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IMH.A - Q3 2020 Impac Mortgage Holdings Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Impac Mortgage Holdings Third Quarter 2020 Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to turn the conference over to your host Justin Moisio, Chief Administrative Officer. You may begin.

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

Good afternoon. Thank you for joining Impac Mortgage Holdings Third Quarter 2020 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 and 10-Qs 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*

Thank you, Justin. Good afternoon. Thank you for joining Impac Mortgage Holdings Third Quarter 2020 Earnings Call. The company's executive team is with me this afternoon.

On this call, we will discuss the state of the business and a number of key accomplishments for the third quarter of 2020, including the relaunch of the company's retail and TPO production platforms, the company's return to profitability and the company's extension of our convertible promissory note.

In our second quarter earnings call on August 7, we discussed that the company had executed certain deleveraging actions by the end of April on a trade-date basis and by the end of May on a settlement-date basis.

These actions preserve and improve the firm's liquidity and position the company to return to actively originating loans. The company's June 4 business update expressed the view of the market conditions, and external factors have sufficiently stabilized and the company has elected to restart retail lending activities.

At that time, we also stated that we anticipated restarting TPO lending activities in the early third quarter.

As we entered Q3, the market was characterized by strong margins, reflective of an imbalance between excess consumer demand relative to capacity constraints across the industry. As we marked the firm's 25th anniversary of its initial public offering in November of 1995, we are pleased to announce the company's return to profitability with positive GAAP and core earnings for Q3 2020, the first quarter since Q3 2019 that both metrics have been positive.

The company reported net GAAP earnings of $1.6 million or $0.08 per diluted common share and core earnings of $4.4 million or $0.21 per diluted common share. Origination activities related to GSE, FHA and VA products provided the earnings that returned the firm's profitability.

Fourth quarter results should further benefit from our recent announcement that we reengaged lending activities in the jumbo QM and the alternative credit NonQM product, which has historically been a core competency of the company.

As it further relates to production, the firm generated origination volume in excess of $400 million in the third quarter of 2020 versus only $2 million in the second quarter of 2020.

2020 second quarter volumes reflect our temporary suspension of lending activities during market dislocations. The firm's locked pipeline as of September month end was $350 million versus $100 million for June month end.

While it is challenging to project future performance, MBA an industry forecasts suggest a favorable environment for mortgage lenders in Q4 and throughout 2021. Mortgage Bankers Association forecast mortgage originations of $3.2 trillion in 2020 and $2.5 trillion in 2021 amongst the highest totals over the past 15 years.

With respect to NonQM, while the market has not returned to its pre-COVID crisis volumes, we are encouraged by its reemergence. The current NonQM market is characterized by tighter lending standards across the industry, in line with our firm's long-term view on alternative credit lending, defined by quality, performance and strict adherence to ability to repay our ATR guidelines.

We continue to believe in the market opportunity and demand for NonQM. The market has seen a sufficient number of capital markets investors return to the space and create ample liquidity and improving returns in the sector.

As stated earlier, improving and protecting the firm's liquidity has been a primary objective for the firm in 2020.

The firm's cash and unencumbered whole loan position was approximately $65 million or $3 per common share at the end of the third quarter. We believe this liquidity position as well as a continued focus on strongest risk management has prepared the firm to navigate future market volatility.

In line with these objectives, we would also like to thank our capital partners for their support and sponsorship relating to our October 28 press release, announcing our convertible promissory note extension. The firm has entered into final agreements with the holders of the notes that were due November 9, 2020.

These agreements extend the maturity date of the notes an additional 18 months to May 9, [2020,] and will decrease the aggregate principal amount of notes to $20 million following the firm's scheduled paydown of $5 million in principal on November 9, 2020.

All other terms of the notes remain the same, including the interest rate at 7% and the conversion price at $21.50 a share. The extension provides the company with ample liquidity to support ongoing growth and diversification as well as a margin of safety and stability and navigate potential future market dislocations.

Before turning the call over to our CFO, Paul Licon, I would like to commend our Board of Directors and our senior management team, again, for their steadfast focus in 2020.

I would also like to thank our dedicated employee base remaining loyal to our firm and culture and returning to the mission of creating stakeholder value with excitement and enthusiasm.

Paul, I'll hand it over to you to discuss operating results for the third quarter.

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

Great. Thank you, George. In Q3, we continued to execute on our plan to resume lending operations and ramp up production after pausing operations in March due to market disruptions caused by COVID. Not only have we had success in increasing funding production from $1.7 million in June to $215 million in September to $262 million for the month of October. We have done so while carefully managing our liquidity and increasing profitability.

As George just noted, we have extended $20 million of our $25 million in convertible notes that were originally due in November of this year for an additional 18 months to May of 2022 at the same funding cost.

This extended maturity gives us the flexibility to use our liquidity to continue to increase production and invest capital back into the company for continued long-term growth.

The financial results of the quarter reflected our increased production. Gain on sale of loans in Q3 was $19.3 million versus $1.5 million in Q2. As a result of increasing production volumes, total operating expenses increased from $14.5 million in Q2 and to $16 million in Q3, led by an increase in personnel costs from $7.8 million in Q2 to $11.2 million in Q3.

Under current production conditions, we expect compensation expense to level off. This, of course, is subject to market capacity constraints.

GAAP net income before tax improved from a loss of $22.8 million in Q2 to income of $1.6 million in Q3, while core earnings also saw significant improvement from a core loss of $10.4 million in Q2 to core earnings of $4.4 million in Q3 for a total positive swing in core earnings of $14.8 million during the quarter.

Our 2020 year-to-date GAAP net loss before tax was $86 million while year-to-date core loss was $62 million. This compares to 2019 year-to-date GAAP net loss before tax of $7.4 million and 2019 year-to-date core earnings of $14 million.

Turning to liquidity. As of the end of Q3, we had $55.4 million in unrestricted cash and $9 million in unencumbered loans on our balance sheet, of which we expect to monetize at carrying value versus $43 million in unrestricted cash and $31.6 million in unencumbered loans at the end of Q2.

In addition, we currently have warehouse lines with combined borrowing capacity of $550 million. During the quarter, our fund to settle turn times were in the mid-teens to low 20-day range. However, this remains subject to the risk of increased turn times and capacity constraints of our investors that is inherent in an aggregator execution model.

Based on our current cash position, product turn times and borrowing resources, we feel we have the liquidity necessary to meet our near-term production goals.

Based on current execution levels and marketing conditions, we expect to continue to increase income in Q4 as we exceed our original funding goal of $250 -- of $250 million a month, increase our product diversity and ramp up our TPO channel.

I will now turn it over to Tiffany, our Chief Operating Officer, to discuss production mix and product focus.

Tiffany Entsminger - *Impac Mortgage Holdings, Inc. - Chief Operating Officer*

Thank you, Paul. As previously mentioned, we resumed lending in the retail and wholesale channels in June and August, respectively. Ramping origination and funding volume month-over-month, we ended the third quarter on target for the projected $250 million run rate.

We expect to maintain this run rate through the fourth quarter of 2020 within stressed capacity and retail and a slight increase to projected wholesale volume by the end of the quarter.

The primary focus in both channels has been the origination of GSE and government products. Margins continue to be attractive in these spaces as well as the availability of diversified capital markets distribution exits.

While the initial tightening of the credit box resulting in GSE and government overlays across the industry has normalized to some extent over the last quarter, most lenders still maintain risk-based overlays, and Impac is no different.

We adjusted our credit box in line with many other lenders during the third quarter and continue to monitor these changes to maintain a competitive yet responsible offering in the retail and TPO markets.

Origination volume abounds across the industry and with that, capacity constraints and wage inflation has limited many lenders in their ability to maintain efficient cycle time. Despite any increased expense or competition for resources affecting our current models, we have retained, reinstated and recruited some of the outstanding talent in the market to support our current capacity run rate of at least $250 million a month.

We also continue to offer efficient cycle times to service our consumers and brokers. The company currently has just over 300 employees, up from 250 employees at the end of the second quarter and more than 50 employees added during the third quarter, primarily supporting retail production.

Organic lead volume continued to perform favorably throughout the third quarter, requiring little to no spend into business promotion month-over-month. As we continue to add new products to the channels, adjust marketing to support volume targets and manage seasonality, we anticipate increased spend in business promotion in the fourth quarter for 2020.

As previously noted, our warehouse capacity was reduced as part of our derisking strategy in the second quarter to better support our volume targets. We believe our current warehouse capacity is sufficient to maintain our ongoing origination volume and growth [production.] Synchronization and risk mitigation between our operations, post-closing and warehouse teams to settle assets efficiently, particularly around aggregator delivery is also a primary focus with respect to our continued growth.

We released our jumbo QM and NonQM products as scheduled in the wholesale channel at the end of the third quarter, in addition to a reemergence of investor interest in non-GSE alternative credit products. There seems to be a renewed commitment around liquidity for alternative credit products that abated during the COVID-19 market dislocation.

We are pleased to return to our core NonQM product suite as a complementary offering to our GSE and government products, and we remain optimistic around the growth opportunities in this space.

That concludes the financial results and our prepared remarks. Justin Moisio, our CAO, will now open the call for questions.

QUESTIONS AND ANSWERS

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

So we received some questions ahead of the call. Unfortunately, Trevor Cranston with JMP Securities had a scheduling conflict with our earnings call, busy time of year for everyone.

So I'll just read through some of the questions, which Trevor sent over. We can just kind of work around the table here.

Trevor's first question was, do you still see a $250 million monthly run rate as the right target? What do you see as an attainable production level for the TPO channel near term? So Tiffany, you can take that.

Tiffany Entsminger - *Impac Mortgage Holdings, Inc. - Chief Operating Officer*

The $250 million run rate is the right target to support what we consider to be a baseline level of profitability across the organization. I would say that we have capacity to do up to $350 million, really dependent on the ease of execution with the capital markets.

We're open to increasing the target, but we remain mindful of the risk associated, particularly with the aggregator delivery. The fact that we're still experiencing a global pandemic that had a pretty immediate effect on the market 2 quarters ago is something that we also want to be mindful of.

With respect to TPO, I could see us going to about a $50 million run rate by the end of the year.

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

So Trevor had an additional question regarding hiring employees capacity reach production goals. I think that ties in with what you said about our current capacity. So do you want to touch on that?

Tiffany Entsminger - *Impac Mortgage Holdings, Inc. - Chief Operating Officer*

Sure. So we're continuously hiring. We want to support our growth and also provide that additional stretch capacity beyond our current run rates. We're currently stocked adequately to meet our goals and then some. We want to try to stay ahead of the curve. There's definitely capacity challenges in the market right now. And we want to give the organization an opportunity to not just meet but exceed our goals.

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

Okay. Okay. Next question is related to margins. So Trevor inquired us to an update on our outlook for gain on sale margins in terms of where we are currently and then how we see that going into 2021. So Paul, just generally, any thoughts around that?

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

Sure. Yes. I mean, similar to the rest of the industry, we're seeing execution prices and related margins higher than historical average. Our outlook is that this will continue for the next 12 to 18 months at which point we do expect margins to compress as industry participants increase their capacity and start to work down their pipelines.

I think Tom has some additional color on that.

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

Yes. I think it's hard to talk about gain on sale and loan execution without talking about MSRs and the values associated with that component of the asset.

Liquidity has improved since the spring, and higher yields were quite attractive. And so liquidity continues to improve since the illiquidity event in the earlier portion of the year going into spring.

Interestingly, pricing really hasn't improved yet in line with that liquidity. And so Impac sees the economic value of MSRs as being greater than the market value being offered today.

And with that in mind, conventional yields are probably looking at 10% to 12%. Ginnie yields are probably 15-plus percent. And so we may look at retaining MSRs in the future.

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

Yes, this is George again. I'll just jump in. We get questions often about margins in NonQM product. Traditionally, you would expect margins in alternative credit products to be greater than margins in the GSE product in this universe.

However, the margins are about 50% better without getting into specifics on margins for each product, just that margins are 50% better in GSE than they are NonQM. And as a result, we direct a lot of our efforts in terms of advertising the LOs around the GSE products.

So it's an easier loan to originate quick return times exposed to the firm to less credit risk, we're hard-pressed to aggressively start originating NonQM again when the margin risk return profile is there, although we are building that business back. We're being very cautious around it and sensitive to pricing. Justin?

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

Yes. So I mean Trevor's next question was really around non-QM guidelines, progress on lack of clarity around loans and opt into forbearance. So Tiffany and Tom, I know you both have been very close to that. George, I don't know if you want to weigh in at all.

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

Yes. I'll speak to it. I'd say investors have largely returned to the NonQM market. The appetite, I'd say, is as strong as it was pre-COVID, since the market dislocation. Guidelines are generally more conservative than 2019 and early 2020, primarily as it relates to FICO and LTV.

I think another point worth mentioning is for bearers concerns had led to a lot of the illiquidity of the NonQM market in Q1, and those concerns have eased significantly, particularly as we've seen forbearance rates across the industry, whether it be for NonQM or conventional and government products.

As George just mentioned, margins continue to be lower than pre-COVID and lower than what originators can (inaudible) continue to be lower than pre-COVID and lower than what originators can generate via GSE production. But we've started to see those improve in the last month or 2.

Liquidity is really more than sufficient at this point, and we look forward to increasing supply as we head into 2021.

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

And from a capital markets perspective -- this is George again. From a capital markets perspective, I think we're, I'd say, surprised and encouraged that, in our view, a good percentage of the legacy NonQM asset that was hung on March 15. It's actually cleared the market through securitizations or found homes with larger financially durable capital players who can hold the asset long term.

And so that asset -- the time frame around clearing that was accelerated and compressed. And that, to us, indicates that we have a very healthy securitization and secondary market for NonQM. So once the margins come back into line, we'll deliver into that.

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

Okay. These next 2 questions I could probably lump together. The first piece of it was how do we see -- how long do we see the refi demand lasting for? And then the second component of that is related to the competitive landscape with the demand around refi.

So Tiffany, if you could touch on that, that'd be great.

Tiffany Entsminger - *Impac Mortgage Holdings, Inc. - Chief Operating Officer*

I would say based on some of the research that we've done, the consensus in the industry right now is that rates are expected to stay low, persisting through 2021 and extending at least through the next 12 to 18 months, the projection is right around the 3% average rate.

There's still a large population of consumers across the country that have not yet availed themselves to lower rates in payments. So there's absolutely consumer demand there.

We know there are capacity constraints in the industry, so it's going to take time for that to work its way through the system.

I would say with the capacity constraints related to competitive landscape, there's definitely a wage inflation and probably the most surprising thing that we're seeing is the wage inflation and the increased incentives around recruiting and retaining staff. Salaries seem to be largely outsized and far above a normalized market.

So I think that's only going to be sustainable for a short period of time and hopefully returning to a more normalized rate once the capacity works its way through.

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

Okay. Those are the only questions that we've received. So at this time, we will end our third quarter call.

We look forward to speaking to the market again in 2021 when we report our year-end results. Thank you all very much.

Operator

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