PennyMac Financial Services, Inc.

Fourth Quarter 2018 Earnings Transcript

February 7, 2018

Introduction

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

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

Speaker:

Stanford L. Kurland – Executive Chairman

Thank you, Chris.

Let's begin with Slide 3.

Slide 3

PennyMac Financial's results reflect the strength of our balanced mortgage banking business platform to drive solid results in a market environment characterized by continued rising interest rates, and a somewhat smaller, purchase-oriented mortgage production market.

PennyMac Financial earned pretax income of 58.3 million dollars and diluted earnings per share of 63 cents. Fourth quarter results included a benefit from the remeasurement of state tax-related items totaling 11 cents per share. Additionally, our tax provision rate was reduced to 26.9 percent from 27.4 percent.

Book value per share increased to 21 dollars and 34 cents, from 20 dollars and 67 cents per share at September 30th, pro forma to adjust for the impact of the Company's corporate reorganization completed in November 2018.

During the fourth quarter, we repurchased approximately 24 thousand shares of PFSI common stock at a cost of 500 thousand dollars, representing a weighted average price of 19 dollars and 75 cents per share.

Production segment pretax income was 25.4 million dollars, down 1 percent from the prior quarter and 54 percent from the fourth quarter of 2017. Acquisition and origination volume totaled 19.4 billion dollars in UPB, up 8 percent from the prior quarter and 14 percent from the fourth quarter of 2017. Total correspondent government, non-delegated and direct lending locks were 11.2 billion dollars in UPB, down 1 percent from the prior quarter and 5 percent from the fourth quarter of 2017.

The Servicing segment recorded pretax income of 29.3 million dollars, down 13 percent from the prior quarter and 8 percent from the fourth quarter of 2017.

Excluding valuation-related items, pretax income for the Servicing segment was 44.5 million dollars, up 49 percent from the third quarter and 57 percent from the fourth quarter of 2017.

Valuation-related items for the third quarter included a 67.2 million dollar decrease in MSR fair values, partially offset by a 59.8 million dollar increase from associated hedging activities.

We continued to grow our servicing portfolio, which totaled 299.3 billion dollars in UPB at quarter end, up 5 percent from September 30th and 22 percent from December 31st, 2017. The year-over-year growth was driven by 67 billion dollars in UPB of production and origination activities, along with approximately 18 billion dollars in UPB of bulk MSR acquisitions.

Slide 4

Turning to slide 4, our Investment Management segment delivered pretax income of 2.5 million dollars, flat to the prior quarter and up from 1.5 million dollars in the fourth quarter of 2017. Net assets under management were 1.6 billion dollars, essentially unchanged from the prior quarter end and December 31st, 2017.

On November 1st, the Company completed the previously announced corporate reorganization that simplified its corporate structure through the conversion of all equity ownership to a single class of publicly-traded common stock.

After quarter end, PennyMac Financial completed the acquisition of an additional bulk Ginnie Mae MSR portfolio with a UPB of approximately 798 million dollars.

Also after quarter end, we launched several new products to meet customers' needs. Importantly, we launched a home equity line of credit, or HELOC, initially directed to select customers in our servicing portfolio that will offer them the opportunity to tap into their home equity while retaining their current first-mortgage interest rate. We also launched a prime non-Qualified Mortgage loan product, also known as prime non-QM, to our correspondent clients to offer them greater flexibility to provide borrowers with the right mortgage product to fit their needs. Both of these products benefit PennyMac Financial through our partnership with PennyMac Mortgage Investment Trust which has the ability to securitize and invest in HELOC assets and prime non-QM products, ultimately driving growth in our Investment Management activities.

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

Slide 5

The fourth quarter saw increased market volatility as a result of global growth concerns and uncertainty regarding the trajectory of the Federal Reserve monetary policy. However, the Federal Reserve recently signaled it will be “patient” in regards to any future rate hikes, which has helped reduce volatility.

During the fourth quarter, the average 30-year fixed mortgage rate was 22 basis points higher on average than in the prior quarter. However, at quarter end mortgage rates retreated about 50 basis points from their mid-quarter high of nearly 5 percent in mid-November and have remained at those levels after year end, driving expectations for a modest increase in refinance activity.

Credit spreads widened and finished the year 40 to 80 basis points wider than they were at September 30th, as the increase in volatility during the quarter contributed to a higher premium for risk assets. This year so far, however, spreads have substantially recovered.

A healthy overall economy, low unemployment, and favorable trends among home-buying demographics in addition to slowing home price appreciation growth are driving a purchase market outlook that is expected to grow by mid-single digit percentages over the next couple of years.

Mortgage delinquencies improved further quarter-over-quarter, with the total U.S. loan delinquency rate falling to 3.9 percent at year end, down from 4 percent at September 30th and 4.7 percent a year ago, driven by a favorable U.S. economy, high-quality mortgage underwriting standards and strong home prices.

Now let’s turn to Slide 6 and review the composition of PennyMac Financial’s balance sheet.

Slide 6

PennyMac Financial has developed into a leading independent non-bank mortgage company as a result of its comprehensive mortgage platform and balanced model with profitable production and servicing businesses, each with leadership positions in their respective markets.

We have achieved this position by building a high-quality balance sheet utilizing modest leverage compared to our competitors, with diversified liquidity sources, nearly 5 billion dollars of warehouse financing, and a strong capital base. We have also put in place a financing structure that provides cost-effective term financing for the largest asset on PennyMac Financial’s balance sheet – mortgage servicing rights – with flexibility that provides the Company the ability to expand financing as the MSR asset grows.

Our financial position is further supported by a well-developed and sophisticated risk management and governance infrastructure developed and overseen by our highly experienced executive management team. Our risk management infrastructure combines our extensive market expertise and technology to identify and monitor risks across the enterprise.

Our strength is further supported by the steps we have taken to simplify our corporate structure, converting all equity ownership of the company into a single class of publicly-traded common stock. This reorganization has the potential to expand the investor universe and demand for the Company's stock, and increased PennyMac Financial's market capitalization from approximately 500 million dollars to 1.5 billion dollars.

Now let's turn to slide 7 to discuss our development and utilization of technology.

Slide 7

Throughout PennyMac Financial's history we have focused on the utilization of technology to improve and streamline operations across the enterprise.

Our technology utilization strategy involves a combination of systems developed in-house using the expertise of our information technology development teams along with third-party technology that we deploy strategically. We place significant emphasis on creating innovative mortgage production and servicing systems that drive both cost-saving and scale efficiencies, as well as facilitates new business opportunities. This includes a focus on both enhanced customer-facing portals and interfaces, as well as developing automated "back office" technologies that help improve profitability and realize new competitive advantages.

Let's start with pricing and margin management systems. These systems feature greater pricing granularity and real-time pricing updates. We also are in the process of developing a sophisticated loan bidding system that incorporates statistical analysis and machine learning.

Next is our Servicing System Enhancements. This multi-year project is nearing completion, with a focus on increasing the efficiency of our loan servicing platform. Key features include the automation of certain repetitive tasks and creating efficiencies to better serve our 1.5 million mortgage customers. With this project, we expect that we will realize additional cost savings across our loan servicing platform.

In terms of origination and fulfillment workflow, the key element in this technology upgrade features rule-based engines and applications in development to streamline workflow processes across the platform.

Finally, in our Enterprise Risk Management area, we are currently focused on installing a proprietary risk intelligence system that will enhance our risk monitoring capabilities across the organization and strengthen our capabilities to identify and mitigate risks as they emerge.

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 fourth quarter.

Speaker:

David Spector – President and Chief Executive Officer

Thank you, Stan.

On Slide 8, let's begin with a review of market share and volume trends across PennyMac Financial's businesses.

Slide 8

According to fourth quarter industry data reported by *Inside Mortgage Finance*, PennyMac Financial remained the 8th largest servicer, and became the 3rd largest producer of mortgage loans.

PennyMac increased its correspondent market share by over three percentage points during the fourth quarter, growing production volumes while many of the larger correspondent channel participants saw their volumes decrease. Production volume this quarter was driven by strong growth on behalf of PMT in conventional conforming activity, from which it creates and retains attractive credit risk transfer and MSR investments.

Turning to consumer direct, our market share increased this quarter despite a modest quarter-over-quarter volume decrease as the overall retail market decreased even more.

We estimate that our servicing portfolio now represents over 2.7 percent of all mortgage debt outstanding in the U.S. at quarter end, up from 2.6 percent at September 30th.

Finally, net assets under management in our investment management business were 1.6 billion dollars, essentially unchanged from the prior quarter.

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

Slide 9

Correspondent acquisitions by PMT in the fourth quarter totaled 18.1 billion dollars in UPB, up 9 percent from the prior quarter and up 17 percent from the fourth quarter of 2017.

Government loan acquisitions accounted for 49 percent of total correspondent acquisitions, or 8.9 billion dollars in UPB in the fourth quarter, down slightly from 9 billion dollars in UPB in the prior quarter and down from 9.5 billion dollars in UPB in the fourth quarter of 2017.

Conventional conforming acquisitions, for which PennyMac Financial performed fulfillment services for PMT, totaled 9 billion dollars in UPB, up 21 percent from the prior quarter and up 54 percent year-over-year. As I mentioned earlier, this volume supports PMT's creation of long term investments in CRT from the majority of the conventional conforming loans that it acquires. CRT has been a major driver of PMT's improved performance and the higher loan volumes that are made possible as a result also drive growth in fee revenue for PennyMac Financial.

Total lock volume for the fourth quarter was 19.1 billion dollars in UPB, up 7 percent from the prior quarter and 20 percent year-over-year. Government locks totaled 9 billion dollars in UPB in the fourth quarter, down 2 percent from the prior quarter and down 6 percent year-over-year. Conventional locks totaled 9.8 billion dollars in UPB, up 15 percent from the prior quarter and up 56 percent year-over-year.

Revenue per fallout-adjusted government lock commitment was 29 basis points in the fourth quarter, a decrease from 35 basis points in the prior quarter reflecting our focus on strategically maintaining our market leadership position. The weighted average fulfillment fee paid by PMT to facilitate loan production on its behalf was 32 basis points in the fourth quarter, down from 35 basis points for the previous quarter.

Throughout 2018 we have benefited by receiving incentives under one of our master repurchase agreements to finance mortgage loans that satisfy certain consumer relief characteristics. We expect to cease accruing the incentives beginning in the second quarter of 2019. While there can be no assurance, we expect that the loss of such incentives will be partially offset by an improvement in pricing margins.

Purchase-money loans accounted for 88 percent of our correspondent acquisition volume in the fourth quarter, up from 87 percent in the prior quarter and 76 percent in the fourth quarter of 2017.

We experienced substantial growth in our correspondent seller relationships during the fourth quarter, reaching 710 correspondent clients at quarter end, up from 655 at September 30th. This growth reflects our ongoing strategic initiatives to attract community banks and credit unions, which can derive significant benefits from the broad capabilities of our platform – including interest rate risk management activities – and a continued focus on growing our non-delegated business. In the fourth quarter, we originated 120 million dollars in

UPB of non-delegated correspondent loans, up 61 percent from 75 million dollars in the prior quarter.

Monthly production volumes remained strong in January with total correspondent loan acquisitions of 5.2 billion dollars in UPB, up from 4.8 billion dollars in January 2018. Interest rate lock commitments in January also totaled 5.2 billion dollars in UPB, up from 4.4 billion dollars in January 2018.

Additionally, in January we launched a prime non-QM loan product that utilizes a technology-based underwriting solution.

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

Slide 10

Consumer direct production volume totaled 1.2 billion dollars in UPB in the fourth quarter, down 8 percent from the prior quarter. This decline was primarily driven by higher mortgage rates during most of the fourth quarter, which adversely impacted our refinance-driven volume. As a result, revenue per fallout-adjusted consumer direct lock decreased modestly to 356 basis points in the fourth quarter from 363 basis points in the prior quarter.

The decline in mortgage rates at the end of December held through January and improved the benefits from refinancing for many of the 1.5 million borrowers in our servicing portfolio, increasing demand for both rate-and-term and cash-out refinance mortgages.

January consumer direct originations totaled 357 million dollars in UPB, while locks totaled 761 million dollars. The committed pipeline was up from 593 million dollars at quarter end to 790 million dollars at January 31st.

After quarter end, we launched our HELOC product in our consumer direct channel, designed to support the financing needs of our servicing portfolio customers, while giving them a flexible way to use their home equity to finance a variety of purchases or expenses while maintaining their current first-mortgage interest rate. By taking this step, PennyMac Financial is currently the only major non-bank lender to directly offer a HELOC product. Our wholly-owned subsidiary, PennyMac Loan Services, has begun accepting applications from customers in 5 states, including California, Florida, Oregon, Virginia and Washington, and will roll out the product to customers in additional states throughout the year. As we expand our HELOC program, we also plan to offer it to prospective customers who do not yet have a lending relationship with PennyMac.

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

Slide 11

In the fourth quarter, broker direct production volumes grew 80 percent, totaling 199.1 million dollars in UPB. The quarter-over-quarter growth was driven by the continued build out of our sales force as well as the addition of 161 broker relationships during the quarter.

The broker market environment has become increasingly competitive in recent months, driving quarter-over-quarter revenue margins to 75 basis points from 84 basis points in the prior quarter.

During the fourth quarter, we made progress in expanding our menu of products and features to our broker clients. Notably, we launched Fannie Mae's HomeReady® product and Enterprise-Paid Mortgage Insurance, otherwise known as EPMI, which will help support broker production growth throughout 2019.

In January, total channel originations were 66 million dollars in UPB while locks were 91 million dollars in UPB. The committed pipeline was 73 million dollars at January 31st, essentially unchanged from the end of 2018.

We also continue to enhance the capabilities of our broker portal, also known as POWER. This quarter, we plan on releasing several new additions to our portal, the most noteworthy of which are expanded notifications that facilitate enhanced origination status updates between the broker and the borrower and real-time visibility for the broker into the status of their loan pipeline along with expansion of the system's capabilities to help manage it.

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

Slide 12

Our loan servicing portfolio grew to 299.3 billion dollars in UPB at the end of the fourth quarter, up 5 percent from September 30th and 22 percent from December 31st, 2017. The quarter-over-quarter growth was primarily driven by organic production activities, in addition to the completion of previously announced bulk acquisitions totaling 3.6 billion dollars in UPB. After the quarter end, we completed an additional bulk MSR acquisition of 798 million dollars in UPB.

Driven by higher average mortgage interest rates during the fourth quarter, prepayment speed in PennyMac Financial's owned portfolio – which includes mostly Ginnie Mae MSRs – slowed to 9.8 percent from 12.3 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 – slowed to 7.5 percent from 8.7 percent in the prior quarter. Higher mortgage interest rates also led to a 49 percent quarterly decrease in EBO transaction volume, which totaled 495 million dollars in UPB in the fourth quarter. However, the decline in mortgage rates in December has since increased the eligible buyout population and has improved EBO-related economics, and we anticipate an increase in EBO volumes and contribution to income in the first quarter of 2019.

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

Slide 13

PennyMac Financial benefitted from a strong contribution in the Investment Management segment during the fourth quarter, driven by incentive fees that were earned based upon PMT's continued strong performance.

PMT's earnings increased significantly in 2018 as a result of growing investments in CRT and MSR assets. During the quarter we also made significant reductions to PMT's distressed loan investments through the completion of 267 million dollars in UPB of previously announced distressed loan sales. As a result, distressed loan investments now represent only 8 percent of PMT's shareholders' equity, down from 22 percent a year ago.

While PMT continues to pursue its core investment strategies of CRT and MSRs, it is also partnering with PennyMac Financial to facilitate the build out of its product menu to include HELOC and prime non-QM loans and expand PMT's investment strategies. We expect PMT will utilize its ability to invest in securitization interests backed by these new products originated by PennyMac Financial.

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

Slide 14

Slide 14 summarizes the impact of our hedging approach on earnings for the fourth quarter and full year. Our hedging strategy is designed to moderate the impact of volatility in interest rates on the fair value of the MSR asset.

In the fourth quarter, we recorded fair value losses on our MSR asset totaling 67.3 million dollars, which resulted from expectations for increased prepayment activity in the future driven by lower mortgage rates at the end of the fourth quarter. MSR fair value losses were largely offset by 59.8 million dollars in associated hedging gains and a half million dollar decrease in the fair value of the ESS liability.

While there was significant volatility in interest rates throughout 2018, PennyMac Financial's approach to hedging the MSR asset was successful, as we recorded a 34.1 million dollar gain in the MSR fair value net of hedges and the ESS liability.

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

<u>Slide 15</u>

Pretax income excluding valuation-related changes was 44.5 million dollars, up from 29.9 million dollars in the prior quarter and 28.2 million dollars in the fourth quarter of 2017. This core operating profitability of our servicing segment has increased considerably over the last several quarters and reached its highest level thus far in the fourth quarter of 2018.

Operating revenue increased by approximately 20 million dollars quarter-over-quarter, driven by the 5 percent growth in our servicing portfolio due to organic production activity and the bulk MSR acquisitions completed during the quarter. Operating expenses were flat to the prior quarter on a dollar basis and down as a percentage of our servicing portfolio's average UPB. Credit losses and the provision for defaulted loans were in line with prior period levels.

EBO-related revenue decreased from the prior quarter as a result of higher average interest rates during the fourth quarter. As David mentioned, higher mortgage rates also reduced the population of loans eligible for buyout, resulting in fewer buyouts and lower transaction-related expenses.

Interest expense decreased by 4 million dollars quarter-over-quarter. Interest expense in the third quarter was elevated due to the accelerated recognition of costs related to the refinancing of MSR-backed term notes.

Overall, the core financial performance of our Servicing business remains strong, and we are confident that investments we are making in our operations to capture greater efficiencies and scale will deliver meaningful cost savings in the future.

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 is well positioned for growth in 2019 as we continue to pursue opportunities we find attractive. We are proud of both a firm-wide effort that resulted in the Company becoming the first non-bank lender to directly offer its customers a HELOC product, and the launch of a prime non-QM loan product in our correspondent channel. We continue to realize operational efficiencies across our enterprise, such as in our Servicing business as our investments in technology and portfolio growth add to greater efficiency and scale driving improved operating profits. We remain focused on further development of our direct lending channels and building out our product menu to provide mortgage solutions that meet our customers' evolving financial needs. Our scale, platform and ability to adapt to a changing market environment are reasons why we expect to be a beneficiary of market consolidation and continue delivering strong financial performance in the future.

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 www.ir.pennymacfinancial.com, or call our Investor Relations department at 818-264-4907. Thank you.