PennyMac Financial Services, Inc.

Second Quarter 2019 Earnings Transcript

August 1, 2019

Introduction

Good afternoon, and welcome to the second 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, Chris.

Let's begin with Slide 3.

Slide 3

PennyMac Financial's second quarter earnings reflect exceptional operating performance across all of our business segments, driven by increased profitability in our Production segment and a continued focus on disciplined execution of hedging the interest rate risk inherent in our mortgage servicing rights.

PennyMac Financial earned net income of 72.7 million dollars or diluted earnings per share of 92 cents for the second quarter. During the quarter, we repurchased approximately 50 thousand shares of PFSI common stock at a weighted average price of 20 dollars and 77 cents, which reflects our strategy to support our stock when it is trading at levels we see as below the intrinsic value of the Company. Book value per share increased to 22 dollars and 72 cents, from 21 dollars and 72 cents per share at the end of last quarter.

Production segment pretax income was 98.2 million dollars, up 109 percent from the prior quarter and 417 percent from the second quarter of 2018, driven by record quarterly production volumes and higher margins in our direct lending channels. Production volumes totaled 24.1 billion dollars in unpaid principal balance, up 45 percent from the prior quarter and 51 percent from the second quarter of 2018. PFSI's lock volume in the correspondent channel, consisting of correspondent government and non-delegated locks, was 12.7 billion dollars in UPB, up 64 percent from the prior quarter and 24 percent from the second quarter of 2018. Direct lending locks totaled 4.1 billion dollars in UPB, up 53 percent from the prior quarter and 129 percent from the second quarter of 2018. And finally, correspondent conventional loan acquisition volume totaled 10.7 billion dollars in UPB, up 32 percent from the prior quarter and nearly double the volume in the second quarter of 2018, resulting in 29.6 million dollars of fulfillment fee revenue.

Slide 4

Continuing the quarters' highlights on page 4, the Servicing segment recorded a pretax loss of 2.7 million dollars, down from pretax income of 11.2 million dollars in the prior quarter and 54.6 million dollars in the second quarter of 2018. The results this quarter were primarily driven by net valuation-related items, which included a 259.2 million dollar decrease in MSR fair values, largely offset by 209.4 million dollars in hedging and other gains. The net impact of these items was a 46 cent reduction in earnings per diluted share.

Excluding valuation-related items, pretax income for the Servicing segment was a record 47.1 million dollars, up 33 percent from the prior quarter and 32 percent from the second quarter of 2018. The strong operating results reflect our large and growing servicing portfolio as well as the continued realization of scale efficiencies.

Our servicing portfolio totaled 334.5 billion dollars in UPB at June 30th, an increase of 3 percent from the end of the prior quarter and 27 percent over the same period last year as our loan production activities and strategic bulk acquisitions continue to provide net portfolio growth.

Our Investment Management segment delivered pretax income of 4 million dollars, up from 2.1 million dollars in the prior quarter and 1.1 million dollars in the second quarter of 2018. Segment revenue was 10.4 million dollars, up 18 percent from the prior quarter and 50 percent from the second quarter of 2018. Net assets under management totaled 1.9 billion dollars as of June 30th, up 13 percent from March 31st, as PennyMac Mortgage Investment Trust (or PMT), the REIT that we manage, raised approximately 214 million dollars in new common equity during the quarter to address its significant investment opportunities and positive outlook.

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

Slide 5

Looking forward, the outlook for the direction of the U.S. economy is becoming less certain. The recent rally in Treasury bonds, coupled with yesterday's decision by the Federal Reserve to lower short-term rates, supports the view of a weakening economic outlook, primarily driven by concerns over a slowdown in global growth and heightened uncertainty around the long-term impact of tariffs and ongoing trade tensions.

Reflecting these uncertainties, the average 30-year fixed mortgage rate ended the quarter 33 basis points lower than at the end of the first quarter, driving greater refinance activity and a boost to the purchase market from improved affordability in the midst of the summer home buying season.

In response to lower rates, forecasts for the size of the mortgage origination market in 2019 and 2020 have been revised upward. We currently estimate that approximately 50 percent of the mortgage loans held in Agency mortgage-backed securities are now eligible for refinancing, with an even higher percentage in more recently issued vintages. Purchase originations are still expected to grow by single-digit percentages over the next two years, aided by low rates and moderating home price appreciation.

Credit markets remain healthy, supported by strong employment trends consistent over the last few years. One indicator is the level of mortgages 30 days or more delinquent at June 30th, which is near historical lows, but rose slightly from March 31st. However, serious delinquencies, those 90 days or more delinquent, fell to their lowest levels in 12 years.

Spreads on more seasoned CRT securities widened slightly as a result of elevated prepayment activity, while spreads on more recently issued CRT securities tightened by a few basis points.

Now let's turn to Slide 6 and review PennyMac Financial's history of financial performance.

Slide 6

For PFSI, June 30th marks over 11 years in operation and the end of our sixth year as a publicly-traded company on the New York Stock Exchange. As you can see from the chart, our book value has grown more than threefold since our IPO, with a compounded annual growth rate of 21 percent since the first quarter we reported as a public company.

Our track record of performance has spanned a variety of market conditions and reflects the strength of our balanced mortgage banking model, sophisticated approach to risk management, and the experience and expertise of our management team.

Now let's turn to slide 7 and talk about some of the factors driving our outperformance and sustainability as a leader in the mortgage industry.

Slide 7

PennyMac Financial's business model was designed to grow book value and ensure resiliency across economic cycles. Our business has been built on a foundation of governance and risk management, a key part of which is our sophisticated interest rate risk management strategy designed to mitigate the impact of interest rate volatility on the fair value of our MSR assets and pipeline of mortgage production across different mortgage rate environments. We are a leader in mortgage production, with operations in each of the primary market channels, including correspondent, consumer direct, and broker direct lending. All of our production channels are supported by our highly efficient and centralized mortgage fulfillment division. The other essential component of our balanced model is our large mortgage servicing portfolio, which has grown steadily over time, providing increasing scale benefits. Our ability to grow the portfolio organically provides us a distinct advantage.

Another key strategic differentiator for PFSI is our Investment Management business and synergistic partnership with PMT. PMT's tax-efficient investment platform, leveraging PFSI's broad operational capabilities, makes us unique among mortgage companies.

The success of each of our business segments, along with our disciplined approach to growth, has driven a track record of consistent profitability and produced a strong capital foundation.

Fundamental to maintaining our leading market position and achieving our long-term objectives is our ability to make substantial investments in technology and workflow efficiencies. These investments drive competitive advantages that further enable us to quickly respond to opportunities as they arise – the current market opportunity for increased refinance volumes is just one example.

We have developed a data-driven fulfillment workflow process that systematically identifies required tasks and routes those tasks to centralized specialists throughout the mortgage origination process, driving faster processing speeds with consistently high levels of quality. We have also created a proprietary pricing and bidding system to optimize best execution in each of our production channels. The system analyzes a multitude of loan attributes to develop granular pricing optimized for each loan’s credit characteristics. Our multi-year proprietary servicing technology solution focused on automated work flows and increased efficiency is now largely complete and is expected to provide improved scalability and enhanced service levels for our 1.6 million mortgage customers.

Lastly, I would like to spend a couple of minutes talking about some of the reasons I believe PennyMac Financial will not only sustain but continue to grow its leadership position in the mortgage market. Our comprehensive mortgage banking platform, the operational expertise we possess, and the ability to leverage technology across our businesses will allow us to further expand our market presence.

We believe our scale, strong capital position, and operational excellence, which are enhanced by our sizeable continuous investments in technology, position us for continued success and leadership distinction in the mortgage market.

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 second 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 has grown its market share in both its Production and Servicing businesses over the last two years.

We remain the number one producer of government-insured mortgages, a market position that we have maintained over the last three years. In the conventional market, we have increased our market share substantially.

We estimate that PennyMac's correspondent and consumer direct market share grew year over year, although down somewhat from the first quarter given the significant market expansion as mortgage rates declined. Market share in our broker direct channel grew significantly as we continue to build out our capabilities in this channel. As Stan mentioned earlier, our servicing portfolio continued to grow in the second quarter, and we estimate that we now service over 3 percent of all mortgage debt outstanding in the U.S., up from 2.9 percent at March 31st, and 2.4 percent a year ago.

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

Slide 9

Correspondent acquisitions by PMT in the second quarter totaled 21.7 billion dollars in UPB, up 44 percent from the prior quarter and 45 percent from the second quarter of 2018, split almost evenly between government-insured and conventional loan acquisitions.

Government-insured loan acquisitions totaled 10.6 billion dollars in UPB, up from 6.8 billion dollars in the prior quarter and 9.5 billion dollars in the second quarter of 2018.

Conventional conforming acquisitions totaled 10.7 billion dollars in UPB, up 32 percent from the prior quarter and 99 percent from the second quarter of 2018.

Our non-delegated correspondent business also continued to grow in the quarter with volume totaling 402 million dollars in UPB, up 132 percent from the prior quarter.

Total government and non-delegated lock volume was 12.7 billion dollars in UPB, up 64 percent from the prior quarter and 24 percent from the second quarter of 2018. Delegated government locks were 12 billion dollars in UPB, up 63 percent from the prior quarter and 19 percent from the second quarter of 2018. Non-delegated lock volume totaled 636 million dollars in UPB in the quarter, up 77 percent from the prior quarter.

While the correspondent market remains competitive, margins appear to be stabilizing as they were essentially unchanged from the prior quarter at 30 basis points. The stability of margins is notable in that the consumer relief incentives provided by one of our warehouse lenders declined significantly, reflecting the orderly wind-down of that program.

Fulfillment fees paid by PMT to facilitate loan production on its behalf totaled 29.6 million dollars in the second quarter, up from 27.6 million dollars in the prior quarter. As a percentage of conventional correspondent UPB, the weighted average fulfillment fee was 28 basis points, compared to 34 basis points in the previous quarter, reflecting discretionary reductions to facilitate successful loan acquisitions by PMT.

We also continued to increase the number of approved correspondent sellers, up to 752 at quarter end, a slight increase from 743 approved sellers at the end of the prior quarter.

The technology-driven, centralized fulfillment platform we have created demonstrated its scalability this quarter, processing a record 21.7 billion dollars in UPB of loans, while simultaneously maintaining turn times and the high quality service levels our correspondent clients are accustomed to.

July's production volumes continue to reflect strong performance, with total correspondent loan acquisitions and interest rate lock commitments each exceeding 10 billion dollars in UPB.

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

Slide 10

Consumer direct production volume in the second quarter totaled 2 billion dollars in UPB, up 45 percent from the prior quarter and 116 percent from the second quarter of 2018, resulting from increased refinance volumes driven by lower mortgage rates. This increase reflects the successful pivot of our operational focus to address the significant recapture opportunities within our servicing portfolio.

Behind this success are the investments we have made in our mortgage fulfillment end-to-end process, with capabilities that yield benefits such as expanded operational capacity and greater efficiency. As a result, our consumer direct lending group processed 38 percent more loans than it did in the last quarter, and pull-through rates improved to 67 percent this quarter from 65 percent in the prior quarter.

Revenue per fallout-adjusted consumer direct lock increased to 433 basis points in the quarter from 387 basis points in the prior quarter.

Volumes in our consumer direct channel continued to benefit from lower rates in July, with originations totaling 890 million dollars in UPB. Similarly, interest rate lock commitments in July totaled 1.4 billion dollars in UPB. And finally, the committed pipeline was also up substantially, positioning us for strong production results in the third quarter.

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

Slide 11

Broker direct originations totaled 442 million dollars in UPB in the second quarter, up significantly from 196 million dollars in the prior quarter, driven by our continued focus and development of this channel as evidenced by a 15 percent increase in the number of brokers we have approved.

Lock volume in the quarter totaled 710 million dollars in UPB, up 121 percent from the first quarter and up from 101 million dollars in the second quarter of 2018.

We also continued to enhance the capabilities of our broker portal, known as POWER, and are seeing encouraging signs of higher engagement in the system. We are continuing to incorporate feedback from our top brokers, deploying upgrades and enhancements that will further improve the loan closing experience.

In July, broker direct originations totaled 215 million dollars in UPB and locks totaled 300 million dollars in UPB. The committed pipeline was 286 million dollars at July 31st, reflecting continued strength into the third quarter.

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

Slide 12

Our servicing portfolio grew to 334.5 billion dollars in UPB at the end of the second quarter, up 3 percent from March 31st, 2019 and 27 percent from June 30th, 2018. Portfolio growth this quarter was driven by 24.1 billion dollars in UPB of loan production activities net of 14.3 billion dollars in runoff.

Prepayment speeds on PennyMac Financial's owned portfolio – the majority of which are serviced for Ginnie Mae – increased to 15.8 percent from 10.1 percent in the prior quarter. Similarly, the prepayment speeds of PennyMac Financial's sub-serviced portfolio – which includes mostly Fannie Mae and Freddie Mac MSRs owned by PMT – increased to 13.1 percent from 7.6 percent during the prior quarter.

The 60 plus day delinquency rates on our owned and sub-serviced portfolios remained low and were unchanged from the prior quarter. Our owned portfolio had a delinquency rate of 3 percent as of June

30th, and our subserviced portfolio reported a 60 plus day delinquency rate of 0.4 percent.

The decrease in rates during the quarter also continues to expand the opportunities available for loan modifications which drive increased early buyout transaction volume from Ginnie Mae pools and revenue opportunities which we will discuss later on in the presentation. The UPB of loan modifications this quarter totaled 584 million dollars, up from 483 million dollars in the prior quarter, and the UPB of EBO transactions totaled 868 million dollars, up from 765 million dollars in the prior quarter.

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

Slide 13

Net assets under management totaled 1.9 billion dollars as of June 30th, up 13 percent from the prior quarter. PMT has generated strong results this year and is seeing increased investment opportunity with its organic credit risk transfer and MSR investments related to conventional production. As a result, PMT was able to successfully raise 214 million dollars in new equity during the quarter. Of this amount, 170 million dollars in common equity was raised through an underwritten equity offering of 8.1 million shares. Additionally, PMT raised 44 million dollars in common equity from shares issued through its ‘‘at-the-market,” or ATM, common equity program.

In addition to growth in assets under management, the strong results at PMT are also driving growth in incentive fees, and as a result revenue in our investment management segment grew to 10.4 million dollars, up 18 percent from the previous quarter and 51 percent year over year.

Now I’d like to turn the discussion over to Andy Chang, PennyMac Financial’s Chief Financial Officer, to review the second 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 second quarter earnings for further details.

Slide 14

Slide 14 summarizes the impact of our successful hedging results on earnings for the second 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 second quarter, we recorded fair value losses on our MSR asset totaling 259.2 million dollars or 9 percent of the fair value at March 31st. These fair value losses were driven 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, which were reduced by ongoing hedge costs, and netted to a total of 206.8 million dollars.

As Stan mentioned earlier, our consistent profitability and book value growth across different interest rate environments could not be achieved without the successful focus on and execution of our comprehensive interest rate risk management approach.

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

Slide 15

Pretax income excluding valuation-related changes was 47.1 million dollars in the second quarter, up from 35.3 million dollars in the prior quarter and 35.8 million dollars in the second quarter of 2018.

Record operating results this quarter were driven by portfolio growth combined with effective expense management. As a percentage of the average servicing portfolio UPB, operating expenses continue to decline, demonstrating the economies of scale we continue to achieve in our servicing operations.

Our pretax income excluding valuation-related changes included EBO-related earnings that were 3 million dollars higher than in the prior quarter. The increase was driven by the expanded opportunities in the current interest rate environment to buy out eligible loans profitably and for consumer loan modifications that David discussed previously. 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.

PennyMac Financial has built an operating platform that we believe is unmatched in the mortgage industry to handle large, growing volumes of loans at the highest standards of quality and to deliver strong performance across different market environments. Our ability to react swiftly to the increased opportunity in the loan production market reflects the significant and ongoing investments in technology and operational enhancements, such as in our mortgage fulfillment division, over the past several years. Given the present market environment, we anticipate exceptional performance for PennyMac Financial to persist throughout the second half of this year, while the continued growth of our servicing portfolio is anticipated to drive long-term earnings performance.

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 second 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.