



PennyMac Financial Services, Inc.

Second Quarter 2022 Earnings Transcript

August 2, 2022

Introduction:

Good afternoon, and welcome to the second quarter 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 second quarter 2022 results.

Speaker:

David Spector – Chairman and Chief Executive Officer

Thank you Isaac.

PFSI continues to distinguish itself as a best-in-class mortgage company, delivering strong financial results in the second quarter with an annualized return on equity of 15 percent.

Improved margins across all three channels combined with the quick, decisive and meaningful actions taken earlier this year to align our expenses with lower expected levels of activity led to continued profitability in our production segment despite higher interest rates, increased volatility

and industry overcapacity. We also saw strong contributions from our servicing business, which continues to grow organically driven by production from all three origination channels. This quarter, total loan acquisition and origination volume of 27 billion dollars more than offset 18 billion dollars in runoff and we ended the quarter with a servicing portfolio of 2.2 million customers representing nearly 530 billion dollars in unpaid principal balance, up from 519 billion dollars at March 31st and 473 billion dollars at June 30th, 2021. As demonstrated by this quarter's strong results, the growth of our servicing portfolio will continue to differentiate PFSI and serve as an important asset while the origination landscape remains competitive and challenging.

In PFSI's Investment Management segment, net assets under management were 2.1 billion dollars at quarter end, down from the prior quarter due to PMT's financial performance, which has been under pressure given the impact of widening credit spreads on its investments.

In total, this strong financial performance drove continued growth in book value per share, which was up 5 percent from March 31st to 65 dollars and 38 cents at June 30th.

We continue to prudently manage capital across the company and in the second quarter we repurchased 2.4 million shares of PFSI common stock at an average price of 46 dollars and 81 cents for an approximate cost of 114 million dollars, significantly below current book value per share. In July we repurchased an additional 478 thousand shares, at an average price of 48 dollars and 19 cents for an approximate cost of 23 million 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 review additional details of our financial performance later on in this discussion.

Although current forecasts for 2022 total originations range from 2.4 to 2.8 trillion dollars primarily due to activity in the first half of the year, mortgage application indices point to further declines in the second half as the market reacts to the rapid increase in mortgage rates. As such, Pennymac has taken proactive and meaningful steps to reduce capacity more in line with our view of lower mortgage production activity.

While there is potential for these forecasts to decrease further, we believe our position as one of the largest producers of purchase-money loans in the country, in addition to the expense reductions we made in the first half of the year sets us up well to continue executing profitably.

PennyMac Financial has a long track record of value creation as a publicly traded company operating in different rate environments. We became a public company in May of 2013 with a small correspondent business and a servicing portfolio of under 50 billion dollars in unpaid principal balance. Today, we are a top producer and servicer of mortgage loans in the country. We have obtained these leadership positions with an unwavering focus on profitability, technology, innovation, and liquidity and risk

management, while also delivering strong returns on equity and book value growth for our stockholders.

Though the mortgage market is in a state of transition, our strong financial position and expertise provide us the ability to invest in opportunities created by the current market conditions. Our decision to repurchase shares has always been driven by our expectations for returns on equity in the medium-term, and repurchases at current levels are highly-accretive to book value. We have a long history of serving as responsible stewards of stockholder capital and will continue to prudently allocate capital across the company including share repurchases.

Strong home price appreciation in recent years has driven substantial growth in home equity for many of our 2.2 million customers. While cash out refinance opportunities exist, many do not want to relinquish the low fixed interest rate obtained in the last few years. We are working diligently to introduce solutions for our servicing portfolio customers to access their home equity with new products such as closed-end second lien mortgages. To that end, yesterday we launched closed-end seconds in our consumer direct lending channel for our servicing portfolio customers.

We also remain focused on the continued growth of our servicing portfolio. We expect this growth to be primarily driven by organically created MSRs sourced from our industry leading correspondent business. Given our strong liquidity and capital position, we believe there will be additional opportunities for portfolio growth later this year as more bulk MSR packages are sold in the more difficult origination environment.

As I briefly mentioned, earlier this year we took proactive and meaningful steps to reduce our expense base to better align with lower expected levels of activity. While never easy, we took quick action and made significant reductions to our overall headcount, decreased our marketing spend due to lower expected response rates and returns, and identified and implemented additional efficiencies across the enterprise. In fact, we reduced operating expenses by more than 100 million dollars in the second quarter compared to average quarterly 2021 levels and we expect quarterly operating expenses to decline by another 50 to 60 million dollars in the second half of 2022. However, we recognize the important role new technologies continue to play in the future of mortgage banking and we will continue to prioritize investing in our platform, bettering the customer experience and driving further efficiencies.

Now I'll turn it over to Doug Jones, Pennymac's President and Chief Mortgage Banking Officer, who will review our market share trends and second quarter mortgage banking results.

Speaker:

Doug Jones – President and Chief Mortgage Banking Officer

Thanks, David.

Overall production was solid with margins improving across all three of our production channels. Pennymac maintained its leadership position in the correspondent channel and we estimate that over the past twelve months we represented approximately 14.7 percent of the channel overall.

Total correspondent loan acquisition volume was 21 billion dollars in the second quarter. 51 percent, or 10.6 billion dollars were government loans and 49 percent, or 10.3 billion dollars were conventional conforming loans, for which PFSI earns a fulfillment fee from PMT.

Government acquisition volumes declined consistently with industry volumes, while conventional correspondent acquisitions were up as our correspondent partners are increasingly looking to sell loans servicing-released to high-quality aggregators such as Pennymac. Our reputation in the industry and consistent commitment in the channel have provided our partners the stability and support they need to navigate the current environment.

Government correspondent lock volume was 11.3 billion dollars, down 9 percent from the prior quarter.

Revenue per fallout-adjusted government lock in the second quarter was 27 basis points, up from 23 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 efficiently through the volatile market environments.

In July, correspondent acquisitions were 7 billion dollars and locks were 6.8 billion dollars.

Turning to consumer direct, our market share has nearly doubled since 2020 and we accounted for approximately 1.6 percent of total originations in the channel over the last twelve months.

Origination volumes for the second quarter were 3.7 billion dollars and interest rate lock commitments were 4.3 billion dollars, reflecting a steep decline in refinances. We introduced several new products aimed at growing our share of purchase money loans, including “Lock & Shop,” which allows borrowers to lock in current mortgage rates for up to 90 days while searching for a home. Purchase lock volume for the quarter was 951 million dollars, or 22 percent of total locks, up significantly from 791 million dollars, or 9 percent of total locks in the prior quarter.

Margins in this channel expanded as we focused on improving profitability and revenue per fallout adjusted lock was 355 basis points, up from 297 basis points in the prior quarter.

Total originations for our consumer direct channel in July totaled 800 million dollars, and locks totaled 1.4 billion dollars, continuing to reflect the positive trend in purchase mortgage originations. The committed pipeline at July 31st was 1.4 billion dollars.

Originations in our broker direct channel totaled 2 billion dollars and locks totaled 2.2 billion dollars. Though margins in the channel were higher than they were in the prior quarter, the channel remains highly competitive. Revenue per fallout-adjusted lock was 77 basis points, up from 62 basis points in the prior quarter, although we expect margins to decline in the third quarter given increased competition from channel leaders.

We estimate that in the last 12 months we represented approximately 2.2 percent of the origination volume in the channel.

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. To that end, I am pleased to announce that all brokers approved to sell Pennymac products will have migrated to our new and improved POWER portal by the end of this month, providing them with additional capabilities including faster fulfillment times, better data collection and communication capabilities, and an improved closing process.

Broker originations in July totaled 400 million dollars and locks totaled 700 million dollars. The committed pipeline at July 31st was 800 million dollars.

As David discussed earlier, these acquisition and origination volumes continue to drive the organic growth of our servicing portfolio. I am pleased to report that we ended the quarter with a servicing portfolio of 527 billion dollars, or approximately 4.1 percent of all residential mortgage debt in the U.S.

Prepayment speeds have slowed meaningfully given higher mortgage rates. PennyMac Financial's owned servicing portfolio reported a prepayment speed of 12 percent in the second quarter, down from 17.1 percent in the prior quarter. Similarly, prepayment speeds in PennyMac Financial's sub-serviced portfolio – which includes mostly Fannie Mae and Freddie Mac mortgage servicing rights owned by PMT – were 9.3 percent, down from 13 percent in the prior quarter.

PFSI's owned servicing portfolio, which consists primarily of Ginnie Mae MSRMs, had a 60 day plus delinquency rate of 3.2 percent, down from 3.9 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 0.5 percent, down from 0.7 percent at March 31st.

The UPB of completed modifications was 4.2 billion dollars and the UPB of EBO loan volume totaled 572 million dollars, both down from the prior quarter as opportunities have declined due to lower delinquency levels and higher mortgage rates.

Before I turn it over to Dan, I did want to re-emphasize a point that David made earlier regarding the importance of our servicing portfolio as a key differentiator and key asset to our business. These customers not only provide monthly cash flow in the form of mortgage payments, but are also our potential future origination customers, as they purchase new homes or utilize new products to access the equity in their homes. Our servicing technology platform, SSE, improves our efficiency and flexibility, giving us a low-cost advantage in providing all the mortgage needs our customers may have. We have built this company with the idea of creating a balanced business model. As we continue to organically grow our servicing portfolio we expect to continue to see benefits in both our servicing and production businesses.

I'll now turn it over to Dan who will review PFSI's 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 129 million dollars, or diluted earnings per share of 2 dollars and 28 cents.

Production segment pretax income was 9.7 million dollars. 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.

Production revenue margins were higher in all three channels compared to the prior quarter. Revenue per fallout-adjusted lock for PFSI's own account was 99 basis points in the second quarter, down slightly from 102 basis points in the prior quarter due to a higher percentage of our volume in the correspondent channel. This includes 6.7 million dollars in gains realized related to the timing of revenue and loan origination expense recognition, hedging, pricing & execution changes, and other items.

Expenses in our production segment have declined from the prior quarter and as David mentioned, we currently expect them to be reduced further from current levels in the second half of 2022.

The Servicing segment recorded pretax income of 167.6 million dollars, down from pretax income of 225.2 million dollars in the prior quarter and up from 30.9 million dollars in the second quarter of 2021.

Pretax income excluding valuation-related items for the servicing segment was 88 million dollars, up slightly from the prior quarter as higher loan servicing revenue and lower expenses were largely offset by higher realization of MSR cash flows and lower EBO related income.

Operating revenues increased from the prior quarter as loan servicing fees grew by 11 million dollars primarily due to growth in our servicing portfolio and earnings on custodial balances and deposits increased by 8 million dollars due to higher short-term interest rates. 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, decreased by 8 million dollars.

Realization of MSR cash flows increased by 11 million dollars driven by higher average MSR values during the 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 14, you can see the fair value of our MSR increased by 234 million dollars in the second quarter, driven by higher mortgage rates which resulted in expectations for lower prepayment activity in the future.

Hedging losses totaled 176 million dollars, primarily driven by higher interest rates.

Finally, our Investment Management segment delivered pretax income of 247 thousand dollars, up from 97 thousand dollars in the prior quarter.

Net assets under management totaled 2.1 billion dollars as of June 30th, down 7 percent from March 31st and down 12 percent from June 30th, 2021 due to PMT's financial performance. Segment revenue was 9.7 million dollars, down 5 percent from the prior quarter and 28 percent from the second quarter of 2021.

Now I would briefly like to review our strong balance sheet and diverse capital structure. We have been profitable throughout our history and have done so while maintaining a low debt-to-equity ratio, with a target near or below 3.5 times. While fluctuations in the total debt-to-equity ratio are driven by the origination environment or other opportunities, non-funding debt-to-equity has historically remained at or below 1 time. Similarly, the ratio of our tangible net worth to assets excluding loans eligible for repurchase has increased recently due to the continued growth in stockholders' equity and a reduction in the balances of loans held for sale from peak levels.

PennyMac Financial's diverse financing sources include 1.8 billion dollars of senior unsecured debt at low fixed rates, with the first maturity more than three years away. This quarter we issued 500 million dollars in new, 5-year term notes secured by Ginnie Mae mortgage servicing rights, bringing

our total term note issuance to 1.8 billion dollars. Though we expect to refinance the 1.3 billion dollars of these secured term notes maturing next year, Pennymac has the ability to extend each of the maturities for an additional two years in the event of market dislocation. Importantly, our MSR securitization structure provides the ability to issue secured term notes to extend duration to better match the life of our MSR investment and is complemented with revolving bank financing to support fluctuating MSR and advance balances.

As you can see, our risk governance emphasis provides a strong foundation to navigate the transitioning mortgage landscape with a diverse capital structure, low overall leverage, and 2.8 billion dollars of available liquidity at June 30th.

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.

While it was another strong quarter for PFSI, we remain diligent in identifying and implementing additional efficiencies across the Company while also simultaneously making investments in transformational technology projects which we believe will position PFSI for continued success. Though PFSI's returns are projected to trend lower over the next few quarters due to volatility in the current market environment, I remain

confident in our positioning over the long-term given our balanced business model with a large and growing servicing portfolio and this management team's long history of executing through various markets.

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.