



PennyMac Financial Services, Inc.

Third Quarter 2021 Earnings Transcript

November 4, 2021

Introduction:

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

Speaker:

David Spector – Chairman and Chief Executive Officer

Thank you Isaac.

PennyMac Financial again delivered outstanding financial performance in the third quarter, reflecting higher income from production against a normalizing origination market and strong core servicing results, partially offset by fair value declines on mortgage servicing rights and interest rate hedges.

Net income was 249 million dollars or diluted earnings per share of 3 dollars and 80 cents, representing an annualized return on equity of 29 percent. Book value per share grew 6 percent to 58 dollars at September 30th.

We repurchased 4.2 million shares of PFSI's common stock during the quarter for an approximate cost of 257 million dollars; and we continued in October with an additional 1.4 million shares, for an approximate cost of 90 million dollars. This brings the total repurchases year-to-date to approximately 790 million dollars, and since the beginning of 2020, we have now repurchased over 21.7 million shares, or approximately 28 percent of PFSI's common shares outstanding.

PFSI's Board of Directors also declared a third quarter cash dividend of 20 cents per share.

Additionally, I am pleased to note that PFSI joined a handful of leading non-bank mortgage companies able to access long-term corporate debt at attractive terms, and this quarter we issued 500 million dollars of 10-year senior unsecured notes, consistent with our long-term growth plans and further strengthening PFSI's balance sheet.

Dan Perotti, PFSI's Senior Managing Director and Chief Financial Officer will review additional details of our financial performance later on in this discussion.

In total, loan acquisition and origination volumes were 59 billion dollars in the third quarter. These strong production volumes again led to servicing portfolio growth despite elevated prepayment activity.

PennyMac Financial's servicing portfolio totaled 495 billion dollars in unpaid principal balance at September 30th, up 5 percent from the end of the prior quarter and up 23 percent from September 30th, 2020.

PFSI's Investment Management segment revenues were 9.8 million dollars, down from the prior quarter as no incentive fee was earned for PMT's performance this quarter. Net assets under management were 2.5 billion dollars, up from the prior quarter due to PMT's issuance of 250 million dollars in preferred shares.

PFSI's strong operational and financial results in the third quarter demonstrate the power of the balanced production and servicing mortgage banking model we have built. With this experienced management team, a strong capital base and the robust risk management processes we have in place, I remain confident that PennyMac Financial will successfully navigate the upcoming shift in the mortgage market. Furthermore, given PFSI's continued investment in technology and marketing, I remain excited for our growth prospects ahead in a rising interest rate environment.

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 large. Despite the increase in recent weeks, interest rates continue to be historically low and remain consistent with the projections of leading economists.

Current forecasts for 2022 originations total 3 trillion dollars. It is worth noting that purchase originations are expected to grow to a record 2 trillion dollars in 2022, up 9 percent from this year's levels, while refinance originations are expected to decline to 1.1 trillion dollars.

So while industry refinance volumes are expected to decrease significantly, we believe the outlook for PennyMac Financial remains strong given our large, profitable and growing servicing business; our position as the largest producer of purchase-money loans in the U.S.; and the continued expansion of our direct-lending businesses.

PennyMac Financial's balanced multi-channel production model provides flexibility to optimize profitability across different production environments. While trends in production margins were mixed across channels in the third quarter, pretax income from PFSI's production segment increased 35 percent from the second quarter due to the continued success of our consumer direct lending channel, which had higher margins during the quarter.

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 enhance profitability of our production segment.

Our large and growing servicing portfolio will become an increasingly important component of our earnings as interest rates increase, and we believe this provides a competitive advantage relative to other mortgage banks as the industry's origination volumes return to more normalized levels. The expertise of our deep management team, combined with the technology and marketing investments we are making, 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 continue to position us well.

Now I'll turn it over to Doug Jones, President and Chief Mortgage Banking Officer, 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

through the first nine months of this year we represented approximately 17.7 percent of the channel overall. Total correspondent loan acquisition volume was 44 billion dollars, down 6 percent from the prior quarter and down 1 percent from the third quarter of 2020. Our correspondent mix was similar to the previous quarter, as 65 percent of acquisitions were conventional loans and 35 percent were government loans.

Government loan acquisitions in the quarter totaled 15.4 billion dollars, down 5 percent from the prior quarter and down 9 percent from the third quarter of 2020. Conventional correspondent acquisitions, for which PFSI earns a fulfillment fee from PMT, totaled 28.6 billion dollars, down 6 percent from the prior quarter and up 5 percent from the third quarter of 2020.

Government correspondent locks were 16.2 billion dollars, up 4 percent from the prior quarter and down 20 percent from the third quarter of 2020.

Revenue per fallout-adjusted government lock in the third quarter was 27 basis points, down from 30 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 and remain the channel leader.

In October, our correspondent acquisitions were 12.9 billion dollars in UPB and locks were 11.5 billion dollars.

Turning to consumer direct, not only did we see records in our overall volumes, as David mentioned, but we saw records in both purchase and New Customer Acquisition activity. Purchase lock volume for the quarter was a record 788 million dollars, up from 740 million dollars in the prior quarter and 474 million dollars in the third quarter of 2020.

Similarly, New Customer Acquisition, or non-portfolio interest rate lock commitments were 2 billion dollars, up from 1.5 billion dollars in the prior quarter and up from 920 million dollars in the third quarter of 2020.

Additionally, the positive trend in recapture is expected to continue as capacity increases and prepayments return to more normalized levels.

In total, Consumer Direct origination volumes for the third quarter were 11.1 billion dollars and interest rate lock commitments were 16.3 billion dollars. We estimate that our market share in the channel has increased meaningfully since last year and we have accounted for approximately 1.4 percent of total originations in the channel through the first nine months of 2021.

The ongoing success we see in the channel can be attributed to the increased application of data analytics and the investments we have made in our loan fulfillment and sales process. Additionally, I remain excited for the future growth prospects for this channel, driven by the continued growth of our servicing portfolio as noted earlier and leveraging the investments we have made and will continue to make in the technology and marketing areas.

Revenue per fallout-adjusted lock was 382 basis points in the quarter, up from 343 basis points in the second quarter.

In October, originations for our consumer direct channel totaled 3.6 billion dollars, and locks totaled 4.9 billion dollars. The committed pipeline at October 31st was 6.3 billion dollars.

Lastly, originations in our broker direct channel totaled 4 billion dollars, essentially unchanged from the prior quarter. Lock volume totaled 4.9 billion dollars, up 8 percent from the prior quarter. Pricing margins in the channel continue to reflect competition between channel leaders and revenue per fallout-adjusted lock was 77 basis points, a modest improvement from 71 basis points in the prior quarter.

We estimate that we now represent approximately 2.4 percent market share in the channel over the first nine months of the year, with over 2,100 brokers approved to offer our products, or approximately 14 percent of the total population of brokers.

Despite 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 October totaled 1.3 billion dollars and locks totaled 1.5 billion dollars. And the committed pipeline at October 31st was 1.6 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 third quarter was more than offset by the addition of 59 billion dollars in total production, and we ended the quarter with a servicing portfolio of 495 billion dollars in unpaid principal balance; approximately 4.1 percent of all residential mortgage debt in the U.S.

PennyMac Financial's owned portfolio reported a prepayment speed of 27.2 percent in the third quarter, down from 28.3 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 – was 23.6 percent, down from 24.7 percent in the prior quarter.

PFSI's owned servicing portfolio, which consists primarily of Ginnie Mae MSR's, had a 60 day plus delinquency rate of 6.1 percent, down from 6.7 percent at the end of the prior quarter, while our subserviced portfolio, consisting primarily of conventional loans, reported a 60 day plus delinquency rate of 1.2 percent, down from 1.6 percent at June 30th as borrowers continue to emerge from forbearance plans.

The UPB of completed modifications was 4.7 billion dollars, down from 5.5 billion dollars in the prior quarter and the UPB of EBO loan volume totaled 5.5 billion dollars, down from 6.8 billion dollars in the prior quarter as a result of a smaller population of loans eligible to be bought out.

I'll now turn it over to Dan who will speak to the financial results for the quarter.

Speaker:

Dan Perotti – Senior Managing Director and Chief Financial Officer

Thanks, Doug.

As David mentioned earlier PFSI's net income was 249.3 million dollars, or diluted earnings per share of 3 dollars and 80 cents. I will cover each segment's results and then briefly review our forbearance and servicing advance trends.

Production segment pretax income was 330.6 million dollars, up 35 percent from the prior quarter and down 46 percent from the third quarter of 2020. As you will see on slide 9, 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, consumer and broker direct represented 26 percent of fallout adjusted lock volume in the third quarter but accounted for approximately 84 percent of segment pretax income.

Production revenue margins in the direct lending channels increased from the prior quarter while government correspondent margins were

down slightly. Revenue per fallout-adjusted lock for PFSI's own account was 165 basis points in the third quarter, up from 154 basis points in the prior quarter. Our costs vary by channel, ranging from approximately 10 basis points in correspondent to 140 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 8 million dollars, down from pretax income of 30.9 million dollars in the prior quarter and down from pretax income of 111.7 million dollars in the third quarter of 2020.

Pretax income excluding valuation-related items for the servicing segment was 148.4 million dollars, down 15 percent from the prior quarter and down 17 percent from the third quarter of 2020. The decrease from the prior quarter was primarily driven by decreased income from loss mitigation activity.

Operating revenue increased 7.4 million dollars from the prior quarter driven by an increase in loan servicing fees from a larger servicing portfolio while operating expenses as a percentage of average servicing portfolio UPB decreased.

Payoff-related expenses, which include interest shortfall and recording and release fees related to prepayments, remained elevated, but decreased slightly quarter-over-quarter.

In order to protect the value of our MSR asset we utilize a comprehensive hedging strategy. This 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 13, you can see the fair value of our MSR decreased by 65 million dollars in the third quarter, including 56 million dollars in fair value increases due to changes in interest rates, and 121 million dollars in other valuation declines. These valuation declines were primarily driven by elevated levels of prepayment activity and increases to short-term prepayment projections. Hedging losses totaled 86 million dollars, and included 69 million dollars in fair value declines primarily driven by increases in market interest rates and 17 million dollars in declines due to hedge costs.

Our Investment Management segment delivered pretax income of 1 million dollars, down from 4.1 million dollars in the prior quarter as no incentive fees were earned for PMT's performance this quarter.

Net assets under management totaled 2.5 billion dollars as of September 30th, up 6 percent from June 30th and up 9 percent from September 30th, 2020 due to PMT's sale of 250 million dollars of preferred stock. Segment revenue was 9.8 million dollars, down 28 percent from the second quarter and unchanged from the third quarter of 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 3.2 percent at September 30th from 4.9

percent at June 30th as borrowers in forbearance plans at June 30th who have since exited more than offset new forbearance plans.

Servicing advances outstanding increased modestly to approximately 430 million dollars at September 30th, from 424 million dollars at June 30th. Advances are expected to increase over the next few months 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 – Chairman and Chief Executive Officer

Thank you, Dan.

Looking forward, we have plans in place to leverage investments in technology and marketing across the business, and I am optimistic we will continue to increase our market share while successfully addressing the changing needs of the more than 2 million customers in our large and growing servicing portfolio. It is for these reasons we expect PennyMac Financial to continue delivering attractive returns on equity, which we expect will trend towards our pre-COVID average over time.

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 third 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.