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IMH - Q1 2020 Impac Mortgage Holdings Inc Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Impac Mortgage Holdings First Quarter Earnings call. (Operator Instructions) I'd now like to hand the conference over to your speaker today, Justin Moisio. Please go ahead, sir.

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

Thank you. Good morning, everyone, and thank you for joining Impac Mortgage Holdings First Quarter 2020 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 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 morning, and thank you for joining Impac's first quarter 2020 earnings call. The company's executive team is with me this morning in California: Paul Licon, our CFO; Tiffany Entsminger, Chief Risk Officer and Head of Operations; Justin Moisio, Chief Administrative Officer; Nima Vahdat, General Counsel; Tom Donatacci, our Chief of Staff, is joining us from East Coast.

In our 2019 year-end earnings call on March 13, we identified the potential for supply and distribution constraints and attendant liquidity risks associated with the adverse impact of COVID-19 to our business and to the global financial markets. The Federal Reserve's emergency rate cut on March 15 and the resumption of its mortgage-backed securities quantitative easing program, creating unprecedented volatility in the interest rate and credit markets in which we operate. Materially affecting our GSE and NonQM businesses respectively.

For January and February of 2020, the company had created substantial momentum across all of our lending channels. A corresponding growth in volumes and preliminary unaudited GAAP and core earnings of $5 million and $14 million, respectively.

The company was poised to record a significant increase in originations for March 2020 with capacity projected at approximately $1.4 billion, up from $190 million in March of 2019.

The dislocations in the global financial markets caused by COVID-19 require the company to make the difficult but necessary decision to curtail March originations to only $350 million, well below operating capacity and to fully suspend origination activity on March 30.

The company instituted aggressive measures to delever the company's balance sheet. The company accomplished these objectives by the end of April on a trade date basis and by the end of May on a settlement date basis. We satisfied all commitments and met all margin costs from our capital partners. We more than doubled our liquidity profile as measured by unrestricted cash from 2019 year-end to the end of May.

By early June, we resumed lending activities as we have for over 25 years from numerous economic cycles with a singular focus on creating long-term value for our stakeholders. The company's business updates of March 30, April 15 and June 4, which were available on our Investor Relations website, provide detail as the actions executed by the company from March 15 to the present.

The purposes of this earnings call, we reiterate the following subset of those activities. Beginning in March, the company made the decision to prioritize and protect liquidity. We substantially reduced leverage by curtailing originations, selling our whole loan and mortgage servicing right portfolios, repaying secured debt and restructuring and extending near-term unsecured debt.

The company closed out the entirety of its TBA hedge position on March 18, 2020, concurrent with curtailing and then halting lending activity at the end of March.

Hedging with TBA can create a mismatch between the immediacy of margin calls payable on the TBA and the extended time frames required to monetize gains embedded in the whole loan pipeline. The company satisfied all margin calls on time through under our TBA agreements. The company also satisfied all of its obligations under its warehouse lending and repurchase facilities and rightsized its borrowing capacity electing to reduce capacity from $1.7 billion to $600 million and to reduce warehouse counterparties from 6 to 3. The company believes that its existing borrowing capacity is sufficient to fund near-term origination activities.

In line with satisfying these obligations, the company reduced exposure to warehouse borrowings and corresponding loans held for sale, including NonQM loans. As of December 31, 2019, the company's outstanding warehouse balance was $700 million, with corresponding loans held for sale of $758 million, of which $275 million were NonQM loans.

At the end of May, the company's outstanding warehouse balance was $10 million, with corresponding loans held for sale of $31 million, of which $11 million were NonQM loans.

The company also completed the sale of over $4 billion in UPB of Freddie Mac mortgage servicing rights in May. The initial settlement proceeds we used to pay down the company's related borrowing facility in its entirety. Follow-on settlement proceeds of approximately $5 million from the sale are expected to be additive to the company's unrestricted cash balance.

The company entered into agreements with its convertible promissory note holders originally due May 8, 2020, in the original aggregate principal amount of $25 million to extend the term by additional 6 months to November 9, 2020.

The company believes that totality of the above efforts has mitigated exposure to mortgage loan forbearance-related liquidity constraints, basis risk and mark-to-market shocks related to interest and credit risk volatility experienced within these asset classes.

Company's debt-to-equity leverage ratio and its wholly owned licensed origination subsidiary Impac Mortgage Corp. has been reduced from 4.5:1 to less than 1.5:1 from the end of December to the end of May.

Additionally, the company's unrestricted cash balance over the same period has increased from $25 million to $58 million. The company also carries a balance of unencumbered whole loans with UPB of $20 million as of the end of May, carried at a fair value of $16 million.

We expect to monetize unencumbered loans at levels approximating carrying value, again, with settlement proceeds being additive to our unrestricted cash balance.

The company's June 4 press release expressed the view that market conditions and external factors, while not fully normalized, had sufficiently stabilized to the extent that the company had elected to reengage in its lending activities. On a go-forward basis, the company will focus on segments of the market that have demonstrated adequate and stable capital markets distribution. Initially, GSE and government lending. The company is currently evaluating the non-agency jumbo and NonQM products, and we'll continue to monitor these market segments as facts and circumstances evolve. We are prepared to participate in the reemergence of NonQM lending. NonQM has been a key differentiator for the company and aligns with our historical position as a leader of alternative credit. The company has reestablished the margin of safety with respect to its liquidity profile and has identified a path to possibly originate in today's market environment. The company will continue to balance opportunity with rigorous risk management discipline as it navigates way forward. Before turning the call over to Paul Licon, I would like to comment our Board of Directors and our senior management team for their support and tireless efforts over the last 3.5 months. With pride and profound gratitude, I will also like to acknowledge contributions of our dedicated employees, who remains steadfast and accountable to each other through these challenging times to the benefit of our capital partners, to the benefit of our local community and to the benefit of our customer, the American homeowner. Thank you. Paul, I want you to discuss operating results for the first quarter.

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

All right. Thanks, George. Q1 was a tale of 2 quarters. Heading into March, January and February quarter earnings were $40 million. Then in the month of March, due to the spreading of the coronavirus and the expected financial impact on borrowers, we saw collapse of the NonQM market from the investor side. Like this for a NonQM loan stopped significantly overnight. Although we did not have 100% exposure to this product, NonQM loans still made up a significant portion of our held-for-sale portfolio. It is within this backdrop that we saw our gain on sale of loans decrease by $54 million from $26 million in Q1 to a loss on sale of loans of $28 million in Q1 2020. Core loss for the month of March was $69.5 million for total quarterly core loss of $56 million in Q1. GAAP loss for the quarter was $64.7 million. This compares with a GAAP loss of $677,000 and core earnings of $1.8 million in Q4. As George touched on earlier, in anticipation of the decrease in proceeds from NonQM loan sales and expected increase in margin calls from our warehouse lenders, due to the loss in value of NonQM collateral, the company decided that a strategy to preserve liquidity was the most prudent path to follow. Although not an easy decision, we decided to pause our origination operations at the end of March. This action allowed us to reduce expenses across the company and assisted in preserving precious capital that otherwise would have been required to fund [haircuts] on the originations and increased our exposure to further margin calls. Since that decision was made, we have made significant progress in clearing out our total loan portfolio including our NonQM loans, the trade with our investors and have reduced the margin call exposure to our warehouse lenders. Our loan held-for-sale balance at the end of Q1 decreased by $238 million to $520 million from a Q4 ending balance of $758 million. Associated warehouse borrowings decreased by $200 million from $700 million at December to $500 million at the end of Q1.

As we have sold off our loan portfolio, we have been able to repay margin cash from our warehouse lenders.

Unrestricted cash at March 31 was $80.2 million, with an unencumbered loan held-for-sale balance of $2.9 million versus an unrestricted cash balance of $24.7 million with an unencumbered loan held-for-sale balance of $3.2 million at the end of December.

Also during the quarter, our MSR balance decreased from $41.5 million at Q4 to $24.3 million at March 31, primarily as a result of mark-to-market write-downs from increased speed assumptions.

From March to May, we further reduced our loan held-for-sale portfolio by an additional $489 million to $31 million. Paid down $491 million in warehouse line borrowings to a month end balance of $10 million, extended the maturity of our $25 million convertible note, sold our Freddie MSR portfolio. Tom will be speaking about our service and activity later. And repaid $15 million in outstanding MSR facility borrowings, resulting in a decline of our leverage ratio at the holding company level, excluding our consolidated legacy trust from 16:1 in March to 4:1 at the end of May.

As of May 31, our unrestricted cash balance was $58 million with an unencumbered loan held-for-sale balance of $19.5 million.

In addition, the UPB of our servicing portfolio has decreased to $150 million of Ginnie Mae only loans from a servicing UPB of $4.7 billion as of March 31, which consisted of both Ginnie and Freddie loans, primarily as a result of selling our Freddie MSR portfolio.

We have also undertaken a thorough review of expenses at the company and have taken steps to rightsize our cost structure.

As we come out of these trying times and move forward from this crisis, we feel that we have the liquidity and resources available to restart our lending operations in a responsible and disciplined manner.

I'll now pass the call over to Tom Donatacci to discuss the company's recent initiatives regarding its mortgage servicing.

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

Thanks, Paul. We're pleased to announce the successful sale of $4.1 billion UPB of Freddie Mac MSRs, which closed on May 30, 2020. The sale consisted of approximately 15,000 loans with a weighted average note rate of 3.886%, 80% California concentration, seasoned 39 months, with a net servicing fee of 25 basis points.

The sale was executed via market auction, which resulted in a winning bid of 51 basis points, slightly above a 2 multiple or approximately $20.1 million from a large regional bank. The sale date payment of $15 million has been received and the portfolio will transfer on July 1, 2020.

The remaining holdback funds will be received over the coming months. The transaction was executed during a time of significant market volatility, where we saw MSR prices and liquidity in a decline. And so the results were satisfactory and at the upper end of our expectations.

A recent industry market survey of 7 of the most active conventional MSR co-issue buyers had an average new origination California MSR bid of a 1.63 multiple versus the higher auction results.

The terms of the sale also included limited reps and warrants, resulting in limited tail risk exposure to impact on the sale as well.

As George mentioned earlier, the firm made the decision to prioritize and protect liquidity. This MSR sale was initiated by Impac to manage risk and improve liquidity during the market dislocation caused by COVID-19.

The proceeds of the sale were used and will continue to be used to increase our cash position and pay down our financing line on the MSRs, which has been brought to a 0 balance. None of the proceeds were used or required to satisfy debt to any GSE or any other entity.

In addition to the remaining purchase price funds of $5 million, expected to be received on this transaction in the coming months, we have also established a team to accelerate the receipt of approximately $1.8 million due from past MSR transactions. This document delivery and confirmation project is currently underway, and we expect most, if not all, of that balance to be collected in 2020 as well.

I will now turn over to Tiffany Entsminger, who will provide insight into our current operational capacity.

Tiffany Entsminger - *Impac Mortgage Holdings, Inc. - Chief Risk Officer & Head of Operations*

Thanks, Tom. Consumer demand for refinancing and the corresponding margins for GSE eligible and government loan products are higher than they have been in years. Impac was well suited to originate and fund over $1 billion heading into March prior to the market events that caused us to pull back from lending activity as a preventative risk measure. While the NonQM market is still rebounding, there is substantial liquidity in the GSE eligible FHA and VA lending market to responsibly serve consumers. It is here that we remain focused.

Initially targeting $250 million in funded volume by the end of Q3 2020 in the retail channel alone provides a baseline of profitability for the origination platform.

In addition, we're updating the product offerings in our wholesale channel to provide GSE eligible and government offerings to the TPO community. The management team thought to create a liquidity margin -- liquidity margin of safety through aggressive derisking efforts, and we remain committed to maintaining a run rate that will support that margin going forward. Originating loans with strong credit quality, maximizing operational efficiencies, optimizing geographic diversity in the portfolio, and continuing to be sensitive and alert to changing consumer needs around forbearance and COVID-related hardship will be top of mind during the next quarter.

Justin Moisio will now discuss near-term production mix and product focus.

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

Thank you, Tiffany. Our targeted $250 million monthly run rate in the third quarter will be originated through our call center. We are focused on segments of the market that have demonstrated adequate and stable capital markets distribution exits, which will initially be GSE, FHA and VA lending. Keeping in step with other originators, we've reevaluated the credit box within these product offerings instituting some overlays where necessary and remain competitive and responsible in our approach to serving the market.

Currently, with GSE eligible originated loans having some of the widest margins since 2008, we've been able to remain competitive in pricing while optimizing execution.

With pent-up demand from borrowers who may have taken a pause in March and April, we've been able to keep our business promotion expense at bare minimum, as we continue to work through the tremendous backlog of high quality leads we've received while our origination efforts were suspended.

Impac has a storied history around alternative credit and a pioneer in both the Alt and NonQM space. We continue to have a strong appetite around NonQM and continue to pay attention to the changing forbearance landscape, borrower behavior and appropriate risk-based pricing for these products.

The GSEs, FHA and VA have published guidance on forbearance, management and practices for impacted borrowers identifying solutions in the alternative credit market to ensure servicers, warehouse lenders and investors have consistent expectations will be a significant milestone prior to relaunching the product in a meaningful way.

Impac remains committed to serving borrowers across all markets and continues to participate in dialogue and discovery in this area with the goal of participating in NonQM originations in the same thoughtful and risk focused ways as it has in the past.

On Monday, the CFPB issued a proposal to revive -- revise the qualified mortgage rule, which has the potential to significantly impact the NonQM market. Nima Vahdat will provide additional detail around the proposed CFPB rule changes. Nima?

Nima J. Vahdat - *Impac Mortgage Holdings, Inc. - General Counsel, Secretary & Chief Compliance Officer*

Thank you, Justin. The company remains focused on the future and the impact of proposed regulations and legislation on the organization as it moves forward. In the NonQM space, the CFPB issued proposed rules to address the expiration of the QM patch that give agency loans the presumption of ability to repay and qualified mortgage compliance. The CFPB's proposed rule extends the QM patch originally set to expire in January until the effective date of proposed amendments to the ATR QM rules.

The proposed amendments to the ATR QM rule would eliminate the 43% debt-to-income and prescriptive underwriting requirements in favor of a price-based approach. The theory being that the higher price of the loan, the less the borrower have an ability to repay. An alternative theory being that lenders concerned about a borrower's ability to repay will price that loan for the credit risk. And as a result, a higher price could be considered a proxy for lenders perception of the borrower's ability to repay.

This CFPB is also considering alternative DTI thresholds or hybrids between the DTI and price-based approaches. The proposed amendments have been supported by the MBA and the National Association of Realtors, among others, as a way of avoiding disruption to the overall mortgage market.

However, should the proposed amendments broaden what is considered a qualified mortgage considerably that could serve to constrain the NonQM market as a whole. Another significant development was the failure of California Assembly Bill 2501 last week. The proposed reforms under this bill would have been sweeping. As an attempt of providing COVID-19 relief, the bill would have prohibited foreclosures during the year after the bill became active and would have afforded forbearance periods of up to 12 months without borrowers accruing interest or other fees. The bill would have imposed penalties on lenders and servicers for violating its provisions and would also have exposed the industry to new consumer litigation.

Despite the attempt of providing consumer protection, the potential negative impact on lending in the state could have been considerable. It remains unclear that the bill will be reintroduced, but the industry feels that the California legislature came to the right conclusion.

I will now turn the call back over to George for closing comments.

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

That concludes our financial results and prepared remarks. We'll now open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

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

Actually, Victor, I received a couple of calls -- I'm sorry, a couple of e-mails right before this with some questions. So let me just walk through those now with our team.

The first question we received. Based on your current mix of production, what volume levels would the company need to reach to return to profitability?

So Paul, I think you want to touch on that one?

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

Yes. Thanks, Justin. As we move forward with restarting our production, we anticipate ramping up our volume to $250 million a month of high-quality conventional products, predominantly from our consumer direct channel. This is a level that we expect to achieve consistent profitability. Looking down the road, we are reviving our third-party origination or TPO business. We have maintained key leadership within the building for this business channel and would expect within 1 to 2 quarters that it will once again contribute high-quality GSE, FHA and VA loans.

Our TPO business is also foundational for our NonQM business, which is potentially nearly 6 months away, predicated on a reform -- I'm sorry, on a uniform standardization around forbearance.

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

Okay. The other question we received was the company as well as the industry has mentioned a lot regarding forbearance. So how exactly is the company handling loan forbearance? So probably, Tiffany, if you want to take that one?

Tiffany Entsminger - *Impac Mortgage Holdings, Inc. - Chief Risk Officer & Head of Operations*

Sure. For our conventional and government loans currently being serviced through our subservicer, we're adhering to the guidance provided by Fannie Mae and Freddie Mac, which allows borrowers experiencing a COVID-related hardship to opt into a forbearance period with the opportunity to extend as needed. For our NonQM population, we're actively engaged with our special servicer to ensure that we're adhering to industry best practices for this asset.

Above all, our goal is to support our borrowers during this difficult time through all available options, promoting continued homeownership and pass to reinstatement for borrowers who are experiencing hardship. Unlike GSE and government markets, there's no uniform approach governing the NonQM borrower contact, hardship documentation and available program offerings as it relates to forbearance, which is having an adverse impact on the liquidity market.

We're actively engaged through discussions with investors, warehouse lenders and rating agencies to promote a standardized approach around forbearance. And as mentioned in our previous press release, Impac created Copperfield Capital Corp, which leverages existing expertise within our company to address these issues and provide support to alternative credit clients navigating these same issues around forbearance.

Operator

Thank you. At this time, the company -- we haven't received any additional questions, so we will conclude our first quarter earnings call. Thank you, everyone, for joining us, and we'll be back with you in early August for our second quarter earnings call. Thank you.