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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Impac Mortgage Holdings 2021 Third Quarter Earnings Conference Call. (Operator Instructions)

And now I would like to turn the call over to General Counsel, Mr. Joe Joffrion. You may begin sir.

Joseph O. Joffrion - *Impac Mortgage Holdings, Inc. - Senior VP & General Counsel*

Good morning, everyone, and thank you for joining Impac Mortgage Holdings Third 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 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 and Form 10-Qs filed 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 any outlook and 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*

Thank you, Joe. Good morning. Justin Moisio, our Chief Administrative Officer; and Jon Gloeckner, our Treasurer and Principal Accounting Officer, will join the prepared remarks. Obi Nwokorie, our EVP of Alternative Credit Products; and Tiffany Entsminger, our Chief Operating Officer, will be available for the Q&A section of today's call.

Approximately 3 months ago, during our Q2 2021 earnings call on August 12, we discussed that the company continued to grow its retail and TPL origination platforms, while continuing to remain focus on liquidity and risk management following the 2020 COVID crisis. The company's last business update expressed the view that market conditions in the GSE space had continued to normalize with margins narrowing as the capacity to originate in process loans in the industry caught up with consumer demand.

These trends within our rates business generally continued in the third quarter and are anticipated to remain in effect through the end of the year, absent the material move in interest rates. We also previously referenced the increasing investor demand, expansion of underwriting guidelines as well as improving margins for the company's NonQM production, a competency of the firm that we're currently investing in with capital market securitization talent and a growing sales and operations team. Our credit business exceeded expectations for the third quarter, measured by the increase in our NonQM origination volume and forward submission in locked pipelines.

The company reported net GAAP income of $2.1 million or $0.08 per diluted common share and core earnings of approximately $800,000 or $0.04 per diluted common share for the second quarter of 2021. Core earnings are an alternative measure of results that senior management utilizes to gauge the company's performance. Core earnings isolates results from recurring business activities by adjusting for certain nonrecurring items, such as changes in the fair value of our long-term debt and our 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 total originations of approximately $680 million in Q3 2021 versus $610 million in Q2 2021, with NonQM originations contributing $186 million in the third quarter versus $100 million in the second quarter. We do not typically provide forward-looking guidance, but we will note that our locked NonQM pipeline was only $10 million at the end of 2020, $80 million at the end of Q2 and approached $200 million as of the end of October 2021. This marks a significant accomplishment for our NonQM franchise, which we relaunched in earnest post-COVID market dislocation in the fourth quarter of 2021 and demonstrates the company's pivot towards NonQM originations across both our retail and our TPO channels.

We anticipate continued growth of NonQM originations with attractive margins in both origination channels and for the NonQM production ramp within our TPO channel to accelerate as new account executive additions, acclimate their customers to our products, competitive pricing and market-leading service levels. We believe in the market opportunity and demand for NonQM and the company's ability to be an innovative market leader in this segment.

Since 2004, we have originated in excess of $4.5 billion of NonQM steadily, yet responsibly, increasing our production from $130 million in 2015 to over $1.25 billion annually in the 2 consecutive years leading up to the COVID crisis. The company, subject to capital markets and liquidity conditions, projects to fund $1.5 billion in NonQM in 2022, with an increasingly steep monthly run rate over the third and fourth quarters of next year.

As we noted in our Q&A session, during our previous earnings call, the company has now established the seasoned structured products capital markets team, led by Obi Nwokorie, based in New York City. This should enable the company to directly or synthetically access the securitization market and opportunistically retain economic interest in the subordinated tranches and asset management and servicing fees of our offerings, evidencing our confidence in the long-term performance and risk-weighted returns of the loans we originate.

Turning now to our long-standing preferred B litigation. As we disclosed in our 8-K filing on July 19, 2021, the Maryland Court of Appeals issued an order, which affirmed the lower court's ruling, specifically that the proposed 2009 amendment to the preferred B articles did not receive the required votes, and therefore, the original preferred B articles will remain in place.

I'm going to turn the call over now to our General Counsel, Joe Joffrion for a more detailed update on this matter. Joe?

Joseph O. Joffrion - *Impac Mortgage Holdings, Inc. - Senior VP & General Counsel*

Thanks, George. As a result of the court's order, the company will be required to pay approximately $1.2 million in unpaid dividends to certain preferred B stockholders, which amount was previously accrued by the company back in 2018. The payees of the unpaid dividends will be determined once the Circuit Court determines the basis for an appropriate record date. In addition, the court's order required a special meeting of preferred B stockholders for the election of 2 additional directors of the company. Co-plaintiff, Camac Fund, called for a special meeting of preferred B stockholders, which was convened on October 13, 2021, but adjourned by a vote of all shares present to November 23, 2021, due to a lack of quorum sufficient for election of directors.

The company is hopeful a quorum will be achieved at the next special meeting date, and we will welcome the new directors once selected and look forward to their contributions, especially in aligning the company's stakeholders to create a sustainable capital structure and strategic vision for the future. With respect to payment of future dividends on preferred B stock, such dividends are cumulative, however, they are not payable unless declared by the Board. The preferred B stock is perpetual with respect to both its liquidation preference and payment of dividends.

At this time, there is no intent to declare any dividends on the preferred B stock especially in light of the $82 million in short- and long-term debt that has seniority in the company's capital structure. Additional information on the company's capital structure, the court's order and the special meeting of preferred B stockholders can be found in our 10-Ks, Qs and 8-K filings. Jon Gloeckner will now discuss the operating results for the third quarter of 2021. Jon?

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

Thank you, Joe. For the third quarter, the company reported GAAP earnings of $2.1 million as compared to a loss of $8.9 million in the second quarter and earnings of $1.6 million in the third quarter of 2020. For the third quarter, core earnings were approximately $800,000 as compared to a loss of $6.9 million in the second quarter and earnings of $4.4 million in the third quarter of 2020.

As mentioned in our previous earnings calls, 2021 continues to be a transitional period for many mortgage originators, including ourselves, as we have not been immune to the competitive pressures seen throughout the industry. During the third quarter of 2021, our originations were $680 million with margins of 287 basis points as compared to originations of $610 million with margins of 175 basis points in the second quarter of 2021. As we had indicated on previous calls, in the first quarter of 2021, we shifted our production to focus on NonQM as a result of the impending margin compression in conventional originations.

As a result, we were able to grow our NonQM production to $186 million with 26% coming from our retail channel during the third quarter, as compared to $100 million during the second quarter of 2021 with just 8% from our retail channel. The shift in our production focus and subsequent increase in NonQM production through both our TPO and retail channels was a key component in our $8.9 million increase in gain on sale loans as compared to the second quarter.

During the third quarter of 2021, our income -- other income increased $3.1 million in mark-to-market fair value gains on our net trust assets as a result of a decrease in residual discount rates, which was partially offset by $1.8 million in fair value losses on our long-term debt due to an increase in fair value as a result of a decrease in discount rates as well.

Changes in fair value of net trust assets and long-term debt are excluded from core earnings. Despite operating expenses being relatively flat at $19.7 million in the third quarter, personnel costs increased to $12.7 million from $12 million in the second quarter. The increase in personnel costs during the third quarter was primarily the result of an increase in variable compensation as a result of the increase in origination volume as well as the continued expansion of our NonQM franchise as we continue to add new talent. As we've stated on previous calls, in addition to the aforementioned increases in personnel costs experienced during the quarter, the competition for talent industry-wide has also contributed to an increase in personnel costs as compared to previous quarters, which continue to remain elevated across the industry.

Our business promotion expense increased to $2.2 million in the third quarter as compared to $1.8 million in the second quarter. This was primarily the result of our efforts to target NonQM production in our retail channel, expand production outside of California and maintain lead volume. While the company previously experienced a substantial amount of organic lead flow, the increase and competition has prompted an increase in marketing spend to maintain a consistent level of lead volume.

We currently have warehouse lines with a combined borrowing capacity of $575 million and expect to increase our borrowing capacity in the future to meet the growing funding demands of our NonQM production goals. We continue to carefully manage our liquidity and balance the demands of an aggregation model. Our strong liquidity position gives us the flexibility to continue to invest in the growth of our NonQM production.

I will now turn it over to Justin to discuss production activity during the quarter.

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

Thank you, Jon. As we discussed the last 2 quarters, the landscape of the GSE lending space continues to present challenges to growth. Decreased loan applications industry-wide is suggestive of the noticeable stagnation in GSE origination volume for many lenders competing for market share. While margins were impacted favorably earlier in the year by the removal of the 50 basis point refi adjuster, ongoing competitive pressure and rate movement has continued to constrict margins as well as the opportunity for growth around GSE products. Our retail channel, the primary driver of GSE originations, maintained relatively flat GSE production as compared to the second quarter. Impac will continue to originate in the GSE space, but will remain diligent around market conditions with an eye towards protecting margin and credit quality.

During the last earnings call, we discussed the important pivot within our consumer direct retail call center, allowing it to navigate shrinking GSE margins and offsetting this volume with NonQM origination volume and revenue. We have successfully made this pivot much earlier than anticipated. Our NonQM funding volume in the retail call center increased to $54 million in the third quarter, a substantial increase over the $8 million of NonQM funding volume in the second quarter of this year. This momentum continues to carry into the fourth quarter as the retail call center funded $30 million of NonQM volume in October alone.

As Jon mentioned earlier, our business promotion expense attributed almost entirely to our retail channel increased in the third quarter as compared to the second quarter. We increased business promotion to both maintain our GSE lead volume in the call center and augment targeted marketing to attract NonQM-focused consumers. While we're pleased with how quickly we have been able to shift focus and increase NonQM product in the call center, the results are unremarkable given the successful history of NonQM originations in our Consumer Direct platform.

In the 3-year span from 2017 to 2019, the consumer direct call center originated, on average, $300 million of NonQM annualized production. In total, $1 billion of the $4 billion in NonQM securitizations, backed by Impac collateral over the last 6 years, was driven by retail originations. By leveraging the sales and marketing expertise that was so successful in ramping up this product previously, we've compressed the time line significantly in shifting product composition within the retail channel.

With the aforementioned increase in business promotion, related to NonQM marketing in the consumer direct channel, we have seen a corresponding shift in pipeline composition. Currently, NonQM originations represent approximately 35% of our locked consumer-direct pipeline as compared to approximately 13% at the time of our last earnings call in August. Additional marketing allocations will continue to be deployed as needed to leverage the expertise in the call center and educate consumers around the NonQM product offering to further promote growth in the channel.

The primary focal point in ramping up our NonQM production remains within our third-party wholesale origination channel. Wholesalers traditionally been a driving channel around NonQM originations industry-wide as well as a successful vehicle for increasing volume within Impac over the last several years. Measuring from the first quarter of this year, the momentum around NonQM origination volume has steadily increased. As George mentioned earlier on the call, the company originated over $185 million of NonQM production in the third quarter as compared to $100 million in the second quarter of this year. Roughly 70% of our monthly NonQM production volume was generated through our TPO channel, with the overall composition of the TPO pipeline sitting at approximately 95% NonQM.

Through October, our monthly NonQM run rate across all channels in the organization is now over $100 million per month. The progress in our TPO channel is indicative on the unequivocal focus the business has on building a successful alternative credit platform. Precision around credit guidelines, pricing and service levels has promoted increased volume as well, with NonQM submissions increasing 25% month-over-month from September to October. The increase in submission volume within the wholesale channel produced the third largest wholesale NonQM funding month in October as compared to historical volumes at Impac since 2015, which is a remarkable accomplishment for our NonQM team.

While the dramatic growth of our wholesale channel, following its relaunch in the first quarter of 2020 has produced positive results -- I apologize, 2021, the TPO channel has still not fully relaunched the correspondent division. There is additional opportunity to capture market share and drive volume through delegated and nondelegated correspondent business relationships in the future once that is launched. In support of continued expansion and progress of our NonQM lending channels, we remain committed to investing in resources that drive operational efficiency, enhance technology aimed at providing improved counterparty experience and attract talent to grow our teams across underrepresented regions of the country.

We've added talented sales personnel to our workforce over the last quarter. We'll continue to build our NonQM teams within both channels to offer alternative credit products in the same thoughtful and responsible manner, which we've done since 2015.

That concludes our prepared remarks at this time. So at this point, we'd like to open up the call for any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

First question comes from Trevor Cranston, JMP Securities.

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

A couple of questions on the NonQM side. First, I guess, when you look forward to 2022, and I think you gave commentary that you expect the NonQM originations to be over $1 billion next year. Can you talk about how you see the split between wholesale and retail originations in that number going forward?

And then the second question would be, can you talk about sort of how you're thinking about the timing as to when you might be able to start retaining some interest in NonQM securitizations?

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

Trevor, it's Justin. So I'll take the first part of that. I'll let Obi touch on kind of -- and George touch on anything around -- our thoughts around kind of retaining those pieces. So I would expect, that going forward, while you'll see NonQM volume continue to increase in both channels, we won't be able to maintain the same growth trajectory that we've had. I mean you're still going to be at probably about 70% of that coming from wholesale, which is about where we are right now compared to retail.

But the number that George had put out there, I think, is a very attainable number because like we said, you already at $100 million of NonQM a month across all channels through October and that was about -- $80 million of that was wholesale and about $30 million of it was retail. So those splits could change slightly, but predominantly, it will come through the TPO channel. Obi, George, I'm not sure if either of you have commentary on forward looking around retaining any of that.

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

Well, let me -- I just -- I thought I heard Trevor say that we projected forward looking of $1 billion. We're already at $1 billion a year run rate given October volumes. So we're projecting $1.5 billion in 2022. And I think that's not aspirational. It's easily achievable. And then that segues into -- I think it sets up nicely. Obi being able to handle securitization -- part of being equipped to securitize as you need the volume to tighten up the aggregation periods. And so we thought we needed to get to something between $300 million and $400 million a quarter in order to introduce securitization as one of our capital markets exit. So we're there currently. Obi, maybe you want to take the follow-on to that.

Obi Nwokorie - *Impac Mortgage Holdings, Inc. - Executive VP of Alternative Credit Products, CIO & Director*

Yes. Thanks, George. So we've begun to address kind of the building blocks towards a securitization program. As you imagine, there are a lot of conversations with counterparties, bankers, lawyers, rating agencies, et cetera. So we've begun to address those. I think with respect to actual timing, it's going to depend on really how quickly we can get some of those pieces in place. Our intention, our goals, are to become a regular issuer of NonQM securitizations. And so whether that's end of first quarter or sometime in the second quarter, we'll probably be in a better position to update as to timing probably on the next call. But that is our goal to get something in place sometime early 2022.

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

Okay. Got it. That's helpful. And then we've seen a little bit of credit spread widening in the fourth quarter, which seems to have impacted securitization executions. And anecdotally, I've heard a couple NonQM investors say that they're seeing modestly lower pricing on loans. Can you comment on whether or not you guys are seeing that same sort of trend so far in 4Q? And if you would expect that to impact NonQM gain on sale margins at all?

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

Obi, if you want to take that one, too?

Obi Nwokorie - *Impac Mortgage Holdings, Inc. - Executive VP of Alternative Credit Products, CIO & Director*

Yes, I'll take that, Justin. Thanks for the question, Trevor. So yes, we've definitely seen softening in the NonQM pricing since the beginning of the fourth quarter. We show out, on average, 2 to 3 ports a month. And so we've probably shown out somewhere in the neighborhood of 5 ports since then, and we've definitely seen prices lower by between 75 to 100 basis points over that period. Obviously, it's driven by a combination of factors, sell-off in rates, flattening of the yield curve and a general widening of credit spreads due to strong supply and other seasonal factors. And so we basically, like I said, seen a softening there.

One of the things that we're doing and other originators are doing is adjusting rate sheets. And so we anticipate -- or we expect to begin to see those prices moderate sometime here shortly. But definitely, there has been a softening of prices. And I think originators are beginning to react to that. Does that address your question?

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

Yes, that's perfect. And I guess flipping to the conventional side for a second. First, do you guys have the mix between what the volume was in 3Q between purchase and refi? And then looking forward into fourth quarter, it seems like most lenders have been guiding for lower volumes seasonally and some increased compression and gain on sale. I was curious if you guys could comment to what you guys are seeing on that side.

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

Yes, Trevor. I think maybe Jon and I -- Jon, I'll give you a moment here, can take this one. So kind of splits there. I mean, obviously, with the call center being heavy refi, I mean, as an organization, you're looking at probably 80% to 85% purchase in Q3 -- I'm sorry, in refinance in Q3, which is down a bit compared to Q2 because in Q2, we were about, I would say, 90% to 92% refi. So a little bit more purchase money is coming through in Q3, bringing that down to about 85%.

As far as just overall GSE volume, things of that nature for what we're expecting in Q4, I can speak to a local market a bit. We've seen a decent amount of headcount reduction to GSE platforms. And I know there's chatter ongoing that we'll see more rightsizing of those platforms in this area, with competition in margins that really being the main driver. But as always, and we seem to talk about this every year at this time, seasonality plays a major part in that. So we would expect a slight dip in our GSE volume in the fourth quarter compared to third quarter.

However, with our pivot, as we talked about at length on the call to NonQM focus through the call center, ideally that reduction of whatever GSE volume falls off here in the fourth quarter is offset by that NonQM production as far as gain on sale. Jon, do you have any thoughts there?

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

Yes. Trevor, this is Jon. I'd say not necessarily GSE specific, but echoing what Justin and Obi have already touched upon, Q3 looked like the high watermark for us for gain on sale margins at about 287 basis points for the quarter. We had a significant increase in NonQM production with healthy margins, which made up for some of the GSE compression in both margin and volume. Outside of any material changes in interest rates or credit or other macroeconomic events, I would say our expectation would be that we will continue to see some compression in both GSE and NonQM, as Obi had mentioned, and the margins, which is reflective of the typical seasonality seen during the fourth and first quarters.

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

Yes, do we have any other questions online?

Operator

There are no further questions at this time. I would now like to turn the conference back to Mr. Justin Moisio.

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

Okay. Well, thank you, everyone, for joining us early this morning. We'll be back in the early part of 2022, providing an update on where we ended the year. So thank you all for joining us.

Operator

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