



PennyMac Financial Services, Inc.

First Quarter 2023 Earnings Transcript

April 27, 2023

Introduction:

Good afternoon, and welcome to the first quarter 2023 earnings discussion for PennyMac Financial Services, Inc. The slides that accompany this discussion are available on PennyMac Financial's website at pfsi.pennymac.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 first quarter 2023 results.

Speaker:

David Spector – Chairman and Chief Executive Officer

Thank you, Isaac.

In one of the most challenging mortgage origination markets in recent history, PennyMac Financial delivered solid net income and continues to distinguish itself as a best-in-class mortgage company. Annualized return on equity for the quarter was four percent, with net income of 30 million dollars or 57 cents in earnings per share.

We remained active in stock buybacks during the quarter, repurchasing 45 million dollars in common stock. Although repurchase levels were down

from prior quarters, we prefer to maintain flexibility to address potential risks and opportunities as the market environment continues to evolve.

Dan Perotti, PFSI's Senior Managing Director and Chief Financial Officer, will provide greater detail surrounding the drivers of our financial results later on in this discussion.

PFSI's balanced business model continues to perform well on an operational basis, with strength in servicing profitability offsetting the loss in production income.

Total production volumes in the first quarter, including acquisitions made by PMT, were 22.8 billion dollars in unpaid principal balance, essentially unchanged from the prior quarter. With prepayment speeds at multi-year lows, these volumes continued to drive the organic growth of our servicing portfolio, which ended the quarter at nearly 565 billion dollars in UPB.

In PFSI's investment management segment, PMT had a strong quarter with earnings in excess of the dividend level, which drove an increase in its book value per share.

With mortgage interest rates currently still above 6 percent, the most recent third-party forecasts for 2023 originations range from 1.6 to 1.8 trillion dollars, down meaningfully from 2022. While many industry participants have taken the appropriate steps to reduce capacity, the pace of this reduction has been slow, and we believe overcapacity still remains. That said, average quarterly origination forecasts for the remainder of 2023 are meaningfully higher than the industry's estimated origination volumes in

the first quarter, consistent with our own expectations as we move into the more typical homebuying season. Originations in 2024 are currently expected to approach more normalized levels, with estimates suggesting an origination market above 2 trillion dollars.

As Dan will discuss later, the primary contributor to PFSI's strong financial performance in recent periods has been its large and growing servicing business. We have demonstrated that even in a challenging origination environment, our large servicing portfolio, multi-channel production capabilities and balanced business model have positioned the company well to continue making progress towards achieving its long term goals.

PennyMac Financial's servicing business is a critically important asset and has driven much of the success that we have enjoyed in mortgage banking. Our large servicing portfolio provides strong and consistent cash flows, enabling us to remain profitable while also continuing to invest in the technology supporting our businesses.

We also view our multi-channel production approach as a unique competitive advantage, and our centralized, cost-efficient fulfillment division, which supports all three channels, provides us the ability to allocate resources towards channels where we see the most opportunity in the current market environment.

The correspondent channel tends to represent a larger percentage of total industry originations in a purchase-centric market as many correspondent clients are independent mortgage banks, community banks and credit

unions that maintain strong ties with borrowers in their local communities. Pennymac has also developed many strong relationships with purchase-focused, builder-owned mortgage companies, which, combined with the exit of other correspondent channel participants, has driven the consistency of our acquisition volumes in recent quarters despite a much smaller origination market. Investments we have been making in the channel have resulted in an extremely low cost structure, allowing us to operate efficiently while also driving the organic growth of our servicing portfolio. Importantly, this growth drives opportunity in future periods, when the borrowers we add to our servicing portfolio may also represent low-cost leads for our consumer direct lending division.

Similar to our sellers in the correspondent channel, mortgage brokers across the country also maintain strong relationships with real estate agents and realtors in their local communities. These relationships provide brokers consistent access to the purchase market, as evidenced by the fact that 86 percent of total originations in this channel during the quarter were purchase loans. To be successful in the broker channel, it is essential to support our broker clients with the technology, tools and products they need to best serve their communities. Several prominent participants have recently exited the broker channel and we believe our continued commitment drove higher volumes and a meaningful increase in market share quarter over quarter.

Our consumer direct division serves to protect the value of our servicing portfolio in a declining interest rate environment. Loan officers in our

internet and call-center based consumer direct lending division are leveraging the investments we have made in our technology platform to offer borrowers loan products best suited to their needs. While volumes in this channel have been constrained in recent periods, the higher note-rate servicing we have been adding through our correspondent channel positions us well in the future when mortgage rates decline or there are periods of interest rate volatility. We saw some of this activity late in the first quarter when interest rates declined due to stress on the regional banks, which drove the increase in lock volumes in this channel from the prior quarter.

PennyMac Financial has a long history of investing in and deploying leading mortgage banking technology, with a focus on increasing self-service capabilities and transparency throughout the loan origination process. We also believe it is critical to ensure that the investments we are making support the timely roll-out of new products and other key features that our customers and business partners need to succeed in any origination market.

In correspondent, we completed a multi-year technology initiative which has resulted in an industry-leading and flexible loan delivery platform that we call P3. P3 is not only easy for our nearly 800 correspondent sellers to use, but the embedded, automated quality control process provides a continuous feedback loop to ensure high-quality underwriting and minimal loan defects, which benefits both parties over the longer term.

As mentioned previously, we recently released POWER PLUS in our broker direct lending division and have been getting very positive feedback from the brokers who have utilized the system. Making sure brokers can provide flawless closing execution and the best price possible for their customers has been the focus of our improvements, and we believe these features are critical for the success of brokers in the prevailing, competitive origination market. Notably, this quarter we also expanded our list of product offerings with the release of an all-new Jumbo product, called “Optima Jumbo,” for our approved broker partners.

In the consumer direct division, we recently introduced additional CRM capabilities to drive increased lead conversion and loan officer efficiency. We have also established more direct lines of communication with potential borrowers, ensuring we can speak to them how they want and when it’s most convenient for them.

While still early in its development, we are excited and supportive of the potential contributions from artificial intelligence in the loan manufacturing process. We are continuously looking for ways to streamline our business functions and maximize efficiency; and we will continue to assess opportunities that leverage the latest state-of-the-art technology available.

I believe PennyMac Financial is extraordinarily well-positioned given its large and balanced business model combined with strong capital and liquidity management disciplines. Though the environment remains challenging, it is currently our expectation that PFSI’s return on equity will trend toward its pre-COVID range during 2023.

I will now turn the call over to Dan, who will review details of our financial performance.

Speaker:

Dan Perotti – Senior Managing Director and Chief Financial Officer

Thanks, David.

PFSI reported net income of 30 million dollars in the first quarter, or 57 cents in earnings per share, for an annualized return on equity of 4 percent. Strong operating profitability in our servicing segment was partially offset by increased losses in our production segment and net fair value declines on MSR and hedges primarily due to elevated hedge costs.

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

As David mentioned, we continued repurchasing stock, and in the first quarter, we bought back nearly 800 thousand shares for 45 million dollars at an average price of 58 dollars and 99 cent per share. Through April 25th, we bought back nearly 200 thousand shares for 11 million dollars at an average price of 61 dollars and 24 cents per share.

Book value per share was down slightly from the prior quarter end, primarily due to the annual issuance of additional common stock related to our equity compensation awards program.

PFSI reports financial results through three segments: production, servicing and investment management. In the first quarter, the production segment

reported a pretax loss of 20 million dollars; the servicing segment reported pretax income of 57 million dollars; and the investment management segment reported pretax income of 300 thousand dollars.

Overall production, including volumes acquired by PMT, was solid in the first quarter, down only 1 percent from the prior quarter while industry volumes are estimated to be down approximately 17 percent.

Pennymac widened its leadership position in correspondent lending as our strong capital position and consistent commitment to the channel provide our partners with the stability and support they need to successfully navigate the challenging mortgage market. We estimate that over the past twelve months we represented approximately 17 percent of the channel overall, and we believe our market share has been meaningfully higher in more recent periods as correspondent sellers seek high-quality partners like Pennymac. In April, we estimate total correspondent acquisitions will be 6.3 billion dollars, and locks will be 6.8 billion dollars.

As David mentioned, we see strong trends in our broker direct lending division as volumes, margins, market share, and the number of brokers approved to do business with us all increased from the prior quarter. Over the last twelve months, we believe we represented approximately 2.2 percent of the total originations in the channel, and April volumes continue to be strong with estimated originations of 600 million dollars and locks of 900 million dollars. We estimate the committed pipeline at April 30th will be one billion dollars.

In consumer direct, originations were down slightly from the prior quarter; however, activity was up meaningfully in March as David mentioned, which drove an increase in lock volumes from the prior quarter. Our market share in the channel remains low, but we believe PFSI's consumer direct originations are positioned for future growth given the amount of higher note-rate servicing we continue adding to our servicing portfolio through our correspondent production channel. In April, we estimate total originations in the channel will be 500 million dollars and locks will be 800 million dollars. We estimate the committed pipeline at April 30th will be one billion dollars.

As you can see on slide 11 of our earnings presentation, we saw increased revenue contributions from all three channels and slightly lower expenses. The increased loss from the prior quarter reflects timing of revenue and loan origination expense recognition, and hedging, pricing and execution changes, which had a positive impact in the prior quarter but a negative impact in this quarter.

Pretax income in our servicing segment was down from the prior quarter due to net fair value declines on MSR's and hedges, while the prior quarter included net gains on MSR's and hedges. Excluding valuation-related changes, servicing pretax income was 94 million dollars, up from 79 million dollars in the prior quarter. Loan servicing fees increased primarily as a result of continued portfolio growth, and the earnings we recognize from placement fees on custodial balances and deposits increased due to higher short-term interest rates, despite seasonally low custodial balance

levels. Income from EBO-related activities increased 13 million dollars from the prior quarter, although we expect a lower contribution in coming quarters due to the higher interest rate environment. Partially offsetting these revenue increases were higher operating expenses, up from a seasonal low in the fourth quarter, and increased interest expense driven primarily by higher short-term rates and the issuance of a 680 million dollar term loan secured by Ginnie Mae MSR and servicing advances, which I will speak about later.

In order to protect the value of our MSR asset, we utilize a comprehensive global 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. The fair value of PFSI's MSR, before recognition of realization of cash flows, decreased by 90 million dollars during the quarter, driven by lower market interest rates. Hedge gains totaled 47 million dollars and were impacted by 32 million dollars in hedge costs, which were elevated due to significant interest rate volatility. The net impact of MSR and hedge fair value changes on PFSI's pretax income was 43 million dollars, and the impact on earnings per share was 59 cents.

As expected, delinquencies declined from seasonal highs at year-end, and servicing advances outstanding for PFSI's MSR portfolio decreased to approximately 427 million dollars from 520 million dollars. No principal and interest advances are outstanding, as prepayment activity continues to sufficiently cover remittance obligations at this time.

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

Now I would like to briefly talk about PFSI's strong capital and liquidity position, which you can see on slide 24 of our earnings presentation. Overall leverage increased from December 31st primarily due to higher balances of loans held for sale. However, non-funding debt-to-equity remained low at 1.2 times at March 31st.

During the quarter, we further strengthened our balance sheet, opportunistically raising 680 million dollars in the form of a 5-year term loan secured by Ginnie Mae MSR and servicing advances at an attractive price of SOFR plus 300 basis points. Looking ahead to upcoming maturities, the secured term notes due in August of this year can be extended for two years at PFSI's discretion. Finally, given our demonstrated access to liquidity and financing, we feel PFSI is extraordinarily well-positioned to continue executing even in a potential recessionary environment with higher delinquency levels.

And with that, I would like to turn it back to David for closing remarks.

Speaker:

David Spector – Chairman and Chief Executive Officer

Thank you, Dan.

As you can see, I am very excited for PennyMac Financial's future. Our servicing portfolio continues to grow and our competitive position within the correspondent and broker direct lending channels has never been better. We are increasingly seeing new correspondents and brokers turn their attention to Pennymac, and its best-in-class mortgage platform, as a trusted and innovative business partner. For these reasons, I am confident in PennyMac Financial's ability to continue profitably executing against our strategic plans while also continuing to grow as a respected leader in the mortgage industry.

We encourage investors with any questions to contact our Investor Relations team by email or phone.

Thank you.

Operator:

This concludes PennyMac Financial Services, Inc.'s first quarter earnings discussion. For any questions, please visit our website at pfsi.pennymac.com, or call our Investor Relations department at 818.264.4907. Thank you.