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IMH - Q2 2015 Impac Mortgage Holdings Inc Earnings Call

EVENT DATE/TIME: AUGUST 07, 2015 / 4:00PM GMT

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Impac Mortgage Holdings, Incorporated second-quarter 2015 earnings call. (Operator Instructions). As a reminder, the call is being recorded Friday, August 7, 2015 and I now would like to turn the call over to Justin Moisio with Investor Relations. Please proceed.

Justin Moisio - *Impac Mortgage Holdings, Inc. - VP, IR*

Thank you. Good morning, everyone and thank you for joining Impac Mortgage Holdings' second-quarter 2015 earnings conference call. During this call, we will make projections, estimates, assumptions 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. I would like to get started by introducing Joseph Tomkinson, Chairman and CEO of Impac Mortgage Holdings.

Joseph Tomkinson - *Impac Mortgage Holdings, Inc. - Chairman & CEO*

Good morning. Welcome and thank you for joining our second-quarter earnings call. On the line with me in the room is Bill Ashmore, our President; Todd Taylor, our Chief Financial Officer; and Ron Morrison, our General Counsel.

Let's begin with a brief review of the results for the second quarter of 2015. In the second quarter, the Company reported net earnings of $16.8 million or $1.33 per share and this compares to $34 million or $2.94 a share for the first quarter and $82,000 or $0.01 per share for the first quarter of 2014. Excluding the deferred tax benefit in the first quarter, we have delivered some very good earnings of $27 million in the first half of the year and this compares to a loss of $2.9 million in the first half of 2014. Our net earnings increased significantly over the first half of 2014 primarily due to an increase in our operating income from additional volumes and net earnings of the acquired CashCall Mortgage division.

Further, the first half of 2015, we have had some significant GAAP accounting items to work through. Mostly these are related to the CashCall Mortgage acquisition and as a result of the first quarter and second quarters, this year has required us to spend a lot more time explaining and laying out the overall financial results. Having said that, we believe the Company had very positive operating results in light of substantial mortgage rate volatilities for the first half of the year.

Operating income as reflected on the income statement shows a decrease to $16.7 million in the second quarter as compared to $17.2 million in the first quarter of 2015 and shows an increase compared to a loss of $4 million in the second quarter of 2014. However, the income statement in the first half of 2015 includes a number of items that are required by GAAP and are not related to the current operating results. These items are all related to how we are required to account for the CashCall Mortgage acquisition and/or discussed in detail in the earnings release.

We believe it is more useful to discuss the operating results excluding these items to get a better understanding of the ongoing and future operations of the Company. Adjusting for these items, net earnings before taxes for the second quarter of 2015 was $8.6 million and this compares to $10.3 million in the first quarter of the year, primarily due to an overall decline in the gain on the sale of margins.

In the second quarter of this year, our total originations increased to $2.6 billion, up from $2.4 billion in the first quarter 2015. Of the $2.6 billion in total originations, approximately $1.6 billion or 60% was originated through CashCall Mortgage retail channels.

In the first half of the year, we have originated approximately $5 billion in total volume as compared to just $818 million through the first half of last year. Additionally, in the first half of 2015, our wholesale volume of $698 million has already surpassed the wholesale origination channel's total production of $580 million for all of 2014. The same can be said for our correspondent channel. For all of 2014, the correspondent channel standalone business, excluding CashCall production, was approximately $1.1 billion. In just the first half of 2015, the comparable correspondent production has been approximately $1.2 billion.

The expansion of our business channels in the second quarter of 2015 has seen an increase of 60% in purchase money transactions over the first quarter of 2015. We believe the trend of increased production with a greater percentage of purchase money loans in these channels will continue for the second half of 2015. We believe our efficient retail channel will complement the wholesale and correspondent businesses by increasing overall gain on the sale margins and lowering overall costs for mortgage originations. We anticipate that these channels will continue to see a growth month over month as a result of the increased pipeline growth that both channels have recently enjoyed due to our marketshare expansion.

Pursuant to the CashCall Mortgage asset purchase agreement, during the first quarter of 2015, gain on sale of loans was net of CashCall Mortgage operating expenses. Beginning in the second quarter of 2015, the operations of CashCall Mortgage were reported as a component of our operating expense. Therefore, the operating expenses are no longer a reduction to the gain on sale of loans reported in the first quarter. This is why it appears there was a dramatic increase in personnel expense and business promotion expense in the second quarter.

If the gain on sale revenue recognized in the first quarter did not include operating expenses for the CashCall Mortgage division, the gain on sale margins for the first quarter would have been approximately 230 basis points as compared to 186 basis points in the second quarter. It should be noted that, during the first quarter 2015, mortgage interest rates were the lowest they have been since 2013 and as expected, had higher margins due to expansions of margins during this dropping rate environment.

The declines and gain on sale margins in the second quarter were predominantly in the CashCall Mortgage consumer direct channel while in the business-to-business channels wholesaling correspondent channels saw an expansion of margins in the second quarter of 2015. In the second quarter of this year, our overall gain on sale margins declined by 19% or 44 basis points primarily as a result of an increase in approximately 40 basis points in the mortgage interest rates resulting in reduced margins in the CashCall Mortgage consumer direct channel.

I might want to also add this was totally expected. The gain on sale margins of CashCall Mortgage tend to fluctuate with the pricing and hedging strategy it uses in the division to focus on creating long-term profitability. However, this pricing and hedging strategy sometimes results in shorter-term volatility. The hedging and pricing strategy can produce higher margins in a decreasing rate environment, but can also result in short-term volatility and gain on sale margins in an increasing rate environment as we saw and as we expected in the second quarter of this year.

As a result of this pricing and hedging strategy in the consumer direct channels, as interest rates fluctuate, we expect to continue to see this volatility in margins in the consumer direct channel. In an effort to reduce this volatility as part of our strategy, we have been taking steps, including the introduction of different loan products, the geographic expansion and the establishment of a third-party retention program, which will create an additional source of revenue within the CashCall Mortgage channel and over time, this approach will create less volatility and longer-term profitability for the Company overall.

The CashCall Mortgage consumer direct channel's marketing strategy is to offer attractive mortgage loans, interest rates through television and radio advertising to create lead generation for the call center. In the second quarter of 2015, advertising costs increased as part of our efforts to develop a national advertising campaign to better leverage the CashCall Mortgage brand and as we continue to expand our geographic marketing efforts programs from CashCall Mortgage's original 11 license states to 45 license states. The marketing that began in the second quarter expanding CashCall Mortgage's footprint is only the beginning of our efforts to solidify its brand as an efficient, best rate available mortgage provider. CashCall Mortgage's ability to close loans in 15 days with a high level of consumer satisfaction will be a central theme in this channel's expansion.

During the second quarter of this year, we successfully completed two financing transactions and this totaled $55 million. In May of this year, the Company announced that it had issued a $25 million convertible debt issuance. Also in June 2015, the Company announced that it had entered into a $30 million credit facility with the Macquarie Group. This capital will be used to support the warehouse haircut requirements associated with the higher volumes that we are seeing of other products and contingent consideration payments associated with the acquisition of CashCall Mortgage.

The Company's current capital position allows for the continued growth of the mortgage lending platforms, as well as providing the ability to selectively retain mortgage servicing rights. At the end of the second quarter of 2015, the Company's cash position had increased to over $34 million from $5.6 million at the end of the first quarter. At June 30, 2015, the Company's mortgage servicing portfolio increased to $4.1 billion and this is a 58% increase from March 31, 2015 and the retained mortgage servicing rights increased to $44.2 million as of June 30, 2015 and this compares to $26 million at the end of March 31 of this year.

Our warehouse lending division continues to grow and finance receivables representing our warehouse lending advances to our warehouse customers increased to $54 million as of June 30 this year. During the second quarter of 2015, the warehouse lending division had $213 million in fundings as compared to $124 million in the first quarter of 2015.

Now let's turn to what we are seeing early in the third quarter. Despite the recent increase in the pipeline over the first-quarter levels, July production dropped to $740 million. However, it is expected that August and September will be substantially stronger production months.

We also have been able to expand our margins in the consumer direct channel from the end of the second quarter. As a result of the expanded state licenses in our CashCall Mortgage channel and the nationwide marketing campaign, we are now seeing an increase of applications within these newly licensed states and expect to begin to generate funding in both the third and the fourth quarter. To provide additional context, CashCall Mortgage only originated loans in 19 states during the second quarter.

Now in the third quarter, it will grow to 36 states and then in the fourth quarter, 41 states. This expanded national lending footprint will unlock significant opportunities to greatly diversify the CashCall Mortgage loan production and increase its total production. The geographic expansion, additional loan product offering and the anticipated service retention business is expected to mitigate the reduced refinance activity expected during the latter half of 2015 and it will maintain the CashCall volumes throughout the rest of the year.

In addition to CashCall Mortgage, Impac's business-to-business channels of wholesale and correspondent will also be part of our overall growth during the second half of 2015. Currently, our business-to-business channels mostly run rates are around $360 million and growing. These channels also complement our current retail mix of business with nearly half of the business-to-business production being purchase money transactions and now 45% FHA and VA loans.

Even though our Alt-QM loan volumes were a little lower than forecasted, we believe that these loan programs will be an important part of the overall production story. In July, as a result of the feedback from our borrowers and our business-to-business channels, we have simplified our Alt-QM program guidelines, which are expected to create a more origination-friendly loan product. These changes will further provide flexibility to help qualify high credit quality borrowers that are unable to get financing from the current traditional mortgage programs. As a result, we have seen a significant increase in our Alt-QM pipeline. However, we do not anticipate these programs providing a material amount of revenue to the origination channels until 2016.

Now with regard to our business-to-business channels during the last half of this year, our strategy is to remain to increase the percentage of our customers' delivery, multiple loans per month and expanding geographically in the Midwest and East Coast states. In addition, our non-delegated underwriting channels in both wholesale and correspondent sellers will continue to expand as we have seen throughout 2015.

Even though the Company faced headwinds in the second quarter as a result of rising interest rates, the Company still delivered very solid earnings. Early indications are that the third quarter will have improved lower margins as interest rates retreat from the second-quarter levels and consumers adjust to slightly higher interest rates. I misquoted that or I misstated it. We will have improved margins as interest rates retreat from the second quarter.

I ran out of paper. Did you guys forget to give me the rest of it? I think that is the close. Anyway, this concludes my prepared remarks and we will now open the telephone lines to any questions that you have and especially I hope someone has some questions regarding volatility of interest rates. I think that one of the things that I want to comment on is -- and I've said this before -- that this Company, this management team has always, in the last 28 years, managed interest rate risk very, very successfully and that is what we did in the second quarter. Second-quarter interest rates were expected to go up as they are expected to go up at the end of the year. And again, I want to emphasize that by increasing the product mix, by diversifying into different states, by expanding the loss mitigation of -- excuse me -- not the loss mitigation, but the retention business, all of that is going to mitigate the volatility in the interest rates.

Now do we have any questions? I hope not.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Austin Hopper, AWH Capital.

Austin Hopper - *AWH Capital - Analyst*

Thanks for taking the questions. I got on a little late, so I apologize. You got an earnout with CashCall based on the recent acquisition. Can you just maybe indicate what you are obligated to pay them from your Q2 financial performance?

Todd Taylor - *Impac Mortgage Holdings, Inc. - EVP & CFO*

This is Todd Taylor. I can take that. The second-quarter earnout was based on an earnout percentage of 65% of the CashCall Mortgage division earnings and it approximates about $8 million.

Austin Hopper - *AWH Capital - Analyst*

Thank you. Great. And then I don't know if you talked about this at all, but can you tell us what the rate locks were in May, June, July and then so far in August?

Joseph Tomkinson - *Impac Mortgage Holdings, Inc. - Chairman & CEO*

Can we get back to you on that? We will take a look at the pipeline.

Austin Hopper - *AWH Capital - Analyst*

Okay, great. Great, thank you.

Operator

(Operator Instructions). Elliott Altman, Axa.

Elliot Altman - *Axa Advisors - Analyst*

Congratulations on another successful quarter. My question is regarding the deferred tax asset and whether or not further recognition will be realized this year based off of your net earnings in the first and second quarter. If production stays the same, it looks like you will have higher net income than the deferred tax asset going forward.

Todd Taylor - *Impac Mortgage Holdings, Inc. - EVP & CFO*

This is Todd Taylor again. I can take that. The deferred tax asset that we recognized in the first quarter is associated with expected tax benefits in 2016 and 2017. In the second quarter, when we were looking at our projected taxable income, we did not have enough evidence to continue to record an additional asset. But as far as time goes on, it is hard to predict what it is going to be into the future because it has to do with projections of taxable income, which is not necessarily indicative by just the GAAP earnings. So there is a number of adjustments in there to get to taxable. So it is hard to predict. We possibly could be recognizing more deferred tax asset into the future, yes. But I won't know that until we get further -- closer to those periods.

Elliot Altman - *Axa Advisors - Analyst*

Okay, thank you. Also I would like to know the pipeline as well from the other gentleman who just previously called, so that would be great as well as of the end of the quarter.

Joseph Tomkinson - *Impac Mortgage Holdings, Inc. - Chairman & CEO*

I think what the gentleman was also asking, and I think Bill has just stepped out to go look it up, but there was a significant increase in the pipeline, but they are looking it up right now. Okay?

Elliot Altman - *Axa Advisors - Analyst*

Okay, excellent. Thank you.

Joseph Tomkinson - *Impac Mortgage Holdings, Inc. - Chairman & CEO*

Because we have it all, I will give it to you on this call.

Elliot Altman - *Axa Advisors - Analyst*

Thanks.

Operator

Chip Saye, AWH Capital.

Chip Saye - *AWH Capital - Analyst*

Thank you for taking my question. Joe, I wasn't at the annual meeting, but I was able to look at the 8-K that was released on it, so I appreciate you doing that. I have a question from that 8-K. You were talking about originations and it said if we continue on this path, our projections show that we will do somewhere in the neighborhood for 2015 of roughly $10 billion through all channels, a big increase over last year and I just wanted to know is that still the goal for 2015?

Joseph Tomkinson - *Impac Mortgage Holdings, Inc. - Chairman & CEO*

Yes, that is the goal. I'm going to turn it over to Bill Ashmore in a second. For the gentleman that asked what the current pipeline is, the pipeline as of 8/5 is $1.8 billion and that is an increase from the end of May of $200 million if that helps you guys. Okay. Bill?

Bill Ashmore - *Impac Mortgage Holdings, Inc. - President*

Yes, there's a couple of factors in there that are the wildcards and a lot of it has to do with where rates are going to go. As you saw in this first quarter, our first quarter was a big down drop in interest rates and we had a big upswing in volume. Second quarter was flat to slightly higher with rates going down, but compressed margins. Obviously, third quarter, we are talking about a much better quarter, but we are probably not going to see elevated production numbers over the second quarter. So the goal is still the $10 billion. I think we will be close to it and depending upon where rates are and how this third quarter unfolds, and whether we can hold this total pipeline in throughout the quarter, then we still have a good chance of hitting or exceeding the $10 billion.

Chip Saye - *AWH Capital - Analyst*

Okay, so it is still the goal, but you said obviously Q1 was really big in terms of originations Q2. You think Q3 will be similar to Q2, is that what you are saying?

Bill Ashmore - *Impac Mortgage Holdings, Inc. - President*

That is what we are looking for. The July production was down from the end of the second quarter, but the pipeline is elevated to a point where we can see kind of a flat from second to third quarter. Looking to fourth quarter to be a bigger quarter.

Joseph Tomkinson - *Impac Mortgage Holdings, Inc. - Chairman & CEO*

You have got to remember on interest rates, when they swing, there is always a downturn and I mentioned this on my last call that we fully expected, at the shareholders meeting, that we fully expected downturn. It has always been, when you have an increase in interest rates, you are going to see a falloff in production. And then as the consumer becomes acclimated to the new interest rate environment, then the production picks up again. That is exactly what we are seeing.

Chip Saye - *AWH Capital - Analyst*

Okay, I appreciate that color. So as we know, historically, Q1 big, Q2 less, Q3 something similar to Q2 and then Q4 people have had a chance to acclimate to the different rates and you are looking for a really big Q4?

Joseph Tomkinson - *Impac Mortgage Holdings, Inc. - Chairman & CEO*

That is a pretty good characterization.

Chip Saye - *AWH Capital - Analyst*

Okay, I appreciate it. Thank you.

Operator

(Operator Instructions). There are no further questions from the phone lines at this time.

Joseph Tomkinson - *Impac Mortgage Holdings, Inc. - Chairman & CEO*

I guess this ends our question-and-answer series, so I'm going to take my God-given raspy voice and end the call and I appreciate everyone that participated. Thank you.

Operator

Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your lines. Thank you.