PennyMac Mortgage Investment Trust

Third Quarter 2021 Earnings Transcript

November 4, 2021

Introduction

Good afternoon, and welcome to the third quarter 2021 earnings discussion for PennyMac Mortgage Investment Trust. The slides that accompany this discussion are available on 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 Chairman and Chief Executive Officer who will discuss the Company's third quarter 2021 results.

Speaker:

David Spector – Chairman and Chief Executive Officer

Thank you, Isaac.

For the third quarter 2021, PMT reported a net loss attributable to common shareholders of 43.9 million dollars, or 45 cents per common share, driven by fair value declines in PMT's interest rate sensitive strategies.

As noted in second quarter financial reports, FHFA's elimination of the Adverse Market Refinance Fee contributed to a significant decline in the fair value of PMT's MSRs in the third quarter, along with continued elevated prepayments. These impacts were partially offset by strong returns in our credit sensitive strategies and correspondent production segments.

PMT paid a common dividend of 47 cents per share. Book value per share decreased to 19 dollars and 79 cents from 20 dollars and 77 cents at the end of the prior quarter.

We also successfully completed the issuance of 250 million dollars in preferred shares in a public equity offering.

Our high-quality loan production continues to organically generate assets for PMT and this quarter, 28.6 billion dollars in UPB of conventional correspondent production led to the creation of more than 425 million dollars in new, low-coupon mortgage servicing rights.

From PMT's production volumes we are also creating new credit assets, currently in the form of Agency-eligible investor loan securitizations. During the quarter, we purchased subordinate securities from two securitizations of investor loans totaling 548 million dollars in UPB from PMT's correspondent production; and after the quarter, we retained mortgage securities from PMT's inaugural securitization of investor loans totaling 414 million dollars in UPB. In aggregate, at the end of October the fair value of PMT's investments in investor loans was approximately 60 million dollars.

With interest rates rising, the mortgage market is shifting and we believe PMT is uniquely positioned to capitalize on current and evolving investment opportunities given its scale and leadership position in correspondent production.

Leading economists forecast a smaller origination market in 2022 driven by a decline in refinance originations. As a result, we expect to see increased levels of competition and continued lower margins across the industry. However, strong demographic and secular trends are expected to drive growth in purchase activity in 2022 and we believe PMT is well-positioned as a leader in the production of purchase money loans. Additionally, as the environment becomes more competitive, we expect PMT to benefit as correspondent sellers look to increase servicing-released whole loan sales to well-capitalized aggregators like PMT.

For more than 12 years, PMT has successfully navigated various regulatory, interest rate, and origination market environments while delivering strong returns. This can be attributed to the strong management team at PennyMac and the risk management disciplines we have focused on since our founding.

Organic asset creation remains a competitive advantage for PMT relative to other mortgage REITs. While the future of lender risk share is uncertain, we remain focused on opportunities in the current market environment, such as MSRs and investor securitizations with attractive long-term return profiles.

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 mortgage origination landscape, the impact of recently-announced changes from FHFA on PMT, and review the run-rate return potential from PMT's strategies.

While the origination market is in a period of transition, it continues to be large. Despite the increase in recent weeks, interest rates continue to be historically low and remain within the projections of leading economists.

Current forecasts for 2022 originations remain strong at 3 trillion dollars. It is worth noting that purchase originations are expected to grow to a record 2 trillion dollars in 2022, up 9 percent from this year's levels, while refinance originations are expected to decline to 1.1 trillion dollars. Given this backdrop, we believe the outlook for PMT remains favorable given its purchase-money focus and flexible investment platform with organic asset creation capabilities. That said, the current transition in the market is driving heightened competition as David discussed earlier, which is expected to affect PMT's near-term results in correspondent production.

Regulatory changes are also impacting the competitive landscape with a new administration and changing focus. First, FHFA issued a notice of proposed rulemaking to amend the regulatory capital framework for the

GSEs, which would introduce more favorable GSE capital treatment for CRT and an incentive for the GSEs to resume CRT issuance. Notably, Fannie Mae recently completed a new CAS transaction, but the future of lender risk share is still uncertain.

Next, FHFA suspended the GSEs' previously-imposed 7 percent limit on the acquisition of investment properties and second homes, resulting in greater liquidity and competition for these loans. However, PMT has the flexibility to determine the best execution for investor loans, between private label securitization or delivery to the Agencies.

FHFA also suspended the 1.5 billion dollar annual cash window limit for each of the GSEs, increasing competition for loans among correspondent aggregators like PMT. So while correspondents have more flexibility to deliver loans to the GSEs, we expect PMT to remain an attractive option to correspondent sellers looking to sell whole loans servicing-released, particularly as the competitive environment drives tighter origination margins.

Finally, FHFA suspended the limits on the acquisition of refinance and purchase loans with layered risk, which has a minimal impact to PMT.

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 that PMT expects over the next four quarters. In total, we expect the quarterly run-rate return for PMT's strategies to average 42 cents per share or an 8.3 percent annualized return on equity.

This run-rate potential reflects a moderation of performance expectations for PMT's existing strategies in the near-term. In our credit sensitive strategies, lower CRT returns reflect credit spreads that have tightened.

The return potential for our interest rate sensitive strategies has decreased driven by the expectation that prepayment speeds remain elevated in the near term.

In correspondent production, the expected returns reflect our view that heightened competition to acquire conventional loans is expected to result in a lower income contribution than we have experienced in recent quarters.

This analysis excludes potential contributions from new products under exploration, such as new investments in CRT or the introduction of new products other than investor loans.

It is also important to note our forecast for PMT's taxable income continues to support the common dividend at its current level of 47 cents per share.

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 third 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 44 billion dollars, down 6 percent from the prior quarter and down 1 percent from the third quarter of 2020. 65 percent of PMT's acquisition volumes were conventional loans, similar to the prior quarter. We maintained our leadership position in the channel as a result of our consistency, competitive pricing, and the operational excellence we continue to provide to our correspondent partners. PMT ended the quarter with 755 correspondent seller relationships.

Conventional lock volume in the quarter was 29.4 billion dollars, down 3 percent from the prior quarter and down 14 percent year-over-year. Importantly, purchase volume was a record for PMT at nearly 29 billion dollars, up from 27.4 billion dollars in the prior quarter and 21.5 billion dollars in the third quarter of 2020.

PMT's correspondent production segment pretax income as a percentage of interest rate lock commitments was 9 basis points, up from 6 basis points in the prior quarter. The weighted average fulfillment fee rate in the third quarter was 15 basis points, down from 18 basis points in the prior quarter, reflecting discretionary reductions made to facilitate successful loan acquisitions by PMT.

Acquisition volumes in October were 12.9 billion dollars in UPB, and locks were 11.5 billion dollars in UPB.

PMT's Interest Rate Sensitive strategies consist of our investments in MSRs sourced from our correspondent production, and investments in Agency MBS, non-Agency senior MBS and interest rate derivatives with offsetting interest rate exposure.

The fair value of PMT's MSR asset at the end of the third quarter was 2.8 billion dollars, up from 2.6 billion dollars at the end of the prior quarter. The increase reflects new MSR investments that more than offset fair value losses and prepayments.

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

The total UPB of loans underlying our CRT investments as of September 30th was 35.4 billion dollars, down 14 percent quarter-over-quarter. Fair value of our CRT investments at the end of the quarter was 1.9 billion dollars, down from 2.2 billion dollars at June 30th due to the decline in asset value that resulted from prepayments.

The 60-plus day delinquency rate underlying our CRT investments declined from June 30th.

PFSI's position as the manager and servicer of loans underlying PMT's CRT investments gives PMT a strategic advantage, since we can work directly with borrowers who have loans underlying PMT's investments that 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, notably 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 continue to assist those borrowers at risk.

With respect to PMTT1-3, which comprises 6 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 18 million dollars. Through the end of the quarter, losses to date totaled 11 million dollars.

Moving on to L Street Securities 2017-PM1, which comprises 19 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. PMT recorded 17 million dollars in net losses reversed in the third quarter, as 24 million dollars of losses reversed more than offset the 7 million dollars in additional realized losses. We estimate that an additional 20 million dollars of these losses were eligible for reversal as of September 30th subject to review by Fannie Mae and we expect this amount to continue to increase as additional borrowers exit forbearance and reperform. We estimate that only 9 million dollars of the 65 million dollars in losses-to-date had no potential for reversal. This market expectation of significant future loss reversals resulted in the fair value of L Street Securities 2017-PM1 exceeding its face amount by 29 million dollars at the end of the quarter.

The most common method for borrowers to exit forbearance to date has been a COVID-19 payment deferral. This program allows the borrower to defer the amount owed to the end of the loan term and the loan is deemed current after the borrower makes a specified number of monthly mortgage payments.

As David mentioned in his section of the presentation, we continued to invest in securitizations collateralized by investor loans, both during and after the quarter. During the quarter, we added 27 million dollars in fair value of new investor loan securitization investments and after the quarter, we added another 21 million dollars in fair value from PMT's inaugural securitization of investor loans.

In total, this year we have successfully deployed the runoff from elevated prepayments on CRT investments and on slide 8, you can see 925 million dollars of net new investments in long-term mortgage assets more than offset 836 million dollars in runoff from prepayments on CRT assets.

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 60.7 million dollars in pretax income; Interest Rate Sensitive Strategies, which contributed 116.8 million dollars in pretax loss; Correspondent Production, which contributed 27.8 million dollars in pretax income; and the Corporate segment, which had a pretax loss of 12.3 million dollars.

The contribution from PMT's CRT investments totaled 60 million dollars. This amount included 26.4 million dollars in market-driven value gains, reflecting the impact of credit spread tightening and elevated prepayment speeds. As a reminder, faster prepayment speeds benefit PMT's CRT investments as payoffs of the associated loans reduce potential for realized losses. Net gain on CRT investments also included 33.1 million dollars in realized gains and carry, 14.3 million dollars in net losses reversed, primarily related to L Street Securities 2017-PM1 which Vandy discussed earlier, 100 thousand dollars in interest income on cash deposits, 13.2 million dollars of financing expenses, and 800 thousand dollars of expenses to assist certain borrowers in mitigating loan delinquencies they incurred as a result of dislocations arising from the COVID-19 pandemic.

PMT's interest rate sensitive strategies contributed a loss of 116.8 million dollars in the quarter. MSR fair value decreased a total of 63 million dollars during the quarter and included 64 million dollars in fair value increases due to changes in interest rates, 56 million dollars of valuation decreases due to FHFA's elimination of the Adverse Market Refinance Fee, and 70 million dollars in additional valuation declines primarily due to elevated levels of prepayment activity and increases to short-term prepayment projections.

The fair value on Agency MBS and interest rate hedges also declined by 95 million dollars and included 80 million dollars of fair value declines due to increases in market interest rates, and declines due to hedge costs of 15 million dollars.

PMT's Correspondent Production segment contributed 27.8 million dollars to pretax income for the quarter.

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 12.3 million dollars.

Finally, we recognized a tax benefit of 4.7 million dollars in the third quarter driven by fair value declines in MSRs held in PMT's taxable subsidiary.

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

Speaker:

David Spector – Chairman and Chief Executive Officer

Thank you, Dan.

Looking forward, while rising interest rates are driving a competitive environment for aggregators that presents near term challenges, PMT is well-positioned over the long term with a valuable portfolio of existing investments, alignment to the purchase market in its correspondent production business, and a proven ability to organically generate new investments. We remain tirelessly focused on driving improved execution and capitalizing on the current and evolving investment environment, and are optimistic about PMT's ability to deliver attractive returns as we look ahead.

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 third 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.