

PennyMac Financial Services, Inc.

First Quarter 2021 Earnings Transcript

May 6, 2021

Introduction

Good afternoon, and welcome to the first quarter 2021 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 non-GAAP measures that have been reconciled to their GAAP equivalent in our earnings presentation. Thank you.

Now I'd like to begin by introducing David Spector, PennyMac Financial's Chairman and Chief Executive Officer who will review the Company's first quarter 2021 results.

Speaker:

David Spector – Chairman and Chief Executive Officer

Thank you Isaac.

PennyMac Financial again delivered exceptional financial performance in the first quarter driven by continued strong production and core servicing results partially offset by the performance of our hedged mortgage servicing rights.

Net income was 377 million dollars or diluted earnings per share of 5 dollars and 15 cents, generating book value growth per share of 8 percent to 51 dollars and 78 cents.

Importantly, we repurchased approximately 4.7 million shares of PFSI's common stock during the quarter for an approximate cost of 288 million dollars; and through April we repurchased an additional 270 thousand shares, for an approximate cost of 16 million dollars. This brings the total repurchases year-to-date to over 300 million dollars, and since the beginning of 2020, we have now repurchased approximately 18 percent of PFSI's common shares.

We also issued 650 million dollars of 8 year senior unsecured notes, taking our total unsecured notes outstanding to 1.3 billion dollars.

Additionally, PFSI's Board of Directors declared a first quarter cash dividend of 20 cents per share.

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

Operating results across loan production and servicing remained strong and we continue to see the strength of our balanced business model reflected in our results. We also continued to see strong market share growth across our direct lending businesses with another quarter of record lock and funding volumes despite higher mortgage rates and increased competition.

In total, loan acquisition and origination volumes were 67 billion dollars in the first quarter. These strong production volumes again led to

servicing portfolio growth despite continued elevated prepayment activity. PennyMac Financial's servicing portfolio totaled 449 billion dollars in unpaid principal balance at March 31st, up 5 percent from the end of 2020 and up 17 percent from March 31st, 2020.

Finally, PMT, the investment vehicle that PFSI manages, delivered another strong quarter of investment performance and net assets under management were 2.4 billion dollars, up 3 percent from year-end 2020.

With that, I will now turn the call over to Andy Chang, Senior Managing Director and Chief Operating Officer, who will review the mortgage origination landscape and the foundation we have in place to drive continued success into the future.

Speaker:

Andy Chang – Senior Managing Director and Chief Operating Officer

Thank you, David.

The origination market continues to be historically strong as mortgage rates remain near record lows despite the increase in the ten-year Treasury yield since the start of the year. Recent economic forecasts for 2021 originations range from 3.3 trillion to 4 trillion dollars, while average forecasts for 2022 originations remain strong at 2.6 trillion dollars. It is worth noting that in each of 2021 and 2022, purchase originations are expected to total 1.7 trillion dollars, almost 40 percent higher than 2019 levels. So while refinance origination volumes are expected to decline significantly over time as a result of higher interest rates, we believe PennyMac Financial is very well positioned for continued market share growth – especially as we are one of the largest producers of purchase money loans in the U.S.

As Doug will expand on later in the discussion, Production margins across the industry have decreased as a result of excess capacity in the industry relative to the current origination market. While affected by these pressures, margins for PennyMac Financial's Production segment

stand to benefit from a continued shift in mix towards our higher-margin consumer direct lending channel, where we have been investing heavily and where there remains much opportunity for continued growth. Consumer and broker direct have an outsized impact on Production segment earnings as you can see on slide 7 of the earnings presentation. In fact, only 22 percent of fallout-adjusted lock volume in the first quarter was from the consumer and broker direct channels, but they contributed approximately 80 percent to the segment's pretax income.

Servicing becomes an increasingly important component of our earnings as interest rates increase, and we believe that mortgage companies without a balanced business model like PennyMac's will be challenged when origination volumes return to more normalized levels.

Additionally, the investments we have made in technology, such as our cloud-based proprietary servicing system we call SSE, are driving efficiencies across our platform as it continues to grow. Not only are

we seeing scale and workflow benefits from SSE, but it also enables PennyMac to effectively address COVID-19 hardships and implement loss mitigation programs for borrowers, which has contributed to elevated levels of core profitability in the Servicing segment.

Over nearly 8 years as a public company, PennyMac Financial has generated an average annualized return on equity of 26 percent. In the first quarter, PennyMac Financial recorded a 43 percent annualized return on equity, further adding to our long track record of strong financial performance. For the remainder of 2021 we project PFSI to achieve a return on equity closer to our pre-COVID historical returns.

Now I'll turn it over to Doug Jones, PFSI's President and Chief Mortgage Banking Officer, to discuss our mortgage banking businesses.

Speaker:

Doug Jones – President and Chief Mortgage Banking Officer

Thanks, Andy.

As you can see on slide 8 of our presentation, PennyMac maintained its leadership position in the correspondent channel and we estimate that we represent approximately 17 percent of the channel overall. Total correspondent loan acquisition volume was 51.2 billion dollars, down 10 percent from the prior quarter and up 72 percent from the first quarter of 2020. Our correspondent mix percentage was largely unchanged from the previous quarter, as 34 percent of correspondent acquisitions were government loans and 66 percent were conventional loans.

Government loan acquisitions in the quarter totaled 17.4 billion dollars, down 8 percent from the prior quarter and up 28 percent from the first quarter of 2020. Conventional correspondent acquisitions, for which PFSI earns a fulfillment fee from PMT, totaled 33.8 billion dollars, down 11 percent from the prior quarter and up 109 percent from the first quarter of 2020.

Government correspondent locks were 17.1 billion dollars, down 14 percent from the prior quarter and up 15 percent from the first quarter of 2020.

Revenue per fallout-adjusted government lock in the first quarter was 41 basis points, down from 51 basis points in the prior quarter as margins in the channel continued to trend towards more normalized levels.

In April, our correspondent volumes remained strong, with 18.5 billion dollars of acquisitions and 15.6 billion dollars of locks.

Looking ahead further, we expect the role of correspondent aggregators to become increasingly important in the mortgage ecosystem as the government-sponsored enterprises implement changes to their preferred stock purchase agreements. Additionally, the implementation of the 1.5 billion dollar annual limit per client on

cash window deliveries is expected to drive more volume to leading aggregators like PennyMac.

As we turn to consumer direct, we estimate that we gained significant market share during the quarter with approximately 1.3 percent of total originations in the channel.

We originated a record 10.7 billion dollars of loans in the channel, up 33 percent from the prior quarter and 165 percent from the first quarter of 2020 driven by growth in sales and fulfillment capacity as our new hires in fulfillment and direct lending begin to season. Interest rate lock commitments in the first quarter were also a record, totaling 13.4 billion dollars, up 4 percent from the prior quarter and up 87 percent from the first quarter of 2020.

Importantly, New Customer Acquisition, or non-portfolio interest rate lock commitments in the first quarter were 1.5 billion dollars, up from 1.3 billion dollars in the fourth quarter and 267 million dollars in the

first quarter of 2020 as we begin to see the results of the commitment we have made to growing this channel. Similarly, purchase lock volume was a record 514 million dollars, up from 503 million dollars in the fourth quarter and 353 million dollars in the first quarter last year. The technology-based digital marketing platform, coupled with dedicated loan officers and efficient operating processes gives PennyMac a strong foundation for continued growth.

Though mortgage rates increased and the industry remains competitive, we saw revenue per fallout-adjusted lock of 477 basis points in the first quarter, which is very strong by historical standards.

In April, originations in our consumer direct channel totaled 3.5 billion dollars, and locks totaled 4.7 billion dollars. The committed pipeline at April 30th was 7 billion dollars.

Lastly, our broker direct channel continued its impressive growth with a record 5.1 billion dollars in origination volume, up 14 percent from the

prior quarter and 227 percent from the first quarter of 2020. We now estimate that we represent approximately 3 percent market share in the channel, with almost 1,900 brokers approved to offer our products, up 18 percent from the end of 2020.

Volumes and pricing margins in the channel trended as expected in January and February, but decreased in March and April reflecting high levels of competition between channel leaders. Lock volume in the first quarter totaled 5.7 billion dollars, essentially unchanged from the prior quarter while April locks totaled 1.5 billion dollars. Margins in the broker channel decreased more sharply than in other channels and revenue per fallout-adjusted lock was 145 basis points, down from 205 basis points in the prior quarter.

While we have seen them recently stabilize, margins in April were down meaningfully from their average levels in the first quarter, with broker direct margins impacted the most.

In total, these strong acquisition and origination volumes continue to drive the organic growth of our servicing portfolio despite elevated prepayment activity. As you can see on slide 12, 45 billion dollars of portfolio runoff in the first quarter was more than offset by 67 billion dollars of total production added and we ended the quarter with a servicing portfolio of 449 billion dollars in unpaid principal balance, or approximately 3.8 percent of all residential mortgage debt outstanding in the U.S.

PennyMac Financial's owned portfolio reported a prepayment speed of 32.6 percent in the first quarter, essentially unchanged from 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 to 35.1 percent from 38.9 percent.

PFSI's owned servicing portfolio, which consists primarily of Ginnie Mae MSRs, had a 60 plus day delinquency rate of 8.6 percent, down from

10.2 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 2.1 percent, down from 2.7 percent at December 31st as borrowers continue to emerge from forbearance plans.

The UPB of completed modifications was 5.5 billion dollars, down from 6.3 billion dollars last quarter and the UPB of EBO loan volume totaled 4.2 billion dollars, also down from last quarter as a result of the smaller population of loans eligible for modification as delinquency rates continue to decline.

I'll now turn it over to Dan Perotti, Senior Managing Director and Chief Financial Officer who will 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 376.9 million dollars, or diluted earnings per share of 5 dollars and 15 cents.

I will cover each segment's results and then briefly review our forbearance and servicing advance trends.

Production segment pretax income was 362.9 million dollars, down 37 percent from the prior quarter and up 51 percent from the first quarter of 2020.

As you will see on slide 11, 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 have an outsized impact on PFSI's production earnings. As Andy mentioned, consumer and broker direct represented 22 percent of fallout adjusted lock volume in the first

quarter but accounted for approximately 80 percent of segment pretax income.

Production revenue margins declined from the prior quarter and revenue per fallout-adjusted lock for PFSI's own account was 176 basis points in the first quarter, down from 217 basis points in the fourth quarter of 2020. Our costs vary by channel, ranging from approximately 15 basis points in correspondent to 150 basis points in consumer direct, and 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 141.7 million dollars, up from pretax income of 42 million dollars in the prior quarter and down from 170.8 million dollars in the first quarter of 2020.

Pretax income excluding valuation-related items for the servicing segment was 258.4 million dollars, up 10 percent from the prior quarter

and 511 percent from the first quarter of 2020. These increases were primarily driven by continued loss mitigation activities related to COVID-19.

As you can see in greater detail on slide 13, EBO loan-related revenue increased significantly to 283.7 million dollars as a result of continued loss mitigation activity with borrowers emerging from forbearance while related expenses were modest.

Operating revenue decreased 5.6 million dollars from the prior quarter driven by lower net servicing fees as a result of seasonal payment trends and lower earnings rates on custodial deposits. Operating expenses were up 18.4 million dollars from the prior quarter driven primarily by seasonal accruals of compensation related expenses and a greater allocation of corporate expenses.

Payoff-related expenses, which includes interest shortfall and recording and release fees related to prepayments, remain elevated and increased by 4.2 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.

On slide 14, you can see the fair value of our MSR increased by 461 million dollars in the first quarter, driven primarily by lower expectations for prepayment activity in the future as a result of higher mortgage rates. This fair value increase was partially offset by 155 million dollars in other valuation declines, primarily driven by significant levels of prepayment activity and early buyouts.

Hedging and related declines totaled 443 million dollars and included hedge costs of 52 million dollars. Market volatility during the quarter

impacted both hedge costs and hedge effectiveness. Overall, combined with pretax income from our Production segment, our hedging strategies have been successful over time, mitigating the volatility of interest rate changes on our income.

Our Investment Management segment delivered pretax income of 1.4 million dollars, down from 2.6 million dollars in the prior quarter.

Net assets under management totaled 2.4 billion dollars as of March 31st, up 3 percent from December 31st as PMT recorded another strong quarter of investment performance. Segment revenue was 9.6 million dollars, essentially unchanged from the prior quarter.

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 6.3 percent at March 31st from 7.8 percent at December 31st as borrowers in

forbearance plans at December 31st who have since exited more than offset new forbearance plans.

Servicing advances outstanding decreased to approximately 437 million dollars at March 31st, from 454 million dollars at December 31st, consistent with seasonal trends in the first quarter. Advances are expected to increase 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.

Our balanced business model once again delivered outstanding results in an increasingly challenging market. We continue to grow our direct

lending businesses, as well as organically grow our servicing asset, building an extremely valuable mortgage banking enterprise well positioned for future growth. We believe deeply in that value, which is why we continue to repurchase shares. Since the beginning of 2020, we have now repurchased approximately 18 percent of PFSI's common shares. We also continue to make substantial investments in our technology and operations. I remain confident in our ability to profitably and responsibly grow our direct lending channels while maintaining our leadership position in correspondent production. Combined with our large and growing residential loan servicing portfolio, we expect to continue producing strong returns for our stockholders as we look ahead. Finally, we look forward to further discussing our outlook for the business at our upcoming investor day for PennyMac Financial and PennyMac Mortgage Investment Trust.

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 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.