



PennyMac Financial Services, Inc.

Second Quarter 2023 Earnings Transcript

July 27, 2023

Introduction:

Good afternoon, and welcome to the second quarter 2023 earnings discussion for PennyMac Financial Services, Inc. The slides that accompany this discussion are available on our 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 second quarter 2023 results.

Speaker:

David Spector – Chairman and Chief Executive Officer

Thank you, Isaac.

PennyMac Financial reported solid results in the second quarter, reflecting both increased production volumes and profitability from the prior quarter as well as a continued strong contribution from our large and growing servicing portfolio. Strong operating performance was partially offset by net valuation-related losses that resulted from the inverted yield curve and elevated hedge costs driven by multi-year highs in interest rate volatility. Book value per share was up to 69 dollars and 77 cents at quarter end.

Annualized return on equity for the quarter was 7 percent, with net income of 58 million dollars or 1 dollar and 11 cents in earnings per share.

We repurchased 26 million dollars in common stock during the quarter, which was down from prior quarters due to a higher share price, and as we prefer to maintain flexibility as the market environment continues to evolve.

Dan will provide greater detail around the drivers of our financial results later on in this discussion.

PFSI's balanced business model continues to distinguish itself, with production returning to profitability due to higher volumes and margins, and strong operating performance in its servicing segment.

I am proud to announce that in the first quarter, Pennymac was the largest producer of mortgage loans in the country; and total production volumes in the second quarter, including acquisitions made by PMT, were 24.9 billion dollars in unpaid principal balance, up 9 percent 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 over 576 billion dollars in UPB.

In PFSI's investment management segment, net assets under management were 1.9 billion dollars at quarter end, down slightly from the prior quarter.

With mortgage rates currently near 7 percent, the most recent third-party forecasts for 2023 originations range from 1.6 to 1.8 trillion dollars, still well below normalized levels. While industry origination volume in the second quarter was meaningfully higher than the first quarter, higher

mortgage rates are driving borrowers to remain in their homes, leading to low inventory levels and continued home price appreciation. Unit originations in 2023 are projected to total just 5 million, the lowest level since 1990, indicating the potential for industry consolidation if market conditions persist. While 2024 originations are expected to approach 2 trillion dollars, we expect the competitive environment to continue given unit origination volume will likely remain constrained. As you can see from our recent financial performance, mortgage banking companies with large servicing portfolios and diversified business models are better positioned to offset the decline in profitability that has resulted from low origination volumes.

As Dan will discuss later, the primary contributor to PFSI's strong financial performance in recent periods has been its large and growing servicing portfolio. 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 portfolio is a critically important asset and has driven much of the success that we have enjoyed. Our large servicing portfolio provides strong and consistent cash flows. In fact, over the last 12 months, our servicing portfolio has generated 1.3 billion dollars in revenue from servicing and sub-servicing fees, enabling us to remain profitable while also continuing to invest in technology to support our balanced, multi-channel production and servicing platform.

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.

According to Inside Mortgage Finance, the correspondent channel represented 23 percent of total industry originations in 2020 and 2021. This percentage grew to 25 percent in 2022 and we believe it has been approximately 29 percent in the first half of 2023. As you can see, the correspondent channel tends to represent a larger percentage of total industry originations in a low volume environment. We believe this dynamic exists because liquidity is critically important for many sellers who are less willing to invest in servicing in the current environment where origination profitability is constrained. Throughout the quarter, we increased the number of approved correspondent seller relationships to 800 driven by a strategic effort to add sellers who previously maintained a relationship with commercial banks that have pulled back from or recently exited the channel. Further solidifying our leadership position in this channel, the investments we have made in our correspondent division over the years 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 servicing portfolio growth is expected to drive opportunity in future periods, as we continue to grow the population of loans we service with borrowers who may benefit from a refinance when rates decline. As you can see on slide 7 of our earnings presentation, on June 30th, 2022,

only 14 billion dollars in UPB of the total servicing portfolio consisted of loans with note rates at or above 5 percent. Today, approximately 90 billion dollars in UPB, or 15 percent of the total servicing portfolio consists of loans with note rates at or above 5 percent.

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 90 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 that they need to best serve their communities. Several prominent participants have recently exited the broker channel and we believe our continued commitment is driving more partnerships, higher volumes and a meaningful increase in market share in recent periods. The number of approved brokers at June 30th was nearly 3,300, up significantly from March 31st. Additionally, Pennymac TPO recently announced a partnership with ARIVE, a leading origination platform for independent mortgage brokers, which we expect will drive further increases in the number of brokers approved to do business with Pennymac.

Our consumer direct division protects the value of our servicing portfolio in a declining interest rate environment. While volumes in this channel have been constrained in recent periods, production volumes were up nearly 50 percent quarter over quarter as we funded many of the loans originally

locked in March when rates declined due to recent stress at the regional banks.

I believe PennyMac Financial is extraordinarily well-positioned given its large and balanced business model combined with strong capital and robust 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 58 million dollars in the second quarter, or 1 dollar and 11 cents in earnings per share, for an annualized return on equity of 7 percent. As David mentioned, production profitability and strong operating performance in our servicing segment were partially offset by net fair value declines on MSR's and hedges which I will discuss later.

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

In the second quarter, we bought back approximately 400 thousand shares for 26 million dollars at an average price of 60 dollars and 31 cents per share. There have been no share repurchases in July due to the increase of

PFSI's share price and as we prefer to maintain flexibility as the market environment continues to evolve.

Book value per share was up from the prior quarter to 69 dollars and 77 cents, driven primarily by PennyMac Financial's increased profitability.

PFSI reports financial results through three segments: production, servicing and investment management. In the second quarter, the production segment reported pretax income of 24 million dollars; the servicing segment reported pretax income of 47 million dollars; and the investment management segment reported pretax income of 2 million dollars.

Overall production, including volumes acquired by PMT, was solid in the second quarter, up 9 percent from the prior quarter, though originations in the direct lending channels were up more consistent with the overall market.

Pennymac maintained 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 19 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. Pennymac also stands to benefit as banks step back from the channel and increased capital requirements are introduced by bank regulators.

In July, we estimate total correspondent acquisitions will be 5.9 billion dollars, and locks will be 6.4 billion dollars.

We continue to 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 2.6 percent of the total originations in the channel, and July volumes continue to be strong with estimated originations of 700 million dollars and locks of 1 billion dollars. We estimate the committed pipeline at July 31st will be 1 billion dollars.

In consumer direct, originations were up nearly 50 percent from the prior quarter, and margins were meaningfully higher due to a lower mix of streamlined refinance volumes. Our market share in the channel remains low, but as David mentioned earlier we believe PFSI's consumer direct originations are positioned for future growth given the amount of higher note-rate servicing we continue to add to our servicing portfolio through our multi-channel production business. In July, we estimate total originations in the channel will be 500 million dollars and locks will be 700 million dollars. We estimate the committed pipeline at July 31st will be 800 million dollars.

As you can see on slide 10 of our earnings presentation, we saw increased revenue contributions from all three production channels while expenses were in line with the prior quarter. Revenue per fallout adjusted lock for PFSI's own account was 63 basis points in the second quarter, up from 49 basis points in the first quarter, driven primarily by higher overall volumes

and margins. Additionally, segment profitability was negatively impacted by 2.9 million dollars, caused by changes in GSE pricing that did not come with pipeline protection as they historically have.

Our servicing segment continues to perform well, although pretax income was down from the prior quarter. MSR fair value changes and hedging results were negative 36 million dollars, compared to negative 43 million dollars in the prior quarter. Excluding valuation-related changes, servicing pretax income was 75 million dollars, down from 94 million dollars in the prior quarter. Higher servicing fee revenue and earnings on custodial balances and deposits were more than offset by lower EBO income, higher realization of MSR cash flows, and higher interest expense. 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 average balances and short-term interest rates. Income from EBO-related activities decreased 15 million dollars from the prior quarter, and we expect its contribution to remain low in the coming quarters due to the higher interest rate environment. Realization of MSR cash flows increased 28 million dollars from the prior quarter due to increased cash flow generated by the MSR asset during the quarter from servicing and placement fees. Interest expense increased 21 million dollars from the prior quarter due to greater outstanding secured debt and the impact of higher short-term rates.

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 realization of cash flows, increased by 119 million dollars during the quarter, driven by higher market interest rates which resulted in decreasing prepayment projections. Hedge losses totaled 155 million dollars and included 42 million dollars in hedge costs, which were elevated due to the inverted yield curve and significant interest rate volatility. However, hedge costs were meaningfully lower in June and remain at lower levels in July. The net impact of MSR and hedge fair value changes on PFSI's pretax income was negative 36 million dollars, and the impact on earnings per share was negative 51 cents.

Delinquencies increased modestly during the quarter, and servicing advances outstanding for PFSI's MSR portfolio decreased to approximately 407 million dollars from 427 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 1.9 billion dollars at quarter end, down 2 percent from the prior quarter.

Now I would like to briefly talk about PFSI's strong capital and liquidity position. Overall leverage decreased from March 31st primarily due to lower balances of loans held for sale at fair value. Non-funding debt-to-equity remained low at 1.2 times at June 30th, unchanged from March 31st.

PennyMac Financial's diverse funding sources include unsecured senior notes, secured term notes, and secured revolving bank financing lines. Looking ahead to upcoming maturities, the 650 million dollar secured term notes due in August of this year have been extended for two years.

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.

Though the mortgage origination market remains constrained, I have never felt better about our competitive position. Our leading correspondent lending activities continue to drive the organic growth of our servicing portfolio by adding loans at prevailing mortgage rates, which we expect will provide meaningful opportunities for our consumer direct division in future periods when rates decline. I am also extraordinarily proud of the growth we have achieved in broker direct since our entrance into the wholesale channel only five years ago. Our scale, platform and this management team's ability to adapt to changing market environments are the reasons I expect PennyMac Financial to continue leading the industry with strong financial performance.

We encourage investors to join us today at 5:00 PM Eastern Time for our live question and answer session. The webcast will be available at pfsi.pennymac.com. For any additional questions, please contact 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 pfsi.pennymac.com, or call our Investor Relations department at 818.264.4907. Thank you.