PennyMac®

# PennyMac Mortgage Investment Trust

## Fourth Quarter 2019 Earnings Transcript

February 6, 2020

## Introduction

Good afternoon, and welcome to the fourth 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, please take a few moments to read the disclaimer on Slide 2 of the presentation. Thank you.

Now I'd like to introduce Stan Kurland, PMT's Executive Chairman.

**Speaker:**

*Stanford L. Kurland – Executive Chairman*

Thank you, Isaac.

Before I turn it over to David, who will lead the earnings review going forward, I'd like to make a few high level comments. I am pleased to note that PennyMac Mortgage Investment Trust was among the best performing residential mortgage REITs in 2019. I am also pleased to note that since its inception over 10 years ago, PMT has delivered an outstanding annualized return to common shareholders of 12 percent, driven by its unique business model and investment strategies in residential mortgages. I am confident that as I begin to transition away from my day to day operational responsibilities at PennyMac Financial, PMT's manager and services provider, this highly-experienced management team and synergistic relationship will continue to drive attractive risk-adjusted returns to shareholders.

Now let's turn it over to David Spector, PennyMac Mortgage Investment Trust's President and Chief Executive Officer to discuss the Company's fourth quarter and full-year 2019 results.

**Speaker:**

*David Spector – President and Chief Executive Officer*

Thank you, Stan.

Let’s begin with Slide 3.

**Slide 3**

PMT reported net income attributable to common shareholders of 52.4 million dollars, or 55 cents per share, representing an annualized return on average common equity of 10 percent. Book value per common share increased to 21 dollars and 37 cents at year end from 21 dollars and 14 cents at September 30$^{th}$, and PMT paid a dividend of 47 cents per share for the quarter.

PMT reports results through four segments: Credit Sensitive Strategies, which contributed 38.9 million dollars in pretax income; Interest Rate Sensitive Strategies, which contributed 12.3 million dollars; Correspondent Production, which contributed 23 million dollars; and Corporate, with a pretax loss of 15 million dollars.

Our results this quarter reflect continued strong performance from our GSE credit risk transfer investments, an increased income contribution from the Correspondent Production segment, and improved performance from our Interest Rate Sensitive Strategies despite elevated hedge costs driven by continued interest rate volatility.

PMT continued its strong pace of capital investment this quarter, driven by record conventional acquisition volumes totaling 22.7 billion dollars in unpaid principal balance. We delivered CRT-eligible loans of 16.6 billion dollars in UPB to Fannie Mae, which resulted in a firm commitment to purchase 655 million dollars of CRT securities. New MSR investments for the quarter totaled 303 million dollars.

**Slide 4**

Continuing on Slide 4, in November, PMT expanded its capital structure in support of continued growth with the private placement of 210 million dollars of senior exchangeable notes at attractive terms. In addition, PMT's strong performance and outlook for continued investment opportunities drove the successful issuance of 9.2 million common shares in an underwritten equity offering, providing 201 million dollars in new common equity. And, through our “At-The-Market” equity offering program, we sold an additional 637 thousand common shares, for 14 million dollars in net proceeds. For the full year, PMT raised 830 million dollars in new common equity driven by strong share price performance and increased investment opportunities.

I am also pleased to note that after quarter end, we committed to issue 350 million dollars of 3-year term notes related to the remainder of our fifth CRT transaction, which Vandy Fartaj will expand upon later.

Now let’s turn to Slide 5 and discuss the current market environment.

**Slide 5**

Looking ahead, the U.S. economy remains strong with low interest rates. The Federal Reserve has indicated that it expects to maintain the current target for the Federal Funds rate as it continues to monitor the balance between its maximum employment and 2 percent inflation target objectives. In the fourth quarter, the 10-year Treasury bond yield increased 24 basis points. However, the average 30-year fixed rate mortgage increased 10 basis points over the same time period. More recently, mortgage rates have declined again providing support for continued elevated refinance volumes. In recent months, major economists have generally increased their 2020 origination forecasts and we believe these low rates will continue to drive those forecasts higher.

Home prices have continued to appreciate, but at a pace more in-line with wage growth. Most economists forecast continued home price appreciation through 2021, albeit at a slower pace.

Low unemployment and a strong U.S. economy continue to support historically low levels of delinquencies. The total U.S. mortgage delinquency rate was 3.4 percent as of December 31st, down from 3.53 percent at September 30th and 3.88 percent at the end of 2018.

Looking at credit spreads, we saw mixed results this quarter related to CRT investments. Spreads on seasoned CRT securities with higher underlying note rates widened as a result of higher prepayment speeds whereas spreads on CRT with more recent lower note rate originations tightened modestly.

Let's turn to slide 6 and discuss the quarter's investment activities.

**Slide 6**

On slide 6 we detail investment activity for each of PMT's investment strategies during the fourth quarter.  PMT has unique investment opportunities, driven by its conventional correspondent production, which allows us to organically create new CRT and MSR investments. PMT's record acquisition volumes have driven strong capital deployment to these assets.

As I noted earlier, eligible CRT deliveries led to a firm commitment to purchase 655 million dollars in new CRT securities.  Net of runoff, new CRT investments for the quarter totaled 580 million dollars.

PMT's distressed loan and real estate owned portfolio declined further to 80 million dollars in fair value at year end from 95 million dollars at September 30th. The substantial majority of the fair value is REO.

New MSR and ESS investments sourced from the securitization of 22.7 billion dollars in UPB of conventional production were 303 million dollars and net of runoff totaled 237 million dollars.

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. In the fourth quarter, we increased our net Agency MBS position by 515 million dollars, consistent with this strategy.

In total, net new investments in the fourth quarter were 1.3 billion dollars, and long-term mortgage assets as of December 31st grew to 8.4 billion dollars.

Now let's turn to Slide 7 and review the run-rate quarterly return potential of PMT's investment strategies.

**Slide 7**

Our expectation for PMT's investment strategies is a run-rate diluted EPS of 53 cents per quarter, which would result in an annualized return on common equity of 10 percent.

PMT's run-rate potential reflects our expectation for returns over the next several quarters. Our income potential results from continued growth of CRT and MSRs, organically driven by our correspondent production activities.

PMT's equity allocation related to Credit Sensitive Strategies is expected to average 42 percent, with a run-rate annualized return on equity potential of 16 percent. Our Credit Sensitive Strategies primarily consist of our investments in CRT, with a return potential that reflects credit spreads that have tightened.

Equity allocated to Interest Rate Sensitive Strategies is expected to average 36 percent, with an annualized return on equity of 10 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 are primarily driven by our outlook for the earnings contributions from the growing MSR asset and elevated hedge costs driven by market volatility.

Equity allocated to the Correspondent Production segment is expected to average 18 percent, with an annualized return on equity of approximately 11 percent, which reflects a normalization from recently elevated results and the impact of additional equity allocated to the segment pending investment in long-term assets.

This conclude 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 from nonaffiliated sellers in the fourth quarter totaled 37.7 billion dollars in UPB, up 20 percent from the prior quarter and 109 percent year-over-year. 55 percent of our acquisitions were conventional loans, and 45 percent were government loans.

Conventional correspondent acquisitions totaled 20.5 billion dollars in UPB, up 23 percent from the prior quarter and 127 percent from the fourth quarter of 2018.

Government loan acquisitions in the quarter, for which PMT earns a sourcing fee from PennyMac Financial, totaled 16.7 billion dollars in

UPB, up 16 percent from the prior quarter and 87 percent from the fourth quarter of 2018.

As part of its correspondent loan acquisitions, PMT also acquired conventional loans originated by PFSI totaling 1.7 billion dollars in UPB, up from 1.4 billion dollars in the prior quarter.  These loans were originated through PFSI's consumer and broker direct lending channels, and PennyMac Financial remains PMT's largest single correspondent client.

Combined, conventional lock volume totaled 19.7 billion dollars in UPB, up 1 percent from the prior quarter and 105 percent from the fourth quarter of 2018.

According to *Inside Mortgage Finance*, our record acquisition volumes made PennyMac the largest correspondent aggregator in the United States for the second consecutive quarter, reflecting an improved environment and less aggressive competition from the banks who have historically dominated this channel.

Still, the conventional correspondent market remains competitive and margins were stable in comparison to the prior quarter. The weighted average fulfillment fee paid to PFSI to facilitate correspondent loan production was 28 basis points, up slightly from 27 basis points in the previous quarter.

Purchase-money loans accounted for 55 percent of total acquisition volume, which we believe is a significantly larger percentage than the overall origination market.

The number of approved correspondent sellers in our network also continued to rise, to nearly 800 at quarter end, up from 770 at the end of the prior quarter.

Looking at January 2020, monthly production volumes remain elevated with total correspondent loan acquisitions of 11.1 billion dollars in UPB and interest rate lock commitments of 11.4 billion dollars in UPB.

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

**Slide 10**

This quarter we delivered to Fannie Mae a total of 16.6 billion dollars in UPB of eligible loans pursuant to our sixth CRT transaction, which resulted in a firm commitment to purchase 655 million dollars in CRT securities.

On a pro forma basis at December 31st, 2019, PMT's outstanding CRT investments totaled 3.7 billion dollars, with the UPB of the loans underlying the CRT agreements totaling 81 billion dollars.

Credit performance and characteristics of the loans underlying these investments remains strong.  Losses have developed within expectations driven by low unemployment and continued home price appreciation, and totaled 1.7 million dollars in the fourth quarter, bringing lifetime cumulative losses to 8.8 million dollars. The 60 plus day delinquency rate was 0.35 percent, up slightly from 0.31 percent in the prior quarter, reflecting multiple factors including seasonal trends and a reduction in the underlying balances driven by high prepayments.

Now let's turn to Slide 11 and talk about the financing arrangements associated with our CRT investments.

**Slide 11**

This slide details the outstanding financing arrangements underlying our CRT investments. As David mentioned earlier, after the quarter end we committed to issue 350 million dollars of 3-year term notes related to the remainder of our fifth CRT transaction. We have now established term financing for the entirety of our funded CRT transactions with over 1.6 billion dollars of outstanding term notes, pro forma as of January 31, 2020.

Now let's turn to Slide 12 and talk about MSR and ESS investments.

**Slide 12**

PMT's organic MSR investments resulting from its correspondent conventional production activity totaled 1.5 billion dollars at quarter end, up from 1.2 billion dollars at September 30th driven by investment growth from record conventional production volumes and fair value gains as interest rates increased during the quarter. PMT's MSR portfolio totaled 131 billion dollars in UPB at December 31st, up from 116.4 billion dollars at September 30th.

PMT's ESS investments resulting from bulk, mini-bulk and flow MSR acquisitions by PennyMac Financial from 2013 to 2015 decreased slightly to 179 million dollars at year end driven by repayments of the underlying loans. The UPB associated with ESS investments totaled 19.9 billion dollars at December 31st, down from 20.8 billion dollars at September 30th.

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

**Speaker:**

*Andy Chang – Chief Financial Officer*

Thank you, Vandy.

Let's turn to Slide 14 and discuss the fourth quarter's income and return contributions by strategy.

**Slide 14**

PMT's activities in the fourth quarter generated an annualized return on common equity of 10 percent, net of all expenses.

In total, Credit Sensitive Strategies contributed 38.9 million dollars to pretax income, or a 25 percent annualized return on equity for the quarter. Within the segment, CRT investments contributed pretax income of 43 million dollars, which I will expand upon later. Distressed loan and REO investments contributed a 3.7 million dollar pretax loss, primarily driven by holding costs on the remaining REO.

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 income of 12.3 million dollars, or a 5 percent annualized return on equity for the quarter. Improved segment results were primarily driven by fair value gains and higher servicing fee income from a larger MSR asset, and were offset by fair value losses on our 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 is inversely correlated to that of the MBS and our other interest rate hedges. I will discuss this in more detail on the following slide.

Correspondent Production contributed 23 million dollars to pretax income, or a 15 percent annualized return on equity for the quarter, driven by record production volumes.

The Corporate segment contributed a pretax loss of 15 million dollars.

And finally, we recorded 700 thousand dollars in income tax expense.

Now let's turn to slide 15 to further discuss the impact of interest rate movements on our fourth quarter results.

**Slide 15**

PMT seeks to manage its interest rate exposure on a global basis, recognizing interest rate sensitivities that exist across its investment strategies. In the fourth quarter, MSR and ESS investments recorded fair value gains totaling 131.6 million dollars driven by an increase in interest rates and lower expected prepayment activity in the future. PMT's MSR portfolio is concentrated in recently originated vintages, loans that were originated from 2016 to 2018 that are highly sensitive to prepayments at the current level of interest rates and, as a result, the MSR is costly to hedge.

For the quarter, Agency MBS produced fair value losses of 500 thousand dollars, and interest rate hedges produced fair value losses of 150.6 million dollars. The losses on our interest rate hedges include hedge costs, which have been elevated as a result of market volatility and a relatively flat yield curve.

And lastly, as David and Vandy discussed, low mortgage rates during the quarter drove a substantial increase in production volume and the related income contribution from our Correspondent Production segment, which more than offset fair value losses in the Interest Rate Sensitive Strategies segment.

Now let's turn to slide 16 and talk about the performance of our CRT investments.

**Slide 16**

Our CRT investments contributed 43 million dollars of pretax income in the fourth quarter, consisting of 2.5 million dollars in gains from market-driven value changes, and 40.5 million dollars of income excluding market-driven value changes.

Market-driven value changes on our existing CRT investments included fair value losses of 15.3 million dollars reflecting the impact of accelerated prepayment speeds. Offsetting this were gains of 17.8 million dollars included in net gain on loans acquired for sale. These gains relate to the fair value recognition upon loan delivery under firm commitments to purchase CRT securities pursuant to our current transaction with Fannie Mae. In the fourth quarter, 15.6 million dollars of such gains were attributed to the Correspondent Production segment.

Income excluding market-driven value changes consists of net realized gains and net interest expense related to our CRT investments. For the quarter, realized gains and carry on CRT investments totaled 52.5 million dollars, while losses recognized were 1.7 million dollars. Interest income earned on cash deposits securing CRT investments was 8.4 million dollars, while interest expense relating to the financing of these investments was 18.8 million dollars.

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

**Speaker:**

*David Spector – President and Chief Executive Officer*

Thank you, Andy.

Strong financial performance in the fourth quarter and for the full year 2019 was driven by our unique credit risk transfer investments, record conventional production volumes in our correspondent business and disciplined hedging of mortgage servicing rights. We create organic CRT investments through our leading correspondent production business, which delivered approximately 60 billion dollars in UPB of loans to the GSEs this year, resulting in new CRT investments of over 1.8 billion dollars. In light of our investment outlook, in the fourth quarter we expanded PMT's capital structure with the private placement of 210 million dollars of senior exchangeable notes and we issued additional common equity, bringing the total equity raised in 2019 to over 800 million dollars to support continued capital deployment into CRT and MSR investments that we believe are accretive to PMT's overall investment 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.