PennyMac Financial Services, Inc.

Fourth Quarter 2019 Earnings Transcript

February 6, 2020

Introduction

Good afternoon, and welcome to the fourth 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 begin by introducing Stan Kurland, PennyMac Financial's Chairman.

Speaker:

Stanford L. Kurland – Chairman

Thank you Isaac.

As I transition in my personal role at PennyMac Financial, I would like to take a moment to reflect on the past twelve years.

I am incredibly proud of the organization we have built and the success we have achieved, and I believe our dedicated employees and the depth of our management team are unmatched in the industry.

PennyMac Financial has unique capabilities, including its synergistic partnership with PennyMac Mortgage Investment Trust, the REIT that we manage, as well as our best-in-class operating platform, which have established this Company as a leading mortgage banking enterprise.

Our people, platform and governance infrastructure, which includes our focus on risk management, position us well to sustain our competitive advantage in the residential mortgage market across a variety of economic environments. As I relinquish my day-to-day responsibilities but continue my involvement as Chairman of the Board, I am confident that the management team will continue to build on the established foundation in place for future growth while providing superior long-term returns to our stockholders.

I look forward to the continued growth of the Company, and my ongoing responsibilities as Chairman of the Board.

Now I’d like to pass the call on to David Spector, PennyMac Financial’s President and Chief Executive Officer, who will review the Company’s fourth quarter and full-year 2019 results.

Speaker:

David Spector – President and Chief Executive Officer

Thank you, Stan.

Slide 3

PennyMac Financial’s fourth quarter earnings reflected exceptional operating performance, as we achieved records for the Company’s pretax income and operating earnings for the second consecutive quarter. Our results were driven by outstanding performance in our Production segment and improved operating performance in the Servicing segment.

PennyMac Financial earned net income of 152.7 million dollars or diluted earnings per share of 1 dollar and 88 cents. Book value per share increased to 26 dollars and 26 cents, up from 24 dollars and 37 cents at the end of the prior quarter.

In addition, PFSI's Board of Directors declared a fourth quarter cash dividend of 12 cents per share.

Production segment pretax income was 203.3 million dollars, up 13 percent from the prior quarter and 700 percent from the fourth quarter of 2018, driven by record volumes across all of our production channels. Total production volume for the quarter was 42.4 billion dollars in unpaid principal balance, up 22 percent from the prior quarter and up 118 percent from the fourth quarter of 2018, bringing the total for the year to 117.6 billion dollars. PFSI's lock volume in the correspondent channel, consisting of government and non-delegated locks, was 16.9 billion dollars in UPB, up 1 percent from the prior quarter and up 84 percent from the fourth quarter of 2018. Direct lending locks were a record 6.5 billion dollars in UPB, up 16 percent from the prior quarter and up 235 percent from the fourth quarter of

2018. Of these, 5.4 billion dollars were in the consumer direct channel, while 1.1 billion dollars were in the broker direct channel. And finally, correspondent acquisitions of conventional loans fulfilled for PMT totaled 20.5 billion dollars in UPB, up 23 percent from the prior quarter and up 126 percent from the fourth quarter of 2018.

Slide 4

Continuing on to slide 4, the Servicing segment recorded a pretax loss of 5.1 million dollars, versus a pretax loss of 18.1 million dollars in the prior quarter and pretax income of 29.3 million dollars in the fourth quarter of 2018. The segment results this quarter were primarily driven by net valuation-related items, which included a 160.6 million dollar increase in MSR fair value and 194.6 million dollars in hedging and other losses. The net impact of these items was a 31 cent reduction in diluted earnings per share.

Excluding valuation-related items, pretax income for the Servicing segment was 39.1 million dollars, up 55 percent from the prior quarter and down 12 percent from the fourth quarter of 2018. The quarter-over-quarter growth included a 6.5 million dollar reduction in operating expenses primarily due to lower vendor expenses following the completion of our Servicing Systems Environment.

As of December 31st, our servicing portfolio totaled 368.7 billion dollars in UPB, an increase of 6 percent from the end of the prior quarter and 23 percent from December 31st, 2018. This increase was driven by record loan production activity which continued to provide significant portfolio growth despite elevated prepayments.

Our Investment Management segment delivered pretax income of 5.2 million dollars, up from 5 million dollars in the prior quarter and 2.5 million dollars in the fourth quarter of 2018. Segment revenue was 11.8 million dollars, essentially unchanged from the prior quarter and up 50 percent from the fourth quarter of 2018. Net assets under management totaled 2.5 billion dollars as of December 31st, up 10 percent from September 30th as PennyMac Mortgage Investment Trust, the REIT that we manage, raised approximately 215 million dollars in new common equity, most of which was raised late in the quarter. I am pleased to note that for the full year 2019, PMT raised a total of 830 million dollars in new common equity.

After quarter-end, PennyMac Financial completed the acquisition of a bulk Ginnie Mae MSR portfolio with a UPB of approximately 2.4 billion dollars.

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

Slide 5

Looking ahead, the U.S. economy remains strong with low interest rates. The Federal Reserve has indicated that it expects to maintain the current target for the Federal Funds rate as it continues to monitor the balance between its maximum employment and 2 percent inflation target objectives. In the fourth quarter, the 10-year Treasury bond yield increased 24 basis points. However, the average 30-year fixed rate mortgage increased 10 basis points over the same time period. More recently, mortgage rates have declined again providing support for continued elevated refinance volumes. In recent months, major economists have generally increased their 2020 origination forecasts and we believe these low rates will continue to drive those forecasts higher.

Home prices have continued to appreciate, but at a pace more in-line with wage growth. Most economists forecast continued home price appreciation through 2021, albeit at a slower pace.

Low unemployment and a strong U.S. economy continue to support historically low levels of delinquencies. The total U.S. mortgage delinquency rate was 3.4 percent as of December 31st, down from 3.53 percent at September 30th and 3.88 percent at the end of 2018.

Looking at credit spreads, we saw mixed results this quarter related to CRT investments. Spreads on seasoned CRT securities with higher underlying note rates widened as a result of higher prepayment speeds whereas spreads on CRT with more recent lower note rate originations tightened modestly.

Now let's turn to Slide 6 and discuss our expectations for PennyMac Financial's performance going forward.

Slide 6

Since our initial public offering over six and a half years ago, we have successfully grown PFSI's book value at a compounded annual growth rate of 22 percent. The growth in book value has been driven by strong returns on equity. As you can see on the chart on the right, PFSI has delivered these returns on equity throughout varying market environments. Despite a challenging origination market in 2018 that made many lenders unprofitable, PennyMac Financial delivered an ROE of 12.7 percent.

In 2019, we earned an ROE of 21.6 percent. Looking forward, we expect PFSI to earn mid-teens ROEs across different market environments and for 2020, we expect the ROE to be higher.

Our confidence in these returns over time is driven by the balance in our business model between production and servicing, which contributes to the stability of our returns. Furthermore, the operating income from our servicing business has grown substantially in recent years as the portfolio has nearly doubled in size versus three years ago.

Now let's turn to page 7 and talk about the large opportunity in the mortgage market.

Slide 7

Low interest rates made 2019 the largest origination market since prior to the financial crisis, with approximately 2.4 trillion dollars in UPB of originations. As I mentioned earlier, low rates continue to support elevated origination activity in 2020 and currently, average estimates from Fannie Mae, Freddie Mac, and the Mortgage Bankers Association forecast origination volume of almost 2 trillion dollars in UPB.

PennyMac Financial has demonstrated its ability to grow market share over the last six and a half years and we are now the third largest producer of residential mortgage loans in the U.S. *Inside Mortgage Finance* estimates that we represent approximately 5 percent of the origination market, suggesting a large opportunity for growth. The investments we make in technology combined with the size and scale we have achieved are critical to PFSI's success in the highly competitive mortgage market. Our leadership position in the correspondent channel has driven the significant growth of our servicing portfolio, which also expands the opportunity for our consumer direct lending channel where we continue to improve systems while expanding capacity. Looking ahead, we expect our consumer and broker direct lending channels to be drivers of our overall production market share growth, while correspondent volumes will tend to be influenced somewhat by fluctuations in the origination market.

Lastly, the infrastructure we have in place for non-agency loans and home equity lines of credit, including the synergistic partnership with PMT to securitize and invest in these products, positions PFSI for continued success in the event of changes in the mortgage market.

In total, PennyMac Financial is poised for significant growth across its mortgage banking businesses.

Now let's turn to Slide 8 and discuss our ongoing investments in technology across our businesses.

Slide 8

Last quarter we announced the completion of our Servicing Systems Environment technology. We are focused on further enhancing the capabilities and efficiencies of our production systems environment. In our correspondent channel, we are migrating our platform to Ellie

Mae's next generation Encompass Digital Lending Platform and leveraging proprietary systems with the objective to eventually transition our consumer direct and broker direct lending channels onto the same cloud-based platform. We believe this new platform will enable further operational efficiencies and process consistencies, providing an overall improved customer experience as an industry-leading mortgage lender.

In our consumer direct channel, we are currently developing MacForce, an initiative that utilizes enhanced data analytics and transaction history to distribute high quality leads to our sales associates. This will help drive increased conversion and recapture for our portfolio customers in addition to the acquisition of customers in new acquisition channels.

In our direct origination channels, we are regularly releasing updates to the MAC and POWER portals. MAC enables consumers to remain highly engaged with PennyMac by utilizing self-service and communication features, resulting in more focused interactions with our customer-facing associates and improved overall operating efficiency.

Our broker POWER portal enables brokers to effectively and efficiently originate loans and manage their loan pipelines, all the while remaining connected to PennyMac throughout the process.

Finally, we continue to make enhancements to our pricing, margin management, and loan bidding systems to optimize best execution across our production channels.

With that, I'd like to introduce PFSI's Chief Mortgage Banking Officer, Doug Jones, who will review operational results in our mortgage banking businesses.

Speaker:

Doug Jones – Chief Mortgage Banking Officer

Thank you, David.

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

Slide 9

According to industry data reported by *Inside Mortgage Finance,* PennyMac Financial was the third largest producer of mortgage loans in the country in both the fourth quarter and the full year 2019.

We increased our correspondent acquisitions by 20 percent in the quarter, driving our market share up to 16.3 percent from 15.5 percent in the prior quarter and 14.9 percent a year ago. We believe our commitment to consistently high service levels combined with fast turn times is key to our success in winning business from our correspondent seller network, and we expect this to support our market share and industry leadership going forward.

We estimate that this quarter, PennyMac's market share in consumer direct reached 0.9 percent, up from 0.7 percent last quarter and 0.6

percent a year ago as the investments we have made in this channel allowed us to capture the larger refinance opportunity provided by low interest rates.

Our broker direct channel market position also grew quarter-over-quarter, as we continue to add approved brokers and fulfillment capacity, and benefit from the investments we have made in this channel.

As David mentioned, our servicing portfolio continued its growth in the fourth quarter, and we estimate that we now service almost 3.4 percent of all mortgage debt outstanding in the U.S., up from 3.2 percent at September 30th, and 2.8 percent at December 31st, 2018.

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

Slide 10

Correspondent acquisitions by PMT totaled 37.7 billion dollars in UPB in the fourth quarter, up 20 percent from the prior quarter and 109 percent from the fourth quarter of 2018. 45 percent of our acquisitions were government loans and 55 percent were conventional loans.

Government loan acquisitions in the quarter totaled 16.7 billion dollars in UPB, up 16 percent from the prior quarter and up 87 percent from the fourth quarter of 2018.

Conventional correspondent acquisitions, for which PFSI earns a fulfillment fee, totaled 20.5 billion dollars in UPB, up 23 percent from the prior quarter and 127 percent from the fourth quarter of 2018.

Our non-delegated acquisitions increased quarter over quarter to 580 million dollars in UPB.

PFSI’s correspondent lock volume, consisting of government and non-delegated lock volume, was 16.9 billion dollars in UPB, up 1 percent from the prior quarter and 84 percent from the fourth quarter of 2018. Delegated government locks were 16.2 billion dollars in UPB, up 2 percent from the prior quarter and 81 percent from the fourth quarter of 2018. Non-delegated lock volume totaled 647 million dollars in UPB, down 24 percent from the prior quarter.

According to *Inside Mortgage Finance*, our record acquisition volumes made PennyMac the largest correspondent aggregator in the United States for the second consecutive quarter, reflecting an improved environment and less aggressive competition from banks who have historically dominated this channel.

While the market remains competitive, we have seen a modest improvement in PFSI's correspondent margins. Revenue per fallout-adjusted PFSI correspondent lock in the fourth quarter was 39 basis points, up from 36 basis points in the third quarter.

Fulfillment fees paid by PMT for its loan production increased as a result of PMT's record conventional loan acquisition volumes and a modestly higher fulfillment fee rate. As a percentage of conventional correspondent UPB, the weighted average fulfillment fee was 28 basis points, up slightly from 27 basis points in the prior quarter.

Purchase-money loans in our correspondent channel accounted for 55 percent of total acquisition volume, which we believe is a significantly larger percentage than the overall origination market.

The number of correspondent sellers in our network also continued to rise, to nearly 800 at quarter end, up from 770 at the end of the prior quarter.

Looking at January 2020, monthly production volumes remain elevated with total correspondent loan acquisitions of 11.1 billion dollars in UPB and interest rate lock commitments of 11.4 billion dollars in UPB.

Now let’s turn to Slide 11 and discuss consumer direct production highlights.

Slide 11

We originated 3.8 billion dollars in UPB of loans in our consumer direct channel, up 42 percent from the prior quarter and 217 percent from the fourth quarter of 2018, as we continue to add scale, and build out our sales and fulfillment capacity to address the larger market opportunity.

As David discussed earlier, our use of data analytics continues to improve, driving higher quality lead generation and enhanced operational efficiency.

Margins in the channel decreased modestly to 424 basis points from 437 basis points in the prior quarter.

Strong performance in our consumer direct channel continued in January, with 1.3 billion dollars in UPB of originations, 2.3 billion dollars of locks and a committed pipeline of 2.8 billion dollars at the end of the month, up from 2.4 billion dollars at December 31st.

Now let's turn to Slide 12 and review broker direct channel highlights.

Slide 12

Broker direct originations totaled 842 million dollars in UPB in the fourth quarter, up 25 percent from the prior quarter driven by a combination of growth in approved brokers and investments we have made to further scale our operations and fulfillment process.

Lock volume in the quarter totaled 1.1 billion dollars in UPB, up 6 percent from the third quarter and 282 percent from the fourth quarter of 2018.

Additionally, the number of approved brokers increased to 968, up 9 percent quarter over quarter, and we expect that trend to continue as we make significant enhancements in our POWER portal in 2020.

In January, broker direct originations totaled 261 million dollars in UPB, and locks totaled 496 million dollars. And finally, the committed pipeline was up to 484 million dollars at January 31st.

Now let's turn to Slide 13 and discuss servicing highlights.

<u>Slide 13</u>

Our servicing portfolio grew to 368.7 billion dollars in UPB at the end of the fourth quarter, up 6 percent from September 30th and 23 percent from December 31st, 2018. Quarterly portfolio growth was driven by record production volume of 42.4 billion dollars in UPB offset by 22.2 billion in UPB of runoff.

Prepayment speeds remained high in the fourth quarter. PennyMac Financial's owned portfolio – the majority of loans which are serviced for Ginnie Mae – reported a prepayment speed of 21 percent in the fourth quarter, down modestly from 22.8 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 – decreased modestly to 20 percent from 21.1 percent during the prior quarter.

The 60 plus day delinquency rates on our owned and sub-serviced portfolios remained low. Our owned portfolio had a delinquency rate of 3.7 percent as of December 31st, up slightly from the prior quarter reflecting year-end seasonality, while our subserviced portfolio reported a 60 plus day delinquency rate of 0.4 percent, unchanged from the third quarter.

The low interest rate environment in the fourth quarter continued to support elevated volumes of early buyouts from Ginnie Mae securities. The UPB of EBO loan volume totaled 1.7 billion dollars, which is expected to drive future period income.

Now I'd like to turn the discussion over to Andy Chang, PennyMac Financial's Chief Financial Officer.

<u>Speaker:</u>

Andy Chang – Chief Financial Officer

Thank you, Doug.

Slide 14

Turning to slide 14, I will highlight results in our investment management segment.

Net assets under management totaled 2.5 billion dollars at year end, up 10 percent from September 30th. In the fourth quarter, PMT successfully raised equity capital again with 215 million dollars in net proceeds, the majority of which was raised in December, bringing the total equity raised in 2019 to 830 million dollars.

Revenues in PFSI's Investment Management segment were essentially unchanged, as the increase in base management fees was offset by a modest reduction in performance-based incentive fees.

Slide 15

Starting on slide 15, I will highlight some of the key trends and factors in PFSI's financial results. We encourage you to read our press release for more detailed information.

This slide summarizes the impact of our hedging results on earnings for the fourth 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.

We recorded fair value gains on our MSR asset totaling 160.6 million dollars. These fair value gains were driven primarily by expectations of lower prepayment activity in the future due to higher mortgage rates at year end and were partially offset by faster than expected prepayments in the fourth quarter. The fair value gain represented approximately 6 percent of the MSR fair value at September 30th. The MSR fair value gain was more than offset by 194.6 million dollars of hedging and other losses, which include our hedge costs. We incurred higher hedge costs in the fourth quarter due to the market environment and given the strong earnings from our production activities.

2019 was a challenging year for hedging mortgage servicing rights given the volatility in interest rates as evidenced by the 10-year Treasury yield, which ranged from nearly 3 percent at the start of the year to below 1.5 percent in September and ended the year at 1.92 percent. Given this environment, the successful execution of our interest rate risk management is an achievement we take great pride in and a major contributor to the record financial performance in 2019.

Now, let's turn to slide 16 and discuss the profitability of our Servicing segment.

Slide 16

Pretax income excluding valuation-related changes was 39.1 million dollars, up from 25.2 million dollars in the prior quarter and down from 44.5 million dollars in the fourth quarter of 2018.

Operating revenue grew quarter over quarter, driven by increased servicing fee income from a larger portfolio and lower realization of MSR cash flows, partially offset by lower income from custodial deposits due to seasonally lower balances and decreased earnings rates.

Despite a larger servicing portfolio, operating expenses decreased 6.5 million dollars from the third quarter driven by a 5.4 million dollar reduction in vendor expenses following the completion of SSE, our proprietary servicing system, in November.

Interest shortfall expense in the fourth quarter remained elevated and increased 4 million dollars relative to the prior quarter.

And finally, EBO-related income increased 8 million dollars from the third quarter, driven by increased revenue from reperformance of loans bought out in prior periods.

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

Speaker:

David Spector – President and Chief Executive Officer

Thank you, Andy.

PennyMac Financial delivered outstanding performance across all of its businesses in the fourth quarter and throughout 2019. Book value per share grew 22 percent for the year, driven by record profitability in our production segment and our ability to successfully hedge the interest rate risk inherent in mortgage servicing rights in a year characterized by significant interest rate volatility. Each of our production channels grew market share this year and substantial growth in our consumer direct lending channel was a major contributor to the Company's earnings. Our servicing portfolio also grew more than 20 percent for the year while our technology investments continue to drive greater operating efficiency and better service for our 1.8 million customers. With our maturing, balanced business model, the opportunity to continue capturing market share gains across our business and the strong foundation provided by our large and growing servicing portfolio, we expect PFSI to earn a mid-teens return on equity across different market environments; however, we expect PFSI to deliver a higher ROE in 2020.

As we conclude this earnings review, I would like to thank Stan for his vision and leadership of PennyMac over the last twelve years.

I would also like to express my personal gratitude for his guidance and support, and I look forward to working with him closely as he continues his involvement with the Company as Chairman of the Board.

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 fourth 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.