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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the first quarter earnings conference call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions) With that, I would now like to hand the conference over to your speaker today, Justin Moisio. Chief Administrative Officer. Thank you, and please go ahead.

Justin R. Moisio - *Impac Mortgage Holdings, Inc. - Chief Administrative Officer & Corporate Secretary*

Thank you. Good morning, everyone. Thank you for joining Impac Mortgage Holdings First Quarter 2021 Earnings Conference 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 rate 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 and 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. Jon Gloeckner, our Principal Accounting Officer; and Tiffany Entsminger, our Chief Operating Officer, 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 of today's call.

On this call, we will discuss the overall state of the business and key accomplishments for the first quarter of 2021 including the continued momentum from the relaunch of the company's consumer direct and third-party origination or TPO channels in the second half of 2020.

Approximately 8 weeks ago, in our 2020 year-end earnings call on March 11, we discussed the company had continued to grow our retail and TPO platforms and have recorded a second consecutive quarter of profitability, while continuing to maintain our focus on liquidity and risk management post the 2020 COVID crisis. The company's last business update expressed the view that market conditions in the GSE space have begun to normalize, with margins narrowing as the capacity to originate and process loans in the industry began to catch up with consumer demand.

The company is not immune to the margin compression that presented itself in the fourth quarter of 2020 and that has continued into the second quarter of 2021. We also referenced the welcome shift of increasing investor demand, normalization of guidelines and improved valuations for our NonQM product and competency in the firm that we are currently investing in with product innovation, technology enhancements and sales and operations talent. Tiffany will discuss margins across products and channels in further detail later in the call.

The company reported a net GAAP loss of $700,000 or $0.03 per diluted common share and a core loss of $300,000 or $0.01 per diluted common share in the first quarter of 2021. The company operates its origination activities through its licensed subsidiary Impac Mortgage Corp., IMC. IMC serves as the credit counterparty for the company's warehouse lending facilities, whole loan sales arrangements with GSEs, government and non-GSE aggregators. IMC produced GAAP and core earnings of $3.5 million for the second -- for the first quarter of 2021, the third consecutive quarter of positive results for our regulated licensed entity.

Core earnings or loss are an alternative measure of results that senior management utilizes to gauge the company's performance. Core earnings loss isolates results from recurring business activities by adjusting for certain nonrecurring items, such as changes in fair value of long-term debt and trust assets, gain or loss on mortgage servicing rights held for sale and other nonrecurring legacy matters.

As it relates to production volume, we generated originations of approximately $850 million in Q1 2021 versus $800 million in Q4 2020. The company's locked pipeline at the end of the first quarter of 2021 was approximately the same as the end of 2020, $450 million. However, our NonQM locked pipeline was approximately $75 million at the end of the first quarter as compared to $10 million at the end of the year. The shift evidences more recent pivot to our TPO channel, sequenced after having achieved a sustainable monthly run rate of $200 million to $300 million within our GSE centric consumer direct channel during the last 2 quarters of 2020.

Historically, while we've had success delivering NonQM through consumer direct, the TPO channel has been the prime driver of our NonQM production. While we do not provide forward guidance, we will note that we originated approximately $35 million in NonQM for TPO in April versus a de minimis amount in March. While NonQM market has not returned to pre-crisis levels, we are encouraged by growing borrower demand, depth of investor interest and strong capital markets execution, approximating 500 basis points of gross margin for current originations.

The current NonQM market is characterized by moderately tighter lending standards across the industry, which are in line with our firm's long-term view of alternative credit, anchored in quality, consistency, performance and adherence to ability to repay our ATR guidelines.

We continue to believe in the market opportunity and demand for NonQM and the company's ability to be an innovative market leader in this segment. Since the company's founding in 1995, Impac has been recognized as a leader in providing loan products to borrowers in need of alternative to traditional Fannie, Freddie or other government offerings. The origination, securitization and asset management of these products is a core competency of the company, having originated over $90 billion of such loans from 1995 to 2007.

Post the subprime financial crisis, the company consciously maintained resources across these disciplines to manage our legacy Alt-A portfolio. And in early 2014, extended that infrastructure as one of the first mortgage companies to anticipate and actively pursue the revival of NonQM mortgage market.

Since 2014, we have originated in excess of $4 billion of NonQM, steadily, yet responsibly increasing our NonQM production from $130 million in 2015 to over $1.25 billion annually in the 2 consecutive years, 2018 and '19, leading up to the COVID crisis. The company has maintained sufficient warehouse relationships and liquidity to comfortably support existing and future growth targets for our NonQM production and has recently distributed NonQM loans to a wide range of investors, including Wall Street firms, hedge funds and alternative capital partners.

Throughout 2020, and during the first quarter of 2021, rated private label securitizations were issued backed by the company's NonQM product. Impac's NonQM collateral performance originator rankings and adjustment factors with the rating agencies continue to result in efficient permanent capital structures for our investors.

In the near future, we intend to address and add resources to enable the company to directly access the securitization market and opportunistically retain economic interest in subordinated tranches of our offerings, evidencing our confidence in the long-term performance and risk-weighted returns of the loans we originate.

The company is monitoring developments across a range of macroeconomic factors, including trends in inflation, housing affordability, employment and the interest rate environment. Our risk management and product offerings will evolve with the marketplace to successfully navigate these challenges and seek opportunity where risk reward is properly balanced.

As stated earlier, protecting the firm's liquidity continues to be a primary objective for the firm in 2021. The firm's cash and unencumbered whole loan position was approximately $58 million or $2.70 per common share at the end of the first quarter. We believe this liquidity position as well as we -- as well as a continued focus on strong risk management has prepared the firm to navigate future market volatility.

Jon Gloeckner will now discuss the operating results for the first quarter of 2021. Jon?

Jon Gloeckner - *Impac Mortgage Holdings, Inc. - Senior VP of Treasury & Financial Reporting, Principal Financial and Accounting Officer*

Thank you, George. For the first quarter, the company reported a GAAP loss of $683,000 as compared to a loss of $2.2 million in the fourth quarter, and loss of $65 million in the first quarter of 2020. In the first quarter, core earnings were a loss of $262,000 as compared to $3.3 million in the fourth quarter and a loss of $56 million in the first quarter of 2020.

The first quarter of 2021 saw an interest rate environment that increased much earlier in the year than most had anticipated, causing margin compression in excess of expectations due to competitive pressures to retain market share. During the first quarter, we saw margin compression of approximately 28 basis points as compared to the previous quarter. As a result, gain on sale loans decreased by $1.3 million from the fourth quarter to the first quarter.

Total operating expenses increased from $20 million in the fourth quarter to $21.3 million in the first quarter of 2021 due to a more competitive rate environment and continued rebuild of our NonQM platform. This was led by an increase in personnel costs from $13.3 million in Q4 to $14.9 million in Q1.

Escalating personnel costs across the industry due to competition for workforce talent has contributed to this increase in personnel costs.

Additionally, our personnel expense associated with the rebuild of our NonQM platform was higher as we are ramping production and the revenue associated with the upfront investment typically lags by several months given the businesses pipeline.

With the earlier-than-anticipated increase in mortgage interest rates and subsequent margin compression seen in conventional originations during the first quarter of 2021, we have accelerated our pivot to NonQM in our TPO channel. As George mentioned, during March 2021, we saw a significant increase in NonQM locked, which drove April NonQM fundings to be in excess of our first quarter 2021 NonQM funding.

In the first quarter of 2021, our NonQM originations had a weighted average FICO score of 755 and a weighted average LTV of 60%. For the comparable period of 2020, our NonQM originations had a weighted average FICO of 730 and a weighted average LTV of 68%. Tiffany will provide more color on our NonQM production growth later on the call.

Our business promotion expense increased to $1.2 million in the first quarter as compared to $550,000 in the fourth quarter. This was primarily the result of the aforementioned increase in competitive pressure during the first quarter. While the company experienced a substantial amount of organic lead flow during the third and fourth quarters of 2020, the increase in rates during the first quarter prompted an increase in marketing spend to maintain a consistent level of lead volume. However, despite the increase, the company's business promotion spend was roughly 1/3 of what was spent for the same period in 2020.

In April, for the first time in over a year, the call center began to reallocate a portion of its marketing spend towards NonQM production. This has already resulted in an increase in NonQM submissions, which we expect to continue to ramp up throughout the second quarter. We intend to continue to source leads through digital campaigns, which allow for a more cost-effective approach, increasing the ability to be more price and product competitive within more specific target loan products and geographies.

During the first quarter, we maintained our production levels within the call center, originating at a monthly run rate of approximately $250 million per month. However, within our TPO channel, we have started to see growth around our production ramp as part of the channel's relaunch. This is evidenced in the 35% increase in TPO production in the first quarter as compared to the fourth quarter.

We continue to carefully manage our liquidity as evidenced by our balance sheet at the end of the first quarter. The company had an unrestricted cash position of $53 million and $5 million in unencumbered loans on our balance sheet, of which we expect to monetize and be accretive to our cash position. Our strong liquidity position gives us the flexibility to continue to increase production and invest capital for continued growth.

In addition, we currently have warehouse finance with a combined borrowing capacity of $550 million.

During the quarter, within the call center, our funding-to-settle turn times were just under 20 days, however, this remains subject to the risk of increased turn times and capacity constraints inherent in an aggregation execution model. Based on our current cash position, turn times and borrowing resources, while we may bring in additional warehouse capacity in the near future to diversify our financing capabilities, 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, Jon. While 2020 was the year of the GSE loan, the shift in rates and margin compression around the product began sooner than anticipated during the first quarter of 2021. As we discussed last quarter, the guidelines and overlays impacting Fannie and Freddie eligible borrowers began to lift in the fourth quarter of 2020, leading to a more normalized underwrite. Alongside the shift in a more open credit box, competition among lenders contributed significantly to reduced margins across the board. Borrowers are able to shop and lenders find themselves competing aggressively on rates.

Competitive margin reduction was compounded when competing in a higher rate environment. During the first quarter of 2021, despite record high margins and volume across the industry, these competitive end market-driven challenges resulted in a 60 to 80 basis point average margin compression across both retail and TPO when compared to the prior quarter.

Looking back to the first quarter of 2020, margins have compressed significantly, on average, about 100 to 150 basis points for GSE products. Our retail consumer direct channel is the primary driver of GSE originations and was able to scale to a strategic $250 million run rate following its reinstatement of running in the second quarter of 2020.

While the market shift and impact of margin compression can be felt in the industry around GSE originations, we remain committed to serving consumers in the GSE and government lending spaces while also growing our NonQM opportunities across all channels. This is an important pivot for the company, allowing it to navigate shrinking GSE margins, while driving revenue in the NonQM space.

NonQM's reemergence across the market was met with credit and pricing disadvantages that restricted the addressable market of consumers and investors. During the first quarter of 2021, credit, pricing and overall investor interest returned, allowing Impac to resume one of its core competencies and product offerings. Gross margins for NonQM returned to healthy 400 to 500 basis point range by the end of the first quarter in 2021, following 2020 margins that were significantly less than GSE products.

The retail consumer direct channel has also contributed to Impac's overall NonQM originations since 2016. And as Jon noted, additional marketing allocations have been deployed to leverage the expertise in the call center to drive this business once again.

Pipeline compositions have started to shift slightly over the quarter, and the addressable market for self-employed and investor focused consumers is strong. In addition to retail NonQM originations, the primary driver and focal point in ramping up our NonQM production remains within our third-party origination, or TPO channel. The momentum around relaunching NonQM products within TPO has grown considerably over the quarter, with overall loan volume doubling from the beginning to the end of the first quarter this year.

The overall composition of the TPO pipeline was over 90% NonQM at quarter end. We increased the sales and operations headcount by about 10% quarter-over-quarter, which contributed to the ongoing growth of the TPO channel, in line with the strategic expense allocated to growing NonQM across the platform.

We took an iterative and risk-focused approach to updating our credit box and guidelines throughout the quarter to provide a competitive offering to the market, while maintaining high credit quality. Impac will continue to originate in the GSE space, but will remain diligent around the market conditions impacting margin and competition.

Impac's advantage in cultivating a renewed NonQM offering will remain a central focus of the company, along with the continued growth of its wholesale and correspondent channels. Driving process improvement and technology innovation to maximize the NonQM experience for our counterparties will also be top of mind as this market shifts further toward alternative credit opportunities.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Out first question comes from the line of Trevor Cranston from JMP Securities.

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

You guys talked some in the prepared remarks about the pressure in gain on sale margins, which occurred, obviously, during the first quarter. Can you maybe help us sort of contextualize and think about that in terms of kind of where you see margins, I guess, specifically on the agency business today versus even where they were in the first quarter?

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

So specifically around the agency production, Q4 2020 to Q1 2021, it's about a 60 to 80 basis point reduction.

Justin R. Moisio - *Impac Mortgage Holdings, Inc. - Chief Administrative Officer & Corporate Secretary*

And so, Trevor, we're going to feel that in the call center, but we're not going to feel that -- the nice part is we're not going to feel that in our TPO channel. And due to the aggregator model, which, as everybody is aware that we're running currently, we're not in a position to simply just chase volume as some folks have to right now at the detriment of margin.

We're trying to hold our margins pretty firm with where they are. And we're going to have to adjust the composition within the call center. As everyone mentioned on the call, you started to move some of that marketing spend around where it was predominantly that GSE refinance type marketing. It's now pivoting a bit towards NonQM, which will be helpful. And we've also brought in some folks to help originate that VA product.

So we're not quite at the point where we were pre-COVID. We had separate teams for these products, but ideally, that's where we would be in the coming months. And those products, especially NonQM with where we've seen the margins come off the mat there considerably, we really think that a limited amount of NonQM production will offset the decrease in volume from a GSE perspective within the call center because that pipeline has shrunk a bit for the call center GSE production, which is fine.

That's something that, as we said, we anticipated. So I hope that, that helps.

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

Yes, that's very helpful. So on the NonQM business, as you sort of reemphasized that and shifted focus, can you maybe spend some time talking about the loans you guys are currently originating and products you're offering? How that looks today as you've reentered that business and it started to grow more meaningfully today versus what you were doing pre-COVID? And also maybe talk about the landscape of investor demand, if there's been any significant changes that you've seen in terms of what investors are looking for in loans and kind of the economics of the execution of selling loans to investors?

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

Yes. Trevor, I'll take the second part of that question and hand it back to Justin and Tiffany for the product type that we're originating today. I'd say that since the market healed, I mean we were very encouraged in the second and third quarter of last year with the capital markets ability to absorb what had been overhang of NonQM product in the marketplace when the markets became dislocated in the first quarter. And it took a bit of time to clear that overhang.

The overhang was mostly cleared with securitization. And then we've seen in the fourth quarter leading into the first quarter an acceleration of investor demand again, probably whole loan buyers that were reverse engineering into securitization exit. So our gross margins, Tiffany mentioned this earlier in prepared remarks, but our gross margins for NonQM were executing again at close to $1.05 price. And so out of our broker channel, our TPO channel, we've got close to 500 basis points of gross margin in the retail channel. When there's an opportunity to also charge points in fees, we'd have gross margins north of that. And so we're very encouraged by the back end execution.

And we've sold -- the Wall Street firms have come back aggressively bidding for the product. Certainly, hedge funds and alternative investment vehicles -- I mean it's no surprise, right? There's a tremendous push for yield in this market as long as the Fed continues to buy $100 billion plus of treasury and mortgage product, pushing yields down as there is an incredible push for yield in marketplace and NonQM fills that void nicely.

So -- and Justin, Tiffany, I don't know if you want to touch on how our product design might look a little different or maybe it's really just back to the future that the markets now creating product that looks very similar to what we've always been creating.

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

Sure. Yes, this is Tiffany. I would say that the core offerings within NonQM have remained relatively unchanged with respect to a bank statement offering -- a 12- to 24-month bank statement offering, business purpose, DSCR loan, asset depletion and also a full dock product. So that's relatively unchanged.

Certainly, the credit box around those products has migrated over the last year. We're starting to see more of a normalization of the guidelines that opens up that box a little bit more closely aligned with some of the pre-COVID credit offering.

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

Great. Okay. That's helpful. And I guess on the expense side, you mentioned in the prepared comments that you're continuing to invest and hire for the rebuild of the NonQM channel. Can you talk about where -- kind of where you are, overall, in that process? How much more investment in hiring do you think you need to do? And maybe as the demand for agency refi strength, is there any sort of offset there in terms of the overall expense level? Or do you -- some of the -- some of the people who have been more focused on in the agency business and consumer direct, is that going to be kind of just shifted over to the NonQM focus going forward?

Justin R. Moisio - *Impac Mortgage Holdings, Inc. - Chief Administrative Officer & Corporate Secretary*

So Trevor, I can start with that, and Tiffany can weigh in and if George has anything to add, we can do that as well. So obviously, within the call center, we discussed kind of the way in which you'll see that GSE production volume start to come down because we're not going to give up that margin there with how tight it's already gotten. But some of the folks, most certainly, can pivot over from an operational standpoint over to that TPO world, specifically our underwriters and things of that nature can move over nicely.

We'll repurpose some of our agents to be focused more on those alternative credit products. And that shift from an expense standpoint within business promotion, I don't anticipate for that to have any sort of material increase, at least for the next quarter, because we're just going to reallocate some of the money within that channel.

Within -- now within TPO, we already have started to invest in that as evidenced, just from a pipeline makeup because I've seen a lot recently with some of the larger shops doing the broker business are really having to quickly pivot here. But just so you're aware, from a pipeline perspective, at the end of the year within our TPO channel, it was only about 19% was NonQM production opposed to today, which is roughly 90% of that production. So we've already made that shift so it won't be that noisy to hire into. But we are being very strategic in terms of additional specialized resources for the channel.

So George, I don't know if you want to touch on that component for NonQM?

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

Sure. I mean, Justin focused on some of the operations and the credit piece and the sales pieces. But I'd say that we -- one of the lessons that we took away from the COVID crisis of last year is that the need for us to have some more sophistication around capital markets in terms of how the loans that we originate model out for investment-grade levels for securitizations, and how we can then take that reverse engineering of securitizations and be more precise on how we price the themes of some of our offerings.

And so we've -- we're very close to securing some additional resources within our capital markets teams that will permit us to do that. And that would give us another leg away from simply bidding comp exit for our NonQM offering or mandatory forwards, we hope before the end of the year, be able to access the securitization market like we had in years past.

So I think you'll see that coming out of us in the next several months there'll be some announcements around those resources.

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

Okay. Great. I guess the last question, you guys had been working with sort of target of hitting $250 million a month of originations, which, obviously, been successful at doing. As you look forward and the product mix shifts more to NonQM and the agency refi side comes down, is the $250 million a month of originations target still applicable to how you think about the business? Or has that shifted in light of, you think the product mix shifts going forward?

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

Well, I think Justin spoke a little bit about that earlier with respect to the shift in pipeline composition. So I would expect that $250 million, while we would certainly like it to remain constant we have to adjust with the reaction to the GSE products in the market. So I would expect that to possibly reduce that GSE composition and then continue to supplement and grow NonQM and VA on top of that.

Justin R. Moisio - *Impac Mortgage Holdings, Inc. - Chief Administrative Officer & Corporate Secretary*

And it's on us, obviously, to execute at this point, Trevor, but just the NonQM, the margin there fills in the gap significantly compared to these tighter GSE margins from what you've seen across the industry. So to get back up to the combined run rate is a different number, and it's totally dependent upon how much NonQM the company can originate.

But when we spoke to that $250 million number, probably third quarter was when we announced that target, that was we were originating just pure GSE production from the call center and TPO wasn't even up and running yet. So it will be a different make up at this point.

Operator

And there are no further questions, please continue.

Justin R. Moisio - *Impac Mortgage Holdings, Inc. - Chief Administrative Officer & Corporate Secretary*

Thank you. I was going to say at this point, it looks like there's no other questions. So we thank everyone for joining us today, and we'll be back speaking to the market in early August for our second quarter earnings release. Thank you all.

Operator

This concludes today's conference call. Thank you all for participating, and you may now disconnect. Have a great day.