PennyMac Financial Services, Inc.

Third Quarter 2016 Earnings Transcript

November 3, 2016

Introduction

Good afternoon, and welcome to the third 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 third quarter, driven by record production volumes and higher margins in both our correspondent and consumer direct channels. We have been able to capitalize on the strong origination market and the unique ability of our platform to scale up quickly and efficiently to generate higher volumes amid continuing low interest rates.

For the third quarter, PennyMac Financial earned pretax income of 139.3 million dollars, and diluted earnings per share of 1 dollar and 6 cents. Book value increased to 14 dollars and 41 cents per share, up from 13 dollars and 28 cents per share at June 30th.

Looking at the earnings contribution by segment, Production segment pretax earnings were 149.8 million dollars, a 43 percent increase from the second quarter. Total loan acquisitions and originations in the third quarter were 20.6 billion dollars in unpaid principal balance, a 28 percent increase from last quarter. Total lock volumes were

25 billion dollars in UPB, up 32 percent from the second quarter. Strong operational execution in both our consumer direct and correspondent channels helped us capture the current market opportunity.

The Servicing segment had a pretax loss of 10.7 million dollars, compared to a pretax loss of 21 million dollars in the second quarter. Excluding fair value changes, pretax income was 5.2 million dollars, down 73 percent from the previous quarter, reflecting higher expenses from the early buyout transactions in the third quarter which benefit future period income through reduced costs and potential resale of reperforming loans.

We recorded a 39 million dollar decline in the value of our mortgage servicing rights, driven by increased discount rates on Ginnie Mae MSRs. During the quarter, we also saw better-than-expected hedging performance that resulted in gains of 19 million dollars. The servicing portfolio grew to 182.1 billion dollars in UPB, an increase of 6 percent from the second quarter, due to loan production activities.

Investment Management recorded pretax income of approximately 200 thousand dollars, compared to pretax income of 700 thousand dollars in the prior quarter. Net assets under management ended at 1.6 billion dollars, down modestly from June 30th as a result of PMT's share repurchases.

Now let's turn to slide 4 and discuss the trends in PennyMac Financial's financial performance over the last several years.

Slide 4

PennyMac Financial's continuing financial performance reflects our operational foundation and our ability to capture the significant opportunities available in the U.S. mortgage market. We continued our record performance in the third quarter, as evidenced by our earnings growth and significant increase in book value.

Looking at earnings per share growth on the left, for the last 12 months we have delivered 2 dollars and 53 cents per share, versus 2 dollars and 17 cents for all of 2015. Looking at the chart on the right, our book value has increased substantially to 14 dollars and 41 cents per share at the end of the third quarter, a 17 percent increase since the start of 2016. Our consistently strong financial performance is a clear demonstration of how PennyMac Financial is delivering value to its shareholders.

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

Slide 5

While overall interest rates have been volatile recently, mortgage rates have remained largely stable. The average 30-year fixed rate ended the third quarter at just over 3.4 percent, relatively unchanged from July and still low on a historic basis.

Mortgage origination volumes remained strong in the third quarter as demand drove significant activity in both the purchase-money and refinance markets. As home values have improved over time, we have seen more borrowers become eligible for refinance loans. For the fourth quarter, however, we expect a modest reduction in origination volumes due to the normal seasonal slowdown, which typically affects the purchase-money market in particular.

Despite the recent volatility and uncertainty in the global economy, as well as what we see as tepid growth in the overall U.S. economy, housing remains a source of strength. Relatively low mortgage rates and continued strong demand for homes are expected to drive higher sales of existing and new homes. Currently, total home sales – a combination of existing and new home sales – now exceed 6 million per year, up significantly versus the last two years. Economists expect the number to increase to a 6.4 million home sales pace in 2017, and a 6.6 million pace in 2018.

Now let's turn to slide 6 and discuss how PennyMac Financial's hedging approach helped us achieve strong financial performance despite volatility in interest rates in recent periods.

<u>Slide 6</u>

PennyMac Financial is distinctive among public mortgage specialists in that 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 financial hedges in conjunction with the impact of interest rate movements on revenue opportunities. As we have seen throughout this year, low interest rates have driven increased demand for new mortgages, which has led to higher production volumes and revenue. Interest rate declines, such as the ones we saw in the first half of this year, result in fair value losses on the MSR asset due to higher prepayment expectations.

By design, our hedge strategy does not seek to completely offset MSR fair value losses from declining interest rates with gains from financial hedging instruments, as PennyMac Financial should also expect benefits from higher production revenues resulting from lower interest rates. Recent results provide a good example of how increased production earnings more than offset the net MSR fair value losses in the first and second quarters of 2016, in addition to driving significant net income. In a rising rate environment, our hedge strategy employs deep out-of-the-money options that are designed to offset the potential of large losses on the primary hedge instruments.

The chart on slide 6 shows the changes in our MSR value for each of the last four quarters, before and after taking into account our hedges and valuation changes in excess servicing spread liability, as well as the earnings contribution from our production business.

Unique to the third quarter, the MSR value decreased by 39 million dollars, driven by an increase in the discount rate on Ginnie Mae MSRs. The increased discount rate reflects reduced bank participation and higher capital costs for market participants. Our servicing-related hedges also outperformed, primarily due to a tightening of mortgage spreads.

Finally, PennyMac Financial's production segment is generating higher production-related income from higher volumes and strong margins, which helped offset the net MSR valuation reduction in prior quarters.

Now let's turn to slide 7 and discuss our outlook for the U.S. mortgage origination market.

Slide 7

This slide provides an outlook for both single-family mortgage originations and a range of projections for where the 30-year fixed-rate mortgage could be next year.

The graph on the left shows forecasts from the U.S. residential mortgage origination market in 2016, averaging the most recent estimates from Fannie Mae, Freddie Mac and the Mortgage Bankers

Association, contrasted against expectations for the 2017 origination market.

While the industry looks to close out a strong year with close to 1.9 trillion dollars in overall originations, our base case expectation for 2017 is a smaller origination market. However, mortgages for home purchases are forecast to rise by 6 percent in 2017, which could result in the largest purchase market since 2006.

Our outlook for 2017 factors in an eventual modest increase in interest rates. The graph on the right provides different outlooks for mortgage rates, with Fannie Mae forecasting the smallest increase in the 30-year fixed-rate mortgage, from 3.5 to 3.6 percent, and the MBA forecasting the largest, from 3.7 percent to 4.4 percent. Nonetheless, the 30-year rate is expected to be less than the most recent high of 4.6 percent that was reached in June of 2013.

Now let's turn to slide 8 and discuss why we believe PennyMac Financial is uniquely positioned to capitalize on the significant opportunities in the mortgage market.

Slide 8

In the face of a market that could be smaller in 2017, we believe that PennyMac Financial has a set of compelling strategies across our mortgage production and servicing businesses that will allow us to continue to grow.

Although PennyMac Financial is now the second-largest aggregator, we still see a significant opportunity for continued profitable market share growth, particularly in the conventional conforming market for which PennyMac Financial earns a fulfillment fee from PMT. Also, because our correspondent business is focused on purchase-money loans, we expect to benefit from a forecasted strong demand for homes, even with a modest increase in mortgage rates.

We also are leveraging our demonstrated expertise and management of high-volume mortgage production to grow the consumer direct origination channel, which has become an increasingly significant contributor to PennyMac Financial's earnings. Through the activities of this channel, we see a substantial opportunity to recapture or source new opportunities from our large and growing servicing portfolio of more than 900 thousand customers. In addition, we expect the steady growth of our fulfillment capabilities to allow us to originate greater volumes and strengthen our ability to serve current customers seeking to refinance or take out a loan for a new home purchase.

Next is our planned entry into the wholesale channel. This channel represents 10 percent of the U.S. mortgage origination market and is a significant opportunity for us. Currently we are focused on developing the platform, including systems and process infrastructure, needed for a successful launch into this business in mid-2017.

In loan servicing, our strong production volumes should enable us to continue to maintain focus on growing the portfolio organically without relying on MSR acquisitions. In addition, if mortgage interest rates rise modestly, this should be a positive for the MSR asset due to reduced amortization and increased interest income. As we continue to achieve more scale, we expect to see improved servicing efficiencies.

Now, let's go to slide 9 and return to a discussion of PennyMac Financial's third quarter results.

Slide 9

PennyMac Financial achieved record results in its production business during the third quarter. Production segment pretax income rose 43 percent from the second quarter and was almost double our performance from a year ago, driven by strong margins in both correspondent and consumer direct channels that benefitted from the larger overall mortgage origination market.

Interest rate lock volumes in the correspondent channel rose 26 percent from the second quarter. This quarter's performance highlights the ability of our platform to efficiently scale to the available opportunities and achieve higher margins, while capturing market share from less efficient operators. Consumer direct locks increased 19 percent from the second quarter – but what's notable is that our third quarter performance is almost double what it was a year ago, demonstrating that consumer direct is a major growth engine for PennyMac Financial's future.

Our investments in consumer direct sales and fulfillment capacity have been the key growth drivers of this channel. Given the significant potential available within our existing servicing portfolio and the size of the market opportunity, our main focus for consumer direct is on growing our operational capabilities to address greater volumes of loans. 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.

Now let's turn to slide 10 and review the drivers of profitability in our Servicing segment.

Slide 10

As I mentioned earlier, PennyMac Financial's servicing segment realized a pretax loss of 10.7 million dollars in the third quarter. The impact of fair value changes can obscure the underlying profitability of our servicing business. Excluding fair value changes, the servicing segment pretax income was 5.1 million dollars in the third quarter, compared with 19.1 million dollars last quarter, 8.3 million dollars in the first quarter of 2016 and 10 million dollars for the full-year of 2015. As a percentage of the average servicing portfolio UPB, pretax income excluding fair value changes was 1.2 basis points in the third quarter, compared with 4.5 basis points in the second quarter, 2 basis points in the first quarter of 2016, and just under 1 basis point for the full year of 2015.

The decrease in pretax income for the third quarter was largely due to higher expenses from early buyout transactions relative to the second quarter. The higher third quarter EBO-related expenses should produce future value from EBO-related revenues and lower carrying costs. It should be noted that profitability in the second quarter was aided by 5.1 million dollars in servicing activity fees related to a sale of loans by PMT and a 4.9 million dollar reduction to our allowance for credit losses on delinquent loans due to increased expectation of reperformance.

While we report servicing and production as separate segments, their values are interrelated. Much of the servicing portfolio's economic value comes from being a source of new leads for the origination business. We expect the standalone profitability of servicing to improve over time, as we continue to focus on driving efficiencies through technology and realizing economies of scale as the servicing portfolio grows.

With that, I'd now like to turn the discussion over to David Spector, 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.

On slide 11, I would like to begin my remarks by reviewing market share and volume trends across PennyMac Financial's businesses.

Slide 11

PennyMac Financial was the fourth-largest producer of mortgage loans in the United States during the third quarter, according to *Inside*

Mortgage Finance, and we estimate that we remained the 11th largest servicer.

We achieved record correspondent production volumes that led to market share that we estimate was close to 10-½ percent in the third quarter, up from just over 9 percent in the prior quarter, while in our consumer direct business, our market share remained essentially flat.

We estimate that our market share in loan servicing grew to a little over 1.8 percent of all mortgage debt outstanding in the United States.

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

Slide 12

Correspondent production totaled 18.9 billion dollars in UPB for the third quarter, a 30 percent increase from the second quarter. Government-insured and guaranteed loan acquisitions accounted for 62 percent of total correspondent acquisitions, or 11.7 billion dollars in the third quarter. Total lock volume was 21.6 billion dollars, up 35 percent quarter-over-quarter.

PennyMac Financial performed fulfillment services for PMT on 7.3 billion dollars of conventional production during the quarter, representing a 40 percent quarter-over-quarter growth.

In October, total correspondent loan acquisitions were 7 billion dollars in UPB, while interest rate lock commitments were 6.7 billion dollars in UPB.

Our highly automated and scalable platform again delivered record volumes. On a year-over-year basis, our correspondent production volumes increased 31 percent from the third quarter of 2015.

Together, these increases in production volume reflect a larger mortgage origination market and a higher share of originations that are being sold to correspondent aggregators.

Market share increases were driven by maintaining high service levels in a market with elevated volumes, increased business from new sellers added in recent periods, and the purchase-money orientation of our sellers.

Purchase-money loans accounted for 67 percent of our correspondent production during the quarter.

Our non-delegated correspondent program, which launched in the second quarter, drove a majority of the quarter-over-quarter growth in seller relationships. The number of sellers increased to 504, up from 457 in the prior quarter. Now let’s turn to slide 13 and discuss consumer direct production.

Slide 13

Origination volumes in the third quarter for our Consumer Direct production totaled 1.7 billion dollars in UPB, a 12 percent increase from the second quarter, and a 61 percent increase from the third quarter of 2015.

In October, we achieved consumer direct originations of 651 million dollars in UPB and interest rate locks of 1.1 billion dollars in UPB. The committed pipeline was 1.4 billion dollars in UPB as of October 31st, 2016.

Our growth reflects the benefits from ongoing investments in sales and fulfillment capacity. We produced nearly 63-hundred loans in the third quarter, compared with just over 45-hundred loans in the third quarter of 2015.

In addition, we opened a new consumer direct lending call center near Seattle during the third quarter. As we expand our consumer direct platform, this new location allows us to tap into a labor pool of highly experienced mortgage professionals.

We also continue to concentrate on portfolio recapture, with an emphasis on conventional and purchase-money opportunities.

Now let's turn to slide 14 and discuss our loan servicing business.

Slide 14

In the third quarter, our loan servicing portfolio grew to 182.1 billion dollars in UPB, an increase of 6 percent from the second quarter. Strong correspondent and consumer direct production volumes more than offset higher prepayment activity, resulting in sustained organic portfolio growth.

We also completed the previously announced acquisition and transfer of approximately 1 billion dollars in UPB of MSRs related to defaulted government-insured loans from a large bank.

We continue to experience success with early buyout loans – curing and modifying delinquent government loans – which helps reduce future servicing expenses and creates revenue opportunities from the sale of reperforming loans.

Now let's turn to slide 15 and discuss the investment management segment.

Slide 15

PMT's book value per share increased to 20 dollars and 21 cents, up from 20 dollars and 9 cents at June 30th. One key that distinguishes PMT among mortgage REITs is that it has a unique opportunity to take part in GSE credit risk transfers stemming from its own correspondent production. To that end, PMT recently completed its third CRT commitment with Fannie Mae and has entered into a fourth CRT flow commitment with Fannie Mae.

PMT continues to transition capital towards new opportunities such as CRT, and away from distressed loan investments. PMT also continues 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 third quarter's financial results. Anne

Speaker:

Anne McCallion, Chief Financial Officer

Thank you, David.

Slide 16

Turning to slide 16, here is an overview of PennyMac Financial's results by operating segment. Stan reviewed these figures in detail in his section, so let's turn to slide 17 and take a closer look at the results of the Production segment.

Slide 17

Production segment revenues were 232.6 million dollars for the third quarter, up 37 percent from the second quarter. The increase was primarily driven by a 44 percent quarter-over-quarter increase in net gains on mortgage loans held for sale. This increase was primarily driven by strong margins and significant increases in production and lock volumes in both the correspondent and consumer direct channels. Net gains on mortgage loans held for sale during the quarter included a 6.6 million dollar benefit from a change in the estimate of our representations and warranty liability.

Fulfillment fee revenue increased 43 percent to 27.3 million dollars in the third quarter, driven by a 40 percent quarter-over-quarter increase in conventional conforming loan acquisitions fulfilled for PMT. The weighted average fulfillment fee rate during the quarter was 38 basis points, up slightly from 37 basis points in the prior quarter.

During the third quarter, PennyMac Financial acquired 11.7 billion dollars in UPB of government-insured mortgages through correspondent production, a 24 percent increase from the second quarter. The Company also originated 1.7 billion dollars in UPB of loans through consumer direct production, up 12 percent from the prior quarter, and interest rate lock commitments on government-insured correspondent and consumer direct loans increased 26 percent from the second quarter of 2016.

Production revenue, excluding fulfillment fees, as a percentage of consumer direct and government-insured correspondent interest rate lock commitments, was 126 basis points in the third quarter, compared with 116 basis points in the prior quarter, reflecting a strong origination market and solid operational execution from both production channels.

Revenue per consumer direct lock increased to 323 basis points from 307 basis points in the second quarter, while revenue per correspondent lock increased to 68 basis points from 58 basis points in the prior quarter.

Production segment expenses were 82.8 million dollars, a 27 percent increase from the second quarter, due to increased production volumes and higher incentive compensation resulting from the Company's overall financial results.

Let's turn to slide 18 and take a look at the financial performance of the Servicing segment.

Slide 18

Servicing segment revenues were 53.2 million dollars in the third quarter, an increase of 66 percent from the prior quarter. Net loan servicing fees totaled 45.9 million dollars for the third quarter, a 73 percent quarter-over-quarter increase.

Net loan servicing fees included 122.6 million dollars in loan servicing fees reduced by 60.8 million dollars of amortization and 39 million dollars of fair value losses and impairment provisioning related to MSRs, driven by increased discount rates on Ginnie Mae MSRs. In addition, net loan servicing fees included 19 million dollars in hedging gains and 4.1 million dollars in gains due to the change in fair value of the ESS liability.

The securitization of modified and reperforming government-insured loans resulted in 15.6 million dollars of revenue from net gains on mortgage loans held for sale at fair value in the third quarter, versus 14.3 million dollars in the second quarter. These loans were previously purchased out of Ginnie Mae securitizations and brought back to performing status through PennyMac Financial's successful servicing efforts, primarily with the use of loan modifications.

This quarter's valuation adjustments were primarily related to observed market changes in the discount rates for Ginnie Mae MSRs, due to reduced bank participation and higher capital costs for other market participants.

Servicing segment expenses for the quarter increased by 10.9 million dollars to 63.9 million dollars, primarily due to higher expenses from early buyout transactions which are expected to be offset by benefits in the current and future periods, as Stan elaborated on earlier.

Now let's turn to slide 19 and discuss the valuation of PennyMac Financial's MSR asset.

Slide 19

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 ESS, are accounted for at fair value. PennyMac Financial accounted for 75.1 billion dollars in UPB of its originated MSRs under LOCOM, with a fair value equal to its carrying value at September 30th. We also account for another 46.2 billion dollars in UPB of MSRs at fair value.

Most of our purchased MSRs are subject to ESS owned by PMT and the UPB related to the loans underlying those MSRs totaled 33.5 billion dollars at September 30th. The outstanding ESS financing at September 30th, 2016 only relates to Ginnie Mae MSRs.

Let's now turn to slide 20 and take a look at the financial performance of the Investment Management segment.

Slide 20

Investment management revenues were 5.6 million dollars, down 10 percent from the second 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 4 percent from the prior quarter, primarily due to the reduction in net assets under management.

Carried interest from the private Investment Funds decreased to 107 thousand dollars, compared with 244 thousand dollars in the prior quarter, resulting from reduced performance of the private Investment Funds. No incentive fees were received in the third quarter as a result of PMT's financial performance over the four-quarter period for which incentive fees are calculated.

Segment expenses were 5.4 million dollars, down 2 percent from the second 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 outstanding financial performance and leadership in the mortgage markets reflects the strong organization and unique platform we have built. We expect interest rates to begin to rise incrementally from historically low rates, and current industry estimates point to the likelihood of a somewhat smaller U.S. mortgage market next year from lower refinance activity. Nonetheless, we expect the demand for home purchases to remain strong, and we see continued opportunities for us in the mortgage market. We are confident that our continued investment in our operational systems, combined with our financial capacity, will support the ongoing growth of our business. At the same time, we expect our servicing assets to generate higher returns as interest rates rise. Taken together, we believe our platform, focus on risk management, and compliance and governance culture will help ensure the long-term success of PennyMac Financial.

Lastly, 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 third 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.