



PennyMac Financial Services, Inc.

Third Quarter 2022 Earnings Transcript

October 27, 2022

Introduction:

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

Speaker:

David Spector – Chairman and Chief Executive Officer

Thank you Isaac.

In the third quarter, PennyMac Financial once again delivered strong financial performance with net income of 135 million dollars, or 2 dollars and 46 cents in earnings per share. Meaningful income contributions from both our production and servicing segments led to an annualized return on equity of 16 percent and continued growth in PFSI's book value per share despite mortgage rates climbing to their highest levels in more than a decade.

We ended the quarter with a servicing portfolio of 539 billion dollars in unpaid principal balance as additions from loan production continue to offset prepayment activity. Importantly, I believe the growth of our servicing portfolio will continue to differentiate PFSI from its competition, serving as an increasingly important asset while the origination landscape remains challenging. Our balanced business model, with leadership positions in production and servicing combined with our robust risk management disciplines, supports our ability to profitably navigate different market environments. In the current environment, our servicing portfolio is contributing the majority of PFSI's earnings while also providing significant cash flow to support investments across our businesses.

We remained active in repurchasing shares, which at current price levels is accretive to book value and beneficial for our future earnings. This quarter, we repurchased 1.9 million shares of PFSI common stock at an average price of 51 dollars and 13 cents for an approximate cost of 100 million dollars. Through October 26th, we repurchased an additional 882 thousand shares, at an average price of 45 dollars and 73 cents for an approximate cost of 40 million dollars. In the near term, we expect the pace of share repurchases to trend lower in order to maintain our flexibility to address potential risks and opportunities in the evolving market environment.

In PFSI's Investment Management segment, net assets under management were 2 billion dollars at quarter end, down slightly from the prior quarter due to PMT's financial performance.

In total, this strong financial performance drove continued growth in book value per share, which was up 4 percent from June 30th to 68 dollars and 26 cents at the end of the quarter.

PFSI's Board of Directors also declared a third 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.

With mortgage interest rates currently around 7 percent, the most recent third party forecasts for originations have decreased meaningfully, indicating an annualized run rate of 1.7 to 1.9 trillion dollars in upcoming quarters. We believe mortgage banking companies with large servicing balances and diversified business models like PennyMac Financial are better positioned to offset the decline in origination profitability that has resulted from these lower volumes.

In our production segment, purchase activity has been impacted by the affordability challenges created by higher mortgage rates and significant home price appreciation over the last several years. Refinance volumes are expected to remain subdued as nearly all outstanding mortgages are currently out of the money. In the correspondent channel, we are seeing our customers increasingly sell loans servicing-released to stable capital partners like Pennymac as they seek to manage profitability and enhance liquidity. We believe the challenging environment will continue in upcoming

quarters as higher rates persist. That said, we expect the decline in PFSI's production revenue to be largely offset by disciplined expense management activities, which I will speak about later.

Turning to our servicing business, we are forecasting continued portfolio growth as we leverage our low cost structure and industry-leading position in correspondent lending to profitably add current, higher note-rate servicing to our portfolio, providing opportunities for recapture when interest rates decline. We also expect to see attractive opportunities to acquire bulk MSR's over the next 12 to 18 months as originators look to monetize servicing due to decreased origination profitability. According to top economists, the probability for a recession has increased in recent periods. While we recognize the challenges this may present for our servicing business, we believe the risks are mitigated by the fact that consumers are financially in a strong position given the equity built up in their homes over the last couple of years combined with low levels of unemployment at present.

Turning to our investment management segment, credit spread widening in recent periods resulted in fair value declines in PMT's credit investments, translating to a decline in PMT's equity and lower base management fees for PFSI. In addition, we do not expect performance-based incentive fees to be earned in the foreseeable future due to PMT's losses in recent quarters. Nonetheless, as the largest correspondent lender with an orientation towards purchase money loans and strong fundamentals underlying its

seasoned investment portfolio, we believe PMT's long-term return potential remains attractive.

As I mentioned earlier, expense management continues to be a top priority for PennyMac Financial. We implemented meaningful expense savings and capacity reductions beginning early this year as shifts in the market were developing. In fact, quarterly operating expenses have been reduced by more than 170 million dollars, or 37 percent compared to average quarterly 2021 levels; and we have taken additional actions in the fourth quarter to further align our expense base to the lower expected levels of activity. We will continue to monitor the market and make additional adjustments as needed in order to right-size our business appropriately.

PennyMac Financial has produced strong results so far this year with an annualized return on equity of 17 percent which has driven growth in book value per share of 14 percent year to date. Though I believe we are well-positioned to successfully navigate the current market environment, it is our expectation that PFSI's return on equity will decline from current levels before returning to our pre-COVID range over time.

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 third quarter mortgage banking results.

Speaker:

Doug Jones – President and Chief Mortgage Banking Officer

Thanks, David.

Overall production was solid in the third quarter given the market environment, with total production volumes down only 3 percent from the prior quarter. Pennymac maintained its leadership position in correspondent lending as our strong capital position and consistent commitment to the channel provides our partners with the stability and support they need to successfully navigate a challenging mortgage market. We estimate that over the past twelve months we represented approximately 14 percent of the channel overall.

Total correspondent loan acquisition volume in the third quarter was 22.4 billion dollars, of which 46 percent were conventional conforming loans, for which PFSI earns a fulfillment fee from PMT. Government loan acquisition volumes were up 14 percent from the prior quarter, while conventional correspondent acquisitions were down only 1 percent.

Government correspondent lock volume was up 9 percent from the prior quarter.

Revenue per fallout-adjusted government lock in the third 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 efficiently through the volatile market environment.

In October, we estimate correspondent acquisitions will total 7.5 billion dollars and locks will total 8 billion dollars.

Turning to consumer direct, we estimate we accounted for approximately 1.4 percent of total originations in the channel over the last twelve months.

Origination volumes for the third quarter were 2.3 billion dollars and interest rate lock commitments were 3.8 billion dollars, reflecting a steep decline in refinance volumes. Purchase lock volume for the quarter of 1.4 billion dollars was 36 percent of total locks, up significantly from 22 percent in the prior quarter.

Margins in this channel expanded as we focused on meeting the needs of customers in our servicing portfolio and revenue per fallout adjusted lock was 366 basis points, up from 355 basis points in the prior quarter.

We estimate total originations for our consumer direct channel in October will total 500 million dollars, and locks will total 700 million dollars. We estimate the committed pipeline at October 31st will be 600 million dollars.

Originations in our broker direct channel totaled 1.3 billion dollars and locks totaled 1.9 billion dollars, also down significantly from the prior quarter, reflecting intense competition from channel leaders. Revenue per fallout-adjusted lock was 70 basis points, down from 77 basis points in the prior quarter. 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 over the long-term given our excellence in correspondent lending and consolidation in the channel. We remain committed to providing our broker partners and the customers that they serve new

products and a superior mortgage experience. To that end, we earlier this month announced the launch of POWER PLUS, our next generation broker technology platform. Combining a more efficient, precise and convenient loan process with better data collection and communication capabilities, we believe this new technology provides brokers with the tools they need to successfully grow their business and convert leads into loans.

We estimate broker originations in October will total 400 million dollars and locks will total 500 million dollars. We estimate the committed pipeline at October 31st will be 500 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 539 billion dollars, or approximately 4.1 percent of all residential mortgage debt in the U.S.

Prepayment speeds have slowed meaningfully given the rapid and significant increase in mortgage rates. PennyMac Financial's owned servicing portfolio reported a prepayment speed of 9 percent in the third quarter, down from 12 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 6.9 percent, down from 9.3 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 3.5 percent, up from 3.2

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, unchanged from June 30th.

The UPB of completed modifications was 2.4 billion dollars and the UPB of EBO loan volume totaled 250 million dollars, both down significantly as opportunities have declined due to higher mortgage rates. We expect EBO revenues to continue to decline in the coming quarters as lower overall volumes and redelivery gains are expected to be limited due to the higher interest rate environment.

I'll now turn it over to Dan who will review PFSI's financial results, stress scenarios for servicing advances and the new eligibility rules introduced by Ginnie Mae and the FHFA.

Speaker:

Dan Perotti – Senior Managing Director and Chief Financial Officer

Thanks, Doug.

As David mentioned earlier PFSI's net income was 135 million dollars, or diluted earnings per share of 2 dollars and 46 cents.

Production segment pretax income was 39 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 mixed, with margins up in our consumer direct channel and down in our correspondent and broker direct channels. Revenue per fallout-adjusted lock for PFSI's own account was 99 basis points in the third quarter, unchanged from the prior quarter. This includes 36 million dollars in gains realized related to the timing of revenue and loan origination expense recognition, hedging, pricing & execution changes, and other items.

As David mentioned, we remain focused on expense management activities given the current market environment, and although fallout adjusted locks were down only 2 percent from the prior quarter, production expenses net of loan origination expense were down 21 percent.

The Servicing segment recorded pretax income of 145 million dollars, down from pretax income of 168 million dollars in the prior quarter and up from 8 million dollars in the third quarter of 2021.

Pretax income excluding valuation-related items for the servicing segment was 70 million dollars, down from the prior quarter as higher loan servicing revenue, higher earnings on custodial balances and deposits, and lower expenses were more than 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.

Earnings on custodial balances and deposits increased by more than 30 million dollars. As rates continue to rise, the earnings on these custodial balances will rise as well, with a meaningful contribution to overall servicing profitability and largely offsetting the expected decline in EBO revenue. 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 9 million dollars.

Realization of MSR cash flows increased by 20 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 237 million dollars in the third quarter, driven by higher mortgage rates which resulted in expectations for lower prepayment activity in the future. Hedging losses totaled 165 million dollars, primarily driven by higher interest rates.

Finally, our Investment Management segment delivered pretax income of 1.6 million dollars, up from 247 thousand dollars in the prior quarter.

Net assets under management totaled 2 billion dollars as of September 30th, down 3 percent from June 30th. Segment revenue was 10.4 million dollars, up 7 percent from the prior quarter.

Now I would briefly like to review the projected needs for servicing advances in different market scenarios. For delinquent borrowers, PFSI has the responsibility to fund servicing advances for its owned portfolio of predominantly Ginnie Mae MSR. For the subserviced portfolio, any servicing advances are the responsibility of the MSR owner, or PMT. For the owned portfolio, this obligation includes principal and interest or “P&I” advances, advances related to property taxes and insurance or “T&I” advances, and default-related or corporate advances. While we fund T&I and corporate advances throughout the delinquency of a loan, delinquent principal and interest payments are often offset by other prepayment activity in the portfolio and do not require us to fund P&I advances, except in adverse scenarios where high rates of extended delinquencies combine with low prepayment speeds.

On the left side of the table on slide 15, we have presented the current advance balances for our owned portfolio as of September 30th, as well as the current delinquency rate and prepayment speed. On the right side of the table, we have presented projections of peak advance balances over the next 12 months in both an adverse and high stress scenario. In our high stress scenario, we assume delinquencies follow the trajectory we observed during the onset of the COVID-19 pandemic, where payment forbearance was mandated to be available to all borrowers who claimed hardship, in combination with prepayment speeds declining to the lowest monthly level observed in the last 30 years. Even in such a scenario, we project peak advance balances would be less than 2 billion dollars over the next 12 months, or an increase of about 1.6 billion dollars from the current

level of advances. With total available liquidity of 2.8 billion dollars as of September 30th and the ability to borrow up to 600 million dollars against Ginnie Mae servicing advances, we believe PFSI is well-positioned to address the potential impact servicing advances may present in a recessionary environment.

Finally, though they are not required to be implemented until September of 2023 or later, I'd like to briefly speak about the new eligibility standards recently introduced by Ginnie Mae and the FHFA. As discussed in note 22 of our second quarter form 10-Q, these eligibility requirements are assessed at the servicer entity and not at the holding company, or PFSI. PennyMac Loan Services, or PLS, is a wholly-owned subsidiary of PFSI and is the approved issuer and servicer of securities guaranteed by Ginnie Mae. PLS also holds the licenses required to sell and service Fannie Mae and Freddie Mac mortgage loans.

As you can see on slide 17 of our slide presentation, on a pro-forma basis, PLS is well in excess of all prospective capital, liquidity, and leverage requirements for both Ginnie Mae and the FHFA.

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.

We remain focused on the broader challenges facing our industry in the near-term. We will remain vigilant in our risk management disciplines and continue to actively pursue opportunities to further improve efficiency across our businesses. I continue to believe Pennymac is strategically well-positioned in the mortgage market given our strong levels of capital, our large and growing servicing portfolio, and our efficient and low-cost operating platform run by a best-in-class management team.

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.