PennyMac Financial Services, Inc.

First Quarter 2017 Earnings Transcript

May 4, 2017

Introduction

Good afternoon, and welcome to the first quarter earnings discussion for PennyMac Financial Services, Inc. The slides that accompany this discussion are available from PennyMac Financial's website at www.ir.pennymacfinancial.com. Before we begin, please take a few moments to read the disclaimer on slide two of the presentation. Thank you.

Now I'd like to turn the discussion over to Stan Kurland, PennyMac Financial's Executive Chairman.

Speaker:

Stanford L. Kurland – Executive Chairman

Thank you, Chris.

Let's begin with slide 3.

Slide 3

PennyMac Financial's first quarter results reflect a higher mortgage rate environment and a seasonally slow period for home buying activity.

For the first quarter, PennyMac Financial earned pretax income of 62 million dollars and diluted earnings per share of 47 cents. This compares with earnings per share of 1 dollar in the prior quarter, and 23 cents per share in the first quarter of 2016. Book value increased to 16 dollars and 1 cent per share, up from 15 dollars and 49 cents at December 31st, and from 12 dollars and 59 cents at March 31st of 2016.

Looking at earnings contribution by segment, the production segment pretax income was 47.5 million dollars, down 49 percent from the prior quarter and down 31 percent from the first quarter of 2016. The quarter-over-quarter performance was driven by lower volumes and margins in both the correspondent and consumer direct production channels.

Total production volume was 14.9 billion dollars in unpaid principal balance for the quarter, a decrease of 32 percent from the prior period and up 37 percent from the first quarter of 2016. Total interest rate lock volume was 16.3 billion dollars in UPB, down 24 percent from the fourth quarter and up 29 percent from the first quarter of 2016.

The servicing segment generated pretax income of 13.4 million dollars, compared to a pretax gain of 35.1 million dollars in the prior quarter and a loss of 39.5 million dollars in the first quarter of 2016. Excluding valuation-related changes, pretax income for the servicing segment was 22.3 million dollars, down 9 percent from the previous quarter and up 36 percent from the prior year period.

Our servicing portfolio grew to 202.9 billion dollars in UPB, up 4 percent from December 31st, 2016 and up 23 percent from March 31st, 2016.

Slide 4

Continuing with our highlights on slide 4, the Investment Management segment recorded pretax income of 1.1 million dollars, compared with pretax income of 0.4 million dollars in the prior quarter and 1.1 million dollars in the first quarter of 2016. Net assets under management were 1.6 billion dollars, up half a percent from 1.5 billion dollars at December 31st, 2016, and down 4 percent from 1.6 billion dollars at March 31st, 2016.

During the first quarter, we issued 400 million dollars in 3-year term notes from our structured MSR financing vehicle. We are very pleased with this transaction and I will discuss it in more detail later in my presentation.

Lastly, after quarter end we acquired a bulk portfolio of Ginnie Mae MSRs with UPB of approximately 4.3 billion dollars, deploying some of the proceeds from the term note issuance.

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

Slide 5

Mortgage rates during the first quarter were volatile, moving up and down within a relatively narrow range for most of the quarter, but ultimately ended the quarter down 18 basis points from their recent high level at the end of last year. Fixed rate mortgages ended the quarter at 4.1 percent, and have declined further to 4 percent as of April 27th.

The rapid onset of higher rates has slowed prepayment activity in Agency MBS. During the first quarter, prepayment speeds on 30-year Fannie Mae and Freddie Mac MBS averaged 11.8 CPR and 10.8, respectively, compared to an average of 17.6 and 16.4, respectively, for the full year 2016. The slowdown in prepayment speeds for Ginnie Mae MBS was similar to Fannie Mae and Freddie Mac MBS, down nearly six points to an average of 15.7 in the first quarter.

While home sales slowed in the first quarter due to typical seasonal factors, they remain at multi-year high levels. The recent decline in interest rates has supported affordability, although tight inventories continue to pose a challenge for homebuyers in much of the country. However, we are seeing a broad-based pickup in pending home sales, which suggests that the spring and summer home-buying season could be strong.

As we have discussed since the presidential election, any regulatory or policy changes affecting the mortgage industry remain uncertain. While we continue to believe that a more balanced consideration of the costs and benefits of regulation is needed, we believe that any significant near-term impact is likely to be limited.

Now let's turn to slide 6 and discuss our outlook for U.S. mortgage originations.

Slide 6

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 in 2017.

The graph on the left side shows estimates for the size of the U.S. residential mortgage origination market in 2016 from Fannie Mae, Freddie Mac and the Mortgage Bankers Association, contrasted against expectations for this year's origination market.

Despite the recent decline in mortgage rates in April, the latest forecasts indicate little change in the outlook for the 2017 origination market, remaining at just under 1.6 trillion dollars.

Mortgage rates are expected to remain low relative to historic levels; however, forecasts anticipate that mortgage rates will increase modestly through the remainder of 2017. Recently rates have moved lower, and mortgage origination activity has increased. If current mortgage rates persist, we may see an upward revision to 2017 origination forecasts.

Now let's turn to slide 7 and review our Ginnie Mae MSR financing arrangement, marking what we believe is a watershed development for the mortgage banking industry.

Slide 7

Last December, we put in place a financing structure where we pledged our Ginnie Mae MSRs and ESS to a trust. We can borrow against their collateral value in two forms: a variable funding note, which is designed to address fluctuations in collateral value, and term notes. This structure significantly increases the amount of Ginnie Mae MSR financing available to PennyMac Financial.

We borrowed under the variable funding note in the fourth quarter of last year, replacing existing bank financing in the same amount. In the first quarter, we successfully issued 400 million dollars of secured term notes with an interest rate of one month LIBOR plus 475 basis points. The deal was met with strong demand from a diverse group of institutional investors, showing that appetite exists for financing MSRs that are serviced by a counterparty with strong financial and operational performance. As a result of the successful issuance, the effective advance rate on our Ginnie Mae MSR asset increased to 52%, from approximately 26% without the term notes.

The Term Notes have a three-year term, which can be further extended by one year at our option. This term financing better aligns with the expected life of the MSR asset. Our structure also gives us the ability to issue additional term notes as the collateral base grows. The diversification of our financing to include institutional investors, along with the extension of the duration, considerably improves the financial structure of the company.

Now let’s turn to slide 8 and discuss the impact of PennyMac Financial’s hedge approach on our first quarter’s results.

Slide 8

PennyMac Financial seeks to moderate the impact of interest rate changes through a comprehensive hedge strategy that also considers production-related income.

During the first quarter of 2017, while interest rates were volatile, the fair value of PennyMac Financial's MSR increased modestly. MSR fair value gains resulted from lower expected prepayment activity and improvements in the delinquency profile.

Offsetting the gains from MSRs were hedge expenses net of a small gain on the ESS liability. The ESS gain primarily resulted from prepayment activity during the quarter that was higher than projected. Financial markets during the first quarter experienced considerable volatility and inconsistent movement of the Swaps, Treasury and Mortgage markets. These factors led to increased hedge costs and mismatches between our MSR and ESS asset valuation changes and hedge performance.

Now, let's go to slide 9 and discuss the profitability of our servicing segment.

Slide 9

As I mentioned earlier, the servicing segment contributed pretax income of 13.4 million dollars in the first quarter down from 35.1 million dollars in the prior quarter and up from a loss of 39.5 million dollars in the first quarter of 2016. As a percentage of the average servicing portfolio UPB, pretax income excluding valuation-related changes was 4.5 basis points in the first quarter, down from 5.2 basis points for the fourth quarter and up from 4 basis points in the first quarter of 2016.

Excluding valuation-related changes, servicing segment pretax income was 22.3 million dollars, compared to 24.6 million dollars in the prior quarter. The 8 percent decrease was primarily due to higher operating and EBO transaction-related expenses, partially offset by higher EBO-related and operating revenue, in addition to lower amortization expense. During the quarter, EBO activity nearly doubled from the prior quarter, totaling 690 million dollars in UPB. This increase was made possible by the proceeds provided by the term note issuance under our Ginnie Mae financing structure. The significant increase in activity generated higher current period expense. However, we expect this to translate into higher EBO-related revenues in the future.

Additionally, interest paid to third parties increased as a result of the term note issuance and additional financing.

We remain focused on improving the profitability of servicing.

As we continue to grow the servicing asset, we look for greater economies of scale to improve our expense management and drive down our unit costs. As importantly, we are focused on the value enhancement provided by increased EBO initiatives.

This concludes my overview of PennyMac Financial's first quarter performance. Now I'd like to turn the discussion over to David Spector, PennyMac Financial's President and Chief Executive Officer, to review the operational results in each of our businesses.

<u>Speaker:</u>

David Spector – President and Chief Executive Officer

Thank you, Stan.

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

<u>Slide 10</u>

PennyMac Financial was the fourth-largest producer of mortgage loans in the United States during the first quarter, according to *Inside Mortgage Finance*, and we estimate that we remained the 11th largest servicer.

Correspondent production market share grew to 11.3 percent in the first quarter, up from almost 10.8 percent in the prior quarter. In our consumer direct business, the rapid onset of a higher interest rate environment in November and heightened competition drove a reduction in market share to levels in line with the second and third quarters of 2016.

We estimate that the market share of our loan servicing portfolio grew to almost 2 percent of all mortgage debt outstanding in the United States. And lastly, assets under management by our investment management segment were 1.56 billion dollars, up modestly from 1.55 billion dollars in the prior quarter, driven by a preferred share issuance by PMT this quarter.

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

Slide 11

Correspondent acquisitions by PMT in the first quarter totaled 13.9 billion dollars in UPB, a 31 percent decrease from the fourth quarter and up 44 percent year-over-year.

Government loan acquisitions accounted for 67 percent of total correspondent acquisitions, or 9.3 billion dollars in the first quarter, down 26 percent from the prior quarter and up 44 percent from the first quarter of 2016. Conventional conforming acquisitions, whereby PennyMac Financial performed fulfillment services for PMT, totaled 4.6 billion dollars in the first quarter, down 38 percent from the prior quarter and up 42 percent from the first quarter of 2016. Total lock volume was 14.5 billion dollars, down 25 percent from the prior quarter and up 39 percent from the first quarter of 2016.

The decline in our acquisition volumes this quarter primarily resulted from the sharp rise in mortgage rates last November, which drove a significant reduction in total refinance market activity. The increase in mortgage rates occurred at the same time mortgage activity typically begins to slow in the winter months. Combined, these two factors contributed to a 34 percent quarter-over-quarter decrease in total mortgage market production, according to *Inside Mortgage Finance.*

PennyMac's correspondent channel fared a little better than the market overall and we believe gained market share as a result.

Looking at April volumes, correspondent loan acquisitions totaled 4.4 billion dollars in UPB, while interest rate lock commitments totaled 4.8 billion dollars in UPB. The modest decline in mortgage rates after quarter end has helped boost mortgage refinance activity from first quarter levels, and we see increased purchase-money activity as well.

Purchase-money loans accounted for 73 percent of our correspondent production during the quarter, up from 62 percent in the fourth quarter. The purchase-money orientation of our correspondent production volume is an important differentiating factor and one which positions us well for the anticipated origination mix in 2017.

We continued to grow our seller relationships during the quarter, driven by success in expanding our non-delegated correspondent program and smaller seller relationships which utilize more of our platform's extensive capabilities. At the end of the first quarter, we had 557 seller relationships, up from 522 in the prior quarter.

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

Slide 12

Consumer direct production volume totaled 1 billion dollars in UPB in the first quarter, down 49 percent from the fourth quarter and down 14 percent year over year. The committed pipeline at the end of the first quarter was 705 million dollars.

The magnitude and speed of the rise in mortgage rates, along with heightened competition in a smaller mortgage market, significantly impacted our refinance-focused consumer direct volumes and margins this quarter.

We are seeing a pickup in volume from the recent rate decline. In April, consumer direct originations totaled 324 million dollars in UPB, and interest rate lock commitments were 713 million dollars in UPB. The committed pipeline was 780 million dollars in UPB as of April 28th, 2017.

We are implementing a variety of technology enhancements and workflow efficiencies in consumer direct to drive down origination costs and improve the speed and precision of the loan application decisioning processes. These enhancements will allow us to respond to applicants within hours rather than days and drive improved lead conversion as a result. We also are enhancing our portfolio lead generation strategies to better capture the potential opportunities in our servicing portfolio.

A key strategic focus going forward is growing our non-portfolio business by developing affinity relationships, with the goal of having non-portfolio volumes comprise a meaningful percentage of our overall origination volume. We've increased the number of agreements with affinity partners to help deliver on this objective. The success we've achieved thus far leads us to believe that we can grow the non-port volumes to 10 percent of total volume by the second half of this year. To help facilitate these initiatives, and position consumer direct for the next phase in its evolution, we have opened a new processing center in St. Louis, Missouri.

We remain optimistic regarding our strategic direction and our ability to meaningfully grow our retail business in the coming years.

Now let’s turn to slide 13 and discuss our loan servicing business.

Slide 13

In the first quarter, our loan servicing portfolio grew to 202.9 billion dollars in UPB, an increase of 4 percent from the fourth quarter and up 23 percent year-over-year. During the first quarter, our servicing portfolio reached a significant milestone when we surpassed 1 million customers. PennyMac is unique among large non-bank mortgage servicers in our proven ability to deliver consistent portfolio growth, driven by the volumes added by our leading production activities.

Prepayment activity slowed considerably during the quarter as a result of higher rates. The CPR on the MSR portfolio slowed to 12.7 percent from 20.7 percent in the fourth quarter.

After quarter end, we acquired a bulk portfolio of Ginnie Mae MSRs totaling 4.3 billion dollars in UPB. PennyMac Financial acquired the portfolio with funding provided by proceeds from our new Ginnie Mae MSR facility. We continue to seek additional opportunities to supplement the organic growth of our servicing portfolio though additional MSR acquisitions.

As Stan discussed earlier, our EBO transaction volume increased significantly in the quarter. Our expertise in loss mitigation enables us to rehabilitate a significant portion of these loans, allowing customers to remain in their homes.

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

Slide 14

As we mentioned earlier, net assets under management were 1.56 billion dollars compared with 1.55 billion dollars at December 31st, 2016. The growth in net assets was driven by PMT's preferred equity raise, which was partially offset by Investment Fund distributions to investors.

In March, PMT issued 4.6 million shares of 8 1/8th Series A fixed-to-floating rate preferred shares for gross proceeds of 115 million dollars. This was PMT's first preferred share issuance and its first capital raise since August 2015. Proceeds from the issuance are being used to fund PMT's business and investment activities, repayment of indebtedness and potential common share repurchases.

PMT also continued its transition of capital toward newer investment opportunities such as MSRs and CRT on its correspondent production. During the quarter, PMT delivered 1.8 billion dollars in UPB of loans to

Fannie Mae, which will result in approximately 64 million dollars of new CRT investments once the aggregation period is completed.

With that I'd now like to turn it over to Andy Chang, PennyMac's Chief Financial Officer, to discuss the first quarter's financial results.

Speaker:

Andy Chang, Chief Financial Officer

Thank you, David.

Slide 15

Slide 15 is an overview of PennyMac Financial's results by operating segment. Stan reviewed these figures for the first quarter earlier, and the table shows trends for the last five quarters. Let's turn to slide 16 and take a closer look at the results of our Production segment.

Slide 16

Production segment revenues were 110 million dollars for the first quarter, down 37 percent from the prior quarter. The decrease was primarily the result of a 39 percent decrease in net gains on mortgage loans held for sale, reflecting lower total lock volumes and margins in both the correspondent and consumer direct production channels.

Gross margins, which represent the revenue per lock commitment, were 84 basis points in the first quarter, down from 101 basis points in the prior quarter. Revenue per consumer direct lock decreased to 218 basis points from 292 in the prior quarter, while revenue per correspondent lock decreased to 53 basis points from 61 in the prior quarter. These margins are at the low end of the ranges that we've seen over the past several quarters.

Fulfillment fee revenue was 16.6 million dollars in the first quarter, down 39 percent from the prior quarter, driven by a 38 percent quarter-over-quarter decrease in acquisition volumes by PMT. The weighted average fulfillment fee rate during the quarter was 36 basis points, unchanged from the prior quarter.

Production segment expenses were 62.5 million dollars, a 23 percent decrease from the prior quarter, driven by the lower volumes of activity.

Let's turn to slide 17 and review the financial performance of the servicing segment.

Slide 17

Servicing segment revenues were 89 million dollars in the first quarter, a decrease of 18 percent from the prior quarter. Net loan servicing fees totaled 74.2 million dollars for the first quarter, compared with 95.5 million dollars in the prior quarter.

Net loan servicing fees included 129.3 million dollars in loan servicing fees reduced by 48.5 million dollars of amortization and realization of MSR cash flows. Amortization and realization of cash flows decreased

3 percent from the prior quarter. Net loan servicing fees also included 12.7 million dollars in MSR fair value gains and impairment recovery, primarily reflecting expectations for lower prepayment activity in the future. In addition, net loan servicing fees included 22.2 million dollars in hedging losses and a gain of 2.8 million dollars due to the change in fair value of the ESS liability resulting from higher than projected prepayment activity during the quarter. The net loss in MSR value after hedge losses and ESS fair value gains was 6.7 million dollars.

The securitization of reperforming government-insured and guaranteed loans resulted in 24.1 million dollars of revenue in net gains on mortgage loans held for sale at fair value in the first quarter versus 24.5 million dollars in the prior quarter. These loans were previously purchased out of Ginnie Mae securitizations, known as early buyouts or EBOs, and brought back to performing status through PennyMac Financial's successful servicing efforts, primarily with the use of loan modifications. Additionally, net interest expense was reduced by approximately 4 million dollars of interest income from EBO loans held on our balance sheet.

Servicing segment expenses for the quarter were 75.6 million dollars, a 4 percent increase from the prior quarter, driven by growth of the portfolio, increased allocation of compensation expense to the segment and higher technology-related costs.

Now let's turn to slide 18 and discuss the valuation of PennyMac Financial's MSR asset.

Slide 18

MSRs are a significant portion of PennyMac Financial's assets, and their fair value generally increases when interest rates rise and decreases when interest rates fall.

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 related to loans with note rates above 4.5 percent, and all purchased MSRs are accounted for at fair value. PennyMac Financial accounted for 93.2 billion dollars in UPB of its originated MSRs under LOCOM at March 31st. The fair value of these MSRs was 8.9 million dollars greater than their carrying value on our balance sheet. The remaining 42.1 billion dollars in UPB of MSRs are accounted for at fair value.

Most of our purchased MSRs are subject to an ESS liability. The UPB related to the loans underlying those MSRs totaled 30.5 billion dollars at March 31st. The outstanding ESS liability at March 31st relates only to Ginnie Mae MSRs.

Now let's turn to slide 19 and look at the financial performance of the Investment Management segment.

Slide 19

Investment management revenues were 5.4 million dollars, down 6 percent from the fourth quarter of 2016. Segment revenues include management fees, comprised of base management fees from PMT and the private Investment Funds, any earned incentive fees from PMT, any carried interest from the funds and Other revenue. The quarter-over-quarter decline in revenue was primarily driven by a carried interest loss of 128 thousand dollars due to performance of the Investment Funds.

No incentive fees were received from PMT in the first quarter.

Segment expenses were 4.3 million dollars, a 19 percent decrease from the fourth quarter of 2016, driven by a refinement in the expense allocation methodology across segments.

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

<u>Speaker:</u>

Stanford L. Kurland – Chairman and Chief Executive Officer

Thank you, Andy.

PennyMac Financial's first quarter results reflect a mortgage market that is transitioning from a period of historically elevated margins to a period of more normal margins. We have consistently demonstrated an ability to operate through market volatility of various kinds and continue to invest in initiatives that we believe will drive our company forward. These include our consumer direct production channel, non-delegated correspondent initiatives, the future launch of our wholesale mortgage origination platform and the completion of our structure to expand financing for our largest asset, our Ginnie Mae mortgage servicing rights. We are confident that such investments and innovations will help ensure our company's long-term financial and operational success.

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 www.ir.pennymacfinancial.com, or call our Investor Relations department at 818-264-4907.