PennyMac Financial Services, Inc.

First Quarter 2019 Earnings Transcript

May 2, 2019

Introduction

Good afternoon, and welcome to the first quarter 2019 earnings discussion for PennyMac Financial Services, Inc. The slides that accompany this discussion are available from PennyMac Financial's website at 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 first quarter financial results reflect significant interest rate volatility during the quarter that resulted in lower mortgage rates and improving production trends, in addition to an adverse impact on the value of our mortgage servicing rights, which was largely offset by the effectiveness of our hedging strategies.

For the quarter, PennyMac Financial earned net income of 46.1 million dollars, or diluted earnings per share of 58 cents. Book value per share increased to 21 dollars and 72 cents, from 21 dollars and 34 cents per share at December 31st, 2018.

Production segment pretax income was 47 million dollars, up 85 percent from the prior quarter and 174 percent from the first quarter of 2018, primarily driven by higher volumes and margins in our consumer direct lending channel. Acquisition and origination volume totaled 16.6 billion dollars in UPB, down 15 percent from the prior quarter but up 16 percent from the first quarter of 2018. Total correspondent government and non-delegated locks were 7.7 billion dollars in UPB, down 16 percent from both the prior quarter and the first quarter of 2018. Direct lending locks totaled 2.7 billion dollars in UPB, up 36 percent from the prior quarter and 57 percent from the first quarter of 2018. And finally, correspondent conventional loan acquisition volume totaled 8.1 billion dollars in UPB, down 10 percent from the prior quarter and up 92 percent from the first quarter of 2018. This volume resulted in 27.6 million dollars of fulfillment fee revenue for the quarter.

The Servicing segment recorded pretax income of 11.2 million dollars, down 62 percent from the prior quarter and 80 percent from a year ago, primarily driven by net valuation-related losses in the first quarter, which adversely impacted pretax income by 26.3 million dollars or 24 cents per share.

Valuation-related items included a 164.9 million dollar decrease in MSR fair values, largely offset by 134.6 million dollars in hedging gains and

4.1 million dollars due to the change in the fair value of excess servicing spread liability.

Excluding valuation-related items, pretax income for the Servicing segment was 35.3 million dollars, down 21 percent from the fourth quarter and 3 percent from the first quarter of 2018. Strong operating revenues were muted by higher amortization and realization of cash flows as rates declined combined with increased expenses related to large early buyout volumes. The early buyout volumes this quarter are generally expected to benefit future periods as these loans re-perform and are re-delivered.

Our servicing portfolio grew 8 percent quarter-over-quarter to 324.7 billion dollars in UPB at quarter end, up from 299.3 billion dollars in UPB at December 31st, 2018, driven by additions from our loan production and 16.3 billion dollars in UPB of bulk MSR acquisitions, net of runoff.

Slide 4

Continuing our first quarter highlights on slide 4, our Investment Management segment delivered pretax income of 2.1 million dollars, down from 2.5 million dollars in the prior quarter while up from 1 million dollars in the first quarter of 2018. Segment revenue was 8.8 million dollars, up 12 percent from last quarter and up 28 percent from the first quarter of 2018, driven by performance-based incentive fees from PMT's improved financial results and increased base management fees from growth in assets under management.

PMT raised approximately 147 million dollars in net proceeds from the issuance of common shares during the quarter, bringing net assets under management to 1.7 billion dollars as of March 31st, 2019, up 10 percent from December 31st, 2018 and 12 percent from March 31st, 2018.

Now let's turn to slide 5 and discuss the current market environment.

Slide 5

The first quarter of 2019 saw improved market conditions, aided by the Federal Reserve providing greater clarity on expectations for further rate increases this year.

The average 30-year fixed mortgage rate for the quarter was 41 basis points lower than the average rate in the prior quarter, driving a significant increase in refinancing volumes. As a measure of activity, the *Mortgage Bankers Association Refinance Application Index* was 1,786 at the end of March compared to 730 at the end of December.

Lower rates are also expected to have a positive impact on the purchase market as we head into the traditional home buying season. Macroeconomic indicators such as home sales have shown modest improvement, while at the same time, purchase money origination forecasts have seen upward revisions, supported by improved affordability.

We also saw an overall improvement in market sentiment regarding credit investments during the first quarter. Credit spreads on GSE credit risk transfer securities tightened during the quarter, reversing the 40 to 80 basis points of widening in the fourth quarter.

And finally, delinquency levels at March 31st, 2019 improved and remain near their all-time lows supported by the continued strength of the U.S. economy and strong employment trends.

Now let's turn to Slide 6 and talk about growth drivers for PennyMac Financial.

Slide 6

PennyMac Financial's consistent profitability and book value growth have been enabled by our balanced business model, with large production and servicing operations, combined with an investment management business. This unique model positions the Company well to gain share as industry participants adapt to the highly-competitive mortgage market. Although the pace of market consolidation has likely been slowed by the recent decline in interest rates and improved origination market, we expect the trend to continue in the long term.

The market for bulk MSRs remained active during the first quarter, evidenced by our acquisitions totaling 16.3 billion dollars in UPB. With mortgage rates lower, activity in this market may slow somewhat in the near-term but we expect to continue seeing portfolios for sale.

PennyMac Financial is presented with growth opportunities as competitors struggle to compete or exit the market altogether. Within correspondent lending, we are focused on growing non-delegated acquisition volumes, further expanding the number of active correspondent clients, and increasing the volume of business from each relationship. In our broker direct lending channel, we seek to provide a differentiated experience for the broker community through a technology-enabled platform that offers a high degree of self-service capabilities coupled with high-touch client service. We launched this channel in early 2018 and are presently running at a pace of approximately 175 million dollars in UPB of interest rate lock commitments per month. While this is a good start, we are continuing to leverage our technology and robust operational capabilities to become a channel leader over time. Our consumer direct origination channel represents a significant opportunity for earnings growth by successfully executing upon the tremendous opportunities presented by our large and growing servicing portfolio of over 1.6 million customers. The flexibility of our platform and ability to successfully pivot to the increased refinance opportunity this quarter is one example of optimizing opportunities from the servicing portfolio. At the same time, we remain focused on developing our consumer-facing portal technology and strategies to increase purchase-money and non-portfolio volumes.

The development of new products is a critical component of our long-term success by remaining nimble and adapting to changing market conditions. In the first quarter, we introduced a HELOC product in our consumer direct channel and recently expanded its availability into five additional states. We also launched a prime non-QM product in our correspondent channel. As volumes from new products grow over time, we expect PMT to invest in the residual tranches of securitizations with favorable risk-return profiles accretive to PMT's overall return on equity, driving continued growth of our investment management business.

All of the initiatives I've discussed on this slide thus far have at least one thing in common, and that is a reliance on technology for successful execution. Leadership in the mortgage market going forward will be dominated by companies who are able to successfully harness technology to differentiate their platform and realize cost advantages. PennyMac Financial will be one of those companies. We continue to successfully develop and implement new technologies across our business channels to improve the speed, accuracy, and scalability of our operations. Scale is a key to sustained profitability in the mortgage banking industry and it allows us to invest in our business while at the same time facilitating new growth opportunities and furthering competitive advantages.

Lastly, we have in place expense management initiatives across the Company to capture scale efficiencies and increase operating margins, while maintaining capacity to address current refinancing opportunities. Examples include increasing our use of data analytics and predictive algorithms to improve effectiveness in lead conversion and pricing efficiencies, and the implementation of an end-to-end redesign of our direct lending fulfillment process that David will discuss in his section.

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 first quarter.

Speaker:

David Spector – President and Chief Executive Officer

Thank you, Stan.

Let's start with a review of market share trends across PennyMac Financial's businesses on page 7.

Slide 7

According to industry data reported by *Inside Mortgage Finance*, PennyMac Financial remained the 8^{th} largest servicer and was the 4^{th} largest producer of mortgage loans in the first quarter.

We estimate that PennyMac's correspondent market share declined slightly in the first quarter driven by continued strong competition, while market share in the consumer direct channel grew as a result of increased refinance volumes. Our servicing portfolio continued to grow in the first quarter, and we estimate that we now service almost 3 percent of all mortgage debt outstanding in the U.S., up from 2.7 percent at December 31st, 2018.

Lastly, our broker direct lending channel, launched in the first quarter of last year, has grown to nearly a half point of market share over the first full year in operation.

Now let’s turn to Slide 8 and discuss correspondent production highlights.

Slide 8

Correspondent acquisitions by PMT in the first quarter totaled 15.1 billion dollars in UPB, seasonally down 17 percent from the prior quarter and up 15 percent year-over-year.

Government loan acquisitions accounted for 45 percent of total correspondent acquisitions, or 6.8 billion dollars in UPB in the first quarter, down from 8.9 billion dollars in UPB in the prior quarter and 8.8 billion dollars in UPB in the first quarter of 2018.

Conventional acquisitions comprised 55 percent of total correspondent acquisitions or 8.3 billion dollars in UPB, down 10 percent from the prior quarter but up 96 percent year-over-year. Our increased conventional loan volumes have been supported by our unique execution abilities and PMT's ability to create CRT investments.

We continue to focus on growing our non-delegated correspondent volume, which increased 45 percent quarter over quarter to 174 million dollars in UPB, primarily driven by growth of government non-delegated volume following its release late last year.

Total government and non-delegated lock volume totaled 7.7 billion dollars in UPB, down 16 percent from the prior quarter and the first quarter of last year. Delegated government locks were 7.4 billion dollars in UPB, down 18 percent from the prior quarter and 19 percent year-over-year. Non-delegated lock volume totaled 360 million dollars during the quarter, up 58 percent from the prior quarter.

While the correspondent market remains competitive, margins appear to be stabilizing as they were essentially unchanged from the prior quarter at 29 basis points. The weighted average fulfillment fee paid by PMT to facilitate loan production on its behalf was 34 basis points, up from 32 basis points in the previous quarter.

We also continued to increase the number of approved correspondent sellers, which increased to 743 at quarter end, a 5 percent increase from 710 approved sellers at the end of the prior quarter.

April's acquisition volumes were up significantly from last year, with total correspondent loan acquisitions of 6.5 billion dollars in UPB, up from 4.7 billion dollars in April 2018. Interest rate lock commitments in April totaled 7.5 billion dollars in UPB, also up from 5.6 billion dollars in April 2018.

Now let's turn to Slide 9 and discuss consumer direct production highlights.

Slide 9

Consumer direct production volume in the first quarter totaled 1.4 billion dollars in UPB, up 14 percent from the prior quarter driven by increased rate-and-term refinance activity as a result of lower mortgage rates. Revenue per fallout-adjusted consumer direct lock increased to 387 basis points in the quarter from 356 basis points in the prior quarter.

Our ability to source originations from our servicing portfolio continues to improve as data analytics and predictive processes are increasingly being deployed to help prioritize leads and improve the conversion of those leads into funded loans.

We also continue to make technology and operational investments in our consumer direct channel. Our Mortgage Fulfillment Group has developed a new and proprietary end-to-end fulfillment process for this channel that is resulting in broader capabilities to scale the business, reduced fulfillment costs and increased customer satisfaction. Overall, we expect these enhancements to drive increased efficiency and improved pull-through rates. We have also continued to enhance the capabilities of our consumer-facing portal, M.A.C., with a recent emphasis on the refinement of the mortgage insurance products that we offer.

In April, consumer direct originations totaled 602 million dollars in UPB, up from 291 million dollars in April of 2018. Similarly, interest rate lock commitments in April totaled 947 million dollars, up from 556 million dollars in April 2018. And finally, the committed pipeline was also up substantially to 1 billion dollars at the end of April, positioning us well for growth into the second quarter.

Now let’s turn to Slide 10 and review broker direct channel highlights.

Slide 10

Broker direct originations totaled 196 million dollars in UPB in the first quarter, down slightly quarter-over-quarter driven by seasonally lower origination volumes and intense price competition among channel leaders.

In the quarter, we added 93 approved brokers, bringing the total to 682 brokers at quarter end.

We also continued to enhance the capabilities of our broker portal, otherwise known as POWER. This quarter, we incorporated some of the proprietary pricing capabilities of our industry-leading correspondent platform for use in the POWER portal to enhance our ability to provide more granular "best execution" pricing to our broker clients.

In April, channel originations were 108 million dollars in UPB and locks were 210 million dollars in UPB. The committed pipeline was 192 million dollars at April 30th, up significantly from 73 million dollars at January 31st.

Now let's turn to Slide 11 and discuss servicing highlights.

Slide 11

Our servicing portfolio grew to 324.7 billion dollars in UPB at the end of the first quarter, up 8 percent from December 31st, 2018 and up 27 percent from March 31st, 2018. Portfolio growth continued to be driven by our production activities and was supplemented with two bulk acquisitions which we completed this quarter totaling 16.3 billion dollars in UPB.

Lower rates have resulted in many of the loans originated during 2018 being eligible for refinancing, and drove higher prepayment activity during the quarter. Prepayment speeds on PennyMac Financial's owned portfolio – which includes mostly Ginnie Mae MSRs – increased to 10.1 percent from 9.8 percent during the prior quarter. Similarly, the prepayment speeds of PennyMac Financial's sub-serviced portfolio – which includes mostly Fannie Mae and Freddie Mac MSRs owned by PMT – increased slightly to 7.6 percent from 7.5 percent during the prior quarter.

The drop in mortgage rates this quarter also helped expand the EBO buyout population. First quarter EBO transactions totaled 765 million dollars in UPB, up 55 percent from the prior quarter.

Now, let's turn to Slide 12 and review the Investment Management segment.

Slide 12

Our Investment Management segment performed well during the first quarter, driven by the growth of incentive fees that were earned as a result of PMT's continued strong performance and higher management fee revenue as a result of PMT's capital raising activity during the quarter.

PMT's core investment strategies of GSE credit risk transfer and MSRs delivered solid first quarter performance, and the positive outlook for growth of these organically created investments remains. To fund its investment growth, PMT raised 143 million dollars in net proceeds through the issuance of 7 million common shares, marking the first time that PMT has raised common equity in several years. Furthermore, PMT launched an "At The Market" common equity issuance program with the potential to raise a total of 200 million dollars. In the first quarter, PMT issued 221 thousand additional shares under this program for approximately 4.5 million dollars in net proceeds.

Lastly, we pioneered a groundbreaking financing structure for PMT's CRT investments and securitized its first three settled deals. The inaugural issuances from the structure were three-year secured term notes totaling 296 million dollars, which replaced short-term securities repurchase agreements at a similar cost. The new financing structure also provides additional benefits through better alignment of the financing term with the expected life of the related CRT assets and improved returns on equity.

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

Slide 13

Slide 13 summarizes the impact of our hedging approach on earnings for the first quarter. Our hedging strategy is designed to moderate the impact of volatility in interest rates on the fair value of the MSR asset.

In the first quarter, we recorded fair value losses on our MSR asset totaling 164.9 million dollars, which was driven by expectations for increased prepayment activity in the future due to lower mortgage rates. MSR fair value losses were largely offset by 134.6 million dollars in associated hedging gains and a 4.1 million dollar gain from the change in fair value of the ESS liability. The cost of our hedging approach comprises a portion of the net fair value loss of 26.3 million dollars for the first quarter.

PennyMac Financial's consistent profitability and book value growth across different interest rate environments highlight the importance of our comprehensive approach and expertise in managing interest rate risk.

Now, let's turn to slide 14 and discuss the profitability of our Servicing segment.

Slide 14

Pretax income excluding valuation-related changes was 35.3 million dollars, down from an all-time high of 44.5 million dollars in the prior quarter and modestly down from 36.3 million dollars in the first quarter of 2018.

Higher operating revenue driven by portfolio growth was partially offset by higher realization of cash flows resulting from a larger portfolio and an increase in prepayment activity due to lower mortgage rates.   Operating expenses increased only modestly versus a year ago on a dollar basis. As a percentage of the average servicing portfolio UPB, operating expenses were flat to the prior quarter, and down significantly from the first quarter of last year, demonstrating the economies of scale we are realizing in servicing.

Our pretax income excluding valuation-related changes included lower EBO-related earnings than in prior periods. EBO-related revenues were modestly lower than the prior quarter and 13 million dollars lower than a year ago due to elevated EBO revenues in the first quarter of 2018, driven by hurricane-related activity. EBO-related expenses were 2.4 million dollars higher than the prior quarter, driven by large EBO volumes, which we expect to benefit future period income.

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.

This quarter's results highlight both the ability of our balanced mortgage banking platform to adapt to a changing market environment, and our core culture of continuous improvement. We are focused on expense management and greater efficiency across the organization, capturing the benefits of scale and utilizing proprietary and third-party technology solutions to realize competitive advantages through lower costs, while maintaining the high quality and effectiveness of our operations. We believe these initiatives will further differentiate PennyMac Financial from our competition and further solidify our leadership position in the U.S. mortgage market.

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

Thank you.

<u>Operator</u>:

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