

PennyMac Financial Services, Inc.

Fourth Quarter 2020 Earnings Transcript

February 4, 2021

Introduction

Good afternoon, and welcome to the fourth quarter and full-year 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, let me remind you that our discussion contains forward-looking statements that are subject to risks identified on Slide 2 that could cause our actual results to differ materially, as well as certain non-GAAP measures that have been reconciled to their GAAP equivalent. 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 fourth quarter and full year 2020 results.

Speaker:

David Spector – President and Chief Executive Officer

Thank you Isaac.

PennyMac Financial reported strong earnings in the fourth quarter driven by core production and servicing results.

Net income was 453 million dollars or diluted earnings per share of 5 dollars and 97 cents, resulting in book value growth per share of 15 percent to 47 dollars and 80 cents, up from 41 dollars and 67 cents at the end of the prior quarter.

I am pleased to note that PFSI's Board of Directors declared a fourth quarter cash dividend of 20 cents per share, representing a 33 percent increase from the prior quarter.

We also repurchased approximately 1.6 million shares of PFSI's common stock, at an approximate cost of 89.3 million dollars.

And finally, PFSI's Board of Directors approved an increase to its stock repurchase authorization from 500 million dollars to 1 billion dollars of outstanding common stock.

Dan Perotti, PFSI's Senior Managing Director and Chief Financial Officer will discuss the financials in more detail later on in this discussion.

Fourth quarter performance was very strong across loan production and servicing and we continue to see the strength of our balanced business model in our results. Net income in the fourth quarter was the second highest in the history of the company. Direct lending locks were up 13 percent from the prior quarter, total correspondent lock volume was up 9 percent, and the servicing portfolio was up 6 percent from the end of the third quarter.

Each of our business segments performed well during the fourth quarter as the continued low interest rate environment drove record production volumes across all of our channels. These record volumes resulted in the growth of our servicing portfolio to 427 billion dollars in UPB, despite extraordinary levels of prepayment activity. And finally, PMT, the investment vehicle that PFSI manages, was able to largely

preserve its book value in 2020 which led to solid results in PFSI's Investment Management segment.

This performance added to a remarkable year that saw PFSI achieve a return on equity of 62 percent with almost 200 billion dollars in UPB of loans funded. Earnings per share grew 328 percent for the year with net income up 319 percent. This outstanding income generated excess capital that we redeployed into increased levels of production, share repurchases, reduction of debt, and increased servicing activity.

We were quick to step up and aid borrowers as the COVID-19 pandemic spread across the U.S., affecting many of our customers. For the total servicing portfolio, we facilitated approximately 291 thousand forbearance plans for our customers, with over 90 percent of those enrolled through our automated channels. This high level of efficiency was largely due to our cloud-based, proprietary servicing system, otherwise known as SSE. SSE allowed us to quickly implement changes

that enabled us to complete the roll-out of large programs, like the CARES Act forbearance program, in a fast and cost-effective manner.

As of the end of the year we have helped, or are in the process of helping, approximately 145 thousand borrowers successfully emerge from their forbearance plans. The predominant outcome has been through loan modifications to the borrowers to aid in their recovery. We have also seen a large group of borrowers that reperform and exit forbearance on their own. The history of PennyMac Financial was borne out of the Great Financial Crisis, with a desire to help distressed borrowers. This expertise and experience has served us well, enhancing our ability to help many borrowers affected by the COVID-19 pandemic.

While our servicing group was aiding borrowers, our corporate groups were ensuring our capital and liquidity were protected. Our capital markets group achieved significant hedging gains that largely offset 1.1

billion dollars in MSR fair value losses over the year, which were driven by historically low interest rates and fast prepayment speeds.

We issued 650 million dollars in an inaugural senior unsecured note offering, raised funding capacity with our banking partners, and enhanced our existing Ginnie Mae MSR financing structure to include servicing advances. All of these activities allowed us to not only fund record volumes of loans, but also effectively deploy capital into technology and operational projects, as well as repurchase a significant amount of our common stock. Since the start of 2020, we have repurchased approximately 13 percent of the PFSI shares that were outstanding at the beginning of 2020.

This was all done while the vast majority of our employees were working from home for most of the year. I am incredibly thankful and proud of the over 6,000 PennyMac employees who managed through the challenges of the pandemic to deliver these extraordinary results.

Before I turn this over to Andy, I want to take a moment to say all of us at PennyMac are very grateful for the many kind thoughts and tributes we have received since announcing the sad passing of Stan Kurland, our founder and Chairman. While Stan had retired from day-to-day responsibilities at PennyMac, he remained a trusted advisor and dear friend. His leadership helped lay the foundation for PennyMac's long-term success which included building and developing a deep management team that carries on his legacy.

With that, I will turn the call over to Andy Chang, Senior Managing Director and Chief Operating Officer, who will go through some of the initiatives we are focused on to position us for future success in the years to come.

Speaker:

Andy Chang – Senior Managing Director and Chief Operating Officer

Thank you, David.

Over the years, PennyMac Financial has proven its ability to generate profits and value across various market environments, resulting in attractive returns on equity, with an average ROE of 24 percent over our last 7 plus years as a public company. These returns have led to a 29 percent compounded annual growth rate in our book value per share since our IPO. While 2020 was a record, we have a long track record of strong performance. This financial performance is driven by the balanced business model in mortgage banking that we have built over the last 13 years. Our large, organically built servicing portfolio provides a counter-balance to our production activity. Declining interest rates generally produce strong earnings in our production segment, while rising rates will generally produce strong earnings in our servicing segment as prepayments decline and the value of the MSR increases. This balanced business helps generate strong results across a variety of market and rate environments.

Also, our investments in technology, such as our cloud-based proprietary servicing system, have helped us to maximize economies of scale and grow efficiently, and help drive strong results for years to come.

As we look at 2021 we believe the market environment provides PFSI a good opportunity for continued elevated financial performance. Economic forecasts are calling for the mortgage origination market to remain strong in 2021, and while these forecasts vary, they currently average 3.3 trillion dollars. While such a market would be smaller than 2020, it would represent a large origination market by historical standards. Purchase originations in 2021 are forecasted to increase 10 percent year-over-year while refinance originations are expected to decrease but remain elevated relative to historical norms.

With PFSI's historical focus on purchase market originations combined with our large and growing servicing portfolio, we believe we are well-

positioned to successfully grow share in all three of our production channels, driving an increase in our overall market position.

Our large production volumes fuel the organic growth of our servicing portfolio, leading to a larger recurring stream of earnings. Pretax income excluding valuation related changes in our servicing segment in 2020 more than doubled from 2019 as we assisted borrowers emerging from forbearance using various loss mitigation strategies.

With the large and growing servicing portfolio and an industry leading correspondent production group, PFSI is an established leader with a growing presence across all facets of mortgage banking.

We built our correspondent business into the largest in the U.S. over the last decade while at the same time growing our servicing portfolio, primarily organically. These businesses are foundational to PFSI and not easily replicated. The barriers to entry for these businesses that

require scale for success provide PFSI a strategic advantage over our competitors.

These businesses provide PFSI a stable foundation through their low-cost structures while our scaled fulfillment operation enables more aggressive growth in our higher margin direct lending channels. The opportunity to grow these newer channels is exciting and provides PFSI a multi-channel, diversified, and profitable production segment that will further grow the servicing portfolio with high quality assets.

This growth in production is not only due to the significant investments we have made in our production technology, which Doug will elaborate on later, but is also due to the considerable investments we have made in people. During 2020 we added over 2,000 employees to the PennyMac team to expand our workforce to more than 6,000. This hiring mostly occurred in three key areas: servicing, direct lending, and fulfillment services. While many of these employees aided in our record production growth and increased servicing activities due to

COVID, these hires were consistent with PFSI's long-term strategy. This growth will be crucial in further expanding our direct lending channels and supporting our growing servicing infrastructure. We have used our cloud-based technology systems to aid in scaling our businesses to the market and supported that growth with strategic hiring of employees. While our employee base grew by 60 percent during the year, our production volumes grew by 67 percent and our earnings increased by 328 percent.

Many of these employees were on-boarded virtually and have begun their PennyMac careers working from home. As a management team, we are committed to putting the health and safety of our team members at the heart of our decisions. We quickly developed a plan to deal with the COVID-19 pandemic and the various work from home orders across the nation. Our phased approach to returning to our offices extends beyond simply ensuring that PennyMac'ers return to a safe working environment, but also takes mindful consideration for the

challenges faced by our employees related to issues such as dependent care and schooling. I'm proud of the actions we have taken and the dedicated management team across the company that has helped put these plans into action.

Now I'll turn it over to Doug Jones, PFSI's Senior Managing Director and Chief Mortgage Banking Officer, to provide you some more details on our mortgage banking businesses.

Speaker:

Doug Jones – Chief Mortgage Banking Officer

Thanks, Andy.

As you can see on page 11 of our slide presentation, correspondent acquisition volumes totaled 56.9 billion dollars in UPB in the fourth quarter, up 28 percent from the prior quarter and 53 percent from the fourth quarter of 2019. 33 percent of correspondent acquisitions were government loans and 67 percent were conventional loans.

Government loan acquisitions in the quarter totaled 18.9 billion dollars in UPB, up 11 percent from the prior quarter and up 14 percent from the fourth quarter of 2019. Conventional correspondent acquisitions, for which PFSI earns a fulfillment fee from PMT, totaled 38 billion dollars in UPB, up 39 percent from the prior quarter and 85 percent from the fourth quarter of 2019. Government correspondent locks were 19.7 billion dollars in UPB, down 2 percent from the prior quarter and up 22 percent from the fourth quarter of 2019.

In January, our correspondent acquisitions remained strong, with 17.9 billion dollars in UPB of acquisitions, and lock volume of 17.8 billion dollars.

Looking at the consumer direct channel in the center column, we originated 8 billion dollars in UPB of loans, up 27 percent from the prior quarter and 113 percent from the fourth quarter of 2019. Interest rate lock commitments in the fourth quarter totaled 12.8 billion dollars in

UPB, up 18 percent from the prior quarter, and 135 percent from the fourth quarter of 2019.

In January, our consumer direct originations totaled 3.1 billion dollars in UPB, and locks totaled 4.4 billion dollars. The committed pipeline at January 31st was 7.9 billion dollars.

Finally, broker direct originations totaled 4.5 billion dollars in UPB in the fourth quarter, up 28 percent from the prior quarter, and 215 percent from the fourth quarter of 2019. Interest rate lock volume was 5.7 billion dollars in UPB, up 4 percent from the third quarter, and 234 percent from the fourth quarter of 2019.

In January, our broker direct originations totaled 1.4 billion dollars in UPB, and locks totaled 2.1 billion dollars. The committed pipeline at January 31st was 3 billion dollars.

PennyMac remained the largest correspondent aggregator in the U.S. in the fourth quarter. We saw significant market share growth in the

conventional correspondent market this quarter, and our leadership position in government loans remains as a result of our consistency, low costs and operational excellence we continue to provide to our correspondents. While margins across channels have come in lower from the third quarter, we saw the shift in Government correspondent margins come in the most towards more normalized levels.

Margins in our consumer direct channel still remain elevated relative to historical levels. We continue to originate record levels of volumes in this channel as a result of our large and growing servicing portfolio, efficient and low-cost infrastructure, advanced modeling and analytics, and the growth in sales and fulfillment capacity. This growth has focused on new customer acquisition and resulted in our non-portfolio interest rate lock commitments hitting a record in the fourth quarter at 1.3 billion, up from 906 million in the third quarter, an increase of 43 percent.

Lastly, our broker direct channel continued its impressive growth in both locked and funded volumes as we increase the number of approved brokers and our presence in the channel grows. The number of approved brokers totaled 1,574, up 11 percent over the end of the third quarter. We believe this represents approximately 13 percent of the total brokers and non-delegated sellers active in the market today, providing continued room for growth and expansion within the channel in the future.

Our direct lending channels, which include both our consumer direct lending and broker direct lending, have experienced faster growth and are becoming much more significant contributors to PFSI's earnings profile. We believe we will continue to increase their respective market positions as we execute on our growth initiatives in each channel. We have made significant investments to scale our end-to-end mortgage fulfillment process while we expect the substantial investments in

technology we have made to continually improve the customer experience over time.

These technology investments are critical drivers to the growth of our direct lending businesses.

Within our consumer direct lending channel, initiatives include enhancing our lead generation capabilities and use of data analytics, in addition to increasing the use of digital marketing to drive non-portfolio originations. And, we continue to enhance our MAC portal, thus improving the ability for borrowers to self-service throughout the entire origination process.

In our broker direct channel, we are focused on further reducing the length of our loan origination cycle via workflow enhancements and upgrades to our broker portal, POWER. We are growing our best-in-class tools and solutions we provide our brokers with to further enhance their self-service capabilities.

Finally, our Mortgage Fulfillment Division is making enhancements to further automate and improve the production and distribution of loan documents. We are also increasing the use of online closings and automation.

All of these workflow and technology investments will improve the experience for the consumer and for the broker, improve productivity, specifically in sales and operations, which will enable higher volumes at a reduced cost to originate.

As Andy described earlier, all of this record production feeds our servicing portfolio, which at December 31st, 2020 totaled 426.8 billion dollars in UPB, up 6 percent from the end of the third quarter and up 16 percent over the end of 2019.

As you can see on the selected operational metrics on slide 13, PennyMac Financial's owned portfolio reported a prepayment speed of 32.5 percent in the fourth quarter, up from 29.7 percent in the prior

quarter. 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 slightly to 38.9 percent from 39.2 percent.

PFSI's owned servicing portfolio, which consists primarily of Ginnie Mae MSRs, had a 60 plus day delinquency rate of 10.2 percent, down from 11.4 percent at the end of the prior quarter, while our subserviced portfolio, primarily consisting of conventional loans, reported a 60 plus day delinquency rate of 2.7 percent, down from 3.7 percent at September 30th as borrowers continue to emerge from forbearance plans.

The UPB of completed modifications was 6.3 billion dollars, up significantly from 4 billion dollars last quarter and the UPB of EBO loan volume totaled 5 billion dollars, also up significantly from last quarter as a result of the continued focus on loss mitigation activities.

I'll now turn it over to Dan Perotti, Senior Managing Director and Chief Financial Officer to speak to the financial results for the quarter.

Speaker:

Dan Perotti – Chief Financial Officer

Thanks, Doug.

As David mentioned earlier PFSI's net income was 452.8 million dollars, or diluted earnings per share of 5 dollars and 97 cents.

I will review each segment's results and then we will touch on our forbearance and servicing advance trends.

Production segment pretax income was 572.6 million dollars, down 7 percent from the prior quarter and up 182 percent from the fourth quarter of 2019, driven by continued growth in direct lending and strong performance across all channels.

As you will see on slide 20, we provide a breakdown of the revenue contribution from each of PFSI's loan production channels, net of loan origination expenses, including the fulfillment fees received from PMT for conventional correspondent loans.

The direct lending channels continued to have an outsized impact on PFSI's production earnings in the fourth quarter. Consumer and broker direct represented 20 percent of fallout adjusted lock volume in the fourth quarter but accounted for over 70 percent of segment pretax income.

Production revenue margins remain elevated, especially with PFSI's growth in consumer and broker direct volumes. Revenue per fallout adjusted lock for PFSI's own account was 217 basis points in the fourth quarter, down slightly from 236 basis points in the third quarter. Our costs vary by channel, ranging from approximately 15 basis points in correspondent to 150 basis points in consumer direct. As our production mix continues to shift towards direct lending, production

expenses as a percentage of fallout adjusted locks are expected to trend higher.

The Servicing segment recorded pretax income of 42 million dollars, down from pretax income of 111.7 million dollars in the prior quarter and up from a pretax loss of 5.1 million dollars in the fourth quarter of 2019.

Pretax income excluding valuation-related items for the servicing segment was 234.3 million dollars, up 30 percent from the prior quarter and 499 percent from the fourth quarter of 2019. These increases were primarily driven by continued loss mitigation activities related to COVID-19.

As you can see in greater detail on slide 21, EBO loan-related revenue increased significantly to 233.3 million dollars as a result of continued loss mitigation activity with borrowers emerging from forbearance

while related expenses were modest as most of the loans bought out returned to performing status immediately.

Payoff-related expense, which includes interest shortfall and recording and release fees related to prepayments, remains elevated and increased by 8.3 million dollars quarter-over-quarter.

In order to protect the value of our MSR asset we utilize a comprehensive hedging strategy. This hedging strategy is designed to moderate the impact of interest rate changes on the fair value of our MSR asset and also considers production-related income.

The fair value of our MSR decreased modestly in the fourth quarter, driven by higher-than-expected prepayments, increased projections for short-term prepayments and elevated levels of early buyout activity. While we experienced hedging losses in the quarter, the decrease was more than offset by PFSI's production income.

You can see the results of our hedging strategy in the full year view on slide 19. Hedging and other gains of over 943 million dollars largely offset an MSR fair value decrease of over 1.1 billion dollars. Giving consideration to the pretax income from our record production, you can see that our hedging strategies were very successful at mitigating the impact of interest rate changes and MSR fair value losses on our income in 2020.

Our Investment Management segment delivered pretax income of 2.6 million dollars, down from 3.3 million dollars in the prior quarter and down from 5.2 million dollars in the fourth quarter of 2019. Net assets under management totaled 2.3 billion dollars as of December 31st, up 1 percent from September 30th. Segment revenue was 9.7 million dollars, down from 9.8 million dollars in the prior quarter which included gains related to PMT shares owned by PFSI.

Lastly, I would like to touch on the trends we are seeing related to forbearance and loss mitigation.

The percentage of loans in forbearance decreased to 7.8 percent at December 31st from 10.1 percent at September 30th as new forbearance plans implemented since September 30th were more than offset by borrowers in forbearance plans at September 30th who have since exited.

Servicing advances outstanding were approximately 454 million dollars at December 31st, up from 346 million dollars at September 30th, primarily associated with seasonal tax payments. Advances are expected to continue increasing over the next six to twelve months. No P&I advances have been made to date, as prepayment activity continued to sufficiently cover remittance obligations.

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

Speaker:

David Spector – President and Chief Executive Officer

Thank you, Dan.

PennyMac Financial delivered strong fourth quarter results, marking the end to a record year. We achieved record production across all channels, with increased market penetration in our higher margin direct lending channels. This grew our servicing portfolio to over 426 billion dollars in UPB even with elevated prepayment speeds. Our balanced business model continues to deliver consistent profitability and value creation as it has done over the last seven years as a public company.

We believe the growth opportunities in front of us to be substantial and as we continue to grow our direct lending channels, we expect PennyMac Financial's exceptional financial performance to persist through 2021.

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.