PennyMac Financial Services, Inc.

Fourth Quarter and Full-Year 2021 Earnings Transcript

February 3, 2022

Introduction:

Good afternoon, and welcome to the fourth quarter and full-year 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.

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

Speaker:

David Spector – Chairman and Chief Executive Officer

Thank you Isaac.

PennyMac Financial again delivered strong performance in the fourth quarter, demonstrating the earnings power of our balanced business model, with pretax income from our servicing business exceeding that from our production business.

Net income was 173 million dollars or diluted earnings per share of 2 dollars and 79 cents, representing an annualized return on equity of 20 percent. Book value per share grew 4 percent from September 30 to 60 dollars and 11 cents at December 31st.

We continued to repurchase shares, and this quarter we repurchased 3.9 million shares of PFSI's common stock for an approximate cost of 257 million dollars; and in January we repurchased an additional 848 thousand shares, for an approximate cost of 56 million dollars.

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

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 47 billion dollars in the fourth quarter. These production volumes again led to servicing portfolio growth despite continued elevated prepayment activity. PennyMac Financial's servicing portfolio totaled 510 billion dollars in unpaid principal balance at December 31st, up 3 percent from the end of the prior quarter and 19 percent from December 31st, 2020.

In PFSI's Investment Management segment, net assets under management were 2.4 billion dollars at year end, down from the prior quarter due to PMT's net loss in the fourth quarter.

2021 was another record year operationally for PFSI. Total production, including acquisitions made by PMT, were 234 billion dollars in UPB, up 19 percent from 2020. Importantly, in our most profitable channel, consumer direct, originations totaled 43 billion dollars, a meaningful increase from 23 billion dollars in 2020. These production volumes led to servicing portfolio growth of 19 percent despite elevated prepayment activity throughout the year, and as I said earlier we ended 2021 with a servicing portfolio of more than half a trillion dollars in UPB with more than 2.1 million customers.

Although our financial results were down from record levels in 2020, PennyMac Financial still delivered exceptional financial performance with net income of 1 billion dollars and diluted EPS of 14 dollars and 87 cents, representing a return on equity of 29 percent.

This past year was a pivotal one for PennyMac Financial. Early in the year, we became one of only a handful of independent mortgage banking companies able to raise long-term debt and in total we raised 1.15 billion dollars of 8- and 10-year unsecured senior notes throughout 2021. These unsecured senior notes not only strengthen our balance sheet but position us well for the planned growth of the company in the years ahead.

We have substantially invested in transformational technology initiatives throughout our history and 2021 was no different with an additional 100 million dollars of related investments. As we enter 2022 we will begin deploying new technologies to our direct lending channels which enhance consumer and client self-service capabilities and improve overall process efficiency. We will continue to deploy additional technologies throughout

2022 and beyond as we look to enhance the overall mortgage life cycle experience with our borrowers and partners.

Another important use of capital has been our share repurchase program. In 2021 we repurchased more than 15 million shares of PFSI common stock for a total of 958 million dollars, or more than 20 percent of the shares outstanding at the beginning of the year. In fact, combined with PFSI's common share cash dividends, we returned over 1 billion dollars of capital to shareholders throughout the year.

The origination market is projected to decline substantially in 2022. Inside Mortgage Finance estimates the 2021 origination market was 4.8 trillion dollars and current forecasts for 2022 total 3.1 trillion dollars, a reduction of 35 percent year-over-year. However, purchase originations are expected to remain strong at 2 trillion dollars. We believe the decline in overall originations will continue to drive significant competition and pressure on gain-on-sale margins until the current excess industry capacity is reduced. We believe PennyMac Financial's diversification, size and scale position us well to succeed.

Our large and growing servicing portfolio will become an increasingly important component of our earnings as interest rates increase and as prepayments return to more normalized levels. You can see evidence of the benefits of our balanced business model in our fourth quarter results as our servicing segment generated earnings higher than those from production. We believe this balance provides a competitive advantage relative to other mortgage banks as the industry's origination volumes decline. Additionally, SSE, our proprietary servicing system, provides cost and operational efficiency.

Our deep and talented management team has a strong track record of successfully navigating different mortgage cycles and has always maintained a focus on disciplined growth and expense management. Given the current environment, we remain committed to these principles.

That said, the continued expansion of our direct lending businesses is expected to enhance the profitability of our production segment over time. In 2021, we meaningfully increased our market position in consumer direct and more than 80 percent of our production pretax income came from this channel compared to under 50 percent just two years ago. Additionally, we believe we are still in the early stages of our development, with new technology rollouts in our direct lending channels expected throughout the year. These enhancements will provide meaningful benefits to the brokers and customers we work with every day as well as our fulfillment staff and loan officers. By furthering their self-service capabilities, our customers and brokers can fill out an application at their convenience, with a dedicated Pennymacer available via phone, online, etc. Over time, we expect these new tools will drive higher conversion and portfolio retention rates, along with faster closing times and lower loan manufacturing costs.

In January, we launched a new evolution of our brand that I am very excited about, with a vision to become the most trusted and respected partner in the industry. This new brand brings a cohesive feel to all of our business lines and reflects our commitment to the Accountable, Reliable, and Ethical core values that have been foundational to our success. Throughout our history we have managed the growth of the company in a disciplined fashion and with business lines across all channels of residential mortgage banking, we are uniquely positioned to represent trust, stability, and long-term partnership. So while I am tremendously excited about our new brand and some of you may see some Pennymac TV commercials, content via social platforms, or other forms of communication, our targeted approach will remain a continued and ongoing focus.

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, David.

As you can see on slide 8 of our presentation, PennyMac maintained its leadership position in the correspondent channel and we estimate that throughout this year we represented approximately 16.8 percent of the channel overall.

In the fourth quarter, total correspondent loan acquisition volume was 33 billion dollars, down 25 percent from the prior quarter and 42 percent from the fourth quarter of 2020. 52 percent of acquisitions were conventional loans and 48 percent were government loans, compared to 65 percent and 35 percent, respectively, in the third quarter.

Government loan acquisitions in the quarter totaled 15.7 billion dollars, up 2 percent from the prior quarter and down 17 percent from the fourth quarter of 2020. Conventional correspondent acquisitions, for which PFSI earns a fulfillment fee from PMT, totaled 17.2 billion dollars, down 40 percent from the prior quarter and 55 percent from the fourth quarter of 2020 as a result of significant levels of competition for conventional loans, including from the GSEs.

Government correspondent locks were 15.5 billion dollars, down 4 percent from the prior quarter and 21 percent from the fourth quarter of 2020.

Revenue per fallout-adjusted government lock in the fourth quarter was 24 basis points, down from 27 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.

In January, our correspondent acquisitions were 7.6 billion dollars in UPB and locks were 7.5 billion dollars.

As David mentioned, we estimate that our market share in consumer direct has increased meaningfully since last year and we accounted for approximately 1.4 percent of total originations in the channel through 2021.

Origination volumes in the channel for the fourth quarter were 10.6 billion dollars, down 5 percent from the prior quarter and up 32 percent from the fourth quarter of 2020. Interest rate lock commitments were 14.2 billion dollars, down 13 percent from the prior quarter and up 11 percent from the fourth quarter of 2020.

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 in this channel as we leverage new technology and increased brand awareness.

We also continue to see success in our purchase and new customer acquisition channels, despite the smaller origination market. Purchase lock volume in the fourth quarter was 784 million dollars, essentially unchanged from the prior quarter and new customer acquisition lock volume was 1.9 billion dollars, down slightly from last quarter.

Margins remained attractive, with revenue per fallout adjusted lock of 336 basis points; still above what we believe are normalized levels.

In January, originations for our consumer direct channel totaled 3.2 billion dollars, and locks totaled 3.7 billion dollars. The committed pipeline at January 31st was 4.6 billion dollars.

Lastly, originations in our broker direct channel totaled 3.7 billion dollars, down 8 percent from the prior quarter. Lock volume totaled 3.9 billion dollars, down 21 percent from the prior quarter. Pricing margins in the channel continue to reflect competition between channel leaders and revenue per fallout-adjusted lock was 68 basis points, down from 77 basis points in the prior quarter.

We estimate that in 2021 we represented approximately 2.3 percent of the market share in the channel, with over 2,100 brokers approved to offer our products, or approximately 15 percent of the total population of brokers.

Despite elevated levels of competition currently, 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 new products and a superior mortgage experience.

Broker originations in January totaled 0.8 billion dollars and locks totaled 1.2 billion dollars. And the committed pipeline at January 31st was 1.3 billion dollars.

In total, these 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, approximately 33 billion dollars of portfolio runoff in the fourth quarter was more than offset by the addition of 47 billion dollars in total production, and we ended the quarter with a servicing portfolio of 510 billion dollars, or approximately 4.1 percent of all residential mortgage debt in the U.S.

PennyMac Financial's owned portfolio reported a prepayment speed of 23.5 percent in the fourth quarter, down from 27.2 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 19.8 percent, down from 23.6 percent in the prior quarter.

PFSI's owned servicing portfolio, which consists primarily of Ginnie Mae MSRs, had a 60 day plus delinquency rate of 4.7 percent, down from 6.1 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 0.9 percent, down from 1.2 percent at September 30th as borrowers continue to emerge from forbearance plans.

The UPB of completed modifications was 6.2 billion dollars, up from 4.7 billion dollars in the prior quarter driven by forbearance exits from early buyout (EBO) loans previously sold to third parties. The UPB of EBO loan volume totaled 3.7 billion dollars, down from 5.5 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 173.1 million dollars, or diluted earnings per share of 2 dollars and 79 cents. I will cover each segment's results and then briefly review our forbearance and servicing advance trends.

Production segment pretax income was 106.5 million dollars, down 68 percent from the prior quarter and 81 percent from the fourth quarter of 2020 primarily due to lower volumes and margins resulting from a transitioning mortgage market and a return to more seasonal trends. 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 David mentioned earlier. As you can see, consumer and broker direct represented 31 percent of fallout adjusted lock volume in the fourth quarter but accounted for approximately 90 percent of segment pretax income.

Production revenue margins in consumer direct remained attractive but decreased from the prior quarter, while broker direct margins remain below normalized levels. Government correspondent margins were down slightly. Revenue per fallout-adjusted lock for PFSI's own account was 113 basis points in the fourth quarter, down from 165 basis points in the prior quarter. This includes 75.6 million dollars in losses realized related to timing of revenue and loan origination expense recognition, hedging, pricing & execution changes, and other items.

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 126.1 million dollars, up from pretax income of 8 million dollars in the prior quarter and 42 million dollars in the fourth quarter of 2020.

Pretax income excluding valuation-related items for the servicing segment was 217.9 million dollars, up 47 percent from the prior quarter. The increase from the prior quarter was primarily driven by increased income from loss mitigation activity and higher servicing fees.

Operating revenue increased 24.6 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 by 3.4 million dollars from the prior quarter.

Realization of MSR cash flows increased 14.8 million dollars as delinquent loans continue to rehabilitate and provide greater ongoing income to the MSR portfolio.

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 14, you can see the fair value of our MSR decreased by 58 million dollars in the fourth quarter, including 28 million dollars in fair value declines due to changes in interest rates, primarily due to a significant flattening of the yield curve, and 30 million dollars in other valuation declines. These valuation declines were primarily driven by increases to short-term prepayment projections. Hedging losses totaled 38 million dollars, primarily driven by elevated hedge costs during the quarter.

Our Investment Management segment delivered pretax income of 1.5 million dollars, up from 1 million dollars in the prior quarter.

Net assets under management totaled 2.4 billion dollars as of December 31st, down 5 percent from September 30th and up 3 percent from December 31st, 2020. Segment revenue was 10.5 million dollars, up 7 percent from the prior quarter and 8 percent from the fourth quarter of 2020.

Lastly, I would like to touch on the trends we are seeing related to forbearance and loss mitigation. While overall mortgage delinquency rates have returned to their pre-pandemic levels, it is important to note delinquency rates of seriously delinquent loans remain elevated. The percentage of loans in forbearance decreased to 1.5 percent at December 31st from 3.2 percent at September 30th as borrowers in forbearance plans at September 30th who have since exited more than offset new forbearance plans.

Servicing advances outstanding increased to approximately 564 million dollars at December 31st, from 430 million dollars at September 30th. Advances increased from September 30th as expected, since many property tax payments became 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.

2022 brings us a transitioning mortgage market that presents headwinds for PFSI's performance. Our newly evolved brand and marketing focus along with deployment of transformational technologies in our direct lending channels are key components of multi-year investments to achieve our medium-term goals. At the same time, as the market is transitioning to a higher rate environment with elevated levels of competition, we will remain disciplined, taking advantage of our operational scale, while staying focused on profitability and shareholder returns.

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.