

PennyMac Financial Services, Inc.

Second Quarter 2021 Earnings Transcript

August 5, 2021

Introduction

Good afternoon, and welcome to the second 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 second quarter 2021 results.

Speaker:

David Spector – Chairman and Chief Executive Officer

Thank you Isaac.

PennyMac Financial again delivered outstanding financial performance in the second quarter driven by continued strong production and core servicing results partially offset by net MSR fair value declines.

Net income was 204 million dollars or diluted earnings per share of 2 dollars and 94 cents, representing an annualized return on equity of 23 percent. Book value per share grew 5 percent to 54 dollars and 49 cents at June 30th.

Importantly, we continued to repurchase stock, with 2.6 million shares of PFSI's common stock bought back during the quarter for an approximate cost of 155 million dollars; and for the month of July, we repurchased an additional 2.5 million shares, for an approximate cost of 151 million dollars. This brings the total repurchases year-to-date to approximately 600 million dollars, and since the beginning of 2020, we have now repurchased over 18.5 million shares, or approximately 24 percent of PFSI's common shares outstanding. Additionally, PFSI's Board of Directors approved an increase to its stock repurchase authorization from 1 billion dollars to 2 billion dollars.

PFSI's Board of Directors also declared a second 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.

In total, loan acquisition and origination volumes were 61 billion dollars in the second quarter. These strong production volumes again led to servicing portfolio growth despite continued elevated prepayment activity. PennyMac Financial's servicing portfolio totaled 473 billion

dollars in unpaid principal balance at June 30th, up 5 percent from the end of the prior quarter, and 22 percent from June 30th, 2020.

Importantly, and as Doug Jones, Senior Managing Director and Chief Mortgage Banking Officer, will expand on in his section of the presentation, we sold 3.4 billion dollars in UPB of early buyout loans to third-party, whole loan investors, thus reducing the risk associated with holding these loans and increasing our capital efficiency.

PFSI's Investment Management segment delivered increased profitability as a result of incentive fees earned based on PMT's profitability over the last four quarters. Net assets under management were down slightly quarter over quarter to 2.3 billion dollars.

We continue to invest in people, systems and processes across our businesses, laying the groundwork that will allow us to achieve the medium-term goals we outlined in our recent investor day.

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 drivers of profitability for PFSI going forward.

Speaker:

Andy Chang – Senior Managing Director and Chief Operating Officer

Thank you, David.

The origination market continues to be strong on a historical basis as mortgage rates have recently returned to near-record lows. Additionally, we believe FHFA's elimination of the Adverse Market Refinance Fee has resulted in a larger population of loans that would benefit from a refinance at today's lower rates, further supporting the origination market.

Recent economic forecasts for 2021 originations range from 3.6 trillion to 4.2 trillion dollars, while average forecasts for 2022 originations remain strong at 2.7 trillion dollars. It is worth noting that purchase originations are expected to grow and are forecasted to be 1.7 trillion and 1.9 trillion dollars in 2021 and 2022, respectively.

So while refinance origination volumes are expected to decline significantly over the next several years as a result of higher interest rates, we believe the outlook for PennyMac Financial remains strong given our large, profitable and growing servicing business; our position as one of the largest producers of purchase-money loans in the U.S.; and the continued expansion of our direct-lending businesses.

We believe PennyMac Financial's business model with production from the correspondent, consumer direct and broker direct channels contributes to PennyMac Financial's profitability across different production environments. While industry production margins declined in the second quarter, we saw a smaller decrease in overall production margin given the mix shift towards our consumer-direct lending channel.

Our direct lending channels have an outsized impact on Production segment earnings as Dan will discuss later. As we continue to grow our leadership positions in the direct origination channels, this growth will drive the earnings from PennyMac Financial's Production segment.

Our balanced business with our large and growing servicing portfolio also becomes an increasingly important component of our earnings as interest rates increase, and we believe this provides a competitive advantage relative to others when the industry's origination volumes return to more normalized levels. The expertise of our deep management team, combined with the technology investments we have made, support PennyMac's growth strategy in a changing mortgage market. And while we believe the mortgage market will continue to change from a competitive and regulatory perspective, the infrastructure and risk management disciplines that distinguish PennyMac from others in the industry position us well.

Now I'll turn it over to Doug, who will discuss our mortgage banking businesses.

Speaker:

Doug Jones – President and Chief Mortgage Banking Officer

Thanks, Andy.

As you can see on slide 7 of our presentation, PennyMac maintained its leadership position in the correspondent channel and we estimate that

we currently represent approximately 18 percent of the channel overall. Total correspondent loan acquisition volume was 46.7 billion dollars, down 9 percent from the prior quarter and up 56 percent from the second quarter of 2020. Our correspondent mix percentage was essentially unchanged from the previous quarter, as 35 percent of acquisitions were government loans and 65 percent were conventional loans.

Government loan acquisitions in the quarter totaled 16.2 billion dollars, down 7 percent from the prior quarter and up 47 percent from the second quarter of 2020. Conventional correspondent acquisitions, for which PFSI earns a fulfillment fee from PMT, totaled 30.5 billion dollars, down 10 percent from the prior quarter and up 61 percent from the second quarter of 2020.

Government correspondent locks were 15.7 billion dollars, down 8 percent from the prior quarter and up 21 percent from the second quarter of 2020.

Revenue per fallout-adjusted government lock in the second quarter was 30 basis points, down from 37 basis points in the prior quarter. The scale we have achieved in our correspondent business, combined with our low cost structure and operational excellence in the channel allow us to operate profitably through volatile market environments. As we outlined in our investor day, we see additional opportunities resulting from changes to the GSEs' preferred stock purchase agreements and believe the role of well-capitalized correspondent aggregators like PennyMac will be increasingly important over time. Ultimately, we believe

for these reasons, PennyMac will continue its market share growth as a channel leader.

In July, our correspondent acquisitions were 15 billion dollars in UPB and locks were 12.8 billion dollars.

Our consumer direct lending division produced record origination and lock volumes again, despite a smaller origination market in the second quarter. Origination volumes totaled 10.7 billion dollars in UPB, while interest rate lock commitments totaled 14.1 billion dollars. We estimate that our market share in the channel has increased meaningfully since last year and we now account for approximately 1.3 percent of total originations in the channel.

This ongoing success can be attributed to the increased application of data analytics, our growing servicing portfolio, and the investments we have made in our loan fulfillment and sales process.

Purchase lock volume for the quarter was also a record 744 million dollars, up from 514 million dollars in the prior quarter and 505 million dollars in the second quarter of 2020.

Similarly, New Customer Acquisition, or non-portfolio interest rate lock commitments were 1.5 billion dollars, essentially unchanged from the prior quarter and up from 274 million dollars in the second quarter of 2020. The technology-based digital marketing platform, coupled with dedicated loan officers and efficient operating processes gives PennyMac a strong foundation for continued growth.

Revenue per fallout-adjusted lock was 343 basis points in the quarter, a decrease from the first quarter. However margins in this channel remain attractive.

In July, originations for our consumer direct channel totaled 3.5 billion dollars, and locks totaled 5.5 billion dollars. The committed pipeline at July 31st was 7.2 billion dollars.

Lastly, originations in our broker direct channel totaled 4 billion dollars in UPB, down 22 percent from the prior quarter. Similarly, lock volume totaled 4.5 billion dollars, down 21 percent. Pricing margins in the channel decreased sharply, reflecting intense levels of competition between channel leaders. Revenue per fallout-adjusted lock was 71 basis points, down from 140 basis points in the prior quarter.

We estimate that we now represent approximately 2.5 percent market share in the channel, with over 2,000 brokers approved to offer our products, an increase of 11 percent from March 31st, 2021.

Despite these currently-elevated levels of competition, we continue to see opportunity in the channel over the long-term and remain committed to providing our broker partners and the customers they serve a superior mortgage experience.

Broker originations in July totaled 1.2 billion dollars and locks totaled 1.7 billion dollars. And the committed pipeline at July 31st was 1.9 billion dollars.

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 11, approximately 37 billion dollars of portfolio runoff in the second quarter was more than offset by the addition of 61 billion dollars in total production, and we ended the quarter with a servicing portfolio of 473 billion dollars in unpaid principal balance; approximately 4 percent of all residential mortgage debt in the U.S.

PennyMac Financial's owned portfolio reported a prepayment speed of 28.3 percent in the second quarter, down from 32.6 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 to 24.7 percent from 35.1 percent.

PFSI's owned servicing portfolio, which consists primarily of Ginnie Mae MSRs, had a 60 plus day delinquency rate of 6.7 percent, down from 8.6 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 1.6 percent, down from 2.1 percent at March 31st as borrowers continue to emerge from forbearance plans.

The UPB of completed modifications was 5.5 billion dollars, essentially unchanged from the prior quarter and the UPB of EBO loan volume totaled 6.8 billion dollars, up from 4.2 billion dollars in the prior quarter. As David mentioned earlier, we sold 3.4 billion dollars in UPB of EBO loans to third-party, whole loan investors, up significantly from last quarter.

We have long-standing partnerships with several EBO-loan investors, with a program in place to buy delinquent Ginnie Mae loans out of securitizations and sell them to these third-party investors. These transactions provide PennyMac the additional capacity and liquidity to efficiently execute loss mitigation strategies, as sales of these loans to third-parties also eliminates the potential for associated margin calls. Importantly, PennyMac retains the servicing rights and carries an option to repurchase these government-insured loans in the event they become eligible for redelivery into Ginnie Mae securities.

This quarter, we increased meaningfully the number of partnerships we have with these third parties and also expanded the volumes of these sales to our existing partners, driving the quarterly increase in EBO loan volume I mentioned earlier. Finally, transactions like these provide meaningful savings to PennyMac Financial over the life of the loan, while providing the opportunity for redelivery in the future.

I'll now turn it over to Dan 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 204.2 million dollars, or diluted earnings per share of 2 dollars and 94 cents.

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

Production segment pretax income was 244.4 million dollars, down 33 percent from the prior quarter and 55 percent from the second quarter of 2020.

As you will see on slide 10, 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 earlier. As you can see on slide 10 of the presentation, consumer and broker direct represented 23 percent of fallout adjusted lock volume in the second quarter but accounted for approximately 70 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 154 basis points in the second quarter, down from 176 basis points in the first quarter of 2021. 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 30.9 million dollars, down from pretax income of 141.7 million dollars in the prior quarter and up from a pretax loss of 62.4 million dollars in the second quarter of 2020.

Pretax income excluding valuation-related items for the servicing segment was 174.4 million dollars, down 33 percent from the prior quarter and up 101 percent from the second quarter of 2020. The decrease from the prior quarter was primarily driven by a 76 million dollar decrease in EBO loan-related revenue.

Operating revenue decreased 2 million dollars from the prior quarter driven by declines in earnings on custodial balances. Operating expenses were also down quarter over quarter, as the prior quarter included seasonal accruals of compensation related expenses.

Payoff-related expenses, which include interest shortfall and recording and release fees related to prepayments, remain elevated, but decreased slightly 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 decreased by 251 million dollars in the second quarter, and included 196 million dollars in fair value losses as a result of higher expectations for prepayment

activity in the future driven by lower mortgage rates and a flatter yield curve, as well as an additional 55 million dollars in other valuation declines. These valuation declines were primarily driven by significant levels of prepayment activity and early buyouts. Hedging and related gains totaled 91 million dollars.

Our Investment Management segment delivered pretax income of 4.1 million dollars, up from 1.4 million dollars in the prior quarter as a result of incentive fees earned, and down from 4.7 million dollars in the second quarter of 2020.

Net assets under management totaled 2.3 billion dollars as of June 30th, down slightly from March 31st and up 5 percent from June 30th, 2020. Segment revenue was 13.5 million dollars, up 41 percent from the first quarter and 28 percent from June 30th, 2020.

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 4.9 percent at June 30th from 6.3 percent at March 31st as borrowers in forbearance plans at March 31st who have since exited more than offset new forbearance plans.

Servicing advances outstanding decreased to approximately 424 million dollars at June 30th, from 437 million dollars at March 31st. Advances are expected to increase over the next few quarters as many property tax payments become due toward the end of the calendar year. No P&I

advances are outstanding, 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 another outstanding quarter of operational and financial performance, despite the increased volatility in the mortgage market. Our higher-margin consumer direct lending channel continued to expand, producing record locked and funded volumes during the quarter which we estimate has resulted in a significant increase in market share. Strong production volumes across all three channels continued to drive the growth of our servicing portfolio despite the elevated level of prepayments. Our balanced business model is a key strategic advantage for PFSI, which has consistently delivered outstanding returns across different environments, producing a 33 percent return on equity for the first half of 2021. We also remain very active repurchasing shares, driven by our medium-term expectations for PFSI's return on equity.

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