# PennyMac Financial Services, Inc.

Third Quarter 2019 Earnings Transcript

October 31, 2019

## Introduction

Good afternoon, and welcome to the third quarter 2019 earnings discussion for PennyMac Financial Services, Inc. The slides that accompany this discussion are available on PennyMac Financial's website at ir.pennymacfinancial.com. Before we begin, please take a few moments to read the disclaimer on Slide 2 of the presentation. Thank you.

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

## Speaker:

*Stanford L. Kurland – Executive Chairman*

Thank you, Isaac

## Slide 3

PennyMac Financial's third quarter earnings reflected another exceptional quarter of operating performance, as we achieved quarterly records for the Company's pretax income and operating earnings. Our results were driven by outstanding performance in our Production segment, and continued discipline in the execution of our interest rate risk hedging strategy that effectively offset the majority of the fair value losses on our mortgage servicing rights as a result of declining mortgage rates.

PennyMac Financial earned net income of 121.5 million dollars or diluted earnings per share of 1 dollar and 51 cents for the third quarter. Book value per share increased to 24 dollars and 37 cents, from 22 dollars and 72 cents per share at the end of last quarter.

Notably, the Company has initiated a quarterly cash dividend and its Board of Directors has declared a third quarter cash dividend of 12 cents per share. I will discuss this in further detail later in my presentation.

Production segment pretax income was 179.3 million dollars, up 82 percent from the prior quarter and 599 percent from the third quarter of 2018, driven by record quarterly production volumes and higher margins across all of our production channels. Total production volume for the quarter was 34.9 billion dollars in unpaid principal balance, up 44 percent from the prior quarter and 94 percent from the third quarter of 2018. PFSI's lock volume in the correspondent channel, consisting of correspondent government and non-delegated locks, was 16.8 billion dollars in UPB, up 33 percent from the prior quarter and 80 percent from the third quarter of 2018. Direct lending locks were a record 5.6 billion dollars in UPB, up 39 percent from the prior quarter and 184 percent from the third quarter of 2018. And finally, correspondent acquisitions of conventional loans fulfilled for PMT totaled 16.6 billion dollars in UPB, up 55 percent from the prior quarter and 122 percent from the third quarter of 2018.

Let's continue on slide 4 to discuss our Servicing and Investment Management segments.

**Slide 4**

The Servicing segment recorded a pretax loss of 18.1 million dollars, versus a pretax loss of 2.7 million dollars in the prior quarter and pretax income of 33.6 million dollars in the third quarter of 2018. The results this quarter were primarily driven by net valuation-related items, which included a 295.5 million dollar decrease in MSR fair values, largely offset by 254 million dollars in hedging and other gains. The net impact of these items was a 39 cent reduction in diluted earnings per share.

Excluding valuation-related items, pretax income for the Servicing segment was 25.2 million dollars, down 46 percent from the prior quarter and 16 percent from the third quarter of 2018. Results were impacted by additional technology-related expenses of 7 million dollars related to the development and completion of our servicing system modules, which we expect will result in long-term cost reductions and which I will also expand upon later in my presentation. The lower rate environment in the quarter also drove an increase in early buyout loan volume, which was more than double from the prior quarter. As a result, we recognized 9.3 million dollars of additional expenses from the prior quarter, but we expect the buyouts to drive higher future period income from loan redeliveries. And lastly, we recognized higher realization of MSR cash flows, as lower rates also drove faster prepayments in the quarter.

Our servicing portfolio totaled 348.5 billion dollars in UPB at September 30th, an increase of 4 percent from the end of the prior quarter and 22 percent from September 30th of last year as loan production activities continue to provide net portfolio growth.

Our Investment Management segment delivered pretax income of 5 million dollars, up from 4 million dollars in the prior quarter and 2.5

million dollars in the third quarter of 2018. Segment revenue was 11.8 million dollars, up 14 percent from the prior quarter and 49 percent from the third quarter of 2018. Net assets under management totaled 2.2 billion dollars as of September 30th, up 14 percent from June 30th, as PennyMac Mortgage Investment Trust, the REIT that we manage, raised approximately 253 million dollars in new common equity during the quarter.

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

**Slide 5**

Looking ahead, the outlook for the direction of the U.S. economy continues to reflect uncertainty, driven by the lack of clarity around the impact of tariffs on international trade and a slowing rate of global growth. In response, the yield on the ten-year Treasury bond declined during most of the third quarter, driving mortgage rates lower.

The 30-year fixed rate mortgage in the third quarter averaged 3.66 percent and remained at comparable levels through October, driving a substantial increase in refinance activity. As a measure of the increase in activity, the average monthly MBA Refinance Index in the third quarter was 42 percent higher than it was in the prior quarter. Forecasts for total loan originations in 2019 now total over 2 trillion dollars, up 19 percent from the average forecast in June. Similarly, originations in 2020 are now forecasted to total 1.9 trillion dollars, largely driven by the continuation of elevated refinance volumes in a low rate environment.

Purchase originations are still expected to grow by low single-digit percentages into 2021, aided by low rates and home price appreciation that has moderated to levels more consistent with wage growth, while tight levels of supply continue to support home prices.

Credit markets remain strong, as spreads on GSE credit risk transfer securities tightened relative to the prior quarter and delinquencies remained low. The total U.S. mortgage delinquency rate was 3.53 percent as of September 30th, 2019, down from 3.73 percent at June 30th and 3.97 percent a year ago.

Now let's turn to Slide 6 and discuss a major milestone for PennyMac Financial in advancing proprietary technology.

**Slide 6**

I am very pleased to announce that we have completed a multi-year initiative related to the development of a proprietary, workflow-driven servicing system environment that we designed and built with a scalable and flexible architecture, specifically to address PennyMac's unique needs as a top mortgage servicer. Through a phased release development methodology, we have tested and implemented over 150 unique modules into our servicing workflow processes, and believe that the design of our servicing system environment is a substantial technology advancement for PennyMac Financial, creating significant cost and competitive advantages relative to the industry. This environment sits on top of a fully, cloud-based infrastructure which enables a modern approach to data management and real-time processing.  It allows greater flexibility in advancing workflow management, quicker response times to regulatory and market changes, and integrates seamlessly with the enterprise risk management activities required in today's environment.  We are excited by the culmination of our management's efforts to bring reduced costs, increased scalability and improved agility to our mortgage servicing system.  Andy will discuss the cost savings we expect later in the presentation.

In our direct origination channels, we regularly release updates to both MAC, our consumer-facing digital origination portal, and POWER, our broker-facing portal for connecting our growing network of approved brokers with our broker lending division.  David will talk later in more detail about the recent growth we have seen in these channels as a result of our continued investments.

Another important initiative relates to our production enterprise platform, where we are investing to further advance the capabilities and flexibility of our systems using both proprietary and third-party technology to support processing across all production channels. We expect these technological advancements to further enhance our production platform, providing greater scale and efficiency as an industry-leading producer of mortgage loans.

We continue to enhance our state of the art, proprietary loan pricing and bidding system that optimizes best execution within each of our production channels. This system analyzes a multitude of loan attributes to develop granular pricing optimized for the unique characteristics of each loan.

Now let’s turn to slide 7 and talk about PennyMac Financial’s initiation of a quarterly dividend.

## Slide 7

Since our founding in 2008, PennyMac Financial has maintained a focus on strong governance and risk management. We have developed a balanced business model that was built to ensure resiliency across economic cycles. This model includes our commitment to interest rate risk management which has mitigated the adverse impact of interest rate changes on MSR fair values, and has allowed us to more than triple PFSI's book value per share since our IPO in 2013. We have accomplished all of this while maintaining low levels of leverage versus peers, as reflected in our debt-to-equity ratio, which stood at 2.9 times at September 30th.

Our mortgage production and servicing businesses have primarily grown organically, and have developed into mature, industry-leading enterprises that generate significant amounts of capital. Combined with broad financing capabilities and efficient access to capital to support future growth, these factors have placed PFSI in a strong position to initiate a regular quarterly dividend. We believe the establishment of a regular quarterly cash dividend is an important component in the structure of providing long-term, sustainable stockholder returns.

I am pleased to announce that the Board of Directors has declared a cash dividend of 12 cents per share for the third quarter of 2019. We believe that this level of payout currently represents an attractive yield to investors, and simultaneously allows PennyMac Financial to continue to invest in long-term growth of the business.

The current dividend level, which will be reviewed quarterly, will take into consideration a number of factors including PennyMac Financial's earnings, liquidity, the forward-looking economic environment, the Company's growth outlook, the capital required to support ongoing growth opportunities, and compliance with other internal and external factors.

And finally, we believe the initiation of a quarterly cash dividend has the opportunity to expand the universe of potential investors in PFSI over time.

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 third quarter.

**Speaker:**

*David Spector – President and Chief Executive Officer*

Thank you, Stan.

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

**Slide 8**

According to industry data reported by *Inside Mortgage Finance,* PennyMac Financial was the fourth largest producer of mortgage loans in the country during the third quarter.

We increased our correspondent acquisitions by 45 percent in the quarter, driving our market share up to 14.5 percent in the third quarter, up from 13.5 percent in the prior quarter, and up from 11.6 percent a year ago.  We believe our commitment to consistently high service levels and fast turn times is key to our success in winning business from our correspondent seller network, and we expect this to continue to drive further growth in our market share over time.

We estimate that this quarter, PennyMac's market share in consumer direct reached 0.7 percent, up from 0.6 percent last quarter and 0.5 percent a year ago as we successfully leveraged our infrastructure to address the larger refinance opportunity provided by lower interest rates and our servicing portfolio.

Our broker direct channel market position grew significantly quarter-over-quarter, driven by an increase in the brokers approved to offer our products and higher levels of engagement.

Our servicing portfolio continued its growth in the third quarter as Stan mentioned, and we estimate that we now service 3.2 percent of all mortgage debt outstanding in the U.S., up from 3.1 percent at June 30th, and 2.6 percent at September 30th of last year.

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

**Slide 9**

Correspondent acquisitions by PMT totaled 31.5 billion dollars in UPB in the third quarter, up 45 percent from the prior quarter and 90 percent from the third quarter of 2018. The mix of our acquisition activity was 54 percent conventional loans, and 46 percent government loans.

Government loan acquisitions in the quarter, for which PMT earns a sourcing fee from PennyMac Financial, totaled 14.3 billion dollars in UPB, up 36 percent from the prior quarter and 60 percent from the third quarter of 2018.

Conventional correspondent acquisitions totaled 16.6 billion dollars in UPB, up 55 percent from the prior quarter and 122 percent from the third quarter of 2018.

Our non-delegated correspondent business also continued to grow in the quarter, with total volume of 531 million dollars in UPB, up 32 percent from the prior quarter.

PFSI's correspondent lock volume, consisting of government and non-delegated lock volume, was 16.8 billion dollars in UPB, up 33 percent from the prior quarter and 80 percent from the third quarter of 2018. Delegated government locks were 15.9 billion dollars in UPB, up 32 percent from the prior quarter and 74 percent from the third quarter of 2018.  Non-delegated lock volume totaled 853 million dollars in UPB, up 34 percent from the prior quarter.

Given our growth in acquisition volumes, I am proud to mention that according to *Inside Mortgage Finance*, PennyMac was the largest correspondent aggregator in the United States in the third quarter.

While the correspondent market remains competitive, the recent increase in the number of loans eligible for refinance has expanded the market opportunity, with a modest improvement in government margins.  Revenue per fallout-adjusted PFSI correspondent lock in the third quarter was 36 basis points, up from 30 basis points in the prior quarter.

Fulfillment fees paid by PMT for its loan production totaled 45.1 million dollars in the third quarter, up from 29.6 million dollars in the prior quarter as a result of PMT's increased conventional loan acquisition volumes.  As a percentage of conventional correspondent UPB, the weighted average fulfillment fee was 27 basis points, down slightly from 28 basis points in the previous quarter, reflecting discretionary reductions to facilitate successful loan acquisitions by PMT.

Purchase-money loans accounted for 66 percent of total acquisition volume in the third quarter, down from 79 percent in the prior quarter and 87 percent in the third quarter of 2018.

We also continued to increase the number of approved correspondent sellers in our network with 770 at quarter end, up from 752 at the end of the prior quarter, reflecting ongoing initiatives to add community banks and credit unions that benefit from the broad capabilities of our platform.

This quarter, we also launched an e-note pilot with a correspondent seller, and have funded and financed our first notes with a bank warehouse line of credit, and delivered those notes to Fannie Mae. While we do not expect this to drive meaningful volume in the near-term, it is a testament to our industry leadership and commitment to be on the forefront of technology development across all of our production channels.  Further, we believe that having the liquidity source for delivery of e-notes will be an important enhancement for our correspondent customers and drive future growth as the industry continues to adopt e-note closings.

Looking forward, monthly production volumes continue to remain strong in October with estimated correspondent loan acquisitions and interest rate lock commitments expected to both be 14.2 billion dollars in UPB, both up significantly from October 2018.

Now let’s turn to Slide 10 and discuss consumer direct production highlights.

**Slide 10**

We originated a record 2.7 billion dollars in UPB of loans in our consumer direct channel this quarter, up 35 percent from the prior quarter and 106 percent from the third quarter of 2018, as we successfully shifted our focus and capacity to address the expanded opportunity for consumers in our servicing portfolio to refinance their mortgages.

Investments we have made in our mortgage fulfillment end-to-end process continue to yield benefits, as our consumer direct lending group processed 30 percent more loans than it did last quarter, and simultaneously improved pull-through rates to 70 percent from 67 percent over the same period.

Margins in the channel increased to 481 basis points from 433 basis points in the prior quarter, reflecting increased demand for refinance loans.

Our consumer direct channel continued to benefit from the low rate environment in October, with total estimated originations of approximately 1.1 billion dollars in UPB.  Similarly, interest rate lock commitments this month are expected to total approximately 1.9 billion dollars in UPB.  Finally, the committed pipeline is also expected to be up substantially to approximately 2.6 billion dollars, positioning us well for a strong fourth quarter and full-year 2019.

Now let's turn to Slide 11 and review broker direct channel highlights.

**Slide 11**

Broker direct originations totaled 676 million dollars in UPB in the third quarter, up 53 percent from the prior quarter driven by growth in approved brokers and a 71 percent increase in refinance volume.

Lock volume in the quarter totaled 1 billion dollars in UPB, up 42 percent from the second quarter and up from 196 million dollars in the third quarter of 2018.

Our dedication to growing this channel is demonstrated by the increase in the number of brokers approved to offer our products, up 14 percent quarter-over-quarter.  Not only are we approving more brokers, but these brokers are becoming more familiar with and active in using our POWER portal to work with their clients and ultimately submit more applications.

We also continue to enhance the capabilities and workflow processes of our POWER broker portal, and this quarter we released an updated interface to improve ease of use, and updated the infrastructure that supports increased transactional activity.

In October, broker direct originations are estimated to total approximately 280 million dollars in UPB, while locks are estimated to total 360 million dollars in UPB. And finally, the committed pipeline is expected to total 355 million dollars at October 31st, reflecting continued strength into the fourth quarter.

Now let's turn to Slide 12 and discuss servicing highlights.

**Slide 12**

Our servicing portfolio grew to 348.5 billion dollars in UPB at the end of the third quarter, up 4 percent from June 30th and 22 percent from September 30th, 2018. Portfolio growth this quarter was driven by 34.9 billion dollars in UPB of loan production activities, net of 20.9 billion dollars in UPB of runoff.

Prepayment speeds on PennyMac Financial's owned portfolio – the majority of loans which are serviced for Ginnie Mae – increased to 22.8 percent from 15.8 percent in the prior quarter. Similarly, the prepayment speeds of PennyMac Financial's sub-serviced portfolio – which includes mostly Fannie Mae and Freddie Mac mortgage servicing rights owned by PMT – increased to 21.1 percent from 13.1 percent during the prior quarter. The increase in our servicing portfolio prepayment speeds is consistent with declining rates in the quarter.

The 60 plus day delinquency rates on our owned and sub-serviced portfolios remained low. Our owned portfolio had a delinquency rate of 3.4 percent as of September 30th, up slightly from the prior quarter reflecting normal seasonality, while our subserviced portfolio reported a 60 plus day delinquency rate of 0.4 percent, unchanged from the second quarter.

The continued decline in mortgage rates during the quarter also further expanded the opportunities available for loan modifications, which drive increased early buyout transaction volume from Ginnie Mae securities. The UPB of loan modifications this quarter totaled 604 million dollars, up from 584 million dollars in the prior quarter, and the UPB of EBO loan volume totaled 1.8 billion dollars, more than double the volume in the prior quarter.

Now, let's turn to Slide 13 and review the Investment Management Segment.

**Slide 13**

Net AUM totaled 2.2 billion dollars as of September 30th, up 14 percent from June 30th. PMT's increased volume of conventional loan production is generating significant investment growth in PMT's core CRT and MSR investments with accretive overall return profiles. This quarter represents the third consecutive quarter PMT has successfully raised capital, with 198 million dollars in net proceeds from a bulk issuance of 9.2 million common shares in August, and an additional 55 million dollars in net proceeds from the issuance of 2.5 million common shares from PMT’s “At-The-Market” equity offering program. Year-to-date, PMT has raised over 600 million dollars in equity, which has driven higher base management fees paid to PFSI.

Revenues in PFSI’s Investment Management segment grew to 11.8 million dollars this quarter, up 14 percent quarter-over-quarter, driven by the increase in both assets under management and incentive fees based on PMT’s long-term performance.

Now I’d like to turn the discussion over to Andy Chang, PennyMac Financial’s Chief Financial Officer, to review the third quarter’s results.

**Speaker:**

*Andy Chang – Chief Financial Officer*

Thank you, David.

I will highlight some of the key trends and factors in our financial results on the next couple of slides. We encourage you to read our press release on third quarter earnings for further details.

**Slide 14**

Slide 14 summarizes the impact of our hedging results on earnings for the third quarter. Our comprehensive hedging strategy is designed to moderate the impact of interest rate changes on the fair value of our MSR asset while also taking into account production-related income.

In the third quarter, we recorded fair value losses on our MSR asset totaling 295.5 million dollars or approximately 11 percent of the fair value at June 30th. These fair value losses were driven primarily by expectations for elevated prepayment activity in the future due to lower mortgage rates. MSR fair value losses were largely offset by hedging and other gains of 254 million dollars, net of ongoing hedge costs, which have been elevated due to market volatility.

As Stan mentioned earlier, our consistent profitability and book value growth across varying market environments could not be achieved without the successful execution of our interest rate risk management strategy.

Now, let's turn to slide 15 and discuss the profitability of our Servicing segment.

**Slide 15**

Pretax income excluding valuation-related changes was 25.2 million dollars in the third quarter, down from 47.1 million dollars in the prior quarter and 29.9 million dollars in the third quarter of 2018.

Driven by our servicing portfolio growth, operating revenues continued to increase. The increased revenue in the third quarter was largely offset by higher realization of cash flows, due to higher expected prepayments from lower interest rates.

We incurred additional technology-related expenses of 7 million dollars quarter-over-quarter for the development and completion of our servicing system modules. With the completion of this initiative, we expect servicing technology-related expenses in 2020 to be 15 to 20 million dollars lower than in 2019.

We also incurred 9 million dollars of additional expenses related to the increased Ginnie Mae buyout volumes that Stan and David discussed earlier. We expect this elevated activity to drive increased future period income, as loans are modified or reperform and become eligible for redelivery.

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.

Now in our twelfth year of operations, PennyMac Financial has established itself as a leading independent mortgage banking enterprise with the demonstrated ability to profitably navigate and grow through varying market environments. We are positioned for continued growth as we evolve our loan production and servicing platforms to provide sustainable long-term competitive advantages. In addition to our record financial results, we achieved two notable milestones this quarter: the successful completion of our servicing system environment and the initiation of a quarterly cash dividend. At the forefront of our strategic mission is to deliver superior returns and value to our stock, and we believe the establishment of a quarterly cash dividend is an important component in the structure of providing long-term, sustainable stockholder returns.

Lastly, 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 third quarter earnings discussion. For any questions, please visit our website at ir.pennymacfinancial.com, or call our Investor Relations department at 818-264-4907. Thank you.