PennyMac Mortgage Investment Trust

Fourth Quarter 2020 Earnings Transcript

February 4, 2021

Introduction

Good afternoon, and welcome to the fourth quarter and full-year 2020 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 fourth quarter and full year 2020 results.

Speaker:

David Spector – President and Chief Executive Officer

Thank you, Isaac.

PMT produced another strong quarter of financial results and book value growth, driven by the continued recovery in the fair value of its GSE credit risk transfer investments combined with strong Correspondent Production segment results. Net income attributable to common shareholders was 76.6 million dollars, or diluted earnings per common share of 78 cents. PMT paid a common dividend of 47 cents per share, returning the dividend to its pre-COVID levels. Book value per share increased to 20 dollars and 30 cents from 19 dollars and 95 cents at the end of the prior quarter and similar to the dividend, is almost back to pre-COVID levels.

Credit spreads tightened in the fourth quarter driven by optimism related to an economic recovery supported by fiscal stimulus and the distribution of COVID-19 vaccines throughout the country. Additionally, PMT's CRT investments continued to benefit from the elevated prepayment speeds we are seeing across the industry.

PMT’s industry-leading correspondent production business also captured record volumes, benefitting from not only the low rate environment but also the investments in technology and fulfillment capacity made by its manager and services provider, PennyMac Financial.

And finally, we repurchased approximately 927 thousand common shares of PMT during the fourth quarter at a weighted average share price of 16 dollars and 88 cents.

Turning to 2020 full year results, PMT paid dividends of 1 dollar and 52 cents and earned net income attributable to common shareholders of 27.4 million dollars, despite the extreme market dislocations caused by uncertainties related to COVID-19 early in 2020. For the full year, we repurchased 2.8 million shares of PMT at an average price of 13 dollars and 46 cents, or 37 million dollars.

PMT navigated the market dislocation and volatility associated with the investments we manage and the businesses in which we operate remarkably well as a result of our strong risk management disciplines, which Andy will discuss in more detail.

In the current market environment, I believe PMT remains uniquely positioned as the largest correspondent lender in the country to utilize its ability to create organic investments in MSRs sourced from its high quality production. PMT also benefits from the capabilities of its manager and services provider, PFSI, to effectively manage credit losses utilizing a variety of loss mitigation strategies.

Before I turn it over to Andy, I would like to take a moment to express the gratitude I have for the many kind thoughts and prayers we have received since announcing the sad passing of Stan Kurland, our founder and Chairman. While Stan had retired from day-to-day responsibilities at PennyMac, he remained a trusted advisor and a dear friend. His leadership helped lay the foundation for PennyMac's long-term success which included building and developing this deep management team that carries on his legacy.

With that, I will now turn it over to Andy Chang, PMT's Senior Managing Director and Chief Operating Officer.

Speaker:

Andrew Chang – Senior Managing Director and Chief Operating Officer

Thank you, David. I will discuss the financing PMT has against its largest long-term mortgage assets, PMT's investment activity for the quarter, and our outlook for returns from PMT's strategies.

PMT's performance in 2020 reflects the disciplines we maintain in risk and capital management, and the work we did prior to the pandemic, which included financing our CRT investments using term notes that do not contain margin call provisions. As a result, PMT was not subject to margin calls on its CRT investments when their fair values declined sharply early in the year due to credit market volatility and uncertainty of the impact of COVID-19. PMT was therefore able to retain the entirety of its CRT position and the performance of these investments improved throughout the remainder of 2020.

Similarly, in a year where MSR fair values declined significantly due to lower interest rates and expectations for higher prepayment activity, PMT was able to successfully manage the related liquidity risks thanks to the success of its interest rate hedging program.

PMT's capital deployment is currently focused on the large opportunity in conventional correspondent production and the related mortgage servicing rights.

As you can see on slide 7 of our presentation, during the quarter CRT investments continued to decrease driven by substantial runoff from prepayment activity, which exceeded fair value gains. PMT ended the quarter with 2.6 billion dollars of CRT investments, all of which are now funded investments as PMT completed the purchase of its sixth and largest CRT transaction ever. Vandy will discuss this transaction in more detail later.

New MSR investments sourced from the securitization of PMT's record 38 billion dollars in UPB of conventional production totaled 441 million dollars. Net of runoff, MSR and ESS investments increased 380 million dollars.

PMT's position as an industry-leading producer of mortgage loans gives us a unique ability to create attractive, organic investments in MSRs at low interest rates. In fact, during the quarter PMT's invested equity for newly originated, low-rate MSR investments more than offset the runoff from prepayments on its CRT investments.

For 2021, third-party economic forecasts for mortgage originations now average over 3.3 trillion dollars, another robust market supported by low mortgage rates and the Federal Reserve's commitment to keep short-term interest rates near zero through 2023. Purchase originations are forecasted to be up approximately 10 percent from 2020 levels while refinance originations are expected to decrease, positioning PMT for continued strong results given its historical focus towards the purchase market.

On slide 9, we illustrate the run-rate return potential from PMT's investment strategies, which represents the average annualized return and quarterly earnings potential PMT expects from its strategies over the next four quarters. In total, we expect a quarterly run-rate return from PMT's strategies of 53 cents per share or a 10.4 percent annualized return on equity.

This run-rate estimate is down slightly from 58 cents per share, or an 11.4 percent annualized return on equity that we showed last quarter, largely driven by a lower return on equity in our correspondent production business. This is due to conventional correspondent gain on sale margins normalizing, with origination volumes expected to decrease from the record levels in 2020.

In contrast, the return potential for our MSR investments has improved modestly, driven by a decrease in prepayment speed expectations due to the increasing proportion of newly originated loans at lower note rates.

Finally, the return potential for our CRT investments has increased slightly as the equity allocation decreased due to improved financing terms.

Now I'd like to turn the call over to Vandy Fartaj, PMT's Senior Managing Director and Chief Investment Officer, who will discuss the drivers of PMT's fourth quarter investment performance.

Speaker:

Vandy Fartaj – Senior Managing Director and Chief Investment Officer

Thank you, Andy.

Let's begin with highlights in our Correspondent Production segment.

Total correspondent acquisition volume in the quarter was a record 56.9 billion dollars in UPB, up 28 percent from the prior quarter and 53 percent year-over-year. 67 percent of PMT's acquisition volumes were conventional loans, up from 55 percent a year ago. We saw significant market share growth in the conventional correspondent market this quarter, and our leadership position in government loans remains, as a result of our consistency, low costs and operational excellence we continue to provide to our correspondents. PMT ended the year with 714 correspondent seller relationships, up from 698 at September 30th.

Conventional lock volume in the quarter was nearly 40 billion dollars in UPB, up 15 percent from the prior quarter and 100 percent year-over-year.

Also, as Andy mentioned, margins in the channel have normalized, as evidenced by PMT's pretax income as a percentage of interest rate lock commitments, which was 13 basis points, down from 25 basis points in the prior quarter.

For the full year, PMT acquired record volumes of mortgage loans in its Correspondent Production segment as it benefits from investments made by PFSI in the overall platform. PFSI's operational excellence combined with our commitment to fast turn times and outstanding customer service has driven PMT to become the largest correspondent aggregator in the U.S. by a wide margin, and in 2020 total loan production was over 160 billion dollars in UPB.

Acquisition volumes remained strong in January, with 17.9 billion dollars in UPB of total acquisitions, and 17.8 billion dollars in UPB of total locks.

PMT's Interest Rate Sensitive strategies consists of our investments in MSR and ESS primarily sourced from our correspondent production volumes, and investments in Agency MBS, non-Agency senior MBS and interest rate hedges with offsetting interest rate exposure.

As Andy briefly mentioned, PMT successfully managed the related liquidity risks of owning mortgage servicing rights in 2020 and our hedging strategy was a major contributor to the 15 percent return on equity PMT produced in its Interest Rate Sensitive strategies; outstanding performance given the decline in rates and expectations for increased prepayment activity in the future. In fact, PMT's MSR fair value losses for the full-year of 722 million dollars were largely offset by gains from Agency MBS and interest rate hedges totaling 667 million dollars.

The fair value of PMT's MSR asset at the end of the year was 1.8 billion dollars, up from 1.4 billion dollars in the prior quarter. Notably, the fair value of our MSR investments increased since December 31st, 2019 as new MSR investments sourced from PMT's record conventional production volumes more than offset large fair value losses from lower rates and the runoff from elevated prepayment activity.

The fair value of PMT's ESS investments was 132 million dollars, down from 143 million dollars at September 30th and 179 million dollars at December 31st, 2019, driven by repayments of the underlying loans.

Now I would like to discuss drivers of results in PMT's Credit Sensitive Strategies, which primarily consist of investments in CRT.

During the quarter, PMT successfully completed the purchase of its sixth CRT investment with Fannie Mae, called L-Street Securities Trust 2020-PMT1. This was our largest CRT deal with 58 billion dollars in UPB in total loan deliveries from April 2019 through September 2020. At the cutoff date, the underlying UPB of this investment was 44 billion dollars and the face amount of the CRT securities was 1.7 billion dollars.

As David discussed, acquiring term-financing for our CRT investments has been an integral part of PMT's success over the last year. I am happy to announce that shortly after the closing of our sixth CRT transaction, we successfully placed 500 million dollars of 2-year term notes to finance a portion of that investment, and will look for opportunities to term out the remainder in 2021. Similar to the other term notes we issued in the past, this structure does not contain margin call provisions.

PFSI's position as the manager and servicer of loans underlying PMT's CRT investments gives PMT a strategic advantage, given we can work directly with borrowers who have loans underlying PMT's investments and have experienced hardships related to COVID-19. PFSI uses a variety of loss mitigation strategies to assist delinquent borrowers, and because the scheduled loss transactions, PMTT1-3 and L Street Securities 2017-PM1, trigger a loss if a borrower becomes 180 days or more delinquent, we have deployed additional loss mitigation resources and assisted those borrowers at risk.

With respect to PMTT1-3, which comprises 7 percent of the fair value of PMT's overall CRT investment, if all presently delinquent loans proceeded unmitigated to 180 days or more delinquent, additional losses would be approximately 55 million dollars. Through the end of the year, losses to date totaled 7 million dollars. As a reminder, mortgage obligations underlying PMTT1-3 become credit events at 180 days or more delinquent regardless of any grant of forbearance.

Moving on to L Street Securities 2017-PM1, which comprises 18 percent of the total fair value of PMT's CRT investment, such losses will become reversed credit events if the payment status is reported as current after a forbearance period due to COVID-19. While we recognized 108 million dollars of such losses in the fourth quarter, we believe the majority of these losses have potential to be recovered. Currently, we estimate that 44 million dollars of these losses are already eligible for reversal subject to review by Fannie Mae and we expect this amount to increase as additional borrowers exit forbearance and reperform. This market expectation of significant loss recovery resulted in the fair value of L Street Securities 2017-PM1 exceeding its face amount by 53 million dollars at year-end.

A COVID-19 payment deferral, where the borrower defers the amount owed to the end of the loan term and is deemed current after making regular monthly mortgage payments, has been the most common method for borrowers to exit forbearance to date.

Wrapping up, the fair value of our CRT investments at the end of the year was 2.6 billion dollars, down from 2.8 billion dollars at September 30th as runoff from elevated prepayments exceeded fair value gains. The UPB of loans underlying our total CRT investments was 59 billion dollars, down significantly quarter-over-quarter as a result of elevated prepayments. And finally, the 60-plus day delinquency rate underlying our CRT investments was 5.48 percent, down from 6.02 percent as borrowers continue to emerge from forbearance plans.

In total, the increase in net new MSR investment during the quarter more than offset the net runoff on CRT investments, as PMT continues to drive market share growth in its correspondent production business, supported by investments made in technology by PFSI.

Now I would like to turn the call over to Dan Perotti, our Senior Managing Director and Chief Financial Officer, who will review our quarterly financial results.

Speaker:

Daniel Perotti – Senior Managing Director and Chief Financial Officer

Thank you Vandy.

PMT reports results through four segments: Credit Sensitive Strategies, which contributed 134.5 million dollars in pretax income; Interest Rate Sensitive Strategies, which contributed 100.1 million dollars in pretax loss; Correspondent Production, which contributed 52.7 million dollars in pretax income; and Corporate, with a pretax loss of 13.3 million dollars.

The contribution from PMT's CRT investments totaled 141.8 million dollars. This amount included 209.9 million dollars in market-driven value gains, up from 14.5 million dollars of such gains in the prior quarter, reflecting the impact of credit spread tightening and elevated prepayment speeds as well as expectations of recoveries of realized losses in our L Street Securities 2017-PM1 transaction. As a reminder, faster prepayment speeds benefit PMT’s CRT investments as payoffs of the associated loans reduce potential for realized losses and return principal at par for investments currently held at a discount. Net gain on CRT investments also included 48.2 million dollars in realized gains and carry, 108.4 million dollars in realized losses primarily related to L Street Securities 2017-PM1, which Vandy discussed earlier, 100,000 dollars in interest income on cash deposits and 8.1 million dollars of financing expenses.

PMT’s interest rate strategies contributed a loss of 100.1 million dollars in the quarter, primarily driven by net valuation related losses. MSR fair value decreased slightly despite increasing interest rates, which caused our Agency MBS and interest rate hedges to decline in value. The MSR fair value decline was driven by increased projections of future prepayment activity.

Valuation related losses in the quarter were somewhat offset by income excluding market-driven value changes, as servicing fees increased from the prior quarter driven by a larger servicing portfolio, and as PMT continues to benefit from increasing recapture income paid by PFSI.

PMT's Correspondent Production segment contributed 52.7 million dollars to pretax income for the quarter, down from 86.9 million dollars in the prior quarter as gain on sale margins have normalized.

PMT's Corporate segment includes interest income from cash and short-term investments, management fees and corporate expenses. The segment's contribution for the quarter was a pretax loss of 13.3 million dollars.

Finally, we recognized a tax benefit of 9 million dollars in the fourth quarter compared to a tax expense of 22.7 million dollars in the prior quarter, driven by a loss in PMT's taxable REIT subsidiary.

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

Speaker:

David Spector – President and Chief Executive Officer

Thank you, Dan.

2020 was a challenging year for mortgage REITs, many of which were forced to sell assets at distressed levels, curtail operations, or even cease market activity for some period. I am proud of this management team's commitment and the work we have done with respect to liquidity and risk management since the inception of the Company, which proved enormously beneficial for PMT as we were not forced to sell assets to generate liquidity. As a result, PMT's dividend is back to pre-COVID levels, something few other mortgage REITs can state. As the largest correspondent aggregator and with PFSI's extensive investments in foundational production technology, PMT is well positioned for continued creation of organic investments with strong risk-adjusted returns.

Lastly, we encourage investors with any questions to reach out to our Investor Relations team by email or phone.

Thank you.

Operator:

This concludes PennyMac Mortgage Investment Trust's fourth 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.