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EDITED TRANSCRIPT

IMH.A - Q2 2020 Impac Mortgage Holdings Inc Earnings Call

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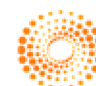

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CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Second Quarter 2020 Impac Mortgage Holdings, Inc. Earnings Conference Call. (Operator Instructions) As a reminder, this conference call will not be recorded.

I would now like to turn the conference over to your host, Justin Moisio.

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

Thank you. Good morning, everyone. Thank you for joining Impac Mortgage Holdings Second Quarter 2020 Earnings Conference Call. During this call, we will make projections and 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. We'd 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 any outlook and any guidance, is effective as of the date given. And we expressly disclaim any duty to update the information herein.

I would like to get started by introducing George Mangiaracina, Chairman and CEO of Impac Mortgage Holdings.

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

Good morning, and thank you for joining Impac Mortgage Holdings Second Quarter 2020 Earnings Call. The company's executive team is with me this morning, Paul Licon, our CFO; Tiffany Entsminger, our Chief Operating Officer; Justin Moisio, Chief Administrative Officer; and Tom Donatacci, Chief of Staff.

In our first quarter earnings call on June 26, we discussed that the company had created substantial momentum across all lending channels in January and February with preliminary unaudited GAAP and core earnings of $5 million and $14 million, respectively, and that we were poised for a significant increase in originations and earnings before we experienced the adverse impact of COVID-19.

Federal Reserve's emergency rate cut on March 15 and the resumption of its mortgage back securities QE program created unprecedented volatility in the interest rate and credit markets in which we operate, materially affecting our GSE and NonQM businesses, respectively.

In previous earnings calls, we discussed how the company's GSE-driven call center and NonQM-driven third-party business functioned in a complementary manner; the call center being scalable and providing high-volume at reasonable margins in a refi environment; third-party business offering inelastic volume and superior margins. As a result of the significant market dislocation caused by COVID-19, the value was signed by investors and counterparties for credit-sensitive NonQM assets declined substantially in the first quarter of 2020 and continued into the second quarter, which necessitated our efforts to protect franchise value by aggressively deleveraging our balance sheet and operating platform. These

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were difficult but necessary decisions to make and precluded us from being able to immediately participate in the favorable interest rate environment for the GSE-driven call center.

Our deleveraging actions were completed by the end of April on a trade date basis -- on a settlement date basis by May month end, preserving our liquidity and positioning the company's return to originating loans. At June 30, we carried an unrestricted cash balance of approximately $43 million and unencumbered whole loans with a fair value of $30 million. The company's debt-to-equity leverage ratio and its wholly owned licensed origination subsidiary, IMC, was reduced to less than 1.5:1 as of the end of June.

The company's June 4 press release expressed the view that market conditions and external factors had sufficiently stabilized that the company had elected to restart our retail lending activities. The industry is currently enjoying attractive margins, and we're positioned to take advantage of the opportunity. Primarily, the secondary market spreads are historically wide and have stretched the capacity levels in the industry extending locked fund times.

The company has always been recognized an industry leader in origination turn times and can compete favorably on service in this market. In July, our first full month since returning to originating, we funded $67 million of retail loans. Our pipeline grew to $155 million by July month end. We anticipate to continue to build the retail platform volume to a run rate of approximately $250 million by September.

At current margins, this volume should produce positive core earnings. The company believes that its existing borrowing capacity under its warehouse lines are sufficient to fund its near-term origination activities.

The relaunch of the TPO channel will take place in the first half of the third quarter with an expanded product set to include NonQM, VA, jumbo and GSE origination. We expect a similar ramp to that of our retail platform in terms of volume with loans funding in the latter part of September and into October.

With respect to NonQM, we are prepared to participate in the emergence of this alternative market segment. A number of participants have returned to the NonQM space and have created liquidity in the sector, which had all but evaporated in March. Extensive work has been done by the company on this product as it relates to revised credit policy guidelines, and we are focused on continuing our conservative view relative to the market as it relates to FICO, LTV, credit overlays and layered credit risk.

The company's product restart will be led by bank statement investor product offerings. We expect origination volumes in this product to be tempered by the fact that the industry has not yet created a standardized approach to address NonQM loans that opt in to forbearance plans. We will proceed cautiously while we work with servicers, investors and rating agencies on this evolving topic.

NonQM has historically been a key differentiator for the company and aligns with our position as a leader in alternative credit markets. We intend to remain prudent and vigilant with respect to risk management.

With respect to MSRs, the company sold $137 million of UPB, of Ginnie Mae mortgage servicing rights, on July 31. The initial settlement proceeds were additive to the company's unrestricted cash balance. The company was a participant in Ginnie Mae's PTAP program, which provided financing on P&I advances. The facility was paid down in full in July, but we are likely to utilize it again as Ginnie Mae originations and retention of MSRs resume.

Additionally, the $4 billion unpaid UPB of Freddie Mac MSR sale reported on our last earnings call closed on May 31 and transferred on July 1. Before turning the call over to Paul Licon, I would like to commend our Board of Directors and senior management team again for their steadfast focus during these times. I would also like to thank our dedicated employee base for remaining loyal to our firm and to our culture and for returning to the mission of creating shareholder value with excitement and enthusiasm.

Paul, I'll turn it over to you now to talk about operating results.

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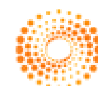

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Paul Licon - *Impac Mortgage Holdings, Inc. - CFO, CAO & Controller*

Okay. Thank you, George. As we mentioned in our previous earnings call, the end of the first quarter and beginning of the second quarter was a difficult time due to the uncertainty and market volatility caused by the pandemic. To face these headwinds, the company went on the defensive and accomplished a number of objectives to protect and preserve liquidity, which included pausing our lending operations, selling most of our remaining loans in the for-sale portfolio, repaying all the balances on our warehouse lines, selling a significant portion of our MSR asset, repaying our MSR borrowing facility in full and extending the maturity of our $25 million of convertible notes. These activities allowed us to reduce our margin call exposure and provide us the liquidity needed to accelerate our recovery in Q2 and beyond.

Although we restarted operations in late Q2, the financial results of the quarter are characterized by significantly lower ending activity due to the pause in lending operations for most of the quarter. Gain on sale of loans in Q1 was $1.5 million versus a loss on sale of loans of $28 million in Q1.

In addition, as a result of pausing our lending operations, we reduced total expenses from $30.8 million in Q1 to $14.5 million in Q2, led by a reduction in personnel cost from $20.7 million in Q1 million to $7.8 million in Q2. GAAP net loss before tax improved from $64.7 million in Q1 to a loss of $22.8 million in Q2, while core earnings also saw a significant improvement from a core loss of $56.1 million in Q1 to a core loss of $10.4 million in Q2. Our 2020 year-to-date GAAP net loss before tax was $87.5 million, while our year-to-date core loss was $66.4 million compared to 2019 year-to-date GAAP net loss of $8.6 million and core earnings of $6.1 million.

Turning to liquidity. As of the end of Q2, we had $43 million in unrestricted cash and a little over $30 million in unencumbered loans on our balance sheet, of which a little more than half were settled earlier this week, and the remainder are expected to be monetized in the next few months. And these proceeds will be additive to our cash balance versus $80 million in unrestricted cash and $3 million in unencumbered loans as of the end of Q1.

As mentioned previously, in Q2, we used a portion of our cash to pay off warehouse lines to deleverage and reduce margin call exposure, which led to the increase in unencumbered assets during the quarter. In addition, we currently have 3 warehouse lines with a combined borrowing capacity of $575 million. Based on our current cash position and borrowing resources, we feel we have the liquidity to not only meet our near-term production goals but also to have the liquidity necessary if we need to scale operations quicker than expected.

As we recently relaunched our lending operations at the end of Q2 and due to the nature of the mortgage industry being a pipeline-driven business, we don't expect to see the full operational or financial impact of our lending operations until the end of Q3 or beginning of Q4. However, as George previously mentioned, we are seeing substantial growth in our pipeline month-over-month. As our lock pipeline continues to grow and convert to our loan held for sale portfolio, we expect to see revenues, net income and core earnings increase.

Based on current margins and marketing conditions, we expect to reach our income-generating goal of $250 million a month at funding volume in late Q3 or early Q4 as we remain focused and committed on expanding and growing our lending operations in a responsible and disciplined manner.

I'll now turn it over to Justin to discuss near-term production mix and product focus.

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

Thanks, Paul. As discussed in our previous call, the targeted $250 million monthly production run rate in the third quarter will be originated through our retail call center. We're focused on segments of the market that have demonstrated adequate and stable capital markets distribution exits, which will initially be GSE, FHA and VA lending.

Keeping in step with these other originators, we've reevaluated the credit box within these product offerings, instituting some overlays where necessary and remain competitive and responsible in our approach to serving the market. We continue to maximize the lead volume generated organically by the call center with little to no marketing spend since the first quarter of this year.

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Currently, our capacity model suggests that we're tracking to originate and fund $250 million monthly by the end of the third quarter. We continue to add talent to the call center to promote efficiency and drive process improvements while we ramp our volume. This month, the company will relaunch its TPO channel. The channel will phase its approach to product launch, starting with VA and evaluating conventional QM jumbo and NonQM. The company intends to participate in NonQM and originations in the same thoughtful and risk focused way as in the past. Impac has a storied history around alternative credit, being a pioneer in both the all day and NonQM space. We continue to have strong appetite around NonQM and continue to pay attention to the changing forbearance landscape, borrower behavior and appropriate risk-based pricing for these products.

In addition to adding talent in the call center, we're adding staff to the TPO channel with experienced government, jumbo and NonQM resources. We anticipate competing competitively in rate, product and service levels, while optimizing margins and originating loans with sound credit risk.

At the end of the first quarter, we furloughed and reduced staff, commensurate with our pause in origination activity in March as we prioritize the protection of our liquidity. However, the company reinstated a significant number of its employees in addition to retaining key personnel, and we continue to hire in both operations and production to meet current origination targets. The company currently has about 250 active employees with approximately 75% supporting production. This compared to an active employee headcount of approximately 550 and, of that, about 65% support of production at the end of February.

We remain focused on adding talent to our team to support ongoing lending operations. We're adequately staffed to meet our targets as well as some access capacity as needed. With that, I'd like to turn the call back over to George. Do you have any closing remarks or you want to just move into Q&A?

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

Yes. Let's open the call for questions.

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

So with that, we can open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

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

Thanks, and actually, I'll jump in because earlier, we received a list of questions from Trevor Cranston of JMP Securities prior to the call. So I'll go through that and read those to the team.

First question, "as you ramp back up on lending volumes, can you comment on how much lending capacity you had beyond $250 million per month? Could you handle volume in excess of that if mortgage rates continue to decline and demand continues to grow?" So Tiffany, if you want to take that?

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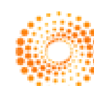

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Tiffany Entsminger - *Impac Mortgage Holdings, Inc. - Chief Risk Officer & Head of Operations*

Sure. One of the strengths of our platform is that we're able to scale and contract very quickly, and we build in stretch capacity to all of our capacity planning to account for rapid market changes. As we leverage outsourcing, both onshore and offshore as well as technology tools to supplement the headcount we needed, this helps with times of significant growth. Our adopting headcount at the $250 million mark have the ability to take on additional volume. And once we reach that target, if it's determined, we want to further grow the platform, we would leverage our recruiting, training and internal tools to target any new origination goals.

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

Thank you. Next question from Trevor. "As third-party lending comes back online, what do margins look like in that business versus what you're producing in cash call?" So Tom, I think you can take that one.

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

Sure. Margins, excluding those for NonQM, are generally wide by historical norms and quite attractive right now. In the retail platform, we're seeing conventional margins at approximately 1.5 to 2x what they were in the first half of 2019 with approximately a 50 basis point narrowing in margin for TPO. Ginnie Mae and VA margins are strong today as well with the spread between the retail platform and TPO being approximately 175 basis points. Conversely, TPO NonQM margins are lower than pre crisis due to the fact that many investors are currently capping their price at 102.5% to the seller.

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

Great. Thank you. Trevor's third question. "How much, if any, does business promotion expense need to increase to hit the $250 million monthly run rate? What about for volume to grow beyond that?"

So I can -- I'll take that one. Since we restarted our origination activities, we've been able to leverage our current organic lead volume, and we've had little spend in business promotion since the first quarter, actually. We do anticipate that we will start spending into marketing to supplement where needed but at a much lower rate than in January and February of this year.

On a go-forward basis, to reach that $250 million monthly run rate, we expect to spend probably between 5% and 10% of what our monthly average was the business promoted during 2019.

Trevor's next question, I'll read it, but I think we sufficiently answered it in Tom's earlier response. "Can you say what type of gain-on-sale margins are baked into our forecast to return to profitability?"

So I think we touched on that with the margin discussion.

The next question. "As you look to restart NonQM lending, can you provide any color on how much investor demand there is for loans today versus pre March or some of your previous loan purchasers not back in the market yet? And how much warehouse capacity do you have available for NonQM loans given your other origination volumes are growing?" So Tom, back to you on that one.

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

Sure. Investor demand has largely returned to pre March levels for NonQM. And substantially, all the investors that existed pre March for Impac are currently active again. Investor demand in the aggregate is strong, but the product profile has changed. It has generally become more conservative regarding higher FICOs, lower LTVs. Impac has always originated high-quality NonQM with a conservative loan characteristic, so this shift in the

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market has had little effect on our production profile. One area that is getting greater focus now than pre crisis is a forbearance EPO and EPD language in the purchase agreements.

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

Great. Next question, "do you have a target for monthly NonQM volume later this year?" So I guess you can tack on to the previous with that.

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

Sure. Sure. We're starting off with a disciplined ramp for NonQM, with a target run rate of $15 million to $20 million per month in 2020, rising to a $75 million monthly run rate by the middle of 2021. Our current warehouse agreements allow for more than these projections will require.

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

Okay. And lastly, is the liquidity level you are carrying at June 30 the level we should expect for the foreseeable future? Or do you anticipate running with lower liquidity levels when those markets stabilize. So Paul?

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

Sure. Well, I think for now, one of our top priorities is going to be maintain our cash balances and keeping a strong liquidity profile. And the reason for that is really twofold. On the upside, we want to be prepared for continued or higher-than-expected growth. But two, we also want to have a safety net during expected or even unexpected times of volatility like what you've recently seen in the markets. But it's really this last part, the unknown, that's difficult since it's impossible or even difficult to predict when these markets will actually stabilize. However, as we grow, we do expect to invest some of our capital in our operations. But that being said, we do feel that our current cash position, our warehouse line capacity and expected cash flows from operations do provide us the strong platform we need for future growth but also for us to be ready for the volatility that we may continue to see in these financial markets.

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

Okay. Great. Thanks. That -- those are all the questions we received to date. So with that, I'd like to close the call, and we look forward to speaking back out to the market in November for our third quarter earnings. Thank you all.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day. You may all disconnect.

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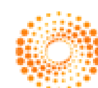

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