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IMH - Q3 2019 Impac Mortgage Holdings Inc Earnings Call

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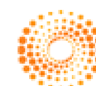

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Trevor John Cranston *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Impac Mortgage Holdings Third Quarter 2019 Earnings Call. (Operator Instructions) I would now like to hand the conference over to your speaker today, Justin Moisio, Chief Administrative Officer. Thank you. Please go ahead.

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

Good afternoon. Thank you for joining Impac Mortgage Holdings Third Quarter 2019 Earnings Call. During this call, we will make projections or other forward-looking statements in regards to, but not limited to, GAAP and taxable earnings, cash flows, interest 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 George Mangiaracina, Chairman and CEO of Impac Mortgage Holdings.

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

Good afternoon, and thank you for joining Impac Mortgage Holdings Third Quarter 2019 Earnings Call. With me this afternoon are Brian Kuelbs, our CFO, Justin Moisio, Tiffany Entsminger, Chief Risk Officer; Nima Vahdat, our General Counsel.

For the third quarter of 2019, the company is pleased to announce GAAP earnings of approximately $1.4 million and core earnings of approximately $8 million. This marks the first consecutive quarters of both positive GAAP and core earnings for the company since the second and third quarters of 2017. The year-to-date 2019 GAAP loss of $7 million contracts -- contrast to 2018 same period GAAP losses of $139 million. $132 million favorable delta or approximately $6.25 per share. The year-to-date 2019 core earnings of $14 million contrast to 2018 same period core losses of $28 million, a $42 million favorable delta or approximately $2 per share. Core earnings are an alternative measure of results that senior management utilizes to gauge the company's performance. Core earnings attempts to isolate results from recurring business activities by adjusting for certain nonrecurring items, such as changes in fair value of long-term debt and trust assets, impairment to intangible assets, including goodwill, changes in contingent consideration, gain or loss on mortgage servicing rights and other nonrecurring legacy matters. We introduced this concept almost a year ago and provide a table within our latest earnings release to enable variation analysis between prior periods. In our view, the $42 million favorable delta in core earnings year-to-date 2019 to 2018, are more accurate measure than traditional GAAP and reflect the effectiveness of the initiatives we've executed over the last year of repositioning the company.

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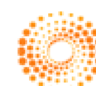

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The company continue to benefit from prevailing low interest rate environment in the third quarter. Originations in the third quarter exceeded $1.6 billion versus $800 million in the second quarter and only $580 million in the first quarter of 2019. The call center was the primary driver of the increased volume more than doubling volume in the third quarter over the second and tripling volume in the third quarter over the first.

In previous earnings calls, we discussed the company's ability over market cycles to contract to scale our consumer direct call center to calibrate at the changing market conditions. While we have increasingly focused attention and resources on our NonQM franchise, we remain cognizant of our dual mandate to maintain optionality within the call center and quickly capitalize on GSE origination during low rate environments. The ability to execute a material increase in volume in the second, third quarters of this year, validates our investment in the call center and our commitment to maintaining a diversified product and channel offering.

The company's GSE-driven call center and NonQM-driven third-party business is a complementary. Call center is scalable, providing high-volume at reasonable margins in a refi environment, a third-party channels to our NonQM offerings introduce interest rate in elastic volume at superior margins. The momentum created this year should accelerate in the future as we continue to invest in technology, product design, industry talent and geographic expansion.

We would like to note that in the third quarter, our GSE margins normalized as compared to the second quarter of 2019. Our call center is known for closing loans in expeditious time frame, on par with the best in the industry as measured by time of lock to close metrics. In the early stages of this refi cycle, these efficiencies and our ability to quickly add capacity resulted in outsized gain on sale margins on our GSE production in the second quarter of 2019.

Margins typically revert back to normalized levels as competition adds capacity and projects a differential between primary and secondary pricing to the consumer. This, in fact, incurred in the third quarter and is reflected in our gain on sale numbers this reporting period. An additional contributing factor to the GSE margin compression, we experienced in the third quarter was the heightened focus on prepay speeds.

In March of 2019, the uniform mortgage-backed security, the UMBS issuance program was initiated, trading with the first settlement occurring in June, requiring an increased focus by Fannie Mae and Freddie Mac on standardizing prepayment speeds at the direction of the Federal Housing Finance Agency, or FHFA. The FHFA established single security governance committee, evaluates changes in programs, policies and practices of the GSEs that influence cash flows to their securities. A key component of this mandate is to align the observed prepayments at various cohort levels across Fannie and Freddie MBS.

To accomplish this objective, the FHA established CPR thresholds with the goal of limiting Fannie and Freddie cohort divergence, no more than 2 CPR, with early warning when 2 CPRs breached. When the difference exceeds 3 CPR, the FHA requires the cause of the divergence to be reported to the Single Security Committee. There is a higher degree of scrutiny with respect to prepayment speeds than anytime previously.

Our call center production, especially in a low-rate environment is heavily California and refinance-weighted. Prepay speeds since the summer have been elevated in general, particularly for California loans that share characteristics historically correlated to higher than national prepay experience. These characteristics include high FICO, low LTV and large loan size, consistent with our call centers core production. Brian Kuelbs will discuss these market dynamics and the effects on our GSE margins on a more granular level in his prepared remarks later on in this call. I will now turn the call over to Tiffany and Justin for further comment.

Tiffany Entsminger - *Impac Mortgage Holdings, Inc. - Senior VP & Chief Risk Officer*

Thanks, George. We started the quarter with significant momentum, nearly doubling our funded units in the call center month-over-month from June to July, and ending the quarter with our highest funded volume of the year. This favorable rate environment contributed to record efficiencies for our loan originators in a way that push the boundaries of traditional staffing models for our fulfillment team. The flexibility of the call center platform allowed us to quickly adjust models to add capacity in department level infrastructure and to provide support for the large influx of volume.

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We remain focused on hiring experienced staff, while also recognizing the talent inside the organization. The combination of attracting seasoned industry professionals from local markets, along with creating opportunities for internal growth resulted in both positive results and a positive culture for the floor. To meet volume demands, we added physical space by leasing an additional floor in our existing buildings through 2020. We've been aggressively adding production staff to the new floor and anticipate reaching level set capacity in Q1 of 2020, subject to a favorable rate environment, along with adding new loan agents through our training program. We've also added a number of seasoned originators and specialty originators to help bolster our specialty teams, such as the VA, FHA and NonQM. We remain focused on product diversity, in addition to capturing GSE origination opportunity in the current market, growing capacity while maintaining a well-rounded staff with experience originating and funding all of our product offerings, provides us further optionality.

We anticipate making these specialty teams a permanent part of the platform to provide optionality between GSE and NonQM offerings going forward. Concurrently with the volume and capacity growth throughout the quarter. We remain steadily focused on origination and funding efficiencies across the board. We realized improvements in loan level cost to origination and fund, in part due to the increased volume but also attributable to tangible improvements in output and accuracy from our staff. Our third-party origination channel is focused exclusively on NonQM production. We saw relatively flat results in the third quarter for wholesale, with a slight increase in correspondent volume at the end of the quarter.

We've invested significant resources in operational improvements and technology aimed at increasing volume in counterparty experience. One metric worth noting here is that we rounded out the last month of the quarter with less than a 24-hour turn time for underwriting, which is a significant and positive outlier in the industry. This provides us a competitive advantage in an underwriting landscape where competitors are outsourcing underwriting and using offshore resources as well as experiencing delayed turn time. Within the correspondent channel, we see diversity in our competitors' NonQM offerings around product and pricing. While some originators appear to be embracing lower credit tiers, it's important that we remain -- that we maintain a competitive offering without compromising our credit philosophy. Year-to-date, our NonQM originations across all channels, average a FICO over 720 and an LTV under 70%, supporting the idea that we want to encourage responsible lending. Heading through the fourth quarter 2019, we expect to see a downward trend in volume due to seasonality. We've adjusted marketing spend accordingly to maximize return during this period with a return to normalized spend and origination activity in January 2020, subject to market conditions.

We continue to focus on maximizing opportunity across all platforms, while managing our capacity responsibly. I'll now turn it over to Justin.

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

Thank you, Tiffany. During the third quarter, as a result of borrowers and agents focused on a lower rate environment, we experienced a decrease in NonQM production within our consumer direct call center. In October, to reverse this trend, we created a stand-alone NonQM team within the call center. This team will exclusively receive all NonQM leads separate from conventional GSE loan agents. It falls under a separate compensation structure. Because of these changes, the call center doubled its NonQM production in October as compared to September. Based on the increasing NonQM pipeline in the call center as well as the increased ramp on digital marketing spend to support this NonQM team, we expect to reach a more normalized monthly run rate of $30 million to $40 million in NonQM production during the first quarter of 2020. Further, as we continue to diversify our call center platform, we've created an additional team to capitalize on the government market. This new team will initially be focused on VA loans, which, similar to NonQM have considerably higher margins than conventional loans in our last interest rate sensitive. Leveraging our core competency within the call center, speed to fund as well as aggressively pricing, we expect to take advantage of a profitable market share and diversify our product offering.

Our commitment to this endeavor is evidenced by our partnership with the Patriotic Service Dog Foundation, a nonprofit organization focused on serving our military and first responder veterans by raising awareness for their needs and providing service dogs to those who may benefit from long-term mental and physical assistance. This partnership creates an authentic aspect of philanthropy that should resonate well within the veteran community. While we have been originating NonQM and VA products for years through our call center by creating a stand-alone team, we create singular focus for each group to enhance production. As we discussed on our first quarter earnings call, the rate environment does have an impact on NonQM activity, not only within our call center, but also within our third-party origination channel. Unlike our call center, where we control the marketing spend, the brokers is the marketing agent for our TPO channel, and thus, the broker might direct their efforts for its conventional repeat business opposed to NonQM production. As George indicated in May, our macro view is that during a sustained refi cycle, the focus of the broker

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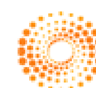

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community would be on conventional production opposed to NonQM, which is a different consumer, different qualification and a different underwriting process. Our NonQM production in the TPO channel remained flat from the third quarter as compared to the second quarter. However, through the first 9 months of 2019, our NonQM production is up slightly over 2018, despite a significant shift in the interest rate environment that require management and resources to be redirected towards conventional production. In spite of this, during the month of October, our TPO channel experienced a 30% increase in NonQM production from September. This substantial increase in NonQM production was a result of our continuing efforts to increase operational efficiencies within the channel as well as recent non-California account executive hires that will continue to boost business in previously underserved regions, and significant marketing efforts, engaging our existing client base. In his prepared remarks, Brian Kuelbs will give additional color on reduction of business promotion, but year-to-date, we've decreased our marketing spend 75% in 2019 as compared to 2018. Interest rates slid from Q2 into Q3, allowing us to continue to pull back on marketing spend. During this time, we experienced higher than normal organic inbound call volumes from old and new customers looking to take advantage of the low interest rate environment and refinance their conventional mortgages. Additionally, these calls converted to applications of fundings at a much higher rate than a previous quarters. Both the high-volume of phone calls and higher conversion rates, allowed us to reduce our spend in Q3 by almost 1/2 of what we would typically spend on marketing in a quarter. I would like to now turn the call over to Brian Kuelbs.

Brian P. Kuelbs - *Impac Mortgage Holdings, Inc. - Executive VP & CFO*

Thank you, Justin. I'll now provide a brief review of the results for the third quarter, starting with revenue. For the 3 months ended September 30, 2019, gain on sale of loans, net totaled $31.1 million compared to $13.7 million in the comparable period of 2018. The increase in gain on sale of loans is primarily due to an increase in mortgage loans originated and sold during the third quarter of 2019, as well as an increase in margins compared to the same period in 2018. For 3 months ended September 30, 2019, we originated and sold $1.6 billion of loans as compared to $900 million of loans originated during Q3 in 2018. During the third quarter of 2019, margins increased approximate -- to approximately 190 basis points as compared to 160 basis points for the same period in 2018. This increase in margins was a result of significant drop in mortgage interest rates during the third quarter of 2019, which allowed to wider gain on sale margins as compared to 2018. The primary drivers of margin expansion was an increase in our consumer direct originations, which increased to 85% of total originations during the 3 months ended September 30, 2019, as compared to 51% of total originations during the same period in 2018. In the second quarter of 2019, we experienced margin expansion to levels we've not seen in years as a result of the decline in interest rates as well as a shift in the percentage of NonQM production. However, during the third quarter of 2019, margins decreased to 190 basis points as compared to 359 basis points for the second quarter of 2019. The significant margin compression was experienced during the third quarter relative to the second quarter as the result of -- it was the result of increased competition for a retail direct loan originations, continued adverse treatment from capital markets and market resources focused on conventional refis versus more time-consuming NonQM originations. Margin compression in Q3 from Q2 is also due to primary secondary spreads remaining constant as rates declined and aggregators reducing purchase prices to manage their volume versus capacity. And while heightened UMBS prepayment speeds resulted in further reduction in prices and margins. These factors compressed margins quarter-over-quarter for the company, while volume originated doubled in Q3 versus Q2. The decline in Q3 margins due to elevated UMBS prepayment speeds has occurred in parts of specified pool creation that takes loans with lower prepayment cohorts out of the multi lender pools and puts them in single lender pools, which has increased prepayments and reduced prices for UMBS securities and further contributed to our compressed margins. I'll now address the liquidity and expenses.

First, liquidity. As of September 30, 2019, total warehouse borrowing capacity increased to $1.5 billion versus $900 million in Q2, just to support our growth of origination volume to $1.6 billion in Q3 versus $821 million in Q2. The available MSR financing capacity as of September was $23.8 million, and with the additional $600 million in warehouse financing, substantial liquidities for the company has been provided for. And now expenses. In the third quarter of 2019, total expenses, excluding impairment charges, were $25.6 million as compared to $28.3 million during the third quarter of 2018, a 9% decrease in total expenses. Key cost saves include business promotion, which decreased to $1.3 million for the third quarter of 2019 as compared to $4.4 million for the same time period in 2018. Mortgage rates declining has facilitated a reduction in more expenses TV media spend while still keeping capacity full with high quality of leads. General, administrative and other expenses decreased to $5.6 million for Q3 of 2019 compared to $7.9 million for the same period in 2018. During Q3 2019, personnel expense increased 17% or $2.7 million to $18.7 million from Q3 of 2018. The increase is primarily related to increased headcount and variable compensation to support the increase in originations in Q3. That concludes the financial results and our prepared remarks. I'll now open the call for questions.

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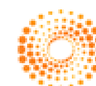

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We have a question coming from the line of Trevor Cranston.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

First question on the compression in the margin that you guys talked about, and I appreciate all the color around that, I think, the explanation of the drivers all made sense to me. But in terms of -- given the magnitude of the compression from last quarter to this quarter, can you give us a sense of, kind of, what the trend was in the margin throughout the quarter? And kind of roughly where you would see it today versus kind of what it averaged out being for the third quarter?

Brian P. Kuelbs - *Impac Mortgage Holdings, Inc. - Executive VP & CFO*

This is Brian Kuelbs. I think we saw pretty continuous and steady competition for loan originations in the primary markets as we transition to Q3, which took an immediate compression to our margins. We anticipate that pressure to continue through Q4, particularly now as we've seen a recent increase in market interest rates this week. And if the rates remain at the current level or continue to rise through year-end. Additionally, with seasonality factors considered, we'd expect the margin levels for Q3 to be consistent through Q4. And we may not see relief until 2020.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

Okay. Got you. That's helpful. And on the personnel expense line, it sounded in the prepared remarks like you guys continue to add people throughout the quarter. And I'm not sure if I heard this correctly, but or maybe continuing to add employees currently. So can you give us a sense of, kind of, where you're expecting the -- that personnel expense line item to come out, kind of, in the fourth quarter and sort of into the beginning of 2020?

Tiffany Entsminger - *Impac Mortgage Holdings, Inc. - Senior VP & Chief Risk Officer*

We should expect that to be relatively flat through the fourth quarter and heading into the first quarter of 2020.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

Okay. So meaning fourth quarter level should be relatively flat versus where the third quarter came in.

Tiffany Entsminger - *Impac Mortgage Holdings, Inc. - Senior VP & Chief Risk Officer*

Right.

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

Yes, and Trevor, this is George. The ads in terms of personnel, are more focused on standing up a VA-only team and a NonQM team, the ads will not be -- as we've reached it -- we've reached a fair level around capacity for our GSE business. So the ads that we intend to make in the fourth quarter and early first quarter will be around those other product lines and channels.

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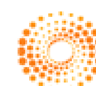

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Trevor John Cranston - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

Okay. I got you. And then -- so speaking of the specialized teams that you guys set up. I don't know if it's too early to say, but can you give us a sense of, kind of, the traction you're seeing within those teams, particularly on the NonQM side, and sort of where you guys think you can get that origination within the call center back up to as that team grows?

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

Yes. So Trevor, it's Justin. So like I said, we just stood up that team in October, and we already doubled that September production. It should be mid- to late first quarter, where we're back up to that monthly run rate of $30 million to $40 million a month for NonQM production and building from there. But isolating that team and separating it from the GSE production, separate comp plans, things like that, that's really enabled us to drive production of NonQM through the call center, which we have lost traction with over the last few quarters. So we'll see kind of just how much we can ramp, but $30 million to $40 million for the first quarter monthly run rate seems about right, and we'll give an update at that time in terms of additional traction organically.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

Okay. Great. And then on the third-party side, in the NonQM space. You mentioned that October results of -- a pretty good month there. It sounded like a reason was because of looking to expand outside more of California. Can you give any more color around that? And if you see that as a significant potential for growth, continuing to move into other geographies and sort of how much percent potential you see to continue growing in that manner?

Tiffany Entsminger - *Impac Mortgage Holdings, Inc. - Senior VP & Chief Risk Officer*

Sure. We're definitely focused on diversifying outside California. We focused some additional marketing attention and spend in other regions. And we're going to continue to try to get whatever volume we can that's non-California base just to have a much more diversified platform. We tend to see a little bit lower loan amounts in certain states that we do see comparable volume and loan amounts in other parts of the country. So we're focused in growing some of our sales force there as well as just retail, marketing and some organic volume that we have.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

Okay. Great. And then -- the last question for me. So you talked about the margin compression on the GSE side. Can you comment just briefly on how NonQM margins hold up in the quarter, if they were relatively flat, or if there is any significant change there?

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

Yes. They've held up flat per -- through the quarter, and we expect them to continue at Q3 levels through Q4 and into Q1. The market demand for the high-quality NonQM loans that we're producing is strong and deep and continues to build. So -- and we feel good about that asset class with regard to stable and attractive margins.

Brian P. Kuelbs - *Impac Mortgage Holdings, Inc. - Executive VP & CFO*

Yes. We also have a mechanism to take down forward rate lock on our NonQM production, and so we've done that over the turn. We're not -- I don't think anyone's really sure what's going to happen around liquidity at the end of this year. And -- so we've locked in effectively a large percentage of our production to the margins that are consistent with what we've had in the third quarter. So fourth quarter margins for NonQM should be right on top of third quarter borrowing anything unforeseen.

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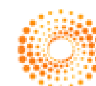

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I'm showing no further questions at this time. I would now like to turn the conference back to our speakers.

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

We have no further comments. So we look forward to speaking with everyone next year for our year-end conference call. Thanks a lot.

Operator

Thank you. 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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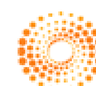

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