PennyMac Financial Services, Inc.

Second Quarter 2016 Earnings Transcript

August 3, 2016

Introduction

Good afternoon and welcome to the second quarter 2016 earnings discussion for PennyMac Financial Services, Inc. The slides that accompany this discussion are available from PennyMac Financial Services, Inc.'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, PFSI's Chairman and Chief Executive Officer.

Speaker:

Stanford L. Kurland – Chairman and Chief Executive Officer

Thank you, Chris.

Let's begin with slide 3.

Slide 3

PennyMac Financial delivered record earnings in the second quarter which were driven by record production volume in both our correspondent and consumer direct channels.

For the second quarter, PennyMac Financial earned pretax income of 84.3 million dollars, a 180 percent increase from the first quarter, and diluted earnings per share of 65 cents. We achieved these earnings even after a 122.4 million dollar non-cash valuation decline on our servicing rights, driven by higher actual and projected future prepayment activity resulting from lower interest rates, offset by 82.4 million dollars in gains from hedges and valuation gains on excess servicing spread liabilities. We estimate that these items reduced earnings by 31 cents per share. We also recorded 5.1 million dollars in servicing activity fee revenue related to a significant bulk sale of performing distressed loans by PennyMac Mortgage Investment Trust during the quarter. We estimate the impact of this item on earnings per share was 4 cents. Book value increased to 13 dollars and 28 cents per share, up from 12 dollars and 59 cents per share at March 31st.

Looking at the earnings contributions by segment, Production segment pretax earnings were 104.5 million dollars, a 53 percent increase from the first quarter, driven by strong margins and an increase in production and lock volumes in both the correspondent and consumer direct channels. Total loan production volumes in the second quarter were 16.1 billion dollars in unpaid principal balance, a 48 percent increase from last quarter. Total lock volumes were 18.9 billion dollars in UPB, up 50 percent from the first quarter. Our volumes were driven by lower interest rates during the quarter, which led to a larger mortgage origination market. In addition, strong operational execution in both our consumer direct and correspondent channels helped us capture market opportunities.

The Servicing segment had a pretax loss of 21 million dollars, compared to a pretax loss of 39.5 million dollars in the first quarter. Excluding fair value changes, pretax income was 19.1 million dollars, an increase of 132 percent from the previous quarter, reflecting the underlying profitability of our servicing business. The servicing portfolio grew to 171.7 billion dollars in UPB, an increase of 4 percent, resulting from our loan production activities.

Investment Management pretax income was 722 thousand dollars, down 37 percent from the prior quarter, driven by a reduction in carried interest revenue from the private Investment Funds. Net assets under management ended the quarter at 1.6 billion dollars.

Now let's turn to slide 4 and discuss the market environment.

Slide 4

During the second quarter, uncertainty in global financial markets led investors into the relative safety of U.S. Treasuries, sending interest rates lower. In particular, the United Kingdom's decision to leave the European Union near the end of the quarter caused a decline in interest rates, and market expectations for interest rates continue to be lower for longer.

Volumes in the mortgage origination market have increased in reaction to lower rates. Analysis suggests that more than half of all fixed-rate mortgages currently outstanding – representing nearly 3 trillion dollars in unpaid principal balance – are “in the money” to refinance, meaning these borrowers could lower their mortgage rate a half of a percentage point or more by refinancing. However, industry capacity constraints are moderating the growth in mortgage volumes and should contribute to a prolonged period of elevated origination volumes and margins for the mortgage industry. While interest rates have fallen, mortgage spreads have widened, suggesting that when interest rates eventually do rise, consumer mortgage rates should not rise as much.

While the U.S. macroeconomic backdrop is mixed, housing fundamentals appear to remain solid. Despite persistently low inventory across many parts of the country, existing and new home sales continue to increase steadily. Lower interest rates have aided home affordability, and with rates forecasted to remain low, we believe that the strength in home purchase demand will likely continue.

Now let's turn to slide 5 and look specifically at the forecast for the U.S. mortgage origination market.

Slide 5

Lower interest rates during the first half of this year have had a significant impact on increasing expectations for the mortgage origination market. The graph on slide 5 shows forecasts for the residential mortgage origination market, averaging estimates from the Mortgage Bankers Association, Fannie Mae and Freddie Mac from April and July, contrasted against the 2015 origination market.

Over the quarter, the forecast for the mortgage origination market has risen by nearly 170 billion dollars, driven by estimates for increased refinance activity, on top of a significant year-over-year increase in purchase activity. This increase is on top of a 150 billion dollar increase in the forecasts from February to May.

The most recent forecast calls for almost 1.8 trillion dollars in total mortgage originations for the year. For the purchase-money originations alone, the current estimate is nearly 1 trillion dollars in volume which would result in the highest level of purchase volumes since 2007.

Now let's turn to slide 6 and discuss why we believe PennyMac Financial is uniquely positioned to capitalize on the significant opportunity in the mortgage market.

Slide 6

PennyMac Financial is a leader in the U.S. mortgage markets and one of only two public company mortgage specialists among the top 10 producers of new mortgage loans. For the first half of this year, we are the fifth largest producer in the country and the second largest nonbank producer. Our mortgage leadership is a reflection of our operational foundation and best-in-class, scalable platform we have built that makes us uniquely positioned to capitalize on market opportunities. For example, this focus has enabled profitable market share growth in the correspondent channel, where we are now the second largest correspondent aggregator behind Wells Fargo. It has also enabled our ability to grow the servicing portfolio organically without reliance on MSR acquisitions. We are leveraging our expertise and leadership in our correspondent channel to grow the consumer direct origination channel, which has experienced 30 percent year-over-year volume growth and has also become an increasingly significant contributor to PennyMac Financial's earnings.

In the second quarter, PennyMac Financial became the country's largest issuer of Ginnie Mae securities. Government-insured and guaranteed loans, which are delivered into Ginnie Mae securities, represent a large and important component of the mortgage market.

Government insured loans provide financing for many first-time homebuyers and in today's market represent the best financing option for many borrowers, in addition to programs offered by the Veterans Administration that provide home financing options for active military, veterans, and their families.

The government-insured share of the total origination market has grown significantly since the financial crisis and now comprises 26 percent of the total.

While banks and other lenders have de-emphasized this segment of the mortgage origination market, we have stepped in to support the government insured and guaranteed loans. As a leading mortgage company, we have in place the operational systems and financial capacity to support the continued growth of our government loan business and overall mortgage banking activities.

Now, let's turn to slide 7 and return to a discussion of PennyMac Financial's second quarter results.

Slide 7

PennyMac Financial achieved record results in its production business during the second quarter. Production segment pretax income rose 53 percent from the first quarter, driven by wider margins that benefitted from a larger overall mortgage origination market, in addition to share gains in the correspondent channel and increased loan fulfillment capacity in our consumer direct channel.

Lock volumes in the correspondent channel rose 54 percent from the first quarter, with similar quarter-over-quarter increases in both government and conventional conforming lock volumes. This quarter's performance highlights the ability of our platform to efficiently scale to the available opportunity and grow our revenues per lock commitment, while capturing market share from less efficient operators. While correspondent lock volume for the government loans, which PennyMac Financial produces for its own account, increased by 54 percent, the average gross margin, or revenue per lock, increased 5 percent.

Consumer direct locks increased 30 percent from the first quarter. The investments we have made to grow our sales and fulfillment capabilities have allowed us to capture more business from our large and growing servicing portfolio. During the second quarter, the average gross margin, or revenue per lock, in the consumer direct channel also increased 3 percent.

Our investments in consumer direct sales and fulfillment capacity have been the key growth drivers for the channel. Given the size of the market opportunity and the significant potential available within our existing servicing portfolio, our main focus for consumer direct is on growing our operational capabilities to address greater volumes of loans. I want to emphasize that the mortgage origination business is highly regulated and complex. We will grow the consumer direct channel in a manner that maintains the highest standards for quality control and governance while continuing to focus on efficiency and profitability.

Slide 8

Turning to slide 8, I would like to spend a few minutes reviewing our approach to hedging MSRs. We seek to moderate the impact of interest rate changes through a comprehensive hedge strategy. In implementing this strategy, we consider the performance of our hedge in conjunction with the company wide-impact of interest rate movements on revenue opportunities. As we have seen in the second quarter, lower interest rates drove increased demand for new mortgages, which led to higher purchase and refinance production volumes and revenues. Interest rates declines, such as the ones we have experienced over the last two quarters, result in fair value losses on the MSR asset due to higher prepayment expectations.

The chart on slide 8 shows the changes in our MSR value for each of the last four quarters before and after taking into account our hedge and valuation changes in excess servicing spread liability. You can see that our hedge and fair value gains on the ESS liability mitigated approximately two-thirds of the fair value loss in this quarter and in the first quarter as well. By design, our hedge strategy does not completely offset non-cash MSR fair value losses with gains from financial hedging instruments, as higher production revenue resulting from lower rates and increased demand for new mortgages should offset the current period MSR valuation losses in future periods. The second quarter's results provide a good example of how increased production earnings more than offset the first quarter's net MSR fair loss in addition to driving a significant increase in net income.

In the event of a rising rate environment, our hedge strategy is designed to capture fair value gains on the MSR asset in excess of the related hedge.

Now let's turn to slide 9 and review the drivers of profitability in our Servicing Segment.

Slide 9

The analysis on slide 9 is similar in format to versions that we have presented in prior quarters, but arranges revenue and expenses for the segment in a manner that provides additional detail on the attribution of the segment's results, excluding and including the impact of fair value changes from interest rates on pretax income.

As I mentioned in my opening remarks, PennyMac Financial's servicing segment realized a pretax loss of 21 million dollars in the second quarter. The quarter's results included a 40 million dollar impact from non-cash fair value losses and impairment provisioning related to MSRs net of hedge gains and gains due to the changes in the fair value of ESS financing.

The impact of fair value changes due to interest rates can obscure the growing profitability of our servicing business. Excluding fair value changes, Servicing segment pretax income was 19.1 million dollars in the second quarter, compared to 8.3 million dollars last quarter and 9.9

million dollars for the full-year 2015. As a percentage of the average servicing portfolio UPB, pretax income excluding fair value changes was 4.5 basis points in the second quarter compared to 2 basis points in the first quarter, and just under 1 basis point for the full year 2015.

Included in this quarter's Servicing segment results were 5.1 million dollars in servicing activity fees related to the sale of performing loans from PMT's distressed portfolio and a reduction to the provision for credit losses as a result of improved loss mitigation outcomes on certain defaulted government-insured loans.

We continue to focus on driving efficiency and implementing technology to control expenses and realize economies of scale as the servicing portfolio grows. We have also developed additional revenue streams such as the redelivery of reperforming government-insured loans included in the EBO-related income, which leverages our expertise in special servicing. We remain diligent in seeking new servicing opportunities, evidenced by the new transaction to acquire

MSRs related to defaulted government loans from a large bank, which David Spector will elaborate on later in his section.

And with that, I'd now like to turn the discussion over to David, PennyMac Financial's President and Chief Operating Officer, to review the operational results in each of our businesses.

Speaker:

David Spector – President and Chief Operating Officer

Thank you, Stan.

Slide 10

On slide 10, I would like to begin my remarks by reviewing market share and volume trends across PennyMac Financial's businesses.

Record correspondent production volumes and servicing portfolio growth led to market share gains in those areas during the second quarter, while our consumer direct market share dropped slightly as our volume growth was essentially in line with the market.

PennyMac Financial was the fifth largest producer of mortgage loans during the second quarter and ended as the 11th largest servicer, according to Inside Mortgage Finance.

In our investment management business, net assets under management declined 4 percent from the prior quarter, driven by the repurchase of PMT's common shares of beneficial interest and the return of capital to investors in the private Investment Funds.

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

<u>Slide 11</u>

Correspondent production totaled 14.6 billion dollars in UPB for the second quarter, a 51 percent increase from the first quarter. Government-insured and guaranteed loan acquisitions accounted for 65 percent of total correspondent acquisitions, or 9.4 billion dollars in the second quarter. Additionally, PennyMac Financial performed fulfillment services for PMT on 5.2 billion dollars of conventional production during the quarter, representing a 59 percent quarter over quarter growth.

On a year-over-year basis, our correspondent production volumes increased 23 percent from the second quarter of 2015. This increase in production volume reflects a larger mortgage origination market, driven by lower mortgage rates during the quarter, as well as our gains in market share. Our increased loan fulfillment capacity, aided by our centralized mortgage fulfillment division, allowed PennyMac to scale its production to capture the market opportunity and become the second largest aggregator after Wells Fargo.

In July, total correspondent loan acquisitions were 5 billion dollars in UPB, while interest rate lock commitments were 6.5 billion dollars in UPB.

During the quarter, we continued to grow our correspondent seller relationships. At the end of the second quarter, we reached 457 correspondent seller relationships, up from 437 at the end of the prior quarter and up from 377 a year ago. Additionally, purchase-money loans accounted for 71 percent of our correspondent production and reflect our purchase-money oriented franchise and the strong demand for home purchases.

During the quarter we also launched our non-delegated correspondent program, whereby PennyMac Financial provides underwriting services to smaller lenders and community banks. We are also pursuing new initiatives to grow seller relationships with credit unions and smaller banks who can benefit from our mortgage expertise and interest rate risk management capabilities. Looking forward into next year, we anticipate a wholesale channel launch in mid-2017.

Now let’s turn to slide 12 and discuss consumer direct production.

Slide 12

Origination volumes in the second quarter totaled 1.5 billion dollars in UPB, a 24 percent increase from the first quarter, and a 32 percent increase from the second quarter of 2015.

The second quarter marked the highest ever quarterly funding volumes for our Consumer Direct channel, which is realizing the benefits from investments in sales and fulfillment capacity. We continue to enhance our capabilities to grow recapture volume from our large and growing servicing portfolio of nearly 900 thousand customers, while leveraging technology and systems to optimize capacity. These strategies generated a 30 percent year-over-year increase in the productivity of our fulfillment personnel and have led to the record funding levels.

Portfolio-sourced originations totaled almost 1.5 billion dollars in UPB in the second quarter while non-portfolio originations were 35 million dollars in UPB. Lower interest rates have contributed to strengthening momentum for consumer direct. In July, total consumer direct loan production was 495 million dollars in UPB while interest rate lock commitments were 1.1 billion dollars in UPB.

The committed pipeline was 1.3 billion dollars in UPB at July 30th.

Now let's turn to slide 13 and discuss our Loan Servicing business.

Slide 13

In the second quarter, our loan servicing portfolio grew to 171.7 billion dollars in UPB, an increase of 4 percent from the first quarter. Prime servicing and subservicing saw net growth of 7.4 billion dollars in UPB quarter-over-quarter, as we continued to add loans through our correspondent and consumer direct loan production activities. Strong correspondent and consumer direct production volumes more than offset higher prepayment activity, resulting in sustained organic servicing portfolio growth.

We continue to experience success in driving adoption of self-service technology by our loan servicing customers through our recently redesigned servicing portal. At quarter end, 62 percent of our servicing customers were registered with PennyMacUSA.com while 82 percent of all payment processing was conducted electronically, up from 58 percent and 79 percent, respectively, last quarter.

Additionally, our focus on outcomes that keep our customers in their homes resulted in over 1,600 modifications being completed during the second quarter. Continued strong modification activity related to the rehabilitation of defaulted government-insured loans drove 14.3 million dollars in securitization income, up from the prior quarter. Another strategy to grow our servicing activities and income is to expand our special servicing business. We are pleased to announce that we have recently entered into a letter of intent to acquire approximately 1 billion dollars in UPB of MSRs related to defaulted government loans from a large bank. This transaction produces an upfront payment to PennyMac Financial and provides additional revenue opportunities with the potential for gains from the securitization of reperforming loans.

Now let's turn to slide 14 and discuss the Investment Management segment.

Slide 14

Net assets under management were 1.6 billion dollars at June 30th, down 4 percent from March 31st, driven by PMT's share repurchases and return of capital to investors in the private Investment Funds. PMT's book value per share decreased to twenty dollars and nine cents, down from twenty dollars and fifty nine cents at March 31st.

Investment Management revenues decreased 3 percent from the first quarter due to a 349 thousand dollar decrease in carried interest resulting from reduced performance of the private Investment Funds. Additionally, PennyMac Financial did not receive incentive fees in the second quarter as a result of PMT's financial performance over the four-quarter period for which incentive fees are calculated.

PMT is focused on deploying capital into investments at attractive returns, including GSE credit risk transfer and MSRs from its correspondent production, enabled by our specialized capabilities as its manager and service provider. PMT is also delivering multifamily loans for Freddie Mac's small balance program and the pipeline at July 31st was 63 million dollars in UPB.

PMT will continue to pursue share repurchases with available capital where the return exceeds alternative investment opportunities.

With that I'd now like to turn it over to Anne McCallion, PennyMac Financial's Chief Financial Officer, to discuss the second quarter's financial results.

Thank you, David.

Slide 15

To recap, on slide 15, pretax income for the second quarter was 84.3 million dollars, compared to pretax income of 30.1 million dollars in the first quarter. Production segment pretax income was 104.5 million dollars, versus 68.4 million dollars last quarter. The servicing segment reported a pretax loss of 21 million dollars, compared to a pretax loss of 39.5 million dollars for the first quarter. Investment Management segment pretax income totaled 722 thousand dollars for the second quarter, down from 1.1 million dollars in the prior quarter.

Let’s now turn to slide 16 and take a closer look at the results of the Production segment.

Slide 16

Production segment revenues were 169.5 million dollars for the second quarter, up 44 percent from the first quarter. The increase was primarily driven by a 48 percent quarter-over-quarter increase in net gains on mortgage loans held for sale and a 29 percent quarter-over-quarter increase in loan origination fees. The increase in net gains on mortgage loans held for sale was driven by strong margins and significant increases in production and lock volumes in both the correspondent and consumer direct channels. The increase in loan origination fees this quarter was also the result of higher mortgage production volumes.

Fulfillment fee revenue increased 48 percent quarter over quarter due to a 59 percent increase in conventional correspondent loan acquisitions fulfilled for PMT in the second quarter, partially offset by a decrease in the weighted average fulfillment fee rate.

During the second quarter, PennyMac Financial acquired 9.4 billion dollars in UPB of Government-insured mortgages through correspondent production, a 47 percent increase from the first quarter. The Company also originated 1.5 billion dollars in UPB of loans through consumer direct production, up 24 percent from the previous quarter, and interest rate lock commitments on Government-insured correspondent and consumer direct loans increased 48 percent from the first quarter.

Production revenue, excluding fulfillment fees, as a percentage of consumer direct and Government-insured correspondent interest rate lock commitments was 116 basis points in the second quarter, compared to 119 basis points in the previous quarter, resulting from a mix issue - an increased contribution of lower margin correspondent locks to total consumer direct and government-insured correspondent lock volume.

Revenue per consumer direct lock increased to 307 basis points, from 298 basis points in the second quarter, while revenue per correspondent lock increased to 61 basis points from 58 basis points in the previous quarter.

Production segment expenses were 65 million dollars, a 33 percent increase from the first quarter, driven by higher direct and allocated compensation resulting from the Company's overall financial results, as well as increased loan production volumes.

Let's turn to slide 17 and take a look at the financial performance of the Servicing segment.

Slide 17

Servicing segment revenues were 32.1 million dollars in the second quarter, an increase of 64 percent from the prior quarter. Net loan servicing fees totaled 26.6 million dollars for the quarter, a 52 percent quarter-over-quarter increase.

The securitization of modified and reperforming government insured loans resulted in 14.3 million dollars of revenue from net gains on mortgage loans held for sale at fair value in the second quarter, versus 13.3 million dollars in the first quarter.

Servicing segment expenses for the quarter decreased by 6 million dollars to 53.1 million dollars, primarily due to a reduction in the provisioning for credit losses resulting from improved loss mitigation outcomes on certain defaulted government-insured loans. Now let's turn to slide 18 for a deeper discussion of PennyMac Financial's MSR asset.

Slide 18

MSRs are a significant portion of PennyMac Financial's assets and their fair value generally increases in a rising interest rate environment 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 with note rates on the underlying loans above 4.5 percent, and all purchased MSRs, including those subject to excess servicing spread, are accounted for at fair value. PennyMac Financial accounted for 67.7 billion dollars in UPB of its originated MSRs under LOCOM, with a fair value equal to its carrying value at June 30th. We also account for another 13.7 billion dollars in UPB of MSRs at fair value, because either the note rates on the underlying originated loans are above 4.5 percent or the MSRs were purchased, including those subject to excess servicing spread.

Most of our purchased MSRs are subject to excess servicing spread owned by PMT and the UPB related to the loans underlying those MSRs totaled 35.6 billion dollars at June 30th. The outstanding ESS financing at June 30th, 2016 only relates to Ginnie Mae MSRs.

Let's now turn to slide 19 and take a look at the financial performance of the Investment Management segment.

Slide 19

Investment management revenues were 6.2 million dollars, a decrease of 3 percent from the first quarter. Segment revenues include management fees, comprised of base management fees from PMT and the private Investment Funds and any earned incentive fees from PMT. Management fee revenue decreased 3 percent from the prior quarter due to the reduction in net assets under management. Carried interest from the private investment funds decreased to 244 thousand dollars, compared to 593 thousand dollars in the prior quarter, resulting from reduced performance of the private Investment Funds. No incentive fees were received in the second quarter as a result of PMT's financial performance over the four-quarter period for which incentive fees are calculated.

Segment expenses were 5.5 million dollars, up 4 percent from the first quarter.

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

Speaker:

Stanford L. Kurland – Chairman and Chief Executive Officer

Thank you, Anne.

PennyMac Financial's performance in the second quarter reflects the significant opportunity in the current market environment and the substantial momentum in our correspondent and consumer direct production activities. We achieved record quarterly earnings, even after the significant reduction in our MSR value, and delivered record production volumes in both our correspondent and consumer direct channels.

PennyMac Financial's leadership in the mortgage market, and outstanding financial performance, reflects our strong organization and unique platform. As a leading mortgage company, we have in place the operational systems and financial capacity to support continued growth of our business. We believe that our platform, focus on risk management, and governance culture are critical elements that will help ensure the long-term success of PennyMac Financial.

We appreciate your support of PennyMac Financial. Finally, we encourage investors with any questions to reach out to our Investor Relations team by email or phone.

Thank you.

Operator

This concludes the PennyMac Financial Services, Inc.'s second quarter 2016 earnings discussion. For any questions, please visit our website, at www.ir.pennymacfinancial.com, or call our Investor Relations department, at 818-264-4907.