PennyMac Financial Services, Inc.

First Quarter 2020 Earnings Transcript

May 7, 2020

Introduction

Good afternoon, and welcome to the first quarter 2020 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 David Spector, PennyMac Financial's President and Chief Executive Officer who will review the Company's first quarter 2020 results.

Speaker:

David Spector – President and Chief Executive Officer

Thank you Isaac.

Slide 3

PennyMac Financial reported record earnings in the first quarter, driven by continued strong production results combined with substantial gains on our interest rate hedge investments which more than offset fair value losses on mortgage servicing rights.

Net income was 306.2 million dollars or diluted earnings per share of 3 dollars and 73 cents.

Book value per share increased to 29 dollars and 85 cents, up from 26 dollars and 26 cents at the end of the prior quarter.

In March, we repurchased approximately 238 thousand shares of PFSI's common stock at a cost of 4.1 million dollars and a weighted average price of 17 dollars and 31 cents per share. PFSI's Board of Directors declared a cash dividend of 12 cents per share for the first quarter.

Production segment pretax income was a record 240.1 million dollars, up 18 percent from the prior quarter and 411 percent from the first quarter of 2019, driven by record volumes in the direct lending

channels and elevated margins across all of our channels. Direct lending locks were a record 9.9 billion dollars in unpaid principal balance, up 38 percent from the prior quarter and up 229 percent from the first quarter of 2019. Of these, 7.2 billion dollars were in the consumer direct channel, while 2.8 billion dollars were in the broker direct channel. Correspondent government lock volume was 14.9 billion dollars in UPB, down 8 percent from the prior quarter and up 101 percent from the first quarter of 2019. Total production volume for the quarter was 35.4 billion dollars in UPB, down 17 percent from the prior quarter and up 113 percent from the first quarter of 2019. And finally, correspondent acquisitions of conventional loans fulfilled for PMT totaled 16.2 billion dollars in UPB, down 21 percent from the prior quarter and up 99 percent from the first quarter of 2019.

Slide 4

Continuing on to slide 4, the Servicing segment recorded record pretax income of 170.8 million dollars, versus a pretax loss of 5.1 million

dollars in the prior quarter and pretax income of 11.2 million dollars in the first quarter of 2019. The segment results this quarter were primarily driven by valuation-related items, which included a 920.3 million dollar MSR fair value loss which was more than offset by 1.1 billion dollars in hedging and other gains. The net impact of these items was 130.8 million dollars in pretax income and a 1 dollar and 17 cent increase in diluted earnings per share.

Excluding valuation-related items, pretax income for the Servicing segment was 42.3 million dollars, up 8 percent from the prior quarter and up 20 percent from the first quarter of 2019.

As of March 31st, our servicing portfolio totaled 384.2 billion dollars in UPB, an increase of 4 percent from the end of the prior quarter and an increase of 18 percent from March 31st, 2019.

Our Investment Management segment delivered pretax income of 3.8 million dollars, down from 5.2 million dollars in the prior quarter and up from 2.1 million dollars in the first quarter of 2019. Segment revenue

was 9.9 million dollars, down 16 percent from the prior quarter and up 12 percent from the first quarter of 2019. Net assets under management totaled 1.8 billion dollars as of March 31st, down 26 percent from December 31st, driven by a reduction in PMT's shareholders' equity.

In early April, after more than a year in development, PennyMac Financial announced an enhancement to its GMSR Issuer trust, to provide private market financing for Ginnie Mae servicing advances and further expand its liquidity profile. PennyMac Financial currently has 600 million dollars of committed capacity available to finance Ginnie Mae MSRs and servicing advances.

Now let's turn to slide 5 and discuss recent developments that have affected the mortgage markets.

Slide 5

During the first quarter of 2020, the United States was significantly impacted by the effects of the COVID-19 pandemic and related public health measures which triggered a substantial slowdown in the economy. Over the last six weeks 30.3 million workers have filed jobless claims, evidencing increased hardships for homeowners and borrowers leading to expectations for higher delinquencies in the future. In response to these hardships, and in an effort to curtail the coming economic impact, the federal government enacted the CARES Act, providing 2 trillion dollars of fiscal stimulus, as well as granting homeowners with federally backed mortgages up to 12 months of forbearance if impacted directly or indirectly by the COVID-19 crisis. The forbearance program is designed to reduce consumer credit losses, however, the advance obligations for mortgage servicers has increased, putting strain on the liquidity of undercapitalized sellers and servicers.

The impact of COVID-19 on the financial markets has been substantial with significantly increased market volatility and reduced liquidity for

many financial assets. In response, the Federal Reserve reduced the Fed Funds rates to near zero, and has supported liquidity through asset purchases in many markets including Agency mortgage-backed securities.

The market volatility and uncertain economic outlook also severely impacted the value of many credit assets, including government-sponsored enterprise credit risk transfer securities, due to expectations for elevated delinquencies and actual losses as well as an increase in the required returns among market participants.

PFSI's strong balance sheet, low leverage and disciplined approach to liquidity management have been critically important in this market environment, and our strong risk management discipline has resulted in an increase in our total liquidity since February.

Now let’s turn to slide 6 to discuss an update on the mortgage origination market.

Slide 6

Prior to the onset of the COVID-19 pandemic, the mortgage origination market was experiencing healthy demand from historically low interest rates. The economic stimulus and infusion of additional liquidity by the Federal Reserve into the financial markets has acted to further lower mortgage market interest rates. These developments have acted to sustain heightened demand for new mortgage loans despite the slowdown in the overall economy and recent economic forecasts currently estimate total originations of 2.4 trillion dollars for 2020, an increase from 2.3 trillion dollars in 2019. The average 30-year fixed rate mortgage decreased 24 basis points this quarter to 3.5 percent at the end of March, and further declined in April to 3.2 percent at the end of the month. The low rate environment has continued to support robust refinance volumes while stay-at-home orders are expected to

reduce demand for purchase mortgages. As Doug will expand on later, we continued to see strong refinance volumes in April.

The spread between the primary and secondary mortgage rate is expected to remain wide for an extended period of time as certain competitors, primarily in the broker and correspondent lending channels, have been forced to reduce or limit their participation due to strains on many of these organizations introduced by the COVID-19 crisis. PennyMac's strong risk management, mortgage market expertise, capital advantages and scale have allowed us to continuously originate, fund and settle loans throughout the crisis.

On the next slide we will discuss the impact of the current market environment on PFSI by business segment.

Slide 7

The current market environment has had an impact across all of PFSI's business segments. In our loan production segment, we continue to see elevated margins across all channels, driven by reduced

competition and already limited industry capacity constraints. We expect to be in a strong position to continue to fund and settle loans, further growing our market share, particularly in the consumer and broker direct channels.

In our servicing segment, we expect to see changes in profitability, aside from the changes in MSR values and related hedge results, due to a combination of factors. First, we expect reduced servicing fee revenue due to increased borrower delinquencies, offset by portfolio growth and the potential for increased subservicing fees from PMT related to delinquent loans.

Second, we expect to earn reduced income on custodial deposits, as short-term rates have declined.

Third, we expect increased expenses as we hire the additional staff required to address borrower hardships, and increased financing costs for the expected increase in servicing advances.

And finally, we expect a near-term reduction in gains from the redelivery of early buyout loans, followed by expected increases in redelivery gains as borrowers emerge from forbearance.

Turning to our investment management segment, the pandemic had a substantial impact on PMT’s CRT investments and, as a result, PMT’s shareholders’ equity decreased significantly resulting in a decline in PFSI’s assets under management. As a result, we expect base management fees to be lower in future quarters and we do not expect to earn performance-based incentive fees for some time.

While prospects for the U.S. economy are uncertain and present some headwinds for PFSI's businesses, given the present market environment, we expect PFSI's overall financial performance to remain elevated throughout 2020.

Now I’d like to turn it over to Doug Jones, PennyMac Financial’s Chief Mortgage Banking Officer, to discuss PFSI’s market share trends.

Slide 8

Thank you, David.

Our correspondent acquisition volumes decreased during the quarter, and based on estimates from *Inside Mortgage Finance*, our market share in the channel was 15.2 percent, down from 16 percent in the prior quarter and up from 13.7 percent a year ago. While we review market share trends on a quarterly basis, it is important to note the longer-term trends are positive, and we remained the largest correspondent aggregator in the U.S. for the third consecutive quarter.

We estimate that this quarter, PennyMac's market share in consumer direct reached 1.1 percent, up from 0.9 percent last quarter and from 0.7 percent a year ago as the investments we have made in this channel allow us to continue to capture the large refinance opportunity.

Our broker direct channel market position also grew quarter-over-quarter reaching an estimated 1.7 percent, up from 1.4 percent at

December 31st, and 70 basis points a year ago as we continue to add approved brokers and fulfillment capacity.

As David mentioned, our servicing portfolio continued to grow in the first quarter, and we estimate that we now service over 3.4 percent of all mortgage debt outstanding in the U.S., up slightly from December 31st, and up from 3 percent at March 31st, 2019.

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

<u>Slide 9</u>

Correspondent acquisitions by PMT totaled 29.8 billion dollars in UPB in the first quarter, down 20 percent from the prior quarter and up 100 percent from the first quarter of 2019. 46 percent of PMT's acquisitions were government loans and 54 percent were conventional loans.

Government loan acquisitions in the quarter totaled 13.6 billion dollars in UPB, down 18 percent from the prior quarter and up 102 percent from the first quarter of 2019.

Conventional correspondent acquisitions, for which PFSI earns a fulfillment fee, totaled 16.2 billion dollars in UPB, down 21 percent from the prior quarter and up 99 percent from the first quarter of 2019.

Government correspondent locks were 14.9 billion dollars in UPB, down 8 percent from the prior quarter and up 101 percent from the first quarter of 2019. Beginning with the current quarter, historical and current period non-delegated correspondent acquisition and lock volumes are now reported in the broker direct lending channel.

PFSI was able to maintain its leadership position in the correspondent channel as competition subsided amidst market volatility stemming from the impact of COVID-19. Revenue per fallout-adjusted government lock in the first quarter was 76 basis points, up significantly from 38 basis points in the fourth quarter.

Fulfillment fees paid by PMT for its loan production decreased as a result of PMT's reduction in conventional loan acquisition volumes and a slightly lower fulfillment fee rate. As a percentage of conventional correspondent UPB, the weighted average fulfillment fee was 26 basis points, down from 28 basis points in the prior quarter.

Purchase-money loans in our correspondent channel accounted for 58 percent of total acquisition volume.

The number of delegated correspondent sellers in our network also continued to rise, to nearly 690 at quarter end, up from 676 at the end of the prior quarter.

Looking at April 2020, volumes and margins remain elevated. Total correspondent loan acquisitions for the month were 11.1 billion dollars in UPB and interest rate lock commitments were 11.2 billion dollars in UPB.

Now let's turn to Slide 10 to review consumer direct channel highlights.

Slide 10

We originated 4 billion dollars in UPB of loans in our consumer direct channel, up 7 percent from the prior quarter and 197 percent from the first quarter of 2019. This was driven by low interest rates and investments we have made to scale the production platform to address the market opportunity. Additionally, enriched use of data analytics continues driving our lead generation abilities and further improve recapture rates.

Margins in the channel improved further from already-elevated levels in the prior quarter. Revenue per fallout-adjusted consumer direct lock was 464 basis points, up from 424 basis points in the prior quarter.

Strong performance in our consumer direct channel continued in April, with 1.7 billion dollars in UPB of originations, 2.9 billion dollars of locks and a committed pipeline of 3.7 billion dollars at the month end.

Now let's turn to Slide 11 and discuss broker direct production highlights.

Slide 11

Broker direct originations, which now include our non-delegated correspondent acquisitions, totaled 1.6 billion dollars in UPB in the first quarter, up 10 percent from the prior quarter. Interest rate lock volume was 2.7 billion dollars in UPB, up 62 percent from the fourth quarter. The strong results were driven by a combination of growth in approved brokers and investments we have made to further scale our operations and fulfillment process. The number of approved brokers increased to 1,074, up 11 percent quarter over quarter while non-delegated correspondent sellers declined slightly to 116 from 123. We continue to increase capacity to address elevated demand and encourage growth of our market position.

In April, broker direct originations totaled 700 million dollars in UPB, and locks totaled 1.3 billion dollars. And finally, the committed pipeline was 1.6 billion dollars at April 30th.

Now let's turn to slide 12 and I will highlight results in our servicing segment.

Slide 12

Our servicing portfolio grew to 384.2 billion dollars in UPB at the end of the first quarter, up 4 percent from December 31st and 18 percent from March 31st, 2019, as our strong production volumes continued to support portfolio growth despite elevated prepayment speeds. PennyMac Financial's owned portfolio reported a prepayment speed of 20.6 percent in the first quarter, down slightly from 21 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 19.2 percent from 20 percent in the prior quarter.

The 60 plus day delinquency rates on our owned and sub-serviced portfolios remained low as of March 31st. Our owned portfolio had a 60 plus day delinquency rate of 3.3 percent while our subserviced portfolio

reported a 60 plus day delinquency rate of 0.4 percent, unchanged from December 31. As David discussed earlier, we expect delinquency rates to increase significantly as a result of hardships arising from the impact of the COVID-19 pandemic

The low interest rate environment in the first quarter continued to support elevated volumes of early buyouts from Ginnie Mae securities. The UPB of EBO loan volume totaled 1.6 billion dollars.

Now I'd like to turn it over to Andy Chang, PennyMac Financial's Chief Financial Officer, to discuss the results of our investment management segment.

Slide 13

Thank you, Doug.

Net assets under management totaled 1.8 billion dollars at March 31st, down 26 percent from December 31st, primarily due to significant non-cash fair value losses on PMT's investments in CRT which resulted in a

significant reduction in PMT’s shareholders’ equity, as noted earlier. We believe that PMT’s fair value losses on CRT are outsized compared to the additional credit losses PMT expects to incur over the life of these investments. While recent market dislocations have affected competitors and created attractive investment opportunities for PMT in its correspondent production business, we expect PFSI’s base management fees will be lower and we do not expect to receive performance incentive fees for some time as a result of the losses PMT incurred during the first quarter.

Starting on slide 14, 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.

Slide 14

This slide summarizes the impact of our hedging results on earnings for the first 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 significant fair value losses on our MSR asset in the first quarter totaling 920.3 million dollars. These fair value losses were driven primarily by expectations of increased prepayment activity in the future due to lower interest rates, combined with higher expected servicing costs due to delinquencies and increased returns demanded by market participants. The fair value decrease in the first quarter represented approximately 31 percent of our MSR fair value at December 31st.

The MSR fair value loss was more than offset by 1.1 billion dollars of hedging and other gains, as our utilization of option coverage for significant movements in rates provided a substantial benefit in the first quarter.

Let's turn to slide 15 to discuss the profitability of our servicing segment.

Slide 15

Pretax income excluding valuation-related changes was 42.3 million dollars, up from 39.1 million dollars in the prior quarter and 35.3 million dollars in the first quarter of 2019.

Operating revenue decreased quarter over quarter, driven by decreased income from custodial deposits due to the decline in short-term interest rates resulting in lower earnings rates.

Operating expenses decreased as a percentage of the average servicing portfolio, driven by a full quarter of cost savings related to our proprietary, cloud-based Servicing Systems Environment (SSE), which was offset by seasonally higher expenses in the first quarter related to payroll taxes and benefits.

Interest shortfall expense decreased by 1.6 million dollars quarter over quarter, but remained elevated. Credit losses and provisions for defaulted loans decreased 7.8 million dollars from the prior quarter due

to a combination of seasonality and initiatives related to loss mitigation.

And finally, EBO-related income increased 7.6 million dollars from the fourth quarter, driven by gains from the reperformance of loans bought out in prior periods.

Now let's turn to Slide 16 and discuss servicing trends for PFSI's MSR portfolio.

Slide 16

The 30 plus day delinquency rates on PFSI's predominately government MSR portfolio have historically been in the range of 6 to 8 percent. As of April 30th, the 30 plus day delinquency rate was 13 percent, driven by borrower hardships related to COVID-19 and forbearance requests. As of April 30, approximately 13 percent of the loans in PFSI's portfolio were in forbearance plans. This reflects our ability to rapidly and efficiently provide access to forbearance with our technology platform.

It is also important to note that of the 13 percent in forbearance, approximately 4 percent are current on their payments through those due April 1st.

PFSI is in a strong position to successfully manage hardships related to COVID-19 given its technology platform and specialty servicing expertise. PFSI began offering forbearance plans on March 19 following the GSEs' initial guidance, allowing customers to request, be evaluated for, and receive forbearance through our automated systems. In fact, 93 percent of PennyMac customers in a forbearance plan have been enrolled through one of our automated channels, reflecting the flexibility of PFSI's technology and our ability to respond to a rapidly changing market environment.

For delinquent borrowers, including those in forbearance plans, PFSI has the responsibility to fund servicing advances for our owned portfolio – again predominately Ginnie Mae MSRs. For the subserviced portfolio, any servicing advances are the responsibility of the MSR

owner, or PMT, and as I mentioned earlier PFSI may receive increased per-loan subservicing revenue for a delinquent loan versus a current loan.

Let's turn to slide 17 to discuss the projected needs for servicing advances.

Slide 17

This slide details PFSI's expectations for servicing advances as a result of the COVID-19 crisis. Ginnie Mae requires a servicer to continue advancing principal and interest payments for delinquent loans until it buys such loans out of the mortgage-backed securities, unlike Fannie Mae, which requires a servicer to continue advancing scheduled principal and interest payments for delinquent loans for 120 days. Similarly, Freddie Mac requires a servicer to continue advancing scheduled interest for 120 days. These principal and interest advances are typically covered by prepayment activity, except in adverse scenarios where high delinquency rates and extended periods of

delinquency combine. The majority of advances related to PFSI's MSR portfolio are expected to be related to property taxes, insurance premiums and other expenses to protect investors' interest in the properties securing the loans.

PFSI's expected servicing advances assume that 25 percent of our borrowers are in forbearance plans and that delinquency rates peak at 20 percent in both the moderate and stress cases. In the moderate scenario, we assume the average months delinquent for the delinquent loans reaches 4 months before the start of recovery, while the stress case assumes the average months delinquent for the delinquent loans reaches 8 months before the start of recovery.

In the moderate case, peak advances reach a total of 450 million dollars in the fourth quarter of 2020, with no principal and interest advances due to elevated collections in principal and interest accounts from higher prepayment activity.

In the stress case, peak advances reach a total of 1.7 billion dollars in the second quarter of 2021, with less than half of that amount in principal and interest advances.

Advance balance projections could increase if recoveries of advances from borrowers or insuring agencies are prolonged or delayed significantly after borrower reinstatement or loan modification.

Historically, PFSI has funded any required servicing advances with corporate cash. As of April 30th, 2020, outstanding servicing advances were 260 million dollars, and PFSI had 1.4 billion dollars in available liquidity less 223 million dollars in liquidity as required by Ginnie Mae.

And, as previously mentioned, PFSI is currently able to borrow up to 600 million dollars against Ginnie Mae MSRs and servicing advances from Credit Suisse. While advance rates vary driven by the type of servicing advance and insurer or guarantor of the underlying loan, Ginnie Mae servicing advances can be financed at an average of 81 percent. Importantly, PFSI's financing structure for servicing advances

allows for expansion via the addition of other lenders or the issuance of term notes, if needed.

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.

I am very proud of our record quarterly financial performance and success given the significant dislocations resulting from the spread of COVID-19 during this period. Interest rates have fallen to new historic lows providing a favorable environment for mortgage origination. With certain competitors forced to reduce or limit their participation, PennyMac Financial is capturing elevated production volumes and margins across all three production channels, and I would like to thank every one of our nearly 4,500 dedicated employees, who enthusiastically adapted to working from home. Over the last twelve

years, our highly-experienced management team has maintained its disciplined approach to interest rate, credit, and operational risks, which has proven essential in the current market environment. As a result, PennyMac Financial reported record earnings and 14 percent book value growth in the first quarter, driven by record production segment profitability and outstanding performance from our interest rate hedging strategies, which more than offset significant fair value losses on mortgage servicing rights.

Additionally, we recognize that the environment is causing increased hardship to customers. We are well positioned as one of the largest and best capitalized independent mortgage producers and servicers in the country to offer and fulfill the forbearance programs announced and required by policymakers. PennyMac Financial was quick to incorporate these requirements into its technology platform and offer borrowers the ability to request forbearance immediately using the self-service capabilities made available. Our expertise in loss mitigation

strategies will help assist our customers to stay in their homes with opportunities for them to refinance or seek modifications to improve their financial well-being. Since the company's founding in 2008, we have successfully navigated periods of market volatility and operational disruptions driven by external influences and we are confident in our ability to address the current challenges and opportunities presented by the impact of COVID-19.

Lastly, we encourage investors with any questions to reach out to our Investor Relations team by email or phone. If any such questions are received, we will post a Q&A to our website.

Thank you.

Operator:

This concludes PennyMac Financial Services, Inc.'s first 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.