PennyMac Mortgage Investment Trust

Second Quarter 2020 Earnings Transcript

August 6, 2020

Introduction

Good afternoon, and welcome to the second quarter earnings discussion for PennyMac Mortgage Investment Trust. The slides that accompany this discussion are available from PennyMac Mortgage Investment Trust's website at www.PennyMac-REIT.com. Before we begin, let me remind you that our discussion contains forward-looking statements that are subject to the risks identified on Slide 2 that could cause our actual results to differ materially. Thank you.

Now I'd like to introduce David Spector, PMT's President and Chief Executive Officer who will discuss the Company's second quarter results.

Speaker:

David Spector – President and Chief Executive Officer

Thank you, Isaac.

Slide 3

For the second quarter 2020, PMT reported net income attributable to common shareholders of 458.4 million dollars, or 4 dollars and 51 cents per common share.

Our record earnings this quarter reflect record Correspondent Production segment results and the partial recovery in the fair value of CRT investments from depressed levels at March 31st, 2020 as a result of market dislocations related to COVID-19. These earnings were partially offset by fair value losses on MSRs, driven by higher-than-anticipated prepayments during the quarter and expectations for higher prepayments in the future driven by lower rates. Interest rate hedges also recorded fair value losses driven by elevated hedge costs and fair value losses on options used to hedge MSRs as volatility decreased by June 30th.

PMT reports results through four segments: Credit Sensitive Strategies, which contributed 458.8 million dollars in pretax income; Interest Rate Sensitive Strategies, which contributed 117.5 million dollars in pretax loss; Correspondent Production, which contributed 139.6 million dollars in pretax income; and Corporate, with a pretax loss of 12.8 million dollars.

As previously announced, PMT paid a dividend of 40 cents per share for the quarter.

Book value per common share was 19 dollars and 39 cents at June 30th, up from 15 dollars and 16 cents at March 31st, 2020.

PMT's capital deployment this quarter continued to be driven by its conventional loan production volumes which totaled 18.9 billion dollars in unpaid principal balance, up 17 percent from the prior quarter and up 76 percent from the second quarter of 2019. New MSR investments for the quarter totaled 203 million dollars, and we delivered to Fannie

Mae, CRT-eligible loans of 1.8 billion dollars in UPB resulting in a firm commitment to purchase 48 million dollars of new CRT securities.

In May and June, we repurchased approximately 566 thousand shares of PMT at a weighted average price of 13 dollars and 36 cents, at a cost of 7.6 million dollars.

Now let's turn to Slide 4 and discuss economic developments affecting our business.

Slide 4

Challenges in the U.S. economy reflect the impact of COVID-19 as a recent resurgence of the virus weighs on states' plans to re-open. Reopening plans, including a return to physical work locations, are now on pause in over 80 percent of the country and the economic recovery is expected to be more gradual than previously forecasted. According to the Bureau of Labor Statistics, the unemployment rate reached a recent high of 14.7 percent at April 30th, while leading economists forecast a gradual recovery to 6.9 percent by the end of 2021. New requests for mortgage forbearance have decreased substantially since March and April and borrowers are beginning to exit forbearance plans as they continue or resume making payments or obtain assistance through government supported loan modification programs. And recently, despite relatively tight levels of supply, economists have begun to forecast home price decreases in metropolitan areas with heavily affected economies.

Fiscal stimulus benefits from the federal government have begun to roll off, with an extension or further stimulus remaining uncertain as Congress has yet to resolve differences on several issues including the jobless benefit, liability protections for business, aid to state and local governments and direct payments to Americans.

Liquidity in the financial markets has largely rebounded since March and April; however markets continue to reflect uncertainty related to the long-term impacts of COVID-19. The improved liquidity during May and June resulted in a significant recovery in the fair value of credit related assets and in particular, government-sponsored enterprise credit risk transfer investments that gained in value.

Now let's turn to slide 5 to discuss PMT's opportunity in the mortgage origination market.

Slide 5

Economic forecasts for total originations in 2020 have increased to nearly 3 trillion dollars, the highest level since 2003, and forecasts for total originations in 2021 have recently increased to 2.3 trillion dollars, similar to the strong market we saw in 2019. These forecasts are supported by all-time low mortgage rates, which continue to drive robust refinance and purchase mortgage demand. Forecasts for purchase mortgage originations have also increased recently as a result of higher demand, including in suburban areas. Additionally, sales of previously owned homes posted their largest ever monthly increase in June and sales of new homes have been above consensus expectations.

Gain on sale margins remain elevated, more specifically in the direct lending channels driven by capacity constraints, while correspondent gain on sale margins have decreased from record levels seen early in the quarter as other market participants have returned.

And as a result of its capital structure, risk management disciplines and significant technology and infrastructure investments made by PFSI in recent years, PMT was able to successfully capitalize on the market opportunity and continued to acquire, fund and settle loans throughout the crisis.

Now let's turn to slide 6 to discuss PMT's investment activity by strategy during the quarter.

Slide 6

On slide 6 we detail investment activity for each of PMT's investment strategies during the second quarter. PMT's investment opportunities are driven by its conventional correspondent production business.

CRT assets increased due to fair value gains of 453 million dollars, and decreased from substantial runoff due to prepayment activity, including a significant reduction in the unfunded commitment related to CRT-6. New investments in CRT were 48 million dollars as we wind down the program with Fannie Mae.

PMT's distressed loan and real estate owned portfolio declined further to 52 million dollars in fair value at the end of the second quarter, from 60 million dollars at March 31st. The portfolio is primarily comprised of REO.

New MSR and ESS investments primarily sourced from the securitization of 18.9 billion dollars in UPB of conventional loan production were 204 million dollars and net of runoff increased 139 million dollars. As a result of the decline in interest rates during the quarter, the fair value of our MSR and ESS investments declined by 112 million dollars, partially offsetting the net new investments.

Agency MBS are held by PMT as part of a comprehensive strategy designed to mitigate the interest rate sensitivity of the MSR and ESS assets. The reduction of Agency MBS in the quarter reflects a rebalancing of the hedge in favor of MBS forwards and does not reflect a significant change in invested equity.

Overall, the net change in PMT's invested equity was a decrease of approximately 60 million dollars in the second quarter.

Now let's turn to Slide 7 and discuss the run-rate return potential from PMT's investment strategies.

Slide 7

PMT's run-rate return potential represents the average annualized return and quarterly earnings potential PMT expects to earn on average each quarter from its strategies over the next four quarters. Our expectation for PMT's investment strategies is an average diluted EPS per quarter of 65 cents, which would result in an annualized return on common equity of approximately 13 percent.

PMT's equity allocation related to Credit Sensitive Strategies is expected to average 37 percent, with a run-rate annualized potential return on equity of 16.1 percent. Our Credit Sensitive Strategies primarily consist of our investments in CRT, with a return potential that has decreased from previous estimates due to the increase in fair value in the second quarter, which decreased our go-forward expected rates of return. The CRT markets continue to reflect uncertainty related to COVID-19 and its associated losses.

Equity allocated to Interest Rate Sensitive Strategies is expected to average 33 percent, with an annualized return on equity of 11.1 percent. We consider the results from this segment in aggregate, as MBS and hedge positions are primarily used to moderate the impact of interest rate volatility on MSR and ESS returns. Our expectations reflect higher return potential on MSRs driven by a reduction in the expected impact on servicing from COVID-19.

Equity allocated to the Correspondent Production segment is expected to average 14 percent, with an annualized return on equity of approximately 38 percent. This is lower than prior projections, as conventional margins have returned to normalized levels faster than originally anticipated.

That concludes my presentation and I'd now like to turn the discussion over to Vandy Fartaj, PMT's Chief Investment Officer, who will review our mortgage investment activities.

Speaker:

Vandy Fartaj – Chief Investment Officer

Thank you, David.

Let’s begin with Slide 9 for a look at our Correspondent Production highlights.

Slide 9

Correspondent acquisitions by PMT in the second quarter totaled 29.9 billion dollars in UPB, up slightly from the prior quarter and up 40 percent year-over-year. 63 percent of our acquisitions were conventional loans, and 37 percent were government loans.

Conventional correspondent acquisitions totaled 18.9 billion dollars in UPB, up 17 percent from the prior quarter and up 76 percent from the second quarter of 2019.

Government loan acquisitions in the quarter, for which PMT earns a sourcing fee from PennyMac Financial, totaled 11 billion dollars in UPB, down 19 percent from the prior quarter and up 4 percent from the second quarter of 2019.

Conventional lock volume was a record 24.8 billion dollars in UPB, up 30 percent from the prior quarter and up 96 percent from the second quarter of 2019.

I am excited to announce that as of July 31st, approximately 80 percent of PMT's correspondent sellers are now on P3, the new correspondent lending portal introduced by PennyMac Financial, our manager and service provider, during the second quarter. This portal leverages PennyMac's proprietary technology and Ellie Mae's next generation Encompass Digital Lending Platform for a best-in-class experience. Importantly, P3 seamlessly integrates with PennyMac's proprietary loan bidding system that instantly prices loans for unique characteristics and required returns. We believe that this new system will improve the overall customer experience while also increasing the speed at which we can deploy updates or system enhancements in a rapidly changing mortgage market environment.

Higher-margin best efforts commitments increased to 38 percent of lock volume in the second quarter, from 23 percent in the prior quarter enabled by our strong capital position and our manager's expertise to efficiently hedge production pipelines across different market environments.

Looking at July, volumes remain elevated. Total correspondent loan acquisitions for the month were 12.7 billion dollars in UPB while interest rate lock commitments were a record 16 billion dollars in UPB.

Now let's turn to Slide 10 and discuss PMT's investments in GSE credit risk transfer.

Slide 10

In alignment with the wind down of investments in CRT, PMT delivered 1.8 billion dollars in UPB of CRT-eligible loans to Fannie Mae in the second quarter. On a pro forma basis at June 30th, PMT's outstanding CRT investments totaled 3.1 billion dollars, essentially unchanged from the prior quarter as fair value gains were offset by higher prepayments and a reduction in the expected face amount of firm commitment to purchase CRT securities. The 60 plus day delinquency rate was 7.3 percent, up sharply from 0.3 percent in the prior quarter as a result of hardships related to COVID-19. The expected increase in losses has yet to materialize and realized losses in the second quarter totaled 2.7 million dollars, bringing cumulative lifetime losses to 13 million dollars.

The UPB of the loans underlying PMT's CRT agreements was 80.5 billion dollars.

Now let's turn to Slide 11 to examine how gains on PMT's CRT investments differ from CAS and STACR securities.

Slide 11

PMT's CRT investments recorded 453 million dollars in fair value gains in the second quarter, representing a significant recovery of the fair value loss in the first quarter, but gains were lower relative to the more liquid tranches of comparable CAS and STACR securities. Although PMT's GSE CRT investments are similar to CAS and STACR, the investments have structural differences that yield different results.

The structure of PMT's fifth CRT transaction is shown on the left, while a comparable CAS transaction is shown on the right.

PMT owns the entirety of the loss position up to 4 percent, including the true first loss position, or subordinate tranche labeled B2. This is the first tranche to absorb losses and is the most price sensitive in an adverse economic environment. Further, the credit enhancement on PMT's subordinate tranche may differ from the credit enhancement on the subordinate tranche of a similar Fannie Mae CAS transaction as shown in the example.

Additionally, as noted in the diagram, the first loss tranche is retained by Fannie Mae and Freddie Mac in respective CAS and STACR transactions, which makes comparison to the fair market value of PMT's securities difficult.

Now let's turn to Slide 12 to discuss how prepayments allow PMT to recoup CRT fair value losses.

<u>Slide 12</u>

PMT avoids any actual losses and expects to recognize fair value gains on its CRT investments when the underlying loans pay off, since principal is received at par, or for CRT-6, the commitment amount is reduced. The reporting conventions used in CRT valuations create a two-month lag in the reporting of prepayments on CRT investments. Therefore, the high level of prepayments in May and June will be reflected in the valuation at September 30th, 2020.

Now let's turn to Slide 13 to discuss trends in MSR and ESS investments.

<u>Slide 13</u>

Despite elevated prepayment activity during the quarter, PMT's MSR assets increased slightly to 1.2 billion dollars driven by investment growth from strong conventional production volumes. New MSR investments totaled 203 million dollars. The UPB of PMT's MSR portfolio totaled 145.3 billion dollars at June 30th, up from 141.8 billion dollars at March 31st.

PMT's ESS investments resulting from bulk, mini-bulk and flow MSR acquisitions by PennyMac Financial from 2013 to 2015 decreased to 151.2 million dollars at June 30th driven by repayments of the underlying loans. The UPB associated with ESS investments totaled 18.2 billion dollars at June 30th, down from 19.2 billion dollars at March 31st.

Now let's turn to Slide 14 to discuss the performance from the Interest Rate Sensitive Strategies segment in the second quarter.

Slide 14

PMT seeks to manage interest rate risk exposure on a "global" basis, recognizing interest rate sensitivities across its investment strategies. PMT has a history of successfully hedging to offset the majority of the interest rate risk inherent in mortgage servicing rights. In the second quarter, MSR fair value decreased due to expectations for increased prepayment activity in the future related to lower interest rates, as well as higher-than-modeled actual prepayments.

Interest rate hedges reported a net loss. While we maintained our hedge discipline throughout the market turmoil, elevated volatility early in the second quarter drove the cost of options to near record highs. Subsequently, volatility decreased by June 30th resulting in fair value losses on options.

Year-to-date through June 30th, MSR and ESS fair value losses totaled 690.1 million dollars, more than offset by gains in fair value of Agency MBS and interest rate hedges totaling 825.3 million dollars. This reflects PMT's disciplined focus on capital preservation and risk management to protect the value of the MSR and ESS assets across varying interest rate environments.

Now I'd like to turn the discussion over to Andy Chang, PMT's Chief Financial Officer, to review the second quarter's financial results.

Speaker:

Andy Chang – Chief Financial Officer

Thank you, Vandy.

Let's turn to Slide 16 and discuss the second quarter results and return contributions by strategy.

Slide 16

PMT's activities in the second quarter reflected a net income attributable to common shareholders of 458.4 million dollars, or an annualized return on common equity of 103 percent, net of all expenses.

In total, Credit Sensitive Strategies contributed 458.8 million dollars of pretax income, or a 283 percent annualized return on equity for the quarter. Within the segment, CRT investments contributed pretax income of 457.4 million dollars, which I will expand upon later.

Interest Rate Sensitive Strategies, which include the performance of our MSRs, ESS and Agency and non-Agency senior MBS positions, and related interest rate hedges, together contributed a pretax loss of 117.5 million dollars, or a negative 64 percent annualized return on equity for the quarter. As Vandy discussed earlier, the segment results were primarily driven by fair value losses on MSR assets and interest rate hedges. While we show the income contribution for each of these interest rate sensitive strategies separately, they are managed together as the interest rate sensitivity of the MSRs and ESS has typically been inversely correlated to that of the MBS and our interest rate hedges.

Correspondent Production contributed a record 139.6 million dollars to pretax income, or a 122 percent annualized return on equity for the quarter, driven by record-high margins and strong production volumes.

The Corporate segment contributed a pretax loss of 12.8 million dollars.

And finally, we recorded 3.4 million dollars in income tax expense.

Now let's turn to slide 17 to discuss the performance of PMT's CRT investments in the second quarter.

Slide 17

PMT's CRT investments contributed 457.4 million dollars of pretax income in the second quarter, consisting of 403.1 million dollars in gains from market-driven value changes, and 54.3 million dollars of income excluding market-driven value changes.

Market-driven value changes on our existing CRT investments included fair value gains of 410.7 million dollars, primarily reflecting a decrease in market discount rates and an improvement in the market's credit outlook since March 31st. Net losses on mortgage loans acquired for sale were 7.6 million dollars. These fair value losses were recognized upon loan delivery during the second quarter under the firm commitment to purchase CRT securities.

Income excluding market-driven value changes consisted of net realized gains and net interest expense related to our CRT investments. For the quarter, realized gains and carry on CRT investments totaled 63.8 million dollars, while losses recognized were 2.7 million dollars. Interest income earned on cash deposits securing CRT investments was 0.5 million dollars, while interest expense relating to the financing of these investments was 7.3 million dollars.

Now let's turn to slide 18 and discuss the delinquency and forbearance trends we see in PMT's MSR portfolio.

Slide 18

The percentage of loans in PMT's MSR portfolio that were 30 days or more delinquent was 5.3 percent at July 31st, down from 6.3 percent at June 30th and up from 5 percent at April 30th.

Servicing advances outstanding were 42 million dollars at July 31st, versus 34 million dollars at April 30th. Fannie Mae and Freddie Mac require a servicer to advance principal and interest payments for delinquent loans for only four months. PMT has not paid any advances related to principal and interest and currently has no principal and interest advances outstanding, as prepayment activity continues to be sufficient to cover the GSE requirements. The majority of advances related to PMT's Agency MSR portfolio are expected to relate to property taxes and insurance to protect investors' interest in the property collateralizing the mortgages. PMT has historically funded servicing advances with corporate cash. PMT has approximately 1.4 billion dollars in available liquidity, less 100 million dollars in minimum liquidity covenants, as of July 31st.

Now let's turn to Slide 19 and discuss COVID forbearances.

Slide 19

59 percent of forbearance plans that were in effect for PMT's servicing portfolio as of April 30th have been extended.

As you can see on the slide, the percentage of loans in forbearance within PMT's MSR portfolio decreased to 5.2 percent at July 31st from 7.3 percent at April 30th. A 13 percent increase in new forbearance plans added since April 30th was more than offset by 39 percent of borrowers in forbearance plans as of April 30th who have exited.

The 39 percent of borrowers who exited forbearance were comprised of 31 percent that remained current or went delinquent and subsequently re-performed; 4 percent that are transitioning to active loss mitigation primarily for payment deferral and streamline modifications, and 4 percent that repaid their mortgage.

Forbearances in effect at April 30th related to loans underlying PMT's earliest CRT investments, PMTT1, PMTT2, and PMTT3 declined at a rate consistent with PMT's MSR portfolio overall. Such cures out of forbearance related to these CRT transactions reduce the loss realization potential which would result if loans migrate to 180 days past due, under these structures.

And with that, I'll turn the discussion back over to David Spector for some closing remarks.

<u>Speaker:</u>

David Spector – President and Chief Executive Officer

Thank you, Andy.

PMT delivered record earnings in the second quarter, rebounding from the significant first quarter loss, which drove a substantial recovery in book value from the prior quarter. As a result of our manager's commitment to risk management and operational discipline, PMT not only protected the value of its assets in a volatile year-to-date period, but was able to continually acquire, fund and settle loans throughout the crisis as others retreated. This led to record profitability in the correspondent production segment. Additionally, PMT's CRT investments recorded substantial fair value gains as they benefited from the significant recovery in the value of risk assets and elevated prepayments throughout the quarter. At the same time, our manager and service provider, PFSI, continues to closely work with borrowers affected by the pandemic to help them successfully refinance or modify their loans to emerge from forbearance plans. Looking ahead, we project book value growth as we expect the earnings potential of PMT's investment strategies to exceed the current dividend level.

Operator:

This concludes PennyMac Mortgage Investment Trust's second quarter earnings discussion. For any questions, please visit our website at www.PennyMac-REIT.com, or call our Investor Relations department at 818-224-7028. Thank you.