PennyMac Financial Services, Inc.

First Quarter 2018 Earnings Transcript

May 3, 2018

Introduction

Good afternoon, and welcome to the first quarter 2018 earnings discussion for PennyMac Financial Services, Inc. The slides that accompany this discussion are available from PennyMac Financial's website at www.ir.pennymacfinancial.com. Before we begin, please take a few moments to read the disclaimer on Slide 2 of the presentation. Thank you.

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

Speaker:

Stanford L. Kurland – Executive Chairman

Thank you, Chris.

Let's begin with Slide 3.

Slide 3

PennyMac Financial's first quarter results demonstrate the earnings power of our comprehensive mortgage banking platform against the backdrop of a rising interest rate environment and intense competition among industry participants adjusting capacity to a smaller origination market.

While the market environment was challenging this quarter, the earnings contribution from our Servicing segment increased, driven by the impact of higher mortgage rates on the value of our mortgage servicing rights and solid operational execution. These results were partially offset by a decrease in earnings contribution from the Production segment, driven by lower margins.

For the quarter, PennyMac Financial earned pretax income of 73 million dollars and diluted earnings per share of 67 cents. Book value per share increased to 20 dollars and 74 cents, up from 19 dollars and

95 cents per share at December 31st, 2017 and 16 dollars and 1 cent at March 31st, 2017.

Our Production segment pretax income was 17.2 million dollars, down 69 percent from the prior quarter and 64 percent from the first quarter of 2017. Acquisition and origination volume totaled 14.3 billion dollars in UPB, down 16 percent from the prior quarter and 4 percent from the first quarter of 2017. Total correspondent government and direct lending locks were 10.9 billion dollars in UPB, down 8 percent from the prior quarter and 2 percent from the first quarter of 2017.

The Servicing segment recorded pretax income of 54.9 million dollars, up 71 percent from the prior quarter and 309 percent from the first quarter of 2017.

We continued to grow our servicing portfolio which totaled 255.3 billion dollars in UPB at quarter end, up 4 percent from the prior quarter and 26 percent from March 31st a year ago.

Excluding valuation-related items, pretax income for the Servicing segment was 36.3 million dollars, up 29 percent from the prior quarter and 63 percent from March 31st a year ago.

Valuation-related items for the first quarter included a 127.8 million dollar increase in MSR values, partially offset by a 103.6 million dollar decline from hedging, and a 6.9 million dollar loss due to the change in fair value of excess servicing spread liability.

Our Investment Management segment delivered pretax income of 1 million dollars, down from 1.5 million dollars in the prior quarter and 1.1 million dollars at March 31st a year ago. Net assets under management were 1.5 billion dollars, down 2 percent from the prior quarter and 1 percent from March 31st a year ago.

Also during the quarter, we issued 650 million dollars of 5-year term notes from PennyMac's Ginnie Mae mortgage servicing rights financing structure at a rate of one month LIBOR plus 285 basis points. We used a portion of the proceeds to refinance 400 million dollars of term notes issued in February 2017. The ability to raise capital at attractive terms from a broad group of institutional investors helps to grow our business while strengthening our balance sheet and liquidity profile.

Now let's turn to Slide 4 and look at the current market environment.

Slide 4

There was significant volatility across financial markets in the first quarter. Interest rates increased sharply, with the average 30-year fixed-rate mortgage rising from less than 4 percent at the start of the quarter to nearly 4.5 percent at quarter end. Mortgage rates have continued to rise after quarter end and are now at the highest levels in over four years.

Total mortgage originations were down 21 percent quarter-over-quarter according to *Inside Mortgage Finance*, driven by a decline in refinancing activity and resulting in prepayment activity reaching multi-year lows.

While the refinancing market is experiencing significant headwinds, demand for home purchases is expected to remain strong. Home sales forecasts indicate multi-year growth of approximately 6 percent in home sales through 2020, driven by continued strong consumer demand for homes.

Over the past several years, the U.S. housing market has experienced broad home price appreciation, resulting in a record level of tappable home equity totaling 5.4 trillion dollars, according to Black Knight Financial Services. Of this amount, nearly 3 trillion dollars is held by borrowers with FICO scores of 760 or higher. This large potential market, along with growth in non-mortgage consumer debt, is expected to create demand for loan products that allow access to home equity. We expect refinance demand to shift increasingly from rate and term activity to more cash-out refinances, in addition to increased use of home equity lines of credit, which will allow borrowers to access their home equity without refinancing their first-lien mortgage.

Mortgage delinquencies increased modestly from a year ago. According to Black Knight Financial Services, the total U.S. loan delinquency rate for loans 30 days or more past due, including areas affected by last year's severe hurricanes, was 3.7 percent at the end of the quarter, compared to 3.6 percent as of March 31st, 2017. Excluding the impact of hurricanes, mortgage performance improved from the same period a year ago.

Now let's turn to Slide 5 and review the current business outlook.

Slide 5

The mortgage origination market is in a period of significant transition as the market absorbs the impact of higher rates on production activity. Competition among originators and aggregators is intense, and market participants have reduced their margin requirements to fill existing operational capacity.

Over time, we expect the market will normalize as capacity adjusts to a smaller market. We are already starting to see some originators reduce headcount and others exit the mortgage business.

As a market leader, we believe that PennyMac Financial is well-positioned for success in a challenging production market. The majority of our production is oriented towards purchase-money loans, which are expected to grow this year, and we have economies of scale and capital advantages that many other firms lack. We have demonstrated our ability to raise low-cost capital and deploy that capital in mortgage servicing rights at attractive returns. We maintain a disciplined focus on expense control and operate a leading, low-cost correspondent aggregator and have a highly variable cost structure in our consumer direct production channel. At the same time, our servicing segment continues to realize benefits from a growing servicing portfolio and higher interest rates.

In addition to our existing growth initiatives in correspondent and consumer direct, our newer growth initiatives include broker direct, non-delegated correspondent and jumbo loans, which David will cover in more detail during his presentation.

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.

On Slide 6, let's begin with a review of market share and volume trends across PennyMac Financial's businesses.

Slide 6

For the first quarter, PennyMac Financial remained the 4th largest producer of mortgage loans and the 8th largest servicer in the country, according to *Inside Mortgage Finance*.

Correspondent market share increased in the first quarter primarily because our origination volumes held up better than the market as a whole. Our consumer direct market share dipped slightly, as our volume decline slightly outpaced estimates for the decline in total retail channel volume this quarter.

With the growth of our servicing portfolio, we estimate that we serviced 2.4 percent of all mortgage debt outstanding in the United States at quarter end, up from 2.3 percent last quarter.

In our investment management business, net assets under management were 1.54 billion dollars, down slightly from the previous quarter.

Now let's turn to Slide 7 and discuss correspondent production highlights.

<u>Slide 7</u>

Correspondent acquisitions by PMT in the first quarter totaled 13.1 billion dollars in UPB, down 15 percent from the prior quarter and 6 percent from the first quarter of 2017.

Government loan acquisitions accounted for 68 percent of total correspondent acquisitions, or 8.8 billion dollars in UPB in the first quarter, down from 9.5 billion dollars in UPB in the prior quarter and 9.3 billion dollars in UPB in the first quarter of 2017.

Conventional conforming acquisitions, for which PennyMac Financial performed fulfillment services for PMT, totaled 4.2 billion dollars in UPB in the first quarter, down 28 percent from the prior quarter and 9 percent year-over-year. The weighted average fulfillment fee in the first quarter was 28 basis points, reduced from 33 basis points in the prior quarter, as the fulfillment fee rate was adjusted to reflect the more competitive market environment.

Total lock volume for the first quarter was 13.6 billion dollars in UPB, down 14 percent from the prior quarter and 6 percent year-over-year. Government locks totaled 9.2 billion dollars in UPB in the first quarter, down 4 percent from the prior quarter and 1 percent year-over-year.

The volume declines were driven by higher mortgage rates and the competitive factors that we have discussed, as well as some seasonal impacts as well. The decrease in our revenue margins reflects these factors, as well as our strategy to deploy capital into additional MSR investments.

The purchase-money percentage of our correspondent acquisition volume was 77 percent in the first quarter, up from 76 percent in the prior quarter, and continues to position us well for the forecasted growth in purchase market origination volumes.

And as Stan mentioned earlier, we increased our emphasis on a prime jumbo offering to better serve our customers and drive additional purchase volume. The Jumbo product also creates potential new investments for PennyMac Mortgage Investment Trust in the subordinate tranches of future securitizations.

Monthly production volumes increased in April. Total correspondent loan acquisitions were 4.7 billion dollars in UPB, while interest rate lock commitments totaled 5.6 billion dollars in UPB, an increase from 4.4 billion dollars in acquisitions and 4.8 billion dollars in locks in April 2017.

Now let's turn to Slide 8 and discuss consumer direct production highlights.

Slide 8

Consumer direct production volume totaled 1.3 billion dollars in UPB in the first quarter, down 23 percent from the prior quarter while up 22 percent year-over-year.

April consumer direct originations totaled 291 million dollars in UPB and interest rate lock commitments were 556 million dollars in UPB.

The committed pipeline increased from 556 million dollars at March 31st, 2018, to 668 million dollars in UPB at April 30th.

Revenue per fallout adjusted consumer direct lock for the first quarter decreased to 326 basis points from 370 basis points in the prior quarter.

Rate and term refinance opportunities from the servicing portfolio declined for consumer direct in the face of rising interest rates. However, we have continued to grow our cash-out refinance and non-portfolio volumes.

To further support the consumer direct channel, we launched a new portal last month, which we expect to help drive further non-portfolio and purchase-money origination volume growth. This portal provides access to technology with increased functionality and is designed to drive a more seamless experience for our customers. It will also provide improved tools for our sales and fulfillment teams to serve our customers faster while driving greater productivity.

Our product emphasis also continues to evolve as we focus on continued growth in conventional loans, FHA and VA refinance and purchase-money loans. We also increased our emphasis on prime jumbo loans in the consumer direct channel as well.

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

Slide 9

Since we launched this channel in January, broker and other user feedback on our state-of-the-art POWER portal and approval process has been favorable, with the client engagement model and value proposition resonating across the broker community.

We are focused on expanding our platform features as we continue to develop the channel. Future enhancements include:

- Messaging and loan status capabilities
- Further automation of broker disclosures, and
- Our jumbo and adjustable rate loan products

As of last week, we have signed up and approved over 200 broker customers, and the pace of growth since launch has been strong.

We view the broker channel as an attractive growth opportunity. It opens up access to an additional 10 percent of the 1.7 trillion dollar U.S. mortgage origination market and enables PennyMac to leverage our proven ability to profitably produce high volumes of mortgage loans.

Our launch in January was tempered somewhat by rising interest rates during a seasonally slow period for the mortgage market. However, the continued addition of approved brokers from an estimated universe of over 10,000 brokers nationwide and ongoing investments in technology and efficiencies will drive our future success in this channel.

Now let’s turn to Slide 10 and discuss servicing highlights.

Slide 10

Our loan servicing portfolio grew to 255.3 billion dollars in UPB at the end of the first quarter, up 4 percent from the prior quarter and 26 percent from the first quarter of 2017. We continue to see organic portfolio growth, resulting from our production activities. During the quarter, we also successfully completed a previously announced bulk MSR acquisition totaling 3.2 billion dollars in UPB.

Mortgages 60 days or more past due were 2.9 percent of our portfolio, down from 3.5 percent at the end of the prior quarter, driven by the improved performance of hurricane-impacted loans.

Completed loan modifications increased to 542 million dollars in UPB in the first quarter from 380 million dollars in UPB in the fourth quarter. The increase in modification activity was the result of solid operational execution, driven largely by hurricane-impacted loans.

Also, we continue to invest in technology and successfully implemented several new servicing system enhancement modules during the quarter.

Next, let's turn to Slide 11 and review the Investment Management segment.

Slide 11

As mentioned earlier, net assets under management were 1.5 billion dollars, down modestly from last quarter.

PMT, the publicly traded REIT that we manage, continues to transition capital from distressed whole loans toward MSRs and CRT that result from its correspondent production.

Our increased emphasis on the Jumbo product in the correspondent and consumer direct channels creates potential new investments for PMT, which benefits our investment management segment.

After the quarter end, PMT issued secured term notes in an aggregate principal amount of 450 million dollars from its Fannie Mae MSR financing structure, called PMT ISSUER TRUST – FMSR. This transaction significantly strengthens PMT's liquidity profile by providing long-term financing from a broad group of institutional investors at attractive economic terms.

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 slides. We encourage you to read our press release on first quarter earnings for further details.

Slide 12

Slide 12 summarizes the impact of our hedging approach on first quarter earnings. Our hedging strategy is designed to moderate the impact of volatility in interest rates on our financial results while also considering the impact of production-related income.

As Stan discussed earlier, mortgage rates increased sharply during the first quarter and ended the quarter about 45 basis points higher than where they started. We recorded fair value gains in our MSR asset totaling 127.8 million dollars, which resulted from expectations for lower prepayment activity in the future driven by the increase in mortgage rates.

The MSR gains were partially offset by associated hedging losses and an increase in the value of the ESS liability, also due to the rise in mortgage rates.

Now, let's go to slide 13 and review the profitability of our Servicing segment.

Slide 13

Pretax income from Servicing in the first quarter was strong and benefited from the valuation-related gains I discussed on the previous slide.

Excluding valuation-related changes, servicing segment pretax income was 36.3 million dollars versus 28.2 million dollars in the prior quarter. The increase was primarily driven by elevated levels of EBO-related revenue from the reperformance of government-insured and guaranteed loans bought out of Ginnie Mae pools in prior periods. First quarter results also benefited from a reduction in the realization of cash flows from the MSR asset due to lower prepayment activity, as well as a reduction in EBO transaction-related expenses due to lower buyout volume during the first quarter. These factors were partially offset by a modest decrease in operating revenue due to elevated levels of ancillary income in the fourth quarter.

Operating expenses increased during the quarter driven by certain seasonally higher levels of expenses, as well as an increase in corporate overhead, which is allocated across segments based upon their relative profitability. Interest expense to third parties increased primarily as a result of the accelerated recognition of costs due to the refinancing of Ginnie Mae MSR-backed term notes, as well as an increase in the amount of MSR-related financing.

Overall, the performance of our servicing portfolio remains strong, and we expect the segment to deliver increasing earnings contribution to PennyMac Financial over time.

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.

The mortgage origination market is in a period of significant transition, with interest rates increasing meaningfully from the end of last year, resulting in a reduction of refinancing volumes. As the market continues to normalize, we believe PennyMac Financial is positioned to perform well as a result of our comprehensive mortgage banking platform and leading production and servicing businesses. We continue to pursue opportunities that are expected to help us grow. These include growth in our consumer direct channel and our recently launched broker channel. We also are focused on the expansion of our product menu to better serve our customers and drive additional volume, including a re-emphasis on jumbo loans and developing loan products to help borrowers access home equity. Technology is the foundation for these initiatives. We are investing in technology to drive greater efficiencies while at the same time focusing on continually improving interaction with our customers to ensure the successful execution of our growth strategies and our ability to deliver strong profitability in the future.

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

Thank you.

Operator:

This concludes PennyMac Financial Services, Inc.'s 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. Thank you.