THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

IMH - Q2 2017 Impac Mortgage Holdings Inc Earnings Call

EVENT DATE/TIME: AUGUST 09, 2017 / 4:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

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

Justin Moisio *Impac Mortgage Holdings, Inc. - VP of Business Development & IR*

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

CONFERENCE CALL PARTICIPANTS

Henry Joseph Coffey *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

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

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter Earnings Conference Call. (Operator Instructions) .

I would now like to introduce your host for today's conference, Mr. Justin Moisio, Vice President of Investor Relations. Sir, you may begin.

Justin Moisio - *Impac Mortgage Holdings, Inc. - VP of Business Development & IR*

Thank you, and good morning, everyone. Thank you for joining Impac Mortgage Holdings Second Quarter 2017 Earnings Conference Call. During this call, we will make projections or other forward-looking statements in regards to, but not limited to, GAAP and taxable earnings, cash flows, interest rate risk and market risk exposure, mortgage production and general market conditions. I would like to refer you to the business risk factors in our most recently filed Form 10-K under the Securities and Exchange Act of 1934. These documents contain and identify important factors that could cause the actual results to differ materially from those contained in our projections or forward-looking statements. This presentation, including any outlook, 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 Joe Tomkinson, Chairman and CEO of Impac Mortgage Holdings.

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

Good morning. And again, welcome, and thank you for joining what is our second quarter earnings call. On the line with me is Todd Taylor, our Chief Financial Officer; and Ron Morrison, our General Counsel. This earnings call should be rather as short, as we had a fairly lengthy shareholders meeting about 2 weeks ago. As have we reported, our GAAP net earnings for the second quarter were $6.4 million or $0.32 per diluted common share and this is compared to net earnings of $12.3 million or $0.92 a share for the second quarter of 2016, which give -- these earnings were not unexpected, as the entire industry is seen a decline in overall production, and as a result, the adjusted operating income decreased to a loss of $174,000. And again, this is compared to $18.5 million for the second quarter of 2016. And again, I'm emphasizing that this was totally expected. The main reason for the drop in the operating income was due to a higher concentration of volume in the third-party origination channel as well as margin compressions, which the entire market has been experiencing, and this is due to the increased competition, which is chasing less available volume in the agency product, and I'm going to talk about that a little bit later in this presentation.

During the second quarter of 2017, the total originations as compared to last year for the same period, decreased 45% or $1.8 billion. However, we saw an increase over the first quarter of approximately 14%. So the -- as expected, our volumes are beginning to move in the right direction. Gain on sale margins decreased by 38 basis points, again, a 200 to 205 basis points in the second quarter of 2017 as compared to 243 basis points in the second quarter of 2016. Also, this was due to declines in the refinance market volume. Despite the total origination volume declines, our non-agency originations continue to increase. In the second quarter of 2017, the non-agency and government originations represented now a total of 40% of the total originations, as compared to just 16% of total originations in the second quarter of 2016. During the second quarter of 2017, origination volume of non-agency loans increased to $232 million, now this compares to $184 million in the first quarter of 2017, and more importantly, just

$289 million of non-agency production for all of 2016. So we're seeing significant increases in the non-agency production, and this is all in our business plan. Now despite the increase in non-agency volume, the volume has not yet reached to the levels we expected to achieve. So we have a lot more growth to achieve in the coming year.

In the second quarter of 2017, the retail channel accounted for 36% of the non-agency originations, while the wholesale and correspondent channels accounted for 64% of the non-agency production. Additionally, in the second quarter of 2017, the company's government loan production increased by $60 million to $481 million compared to $428 million in the first quarter of 2017. So the offset in the increase in the non-agency by the TPO business and the increase in the government loans, we hope, will offset the margin compressions in the overall agency production.

Let's talk a little bit about our strategy to retain the MSRs. In June of 2017, we had an increased size of our servicing portfolio by 11% from the end of the first quarter, bringing our servicing portfolio to $14.7 billion. As of today, our servicing portfolio has increased another $600 million to $15.3 billion. Our retained mortgage servicing rights increased in value to $152 million at the end of the 2nd quarter as compared to $141 million at the end of the first quarter. That's a pickup of approximately $11 million. In the second quarter, our mortgage servicing portfolio generated net servicing fees of approximately $7.8 million. This is a 177% increase in the servicing income during the second quarter of 2017 when we compare it to the second quarter of 2016. By year-end, if the company continues to grow its servicing portfolio to approximately $20 billion, it would then produce servicing fees of an excess of $10 million a quarter.

I'd like to highlight how strong the credit quality of this servicing portfolio is. As of June 30, 2017, this high credit quality servicing portfolio had a weighted average coupon of 3.77%. It had a weighted average loan-to-value of only 66%, and a high weighted average FICO of 737, with very low delinquencies.

Now I'm going to talk a little bit on what we've been focusing on currently at Impac. At the end of the second quarter, our total pipeline was approximately $650 million. This is an increase of $100 million quarter-over-quarter. As of June 30, 2017, our non-agency pipeline had increased to approximately $260 million as compared to $200 million at the end of the first quarter. This is another $60 million pickup. As mentioned during our previous earnings calls, we continue to push forward towards our returns in the securitization market with our non-agency production. We believe that by the middle of September, end of September, the company will have completed all of the necessary rating agency diligence work to begin to aggregate the non-agency production for securitization. It is our expectation that by the end of the year, we will be able to execute non-agency securitizations. The securitization market is important to us as it will allow us to further increase our market share and our servicing income. It will also give us the opportunity to invest in our own residuals, which will more than offset the margin compression we have seen in the agency conforming product. It is our expectation that our first securitization will be in the neighborhood of $300 million to $400 million, and our goal is to have this completed in the fourth quarter.

For last 8 months, we have been working diligently on our technology, and we don't talk a lot about the technology. But by the end of it at October, I expect to have our next-generation initiatives open to our third-party originators and customers, and this will allow them to access our non-agency programs seamlessly. This will allow for automated underwriting and compliance checks, which will increase not only our productivity, but also our customers. I am very excited about this initiative, and I will provide a much more update next -- at the next quarterly call. But through this initiative, we reiterate that our focus is to continue to build our servicing portfolio organically, both in the agency and the non-agency products. Additionally, the enhanced technology will increase our pull through rates, and our non-agency loans will see a decrease in our production costs. As the servicing portfolio grows, we will continue to see the associated income increase. As the number of securitizations increase, we will begin to see significant income spun-off from the non-agency servicing, but also significant income from the residual income produced by this non-agency product.

So in closing, I'd like to remind everyone, at the end of the year, our CashCall Mortgage earn-out will conclude. And beginning in 2018, the contingent consideration will no long be on our balance sheet, and most importantly, we hope to retain a 100% of the CashCall Mortgage earnings with no further earn-out payments. Additionally, given our significant net loss carryforwards, we expect to be very tax-efficient into the future.

This concludes my prepared remarks, and if you have any questions, I am open to take them.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Trevor Cranston with JMP Securities.

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

First question. You talked about the margin compression partially coming from the shift in the mix more towards the correspondent and wholesale channels. With the drop in interest rates we've seen, I guess, primarily through from sort of mid- to end of March through the end of June, there was a decent drop in rates. Are you guys seeing, currently, more refi volume coming through? And is there any expectation that the channel mix would potentially shift back more towards the retail channel in the third quarter if there is higher refi volume?

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

Well, the answer to that, Trevor, is yes, we would see an increase in refinance volume. The strategy has always been to balance the refi and the retail with the third-party originations. The retail has always been focused on the agency. It is gathering steam with the non-agency. But as we see an increase in the interest rates, we see a huge increase in the non-agency through the third-party origination. So my goal is to continue to balance that -- those origination channels, and by doing that, what we -- the end result is, we smooth out the highs and lows that the market with other companies sees. Also, I don't think enough attention is being given to maybe what we've been doing with the servicing portfolio. You know, the servicing portfolio is on target to generate somewhere next year in excess of $40 million, $45 million in net income. That's a huge increase. Also when we begin our securitizations, we will retain the servicing on the securitizations of the non-agency. The non-agency, I used to tell people years ago, I said, "Why are we so focused on agency? We should focus on non-agency. Why do you want to service for 25 basis points, when you can service for approximately 200 basis points." So that's our focus. And I hope that answers your question. The short of it is, every time we see a drop in interest rates, we see an increase in our refinance business.

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

Yes. Okay, that's helpful. And on the Non-QM, you mentioned targeting securitization of those loans hopefully by the end of the year. Can you say, based on other non-QM securitizations that have been in the market and in your own discussions with the rating agencies, if you were to securitize $300 million or $400 million of loans, how much the capital commitment from IMH would be to retain the residual interest and the servicing on those loans in the deal?

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

Right now -- okay, so there's a lot of different Non-QM products out there, and the term Non-QM is being generalized. So I can only speak to our product, but when I look at other securities, the product that's out there is, in a lot of cases, of the lesser quality. That's why I mentioned it in on the call here that our average FICO is 737, and that's an A plus product right there, and our average loan-to-value on this product is 66%. Now if you take a look at the other securitizations out there, you'll see FICO is significantly lower and LTV is significantly higher, and we've been able to tap into a market that we think is of the better quality. The indications, based upon from the rating agencies, that we have gotten in discussion and based upon our history of having previously done close to $100 billion of this type of product in the past, that our haircuts will be significantly lower than some of the competition out there. Now what that number is, I don't know. But we're probably -- internally here, we're thinking between 7% and 10% initially.

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

Got it. Okay, that's very helpful.

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

Let me get Todd's input.

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

Sure.

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

Trevor, this is Todd. Yes. I think that's pretty close. I think that's in[another] assumption that we'll be able to leverage the piece that we're going to retain too, so that our net haircut would be somewhere between 7% and 10%. So I think ultimately, yes, Joe's about right.

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

All right.

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

Got it. Last question from me. A small thing I noticed on the income statement. You guys have been fairly consistently recognizing some positive changes in fair value of the net trust assets. Can you just explain what's been driving that, if it's, sort of, driven by generally tightening credit spreads in the market? Or if it's more based on the actual realized cash flows that are coming in, in the trust?

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

Trevor, I'm going to let Todd answer that.

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

Yes. Trevor, it is based on higher expected realized cash flows. There is a trust that we have been able to cure the cumu loss trigger. And so what that means in plain english is, because it's performing at a higher level, the amount of cash coming to us increases. And so for a period of time, we expect to see this, and so we've incorporated that into the valuation, of course. That's not going to be forever, but it's going to be in the interim period of time until the OC -- the over the collateralization piece gets back down to what it would be kind of under normal circumstances. So -- I know that's a little bit complex, but you can call me later, I can get into more detail, but it is from a higher expected realization of cash for the interim period.

Operator

And our next question comes from Henry Coffey from Wedbush.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

In looking at the mix of business, it just -- on your origination mix, 40% of your business is split between government and non-agency, and 13% of that is non-agency. The other 60% is all traditional GSE product or anything other?

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

I'm sorry, but I'm not -- here I'm not sure what the question is.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

I'm looking at your originations. 27% of it is government, 13% of it is non-agency, and the other 60% is just traditional GSE product?

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

Correct.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

Okay. And then in terms of understanding the servicing portfolio, what's the breakdown in the mix of the servicing portfolio between those 3 asset types?

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

It's predominantly the traditional agency, which is Freddie and Fannie collateral. So right now, today I'd tap my head and I'm going to say, it's probably about 80% Freddie, Fannie, and then 10% government. And at this point in time, we are not retaining any Non-QM servicing, as we're selling [a way] whole loan basis, and that will probably remain the same until we get into a securitization that Joe spoke about. But -- and so, we don't -- we have very little non-QM servicing today in the books.

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

This is why I mentioned the securitization that we will be retaining, not only the servicing but the residuals.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

So you are selling the QM servicing released?

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

Correct.

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

Correct. Right now, we are. Yes.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

Okay. And then looking at the P&L, and -- hope this isn't too technical. That $6.7 million loss on MSRs, that's a fair value mark?

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

Yes.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

Any of that amortization? Or was all of that related to just the change in fair value at the MSR?

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

There is some amortization in that too. If it -- that changes based on mark-to-market change due to the change in rates, plus any [ROM] we saw, also due to the changing rates from people that might have refi, that we got the loan back as well as an additional piece of amortization. It's all in one number, Henry, because of the accounting in GAAP as we do for fair value. That's how you have to report it.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

So what is amortization portion of the $6.7 million?

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

Yes. It's a small component, probably. I don't know. Maybe $2 million.

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

If that.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

So theoretically, and I'm happy to spend 7 or 8 hours talking about GAAP and mortgage accounting, but theoretically we should be able to add that back to earnings to kind of get more of a core sense. So the business was much more profitable? Is that a fair way to think about it? I mean, this is isn't a credit impairment that we're looking at. This is just you wrote something up under the GAAP accounting, now you have to write it down?

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

It's just the movement of the other rates in the market.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

And then just my last question. My favorite term is non-agency and nonprime, and there's a couple of other nons, because then they -- Non-QM, so they don't tell us anything. You gave us a profile of the servicing portfolio which has a high component to it. Can you give us a sense of that, what your origination of the not QM product looks like?

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

Well, the Non-QM product, yes, I did give that. That was 66% LTV 737...

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

Okay. That's not the servicing asset. That's what you're originating.

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

That's where we're originating in the Non-QM space.

Operator

(Operator Instructions) And I'm showing no further phone questions at this time.

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

If there are no other questions, thank you for participating in this call, and this concludes our remarks. Thank you.

Operator

Well, ladies and gentlemen, thank you for participating in today's call. You may all disconnect, and everyone, have a great day.