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PRESENTATION

Operator

Thank you for standing by, and welcome to Q4 2020 Impac Mortgage Holdings Earnings Conference Call.

(Operator Instructions) I would now like to hand the conference over to your speaker today, Mr. Justin Moisio. Please go ahead.

Justin Moisio - *Impac Mortgage Holdings, Inc. - Chief Administrative Officer*

Thank you. Good afternoon, everyone. Thank you for joining Impac Mortgage Holdings' Year-end 2020 Earnings Call.

During this call, we will make projections or other forward-looking statements in regards to but not limited to GAAP and taxable earnings, cash flows, interest risk and market risk exposure, mortgage production and general market conditions. I would like to refer you to the business risk factors in our most recently filed Form 10-K under the Securities Exchange Act of 1934. These documents contain and identify important factors that could cause the actual results to differ materially from those contained in our projections or forward-looking statements. This presentation, including outlook and any guidance, is effective as of the date given; and we expressly disclaim any duty to update the information herein.

We'd like to get started by introducing George Mangiaracina, Chairman and CEO of Impac Mortgage Holdings.

George A. Mangiaracina - *Impac Mortgage Holdings, Inc. - Chairman & CEO*

Thank you, Justin.

Paul Licon, our CFO; and Tiffany Entsminger, our COO, will join me for prepared remarks. Justin will be back along with Tom Donatacci, our Chief of Staff; and Joe Joffrion, our General Counsel, for the question-and-answer segment.

When we met about a year ago for the company's 2019 year-end earnings call, March 13, 2020, to be exact, we reported strong year-over-year operating results and discussed momentum we had anticipated would accelerate as we invested in technology, product design, industry talent and geographic expansion. We also noted that any enthusiasm for future prospects needed to be properly balanced and tempered by potential supply and distribution constraints and tenant liquidity risks associated with the then-current macroeconomic conditions. In fact, 2020 presented the company with extraordinary challenges, the result of unprecedented credit and interest rate shocks and global market dislocations in the first and second quarters of the year. The difficult but necessary decisions the company executed on during the first half of 2020 have been well documented for our frequent business updates and prior quarterly earnings calls. These actions to derisk the balance sheet and to consciously protect liquidity, often at the expense of book value, positioned the company to normalize origination activity in the second half of 2020.

Today, we are pleased to announce a second consecutive quarter of positive operating results with 2020 fourth quarter of $3.3 million, $0.16 a share, following 2020 third quarter earnings of $4.4 million or $0.21 a share. Core earnings are an alternative measure of results that senior management utilizes to gauge the company's performance. They isolate results from recurring business activities by adjusting for certain nonrecurring items such as changes in the fair value of long-term debt and trust assets and loss on mortgage servicing rights and other nonrecurring legacy matters. This concept was first introduced in the beginning of 2019. A table is provided with our earnings release to enable variation analysis between prior periods.

Generating core earnings of approximately $8 million in the second half of 2020 versus core losses of approximately $66 million in the first half of 2020 was hard fought and a remarkable turnaround for the company. We would like to express our gratitude to our Board of Directors, our stakeholders and our capital partners for their steadfast support under the most difficult of circumstances. And I personally want to extend my thanks to our senior management team and our valued employees for their dedication and tireless focus on the company, often while managing stresses over health, family and societal concerns brought on by COVID-19. Collectively, our stakeholders enabled the company to navigate through the unprecedented global market dislocation we experienced last year. On this call, we would like to highlight some of the key accomplishments for the second half of 2020, including the relaunch of our origination businesses, creating a profitable run rate in our consumer direct channel, restarting NonQM originations in our third-party or TPO channel and enhancing the company's liquidity by extending our convertible promissory note.

The company announced the relaunch of our lending activities in late second quarter within our consumer direct channel, focused initially on GSE, FHA and VA product. In the latter half [of the] fourth quarter of 2020, we expanded those offerings to include non-agency jumbo and NonQM and also relaunched our TPO channel. The company generated originations in excess of $800 million in Q4 2020 versus $400 million in Q3 of 2020 and just $2 million in Q2 of 2020. The increase reflects our success in ramping the call center to target originations of at least $250 million per month and the reintroduction of a broader product set across all channels. These origination activities were the prime driver of positive core earnings in the second half of the year. The company was not immune from margin compression experienced by the industry in the fourth quarter. This normalization was anticipated as industry capacity expanded to meet demand. Paul Licon will address this in his prepared remarks.

We entered 2020 with strong momentum, having repositioned the company over the years to expand our core competency related to alternative products. During the first quarter of 2020, prior to the disruption caused by COVID-19, we originated $260 million in NonQM loans and were on pace to exceed our fourth quarter 2019 NonQM origination volume. As financial markets became dislocated in March of 2020, liquidity tightened and credit spreads widened substantially, with particular focus on NonQM payment delinquency and forbearance risk. To protect against market valuation declines, the company had a significant portion of our NonQM portfolio hedged via mandatory forward commitments with investors. Some of these hedges were not honored, causing the company to restructure the sale of these assets at market levels significantly below that which the company would have received under the terms of the mandatory forwards. We ceased originating NonQM loans in the beginning of April 2020.

In the fourth quarter of 2020, market conditions and external factors, while not fully normalized, had sufficiently stabilized to the extent that the company elected to reengage its lending activities within the NonQM market segment. The reemergence of the NonQM market has been defined by products that originated through more restrictive credit underwriting guidelines than pre COVID and consistent with the company's historical -- historic credit philosophy.

We believe the quality of our loans have been demonstrated by their performance through the recent crisis. In 2020, our NonQM originations had a weighted average FICO of 730, weighted average LTV ratio of 68% compared to 731 and 70%, respectively, in 2019. Since the company's inception, we have historically been an innovator with respect to the design and origination of alternative credit products. NonQM is a core competency differentiator for the company, and we look forward to participating in the reemergence of this sector.

As discussed on prior calls, improving and protecting the firm's liquidity was a primary objective for the firm in 2020. In line with these objectives, on October 28, 2020, we announced an extension of our convertible promissory note. This agreement extended the maturity date of the note by an additional 18 months from November 9, 2020, to May 9, 2022, and reduced the aggregate principal amount of the note to $20 million following a paydown of $5 million of principal. The company's cash and unencumbered whole loan position was approximately $60 million at the end of the fourth quarter, as compared to $65 million at the end of the third quarter. We believe this liquidity position provides a margin of safety to address future market volatility.

Finally, I would like to note that November 20, 2020, marked the 25th anniversary of our initial public offering, a tribute to the company's resilience in navigating numerous economic and political events. We remain optimistic about the future. The company continues to originate through our consumer direct and third-party channels and is well positioned to take advantage of opportunities as the agency and alternative credit markets evolve.

I'll now hand the call over to Paul Licon.

Paul?

Paul D. Licon - *Impac Mortgage Holdings, Inc. - CFO, CAO & Controller*

Yes, thanks, George.

In Q4, we continued to successfully ramp up production. We increased our funding volume from $418 million in Q3 to $810 million in Q4, representing a 94% quarter-over-quarter increase. In addition, we grew our locked pipeline by 26% from $359 million at the end of Q3 to $451 million at the end of Q4. And as George mentioned earlier, we continued to carefully manage our liquidity, as evidenced by our cash position of $54 million at the end of the year, while also extending our convertible notes due in November of 2020 to May of 2022 at the same funding costs. Our enhanced liquidity position gives the company the flexibility to continue to increase production and invest capital for continued growth.

The financial results of the quarter reflect increased loan production, net of the effect of the market margin compression. Excluding the effects of quarter-end locked pipeline, we saw margin compression of approximately 73 bps in Q4 versus prior quarter. However, for some context: Our Q4 2020 margins were around 80 basis points higher than our January and February 2020 margins pre COVID. Gain on sale of loans increased from $19.3 million in Q3 to $21.5 million in Q4.

As a result of increasing production volumes, total operating expenses increased from $16.1 million in Q3 to $19.9 million in Q4, led by an increase in personnel costs from $11.2 million in Q3 to $13.3 million in Q4. Under current production goals, we expect compensation expense to level off, subject to market capacity constraints.

GAAP net loss before tax was $2.1 million in Q4 versus pretax income of $1.6 million in Q3. Core earnings were $3.3 million for Q4 versus $4.4 million in Q3. Our 2020 year-to-date GAAP net loss before tax was $88 million, while year-to-date core loss was $59 million, compared to 2019 year-to-date GAAP net loss of $8 million, and core earnings of $16 million.

Turning to liquidity. As of the end of Q4, we had $54 million in unrestricted cash and $6 million in unencumbered loans on our balance sheet, of which we expect to monetize and be additive to our cash balance, versus $55 million in unrestricted cash and $9 million in unencumbered loans as of the end of Q3. In addition, we currently have warehouse lines with combined borrowing capacity of $550 million.

During the quarter, our funding-to-settle turn times were in the low 20-day range. However, this remains subject to the risks of increased turn times and capacity constraints inherent in an aggregation execution model. However, based on our current cash position, turn times and borrowing resources, we feel we have the liquidity necessary to meet our near-term production goals.

I will now turn it over to Tiffany to discuss production mix and product focus.

Tiffany Entsminger - *Impac Mortgage Holdings, Inc. - COO*

Thank you, Paul.

And the fourth quarter marked a steady increase in origination volume, reaching over $800 million in funded volume for the quarter and exceeding our $250 million monthly funding target. We expanded our product offering to include QM jumbo and NonQM in the third and fourth quarters and received favorable market reception among consumers and brokers in both our retail and TPO channels. Our primary focus since the resumption of lending activity in the second quarter has been to originate GSE and government products. Margins have been historically high. Origination volume is undoubtedly higher in their diversified capital markets [axis]. The risk-based overlays imposed by many lenders began to dissipate in the fourth quarter, allowing for a more normalized credit underwrite under GSE guidelines. Impac adjusted its credit box in line with industry standards and accepted risk tolerances, which in turn contributed to increased originations during the fourth quarter.

Talent retention and acquisition remained a relevant topic throughout the quarter. Impac is focused not just on recruitment but also on building a strong leadership infrastructure within its operating channels to support future growth and stability. Our employee head count grew during the quarter to over 320 employees, up from 250 at the end of the second quarter 2020, with the additional staff being added to retail and wholesale sales and operations groups. Ongoing wage inflation and increased personnel expense had an impact on our overall cost to originate. However, the talent hired and retained was essential to growing the channels and exceeding the $250 million targeted monthly run rate. Based on current models, we plan to maintain a run rate of at least $250 million through the first quarter of 2021.

As predicted, we adjusted marketing spend throughout the quarter to support volume targets and drive new product offerings. Organically volume, while preferred, required some supplemental spend into targeted lead sources. Competition among lenders remains untamed, and the resulting pressure to provide consumers with more favorable rates has started to drive some margin compression in the GSE space. Increased business promotion spend and adversely impacted margins will likely persist as rates continue to increase.

A welcome shift in Q4 2020 was the reemergence of a renewed investor interest in NonQM products. The appetite to buy these assets is gaining momentum, while the origination volume is catching up to guideline normalization. Credit risk overlays have been slowly adjusting to look more like a pre-COVID NonQM product; and the performance of the product, despite COVID-related forbearance concerns, have proven study. Taking a focused approach to NonQM originations by way of product innovation, technology investment and origination efficiencies is top of mind in the first quarter of 2021 and beyond. Investing in our wholesale channel is also a strategic step toward NonQM growth and innovation. We are committed to growing our core NonQM products while surveilling opportunities to serve consumers in more targeted offerings such as purchase, second lien and other alternative credit vehicles. Remaining agile in the market around credit and product is just as critical as doing so thoughtfully and responsibly.

That concludes the financial results and our prepared remarks. We'll now open the call for questions.

George A. Mangiaracina - *Impac Mortgage Holdings, Inc. - Chairman & CEO*

Bear with us, please. We're having (inaudible) difficulties with the dial-in.

QUESTIONS AND ANSWERS

Operator

Excuse me, everyone. Our first question comes from the line of Trevor Cranston from JMP Securities.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director & Equity Research Analyst*

I guess, the first question. You guys touched on the margin compression and increased competition somewhat in the prepared remarks. Can you maybe provide some general color around the movement in mortgage rates we've seen, so far, in the first quarter? How -- what kind of magnitude of additional margin compression do you think that will result in? And with that additional margin compression and your target funding levels, is -- does that still come out to a level where you think the company can comfortably remain at a profitable level?

Paul D. Licon - *Impac Mortgage Holdings, Inc. - CFO, CAO & Controller*

Yes. This is Paul. I can start by starting this, and maybe someone else can jump in. Yes, right now, based on what we're seeing, we expect further margin compression in Q1. We're estimating between 15 and 20 basis points of additional margin compression. Again, as Tiffany touched on, it's really just due the increase in rates and competition. Of course, in the next couple of weeks, that could change, depending on what happens in the market, but that's sort of what we're anticipating now.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director & Equity Research Analyst*

Okay. And is that -- so is that -- should I interpret that as like 15 to 20 basis points lower margin kind of on a run rate going forward? Or is that sort of the average number you're expecting for 1Q versus where you're at in 4Q?

George A. Mangiaracina - *Impac Mortgage Holdings, Inc. - Chairman & CEO*

Yes, Trevor, this is George. We don't give forward guidance, but with that amount of margin compression in the GSE product, offset by what we believe will be a shift in production to NonQM and jumbo where the margins are healthier, we're fairly confident that we'll be able to continue to run platform on a positive rate. So...

Justin Moisio - *Impac Mortgage Holdings, Inc. - Chief Administrative Officer*

Yes, yes. Trevor, this is Justin. You talked about the rate move. So kind of, I mean, obviously we're coming off of 2020 record lows in rates, historic refi volume because of how much the borrowers could save on their monthly payments. So over the last few weeks, as we've seen rates tick up slightly here, our borrowers have had some initial shock to those rates. However, there's still very healthy appetite for refinances in the market right now, based on what we've seen from publications as early as recently as Monday indicating about half of the homeowners are currently in the money for refinance. So there's still a lot of ground to cover there, and so we do expect there'll be more competition in the industry. Margins will tighten in a bit more, but as George mentioned, that really opens up opportunities for us because, with a product like NonQM jumbo where Impac historically -- that's our DNA. That's what we've done very, very well. That's where we can pivot nicely to.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director & Equity Research Analyst*

Okay, got it. That is helpful. And in terms of personnel expense, I think you guys commented briefly on the fact that increased competition for employees in the market has had some impact on that. Given that, 4Q, you kind of hit the funding targets and capacity you guys have at the moment, is the personnel expense sort of at a good run rate level? Or is that something that you expect to continue to tick up a little bit into the first quarter?

Tiffany Entsminger - *Impac Mortgage Holdings, Inc. - COO*

This is Tiffany. I would expect it to be more normalized. We certainly have some stretch capacity with the folks that we have onboard, but the ramp-up in the add required a little bit more expense given the competition in the market right now. But now that we have folks in the door and we're producing well, we'll continue to build on our efficiencies with the origination process and then also be able to stretch beyond the current head count that we have with the same folks.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director & Equity Research Analyst*

Okay, got it. And then maybe just to touch on the NonQM and non-agency products for a moment, can you provide some additional color around sort of how the restart of that business has gone in terms of finding partners who are actively originating the product and how much do you think that will change as a result of maybe some refi business dropping off now that rates have moved higher? And then as the second part of that, I guess, when you, when we think back to where the NonQM business was pre COVID of last year and where margins were, kind of how would you kind of compare how you expect that business to look as it ramps up over the course of this year versus where it was before the shutdown?

Tom Donatacci - *Impac Mortgage Holdings, Inc. - Chief of Staff - Business Development*

Sure, Trevor. This is Tom Donatacci. We're already seeing origination growth in the NonQM sector and anticipate to continue growing through 2021, into 2022, with S&P predicting we could see levels as high as $25 billion in originations, levels not seen since 2019. While the halt to the market in early 2020 for both originations and securitizations was industry-wide, the recovery began soon after. And there has been a steady march towards pre-crisis market conditions in both guidelines and pricing, with securitizations of both new originations and portfolios held since early 2020 being well received by the market. A number of factors are supporting the stabilization and the return of the market and volume. One is extraordinary depth of demand from investors created not just an appetite for volume but also as an expanded list of buyers greater than what we had seen in 2019. These investors are able not only to buy dependent upon a securitization exit strategy, but many have entered with the ability to balance sheet the product, which creates additional stability in the market in the event of another market dislocation. The quality underwriting guidelines have improved market-wide, with most products being originated through more conservative -- a more conservative profile based on stronger borrowers. Those that had focused on the lower end of the credit box have had to move up the curve and take advantage of demand in the market. Impac is always focused on higher-quality NonQM originations, and so our criteria hasn't had to shift from the precrisis credit box nearly as much as many of the players in the marketplace.

Past originations have continued to perform well despite some of the economic conditions over the past year, resulting in fewer forbearance requests and, of those requesting forbearance, many continuing to make their payments. As these requests expire or retire, the universe of potential borrowers continues to grow. Historically -- per Paul's comments on margins, historically low rates and wide margins over the last year have migrated many loan officers who had historically focused on NonQM to take advantage of the refinanceable market for GSE products. With rates rising and margins compressing, we're seeing a return of these producers to the NonQM sector, which should boost origination volumes going forward. Lastly, the MBA anticipates purchase demand to exceed refinance demand on a go-forward basis. This is also a positive indicator for the NonQM market, as business owners and real estate investors that rely on NonQM product offerings like bank statement and DSCR programs are typically strong drivers in the purchase market. For these reasons and our long history in the alternative credit space, we're bullish on this sector and our ability to participate competitively in NonQM going forward.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director & Equity Research Analyst*

Okay, that's really helpful color. And so when you think about the overall funding capacity of the company as a whole, as the NonQM piece presumably grows over the course of this year, do you guys have the capacity to kind of grow that alongside the business you're currently doing in the agency lending space? Or would the anticipation be that you sort of shifts more of the funding capacity into the NonQM and it sort of replaces some of what you've been doing on the agency side?

George A. Mangiaracina - *Impac Mortgage Holdings, Inc. - Chairman & CEO*

Trevor, this is George. I -- we have excess capacity to continue to grow the GSE portion of the business, which is primarily driven out of the call center. And when I say capacity, I mean both with respect to liquidity through warehouse lending, with the equity to support the warehousing and with personnel. NonQM business, we have liquidity. Again the haircut is a bit deeper on NonQM, but we have the equity to support the NonQM growth concurrent with the existing run rate or even a little bit higher run rate in GSE. We've got warehouse capacity for NonQM, and we've got capacity in terms of -- human capacity in terms of operating plant around NonQM. And that last piece has been added in the fourth quarter. It's a pipeline business and so we'll continue to build upon that in the first quarter, but we don't have any limitations on being able to continue to build on what we've created in the call center and at the same time concurrently build out the NonQM franchise.

Justin Moisio - *Impac Mortgage Holdings, Inc. - Chief Administrative Officer*

And Trevor, it's Justin. So while TPO, as George indicated, will remain laser-focused on NonQM originations. If you'll remember from years past, one thing that made us very successful within the call center for originating NonQM, albeit $25 million to $50 million a month of that product, was standing up an independent team that would originate that product. So we would just adjust internally for that, but that was something that we, unlike other lenders, were able to do successfully, which was originate NonQM through the call center.

George A. Mangiaracina - *Impac Mortgage Holdings, Inc. - Chairman & CEO*

Yes. We haven't yet begun to spend -- to drive any business promotion out of the call center to NonQM, quite frankly, because the lead generation has been -- cost of customer acquisition has been de minimis around GSE production, but we'll push some of our advertising spend into the NonQM effort in the call center. And you'll see that at the end of the first quarter, and it might take root in the call center in the second quarter and early third quarter of this year.

Justin Moisio - *Impac Mortgage Holdings, Inc. - Chief Administrative Officer*

So at this time, it doesn't look like we have any other questions in the queue, so at this point, thank you, everyone, for joining us. And we'll circle back in early May with our first quarter results.

Thank you.

Operator

This concludes today's conference call. Thank you all for participating. You may now disconnect.
