock as PFSI's market capitalization increases from approximately 500 million dollars to 1.5

billion dollars, making the stock eligible for inclusion in certain broader stock market indices.

There will be no change in ownership percentages as a result of the transaction, with significant percentages held by PennyMac's management. Over time, we expect the percentage held by external shareholders to increase, thereby contributing to increased public float and liquidity of the stock.

I want to take a few moments to discuss the significant opportunities available to PennyMac Financial beginning on slide 6.

Slide 6

The U.S. mortgage market remains the largest consumer finance market by far, with almost 11 trillion dollars in residential mortgage debt outstanding, nearly ten times larger than outstanding auto loan or credit card debt.

As you can see from the chart on the bottom right of the slide, industry forecasts predict modest growth in total mortgage originations over the next several years, driven by purchase-money originations. Low unemployment and real wage growth among key home buying demographics, such as millennials, are driving the projected increase. Despite favorable economic trends in the purchase-mortgage market, both existing and new home sales have disappointed versus expectations recently, primarily because of continued low housing inventories and consumers who are still adjusting to higher mortgage interest rates.

Now let's turn to slide 7 and talk about our expectations for the consolidation in the mortgage industry going forward.

Slide 7

The mortgage industry today is highly fragmented with many smaller independent operators that gained share, enabled by low rates, robust refinance volumes and higher margins in recent years.

The graphs on the right show the share of production and servicing market participants and how fragmented the mortgage market has become as a result. As a comparison, in 2013, the top five market participants represented nearly half of the production and servicing markets, whereas today the top five account for just 28 percent of the production market and 34 percent of servicing – while many other participants compete for the rest.

As mortgage rates have continued to move higher, opportunities for less-operationally intensive refinance loans have diminished and market participants are shifting their focus to more-operationally intensive business that remains such as purchase-money mortgages, with competitive pressure driving margins lower. Traditionally, a decline in refinance volumes has driven consolidation among fewer, stronger market participants and we believe technology will further accelerate the pace of consolidation through this mortgage market cycle.

Successful companies will be those with the size and scale to compete more efficiently. They will have strong operational expertise, ready access to capital, and an ability and willingness to significantly invest in technology to meet increasing customer demand for an end-to-end mortgage experience that is easier and faster.

As an industry leader, PennyMac enjoys significant competitive advantages due to our long-standing operational expertise, our steady focus on introducing new products, and our determination to play a critical role in putting emerging technologies to work for our growing customer base.

Now let's turn to slide 8 and discuss PFSI's unique capabilities as a leader in the U.S. mortgage market.

Slide 8

PennyMac Financial is currently in its eleventh year of operations and went public on the New York Stock Exchange in May of 2013. We have a highly experienced and capable senior management team, and their leadership is the reason that PennyMac Financial has grown to become a leading non-bank residential mortgage specialist.

We have prudently and organically established ourselves as an industry leader. According to industry publication *Inside Mortgage Finance,* we are currently the fourth largest mortgage producer and have the eighth largest servicing portfolio in the country. We are also the largest government-insured producer and the second largest correspondent producer.

Our unique capabilities and ability to scale efficiently have allowed us to profitably increase our mortgage market share and pursue a broad range of opportunities for future growth. In our 10 year history, we have a proven track record of developing and deploying proprietary technology that gives us immense competitive advantages, including the ability to consistently capture efficiencies in our operations and bring to market new products to meet customer needs.

In addition, our unique partnership with PennyMac Mortgage Investment Trust, or PMT – a REIT focused on investments in the residential mortgage market – where PennyMac Financial is the external manager and services provider, creates opportunities for PMT to utilize its tax-efficient balance sheet to invest in mortgage assets created by our platform.

Since PFSI went public in 2013, we have built a track record of continued growth and success. During that time, our loan production market share has more than doubled to 3.8 percent, our loan servicing market share has nearly tripled to 2.6 percent and our book value per share also has nearly tripled from 7 dollars and 27 cents per share to 20 dollars and 67 cents per share as of September 30th, pro forma for our reorganization.

Now let's turn to slide 9 and discuss PFSI's synergistic partnership with PMT.

Slide 9

This partnership provides us with a distinct competitive advantage, uniting PFSI's industry-leading operating platform with PMT's strengths as a tax-efficient investment vehicle.

PFSI is regarded throughout our industry as a leading non-bank residential mortgage specialist with a legacy-free, specialized and highly scalable operating platform and large-scale, technology-driven mortgage production and servicing operations. As I mentioned earlier, we have a seasoned and highly experienced management team and we are well capitalized with diversified sources of funding.

PMT has grown its balance sheet from 324 million dollars in assets at the time of its IPO to more than 7 billion dollars at September 30th of this year. The company has become a leading investor in residential mortgage credit with significant investments in GSE credit risk transfer and mortgage servicing rights sourced from its own mortgage production.

As we explore new product development in non-agency mortgage assets such as home equity lines of credit and prime non-QM loans, this will create new opportunities for PMT to invest in securities organically created from these activities. The attractive growth opportunities presented by the mortgage market are expected to expand the benefits for both PMT and PennyMac Financial in the future.

Now let’s turn to slide 10 and discuss PFSI’s strategic initiatives for growth.

Slide 10

Our operational expertise, efficient access to capital, scale, and investments in technology afford PennyMac Financial the ability to invest in future growth prospects while others in the mortgage industry curtail operations.

We have several overarching, strategic initiatives in place to ensure PFSI is well-positioned to continue its growth. First is continuing to increase market share in production, with a focus on channels with the highest potential for growth such as consumer and broker direct. Second is our continued investment in and deployment of technology. We have placed considerable emphasis on developing innovative technologies to facilitate new business opportunities and enable our ability to profitably scale our operations. Lastly, we are pursuing new products to drive growth in a higher rate environment, including HELOCs and prime non-Agency products to better meet customer needs and address growing segments of the mortgage market.

Initiatives within correspondent production include capturing more non-delegated volume which represents about 30 percent of the total correspondent market; growing market share from smaller correspondents that can benefit from our risk management expertise and efficient processing capabilities, such as community banks and credit unions; and increasing conventional correspondent production volumes to drive growth of PMT's investments.

Within consumer direct, initiatives include improving our lead generation capabilities in order to maximize the potential originations within PFSI's 1.4 million customer servicing portfolio; adding new affinity relationships to increase non-portfolio originations; and continuing enhancements to our consumer-facing mortgage access center, or MAC, to increase automation and make the process smoother for current and potential borrowers.

In our broker direct channel, we are implementing a number of strategies to drive volume growth, including increasing the number of approved brokers who can offer our full-suite of products and improving the functionality of our POWER portal, giving brokers increased process transparency and allowing them to better manage their origination pipelines.

In the Servicing segment, we continue to drive portfolio growth through our production activities and by maximizing recapture opportunities with existing PennyMac customers. In addition, we remain committed to the continued strategic acquisition of bulk MSR portfolios. We are also enhancing our servicing system platform to further its operating capabilities and efficiencies.

Finally, successful execution of our growth initiatives is expected to facilitate additional investment opportunities for PMT and increase earnings from our Investment Management activities.

With that, I would now like to turn the discussion over to David Spector, PennyMac Financial's President and Chief Executive Officer, to discuss our operational performance during the third quarter.

Speaker:

David Spector – President and Chief Executive Officer

Thank you, Stan.

On Slide 11, let's begin with a review of market share and volume trends across PennyMac Financial's businesses.

Slide 11

As Stan mentioned, PennyMac Financial remained the fourth largest producer of mortgage loans and the eighth largest servicer in the country, according to *Inside Mortgage Finance*.

PennyMac increased its correspondent market share to an all-time high with channel volume up 10 percent as we profitably grew volume in a smaller market. Our consumer direct market share rebounded this quarter as we increased volume 41 percent from the prior quarter. We estimate that our servicing portfolio now represents over 2.6 percent of all mortgage debt outstanding in the United States at quarter-end, up from 2.4 percent at June 30th.

Again, in our investment management business, net assets under management were 1.6 billion dollars, up slightly from the prior quarter.

Now let's turn to Slide 12 and discuss correspondent production highlights.

Slide 12

Correspondent acquisitions by PMT in the third quarter totaled 16.5 billion dollars in UPB, up 10 percent from the prior quarter and down 5 percent from the third quarter of 2017.

Government loan acquisitions accounted for 54 percent of total correspondent acquisitions, or 9 billion dollars in UPB in the third quarter, down from 9.5 billion dollars in UPB in the prior quarter and 10.9 billion dollars in UPB in the third quarter of 2017.

Conventional conforming acquisitions, for which PennyMac Financial performed fulfillment services for PMT, totaled 7.5 billion dollars in UPB, up 39 percent from the prior quarter and 15 percent year-over-year, reflecting our unique execution capabilities and improved market conditions during the quarter. The weighted average fulfillment fee in the third quarter was 35 basis points, up from 27 basis points for the previous quarter.

Total lock volume for the third quarter was 17.7 billion dollars in UPB, up 9 percent from the prior quarter and 2 percent year-over-year. Government locks totaled 9.1 billion dollars in UPB in the third quarter, down 9 percent from the prior quarter and 17 percent year-over-year.

Purchase-money loans accounted for 87 percent of our correspondent acquisition volume in the third quarter, up from 85 percent in the prior quarter and 83 percent in the third quarter of 2017.

Revenue per fallout-adjusted government lock commitment was 35 basis points in the third quarter, a decrease from 44 basis points in the prior quarter reflecting heightened competition among nonbank market participants for government-insured loans.

We continued our growth in non-delegated correspondent production with our conventional mortgage products and are seeing encouraging results. We have recently introduced government products to this channel, which is expected to help drive meaningful growth.

Monthly production volumes remained strong in October with total correspondent loan acquisitions of 6.3 billion dollars in UPB, up from 5.4 billion dollars in October 2017. Interest rate lock commitments totaled 6.8 billion dollars in UPB in October, also up from 5.2 billion dollars in October 2017.

Now let's turn to Slide 13 and discuss consumer direct production highlights.

Slide 13

Consumer direct production volume totaled 1.3 billion dollars in UPB in the third quarter, up 41 percent from the prior quarter as we continued to successfully transition to more operationally intensive loans. Increased volumes of cash-out refinances and purchase-money loans helped mitigate the decline in streamlined refinances, which accounted for only 2 percent of funded loans in the quarter, down substantially from 60 percent in the third quarter of 2017. The growth in revenue per fallout-adjusted consumer direct lock to 363 basis points in the quarter from 337 basis points in the prior quarter reflects this successful transition.

MAC, our online portal which we launched in April, has captured 226 million dollars in interest rate lock commitments from its inception through September 30th, reflecting the functionality of the portal and the ongoing enhancements Stan mentioned earlier.

October consumer direct originations totaled 465 million dollars in UPB, and the committed pipeline was down slightly from 704 million dollars at September 30th to 679 million dollars at October 31st.

Now let's turn to Slide 14 and discuss broker direct channel highlights.

Slide 14

We are encouraged by the growth in volumes we have seen in our broker channel. Originations totaled 110.8 million dollars in UPB in the third quarter, up substantially from 61.8 million dollars in the prior quarter driven by the addition of 160 approved brokers and the continued build out of our institutionally-focused sales effort. Additionally, the enhancements we continue making to our broker-facing POWER portal, supplemented by our call center-based specialists and loan level process management, are driving growth by giving brokers greater process transparency and control.

Our platform offers brokers a full suite of conventional and government loans all featured together on one central portal, providing them with the ability to better serve their clients. We have also added new products and features, including Fannie Mae's HomeReady® product and Lender Paid Mortgage Insurance, otherwise known as LPMI, with plans to launch a prime Jumbo product in November.

Broker direct origination volumes continued their positive trajectory in October with total channel originations of 63 million dollars and locks of 107 million dollars. The committed pipeline increased from 64 million dollars at September 30th, to 96 million dollars as of October 31st.

Now let's turn to Slide 15 and discuss servicing highlights.

Slide 15

Our loan servicing portfolio grew to 284.5 billion dollars in UPB at the end of the third quarter, up 8 percent from the prior quarter and 19 percent from the third quarter of 2017. Quarter-over-quarter growth was driven by organic production activities and bulk acquisitions of 11.6 billion dollars in UPB completed during the quarter. After the quarter end, we completed 3.2 billion dollars in UPB of bulk MSR acquisitions, with an additional 1.2 billion dollars pending settlement.

In looking at the recent Hurricanes Florence and Michael, we are proactively engaging customers and providing assistance to those affected. Approximately 16 thousand loans in our servicing portfolio of 1.4 million customers are located in the affected areas, and we believe our exposure in these regions is limited. By way of comparison, over 117 thousand loans in our servicing portfolio were affected by

Hurricanes Harvey and Irma last year, and the impact from those storms was not material to PennyMac Financial's earnings.

Next, let's turn to Slide 16 and review the Investment Management segment.

Slide 16

As mentioned earlier, net assets under management were 1.6 billion dollars, up slightly from the prior quarter-end. The increased earnings contribution was driven by incentive fees of 700 thousand dollars based on PMT's continued strong performance.

PMT has successfully transitioned capital from its distressed portfolio liquidation activities towards MSRs and CRT investments that result from its correspondent production and at September 30th, distressed loans represented only 6 percent of PMT's mortgage assets.

While PMT remains focused on its organically sourced investment strategies of CRT and MSRs, it is pursuing other organic growth strategies such as non-Agency and HELOC securitizations.

Now I'd like to turn the discussion over to Andy Chang, PennyMac Financial's Chief Financial Officer, to review the third 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 couple slides. We encourage you to read our press release on third quarter earnings for further details.

Slide 17

Slide 17 summarizes the impact of our hedging approach on third quarter earnings. Our hedging strategy is designed to moderate the impact of volatility in interest rates on the fair value of the MSR asset while also considering the impact of production-related income.

In the third quarter, we recorded fair value gains on our MSR asset totaling 60.9 million dollars, which primarily resulted from expectations for lower prepayment activity in the future driven by the increase in mortgage rates during the quarter.

The MSR gains were largely offset by 53 million dollars in associated hedging activities and a 1.1 million dollar increase in the fair value of the ESS liability, also driven by higher mortgage rates and a reduction in expected prepayments.

Now, let’s go to slide 18 and review the profitability of our Servicing segment.

Slide 18

The Servicing segment continues to be a major contributor to the Company’s financial results. For the third quarter, pretax income excluding valuation-related changes was 29.9 million dollars versus 35.8 million dollars in the prior quarter and 37.1 million dollars in the third quarter of 2017.

The results this quarter were adversely affected by 4.6 million dollars in interest expense recognized due to the refinancing of term notes in August. As Stan mentioned earlier, the refinancing of the term notes will result in an annual interest savings of approximately 7 million dollars going forward.

Operating revenue increased, driven by a larger servicing portfolio and higher interest income from custodial deposits. The increase in revenue was partially offset by increased realization of MSR cash flows and lower EBO-related revenue resulting from a reduced modification pipeline and lower redelivery margins due to higher interest rates. EBO-related expenses also increased due to a higher volume of loan buyouts from Ginnie Mae securities during the quarter.

Overall, the core financial performance of our Servicing business remains strong, and we expect the segment to deliver a greater contribution to PennyMac Financial's earnings as the servicing portfolio continues to grow and as we capture greater efficiencies in our operations.

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.

As the mortgage market continues to adjust to higher rates, PennyMac Financial stands out from the competition by continuing to deliver strong production results and servicing portfolio growth. The earnings contribution from our growth initiatives focused on product and channel development will become increasingly meaningful over time.

Underlying our success has been the strength of our management team and the development of new technologies across our business to drive greater operational capacity and efficiency. We expect to see consolidation in the mortgage market, and successful firms will be the ones that have the size, scale and technological capabilities to compete. We continue to make investments in technologies to further solidify our position as a leading, cost-efficient producer of residential mortgages, and are confident that we are well-positioned to benefit from the changes taking place in the mortgage market.

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 third 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.