PennyMac Financial Services, Inc.

Second Quarter 2018 Earnings Transcript

August 2, 2018

Introduction

Good afternoon, and welcome to the second 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 second quarter results demonstrate the earnings power of our comprehensive mortgage banking platform against the backdrop of a rising interest rate environment and heightened competition among industry participants adjusting capacity to a smaller origination market.

While the origination market environment continued to adjust to higher rates, the earnings contribution from our Production segment increased from the prior quarter driven by higher production volumes, while the Servicing segment continued to deliver strong results this quarter.

PennyMac Financial earned pretax income of 74.7 million dollars and diluted earnings per share of 70 cents. During the quarter, we repurchased approximately 236 thousand shares of PFSI Class A common stock at a cost of 4.8 million dollars and an average price of 20 dollars and 41 cents per share. Book value per share increased to

21 dollars and 19 cents, from 20 dollars and 74 cents per share at March 31st, and 16 dollars and 40 cents a year ago.

Our Production segment pretax income was 19 million dollars, up 11 percent from the prior quarter and down 71 percent from the second quarter of 2017. Acquisition and origination volume totaled 15.9 billion dollars in UPB, up 11 percent from the prior quarter and down 9 percent from the second quarter of 2017. Total correspondent government and direct lending locks were 11.9 billion dollars in UPB, up 9 percent from the prior quarter and down 12 percent from the second quarter of 2017.

The Servicing segment recorded pretax income of 54.6 million dollars, modestly down from 54.9 million dollars in the prior quarter and significantly improved from a loss of 11.2 million dollars in the second quarter of 2017.

Excluding valuation-related items, pretax income for the Servicing segment was 35.8 million dollars, down 1 percent from the prior quarter and up 134 percent from the second quarter of 2017.

Valuation-related items for the second quarter included a 42.3 million dollar increase in MSR fair values, partially offset by a 24.3 million dollar decrease from associated hedging activities, and a 1 million dollar decrease due to the change in fair value of excess servicing spread liability.

We continued to grow our servicing portfolio which totaled 263.5 billion dollars in UPB at quarter-end, up 3 percent from the prior quarter-end and 15 percent from June 30th a year ago.

Slide 4

Turning to slide 4, our Investment Management segment delivered pretax income of 1.1 million dollars, up from 1 million dollars in the prior quarter and down from 2.5 million dollars in the second quarter of 2017. Net assets under management were 1.5 billion dollars, essentially unchanged from the prior quarter-end and down 3 percent from June 30th a year ago.

After quarter-end, PennyMac Financial completed or entered into agreements to acquire bulk Ginnie Mae MSR portfolios with a UPB of approximately 13.9 billion dollars, which David will discuss in more detail later in the presentation.

Today, we announced a special, one-time cash dividend of 40 cents per share of PFSI Class A common stock, to be paid on August 30th, 2018, to stockholders of record on August 13th, 2018. This distribution represents cash that resulted from previous tax-related distributions from Private National Mortgage Acceptance Company, our principal operating subsidiary, in excess of PFSI's tax obligations.

Also today, we are filing a registration statement for a corporate reorganization that would simplify the Company's corporate structure and convert all equity ownership in PFSI common stock and the private partnership of Private National Mortgage Acceptance Company into a single class of publicly traded common stock. For more information, please visit our investor relations website.

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

Slide 5

The 30-year fixed-rate mortgage remained high in the second quarter relative to the first quarter, reaching 4.66 percent near the end of May before retreating slightly to 4.55 percent at quarter-end. The average 30-year rate during the second quarter was 4.54 percent, 26 basis points higher than the average during the first quarter. One of the primary impacts of this sustained level of higher mortgage rates has been a significant slowdown in refinancing activity.

As the market adjusts to higher rates, mortgage lenders have been managing capacity and production margin requirements to remain competitive. We have also seen an increase in the amount of bulk MSR portfolios offered for sale.

Recent data suggests mixed results in both new and existing home sales, which trended below expectations in the second quarter. While demand for existing homes appears to be strong, low inventory levels, which were near historic low levels during the quarter, have been cited as an impediment to sales volume. However, recent data suggests modest increases in the supply of existing homes for sale. New home sales have also slowed recently, but they are typically more volatile and represent a significantly smaller segment of the market than existing home sales.

While recent home sales showed weakness in the prior quarter, industry origination forecasts project mortgage origination growth beyond 2018, driven by an increase in purchase-money volume. Underlying the forecasted volume growth is a strong economy and job growth through 2020.

Mortgage delinquencies increased slightly from the end of the first quarter, but remain low historically and below year-ago levels.

According to Black Knight Financial Services, the total U.S. loan delinquency for loans 30 days or more past due, including areas affected by last year's severe hurricanes, was 3.74 percent at the end of the quarter, compared to 3.73 percent at March 31st, 2018, and 3.8 percent as of June 30th, 2017.

Similarly, credit spreads remain near post-crisis tight levels, resulting from continued strong credit performance and the strong economy, more broadly.

Now let's turn to Slide 6 and review the current business outlook for PennyMac Financial.

<u>Slide 6</u>

The higher interest rate environment has caused many lenders to adjust operations and strategies to a smaller, and more purchase-focused, mortgage market. As I mentioned, the challenges facing many lenders have led to more MSR portfolios offered for sale. PennyMac Financial's operational capabilities and strong capital position make bulk servicing acquisitions a compelling investment. Bulk acquisitions allow us to supplement our organic portfolio growth from mortgage production and generate additional recapture opportunities for our consumer direct lending channel including opportunities to provide new purchase-money mortgages as our customers buy new homes.

Looking forward, we see significant opportunities for PennyMac Financial to drive production growth by entering segments of the mortgage market where we have not previously participated or where our market presence was underdeveloped. These initiatives include non-delegated correspondent, broker direct and consumer direct lending as well as jumbo loans.

While we are already a leader in the correspondent channel, the non-delegated correspondent market, whereby mortgage aggregators provide underwriting services to smaller lenders and community banks, represents a significant growth opportunity. Given that approximately 28 percent of correspondent channel volume is non-delegated, we have structured our production processes to address the opportunity, and now believe that we have operations and capabilities in place to allow us to significantly increase our share of the non-delegated market going forward.

Last quarter we launched the broker direct channel and have made progress refining the operations and increasing our volume this quarter. We are leveraging our proven loan manufacturing platform and our prior experience from developing our leading correspondent channel to grow our broker direct channel into a market leader.

Similarly, we have focused efforts on capturing non-portfolio and purchase-money volume within our consumer direct channel by refining sales and lead generation strategies. A year ago, our consumer direct volume was predominately streamline refinancing, and today, we have transitioned our model to fully-documented and purchase-money originations. We also recently introduced the new consumer direct

Mortgage Access Center portal, known as MAC, which is an integral part of a comprehensive strategy to grow non-portfolio originations.

Finally, we reintroduced jumbo loans in the first quarter in the correspondent and consumer direct channels and plan to introduce jumbo loans in the broker direct channel in the third quarter.

Our growth initiatives depend on technology and we continue to make substantial investments to facilitate new business opportunities and capture economies of scale. In addition to the launch of the consumer direct Mortgage Access Center portal, we continued to implement servicing system enhancements to drive further expense efficiencies in our servicing activities. To date, our multi-year servicing system enhancement plan is just over halfway to completion.

While we are engaging in initiatives to grow and expand our business, we have not lost our focus on maintaining disciplined expense management. Within loan production, we have built a low-cost correspondent aggregator structure, and our growth initiatives in broker and consumer direct are built to absorb excess capacity in the current market. For our servicing activities, resources required for our recent bulk MSR acquisitions and increased modification volumes have temporarily offset some of the scale benefits from servicing portfolio growth.

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.

On Slide 7, let's begin with a review of market share and volume trends across PennyMac Financial's businesses.

Slide 7

For the second quarter, PennyMac Financial remained the fourth largest producer of mortgage loans and the eighth largest servicer in the country, according to *Inside Mortgage Finance*.

Correspondent market share decreased in the second quarter primarily because our origination volumes slightly under-indexed the total correspondent market growth. Our consumer direct market share dipped, resulting from a drop in volume this quarter which I will discuss in more detail later on in my presentation. We estimate that our servicing portfolio represents approximately 2.44 percent of all mortgage debt outstanding in the United States at quarter-end, up from 2.39 percent last quarter.

In our investment management business, net assets under management were 1.5 billion dollars, essentially unchanged from the previous quarter.

Now let's turn to Slide 8 and discuss correspondent production highlights.

Slide 8

Correspondent acquisitions by PMT in the second quarter totaled 15 billion dollars in UPB, up 15 percent from the prior quarter while down 8 percent from the second quarter of 2017.

Government loan acquisitions accounted for 64 percent of total correspondent acquisitions, or 9.5 billion dollars in UPB in the second quarter, up from 8.8 billion dollars in UPB in the prior quarter and down from 10.4 billion dollars in UPB in the second quarter of 2017.

Conventional conforming acquisitions, for which PennyMac Financial performed fulfillment services for PMT, totaled 5.4 billion dollars in UPB in the second quarter, up 28 percent from the prior quarter and down 9 percent year-over-year. The weighted average fulfillment fee in the second quarter was 27 basis points, down from 28 basis points for the previous quarter.

Total lock volume for the second quarter was 16.2 billion dollars in UPB, up 20 percent from the prior quarter while down 11 percent year-over-year. Government locks totaled 10.1 billion dollars in UPB in the second quarter, up 10 percent from the prior quarter and down 10 percent year-over-year.

Seasonal increases in mortgage market activity drove higher quarter-over-quarter volumes resulting from a larger origination market. Purchase-money loans accounted for 85 percent of our correspondent acquisition volume in the second quarter, up from 77 percent in the prior quarter and 82 percent from the second quarter of 2017.

Revenue per fallout-adjusted lock commitment was 44 basis points in the second quarter, a slight decrease from the prior quarter. While the market remained competitive, we did not see a meaningful shift in the pricing dynamics for correspondent government-insured acquisitions this quarter.

Monthly production volumes remained strong in July. Total correspondent loan acquisitions were 5.7 billion dollars in UPB, while interest rate lock commitments totaled 6.6 billion dollars in UPB.

As Stan discussed earlier, we have renewed our focus on non-delegated correspondent lending. We have refined our operational capabilities to provide greater focus on non-delegated correspondent production and believe that we have addressed limitations to growth. We are optimistic that this channel can provide significant incremental volume by year-end.

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

Slide 9

Consumer direct production volume totaled 911 million dollars in UPB in the second quarter, down 28 percent from both the prior quarter and second quarter of last year.

Revenue per fallout-adjusted consumer direct lock for the second quarter increased to 337 basis points from 326 basis points in the prior quarter. Similar to our correspondent channel results, we did not see any meaningful change in the pricing dynamics in our consumer direct activities during the quarter.

This quarter's decline in consumer direct volumes reflect the transition from portfolio-focused streamline refinance loans to more operationally intensive fully-documented and purchase-money loans that Stan mentioned earlier. While this transition is ongoing, we are seeing benefits from growth in purchase-money and non-portfolio volume. Purchase-money consumer direct production reached 204 million dollars in the second quarter, up 83 percent from a year ago and non-portfolio fundings accounted for 17 percent of second-quarter consumer direct production, up from 8 percent a year ago.

Furthermore, July consumer direct originations totaled 393 million dollars in UPB, and the committed pipeline increased from 828 million dollars at June 30th, 2018, to 831 million dollars in UPB at July 31st.

I want to expand on Stan's comments regarding the release of MAC, our Mortgage Access Center portal, this quarter. MAC is a significant milestone for the channel, providing customers with an easy-to-use mortgage transaction portal. It also offers key functionalities that will help drive market share growth and position PennyMac Financial to drive more non-portfolio business going forward.

Now let's turn to Slide 10 and discuss broker direct channel highlights.

Slide 10

We launched broker direct lending in January, and we are beginning to see progress growing production. Broker direct production volume totaled 61.8 million dollars in the second quarter, up from 6.9 million dollars in the prior quarter.

Production volumes continued their positive trajectory in July. July broker direct originations totaled 25 million dollars, while locks totaled 52 million dollars. The broker direct channel committed pipeline increased from 38 million dollars at June 30th, to 51 million dollars as of July 31st, 2018.

The acceleration of our broker direct volumes has been driven by the POWER portal enhancements as well as the additions to our account executive team. The POWER portal enhancements have been responsible for delivering increased automation and advancing broker service levels to drive continued growth. We also plan to introduce prime jumbo loans to the broker direct channel during the third quarter. As a result of these initiatives, we anticipate further increases in our monthly lock volume.

Now let’s turn to Slide 11 and discuss servicing highlights.

Slide 11

Our loan servicing portfolio grew to 263.5 billion dollars in UPB at the end of the second quarter, up 3 percent from the prior quarter and 15 percent from the second quarter of 2017.

The prepayment speeds on our loan servicing portfolio increased modestly from the prior quarter, mostly due to seasonally higher prepayment activity, but remained lower than the second quarter of 2017. The CPR on PennyMac Financial's MSR investments increased from 11.8 percent last quarter to 12.2 percent this quarter but remained below 14.4 percent a year ago.

While we continue to produce organic portfolio growth from our production activities, we have also become more active in bulk MSR acquisition activity to supplement organic growth. After quarter-end, we completed or agreed to acquire 13.9 billion dollars in UPB of bulk MSR acquisitions sourced from six different sellers. We have already completed acquisitions sourced from three different sellers totaling 6.5

billion dollars in UPB. Further, we entered into agreements to acquire bulk MSR portfolios totaling 7.4 billion dollars in UPB from three additional sellers, which are expected to close by the end of the third quarter.

Next, let's turn to Slide 12 and review the Investment Management segment.

Slide 12

As mentioned earlier, net assets under management were 1.5 billion dollars, essentially unchanged from the prior quarter-end.

PMT, the publicly traded REIT that we manage, continues to transition capital from its distressed portfolio liquidation activities toward MSRs and CRT that result from its correspondent production. PMT made progress liquidating the distressed portfolio during the second quarter, bringing its outstanding UPB down by 61 percent from a year ago.

PMT also initiated loan deliveries to Fannie Mae under a new CRT REMIC structure. This new structure offers several enhancements including more favorable tax treatment, closer alignment with the Fannie Mae CAS structure, which is expected to result in broader availability of financing options, and it also allows a greater percentage of PMT's production to be eligible for investments in CRT.

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 slides. We encourage you to read our press release on second quarter earnings for further details.

Slide 13

Slide 13 summarizes the impact of our hedging approach on second quarter earnings. Our hedging strategy is designed to moderate the impact of volatility in interest rates on the fair value of the MSR asset while also considering the impact of production-related income.

As Stan discussed earlier, mortgage rates rose during the second quarter and ended the quarter about 11 basis points higher than the end of the prior quarter. We recorded fair value gains in our MSR asset totaling 42.3 million dollars, which primarily resulted from expectations for lower prepayment activity in the future driven by the increase in mortgage rates.

The MSR gains were partially offset by associated hedging activities and an increase in the fair value of the ESS liability, also due to the rise in mortgage rates and a reduction in expected prepayments.

Now, let's go to slide 14 and review the profitability of our Servicing segment.

Slide 14

The Servicing segment was a major contributor to the Company's financial results for the second quarter and pretax income benefitted from the valuation-related gains I discussed on the previous slide.

Excluding valuation-related changes, Servicing segment pretax income was 35.8 million dollars versus 36.3 million dollars in the prior quarter and 15.3 million dollars in the second quarter of 2017. Operating revenue increased, driven by portfolio growth and higher interest income from custodial deposits, partially offset by an increase in the realization of MSR cash flows. EBO-related revenue decreased somewhat from the elevated levels of the first quarter, while EBO transaction-related expense increased due to a higher volume of buyouts from Ginnie Mae securities during the second quarter. Interest expense decreased during the second quarter due to the accelerated recognition of costs related to the refinancing of MSR-backed term notes in the prior quarter.

Overall, the financial performance of our servicing portfolio remained strong, and we expect the segment to deliver greater earnings contributions as the servicing portfolio continues to grow.

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.

We continue to invest and pursue the buildout of our business model into new mortgage market segments, products and channels. We believe we are well-positioned to expand our growth and earnings opportunities with the investments we are making in our Production and Servicing businesses. In consumer direct lending, we are seeing success in non-portfolio and purchase-money originations, both of which are important to growing volumes. Further, our investments in the broker direct channel are beginning to deliver results and demonstrate our ability to access this previously untapped market segment. We are making technology investments across our business, such as in loan servicing where system enhancements will allow us to capture greater scale efficiencies. We also remain mindful of prudent expense management and are monitoring the deployment of our human resources and capital to ensure we continue to operate at high levels of efficiency and continue delivering attractive returns to stockholders.

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