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IMH - Q3 2017 Impac Mortgage Holdings Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Third Quarter 2017 Impac Mortgage Holdings Earnings Conference Call. (Operator Instructions)

I would now like to introduce Mr. Justin Moisio, Vice President of Investor Relations. Please go ahead, sir.

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

Thank you. Good morning, everyone. Thank you for joining Impac Mortgage Holdings Third 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 rate risk exposure, mortgage production and general business 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 other 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 Joe Tomkinson, Chairman and CEO of Impac.

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

Welcome, everyone. And with me this morning besides Justin Moisio is Todd Taylor, our Chief Financial Officer; and Ron Morrison, our General Counsel. I'll begin with a quick brief review of the results for the third quarter. The net earnings in the third quarter for 2017 were $2.3 million. That equates to $0.11 per diluted common share that compares to $16.5 million for the third quarter of 2016, which is $1.18 per diluted share.

For the third quarter of this year, adjusted operating income decreased $114,000 or $0.01 per the diluted common share compared to $47.4 million or $3.29 per diluted common share in the third quarter of 2016. And of course, the main reason for the drop in the net earnings are in the operating income, was due to margin compression resulting from historically low interest rate environment in the third quarter of 2016 in which the company was able to generate significantly larger volume with much wider gains on sale of margins.

Additionally, the company recognized a $10.5 million write down in the mortgage servicing portfolio, which was primarily due to a mark-to-market losses and charges associated with payoffs in the portfolio. We have begun an effort, again, to reduce prepayments in the servicing portfolio. And by doing so, we expect to reduce the payoffs in the portfolio as well as reduce the losses on mortgage servicing rights.

During the third quarter of 2017, total originations decreased to $2.1 billion compared to about $4 billion in the third quarter of 2016. And this was driven by decline in the refinance market, which was a direct result in the increase in rates starting in the fourth quarter of last year. However, as expected, our non-agency originations are increasing significantly in our wholesale and correspondent divisions. Gain on sale margins decreased by 64 basis points to 204 basis points in the third quarter of 2017. This compares to 268 basis points in the third quarter of 2016, also, which was due to higher interest rate environment. However, again, as I mentioned, our non-agency originations continue to increase year-over-year. In the third quarter of this year, the non-agency and government originations represented a 35% of the total originations. Now this compares to 12% of the total originations for the same product in the third quarter of 2016.

During the third quarter of 2017, the origination volume of the non-agency loans remain consistent with the second quarter at somewhere around $239.4 million. So for the first 9 months of the year, the non-agency loan production was $656 million, and this compares to $203 million for the same period of time in 2016.

Despite the growth over the last year's volume, we expect our non-agency volumes to continue to grow. As yet, we have not reached the potential levels of the non-agency production and -- that we expect to achieve. In the third quarter 2017, the retail channel accounted for 26% of the non-agency originations, while the wholesale and corresponding divisions increased to 74%. Additionally, in the third quarter of 2017, the company's government loan production increased another $20 million to $500 million, which was compared to $480 million for the second quarter of 2017.

Let's discuss a little bit about the strategy retaining the MSRs and how that is progressing. As of September 30, 2017, we increased the size of our servicing portfolio from the end of the second quarter by 7%, bringing the portfolio to approximately $15.7 billion. Our retained servicing rights increased in value to $159 million at the end of the third quarter as compared to a value of $152 million at the second quarter. That's a pickup of $7 million.

In the third quarter, our mortgage servicing portfolio generated net servicing fees in excess of $8.5 million. This is a 124% increase in the servicing income during the third quarter of 2017 in comparison to the third quarter of 2016. The credit quality of our servicing portfolio asset remains extremely strong.

As of September 30 of this year, the high credit quality servicing portfolio had a weighted average coupon of 3.8%, and a weighted average loan-to-value of 67%, and weighted average FICOs of 735 with very low delinquencies in the overall portfolio.

Let's just shift our discussion a little bit to what's currently taking place at Impac. As everyone knows by now, we announced that Bill Ashmore has elected not to renew his contract with the company. His contract expires December 31 of this year, and Bill has decided to move outside of the company to pursue other professional opportunities. The company's succession plan, which I'm getting a lot of questions on, has actually been in formation for the last 1.5 years. And in the very near future, I will be making some, what I think, are very positive announcements as to the succession plan and the plan in going forward. As I mentioned during our previous earnings call, we continue to push towards our securitization market with our non-agency production. It is our expectation that in the first quarter, most likely somewhere around January, we will be in position to complete our first non-agency securitization in the neighborhood of $350 million to $400 million. This is a significant milestone for the company. Appetite for this non-agency product continues to grow in the marketplace. And we continue to see more interest from potential investors, and we continue to expand our current investor base.

We're now seeing a resurgence of our correspondent and wholesale business, especially outside of California, and within the non-agency space, which has been one of the main objectives of this company. Additionally, we are in the process of formulating a market plan with our CashCall Mortgage team that will diversify our portfolio more geographically and more product-wise with more emphasis on the non-agency and the government loans.

As we assess the current state of the mortgage industry, we do not believe that a brick-and-mortar type of distributive retail platform is the future of the mortgage industry. Impac and CashCall are uniquely positioned from this standpoint, that we have a centralized lending platform that allows us to scale up and down very quickly as the mortgage industry and the market changes. The future, I think, of mortgage lending will exist in the online environment, with millennials and other new homebuyers purchasing their homes conveniently from their smartphones and their iPads. This is why we have spent considerable resources investing in our proprietary mortgage lending technology.

Since the start of the year, we have been working diligently on our proprietary technology, which includes automated underwriting and compliance checks and will increase not only our productivity but also will increase the productivity of our customers. Additionally, the enhanced technology will increase the pull-through rate of our non-agency loans, which will also result in much lower operating cost.

Over the next 2 months, we will complete the testing and the beta testing of this technology with the rollout to our first customers in January of 2018. This will improve -- would move us much closer to transforming into the company -- to a more user-friendly lender for both our retail customers and the wholesale community. The servicing portfolio, as I mentioned, continues to grow, and soon will be nearing almost $10 million a quarter in servicing income, which will help to offset most of the fixed corporate expenses -- corporate overhead expenses. These are all things that we have been anticipating in setting up for 2018.

In closing, I'd like to again remind everyone at year-end, our CashCall Mortgage earnout will have concluded. Beginning in 2018, the contingent consideration will no longer be on our balance sheet and, most importantly, we will retain 100% of the CashCall Mortgage earnings with no further earn-out payments. Additionally, given our significant net loss carry-forwards, we expect to be very tax efficient into the future.

Now I'll close my prepared remarks, and I'll open it up to any questions. Justin?

QUESTIONS AND ANSWERS

Operator

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

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

First question, I wanted to follow up on the comments you made about the continued efforts you guys have made to expand the presence of CashCall and the efforts you guys have made on the propriety technology. Can you guys talk a little bit about what the strategy is in terms of how you are anticipating -- gaining more geographical diversity with that platform? And primarily going to be like a marketing spend in new states to increase production there? Or how you guys are going about that?

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

I'm sorry. Are you still there? I think I hit the wrong button.

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

Yes, I'm here. I Heard silence for about 20 seconds.

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

I'm sorry I'm just going to say it's a good question. Partially, a reallocation of advertising dollars, where you spend the money, targeting the space in which we really want to be. California has always been a very easy state for us. It has been a very profitable state for us because the loan limits are so much higher. And so for us, to move outside of California, it's been a little bit challenging, in that when you have the opportunity to earn a lot of dollars in high-balance states, that's where you concentrate your efforts. However, we recognized also that you also have higher prepay speeds in the state of California. And so for the last several months, we have been in the process of looking at different states that we want to be in that will bring down our prepay speeds. But you have to temper that with what the cost of doing business is and the loan limits. So it's a matter of deploying the advertising dollars, targeting the states, also taking a look at the states that are centric to the non-agency product. I think I mentioned that the non-agency product continues to climb in the different states. Also, we continue to improve our government product outside of the state of California. So that, coupled with the technology will allow us -- once we employ the technology, which will allow us to be more efficient and more centric in other states from the standpoint of I can't compete employee-wise right now in the state of Missouri. As an example, if I wanted to get loans out of Missouri, because the employment costs compared to -- Missouri compared to California are so much different. But with the technology and the way that we have structured our technology -- I told everybody, Look, where do we spend our money? We spend our money right now in compliance, quality control and underwriting. So if we can improve through technology the efficiencies in those areas, then we become more efficient with the technology and we don't have to so much worry about the employee base. And so that's why we've been stressing for the last 9 months the development of the technology. So it's a combination of advertising dollars and technology. Does that help?

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

Got it. Yes. That was very helpful color. And second question. On the prepay speeds in the servicing portfolio, you guys briefly mentioned that you're making some efforts to reduce the speeds there. Can you expand a little bit on that? And also, maybe comment on -- with the prepays that are happening in that portfolio, if you guys are still being fairly successful in recapturing those yourselves?

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

Well, we're a victim of our own success. We've been so successful in recapturing our own portfolio that we've been criticized by bondholders because of the prepay speeds. So one of the ways to slow that down is to get more product outside of California. And when you blend that product into the securities with outside of California product and a better geographical footprint, then as a percentage of the whole, the prepay speeds come down. And so that's what we're really concentrating on. I mean, I can go into -- which I don't think is really for this discussion -- I can go into all the steps that we're taking, but it's quite long and involved. But we need to do a better job in diversifying the portfolio.

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

Okay. That makes sense. Last question. You guys mentioned that you're still on track for targeting your first securitization in sometime around January or early 2018. I just wanted to clarify, are you guys -- with the non-QM originations you're doing currently, are you guys currently selling any to third parties? Or at this point, are you essentially retaining everything in anticipation of that securitization?

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

No. We've got some good third-party investors that we've been working very closely with. And we continue to sell to third parties for the gain on sales. And some of the third parties would like to do joint securitizations with us.

Operator

(Operator Instructions) Our next question comes from the line of Henry Coffey with Wedbush.

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

Couple of questions. Starting with your P&L. You had a $10.5 million write-down. That was about $0.32 a share on your MSR value. Can you give me the components of that charge?

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

Sure. I'll let Todd answer that question. Todd?

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

Hey, Henry. This is Todd. Yes. The prepayments contributed to an amortization of about $7.2 million. And then we also had a mark-to-market charge, which was actually about $800,000, which is net of any hedging pickup we had. And then there was just straight amortization of about $2.5 million. You can see that the prepayments that Joe just spoke about in the previous question really has exasperated that number and increased that, some of which we get --

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

So that's a real loss of value there?

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

Yes.

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

It's not just a fair value mark?

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

Right. That's right. Part of it's a fair market.

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

Well, you just said -- you say $800,000 of $10.5 million is fair value? Is that accurate?

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

Can you say that again? I didn't...

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

That $800,000 of the $10.5 million was fair value and that the rest, the $9.7 million, was real amortization.

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

Well, that's net of a hedging pickup. We had a small hedging pickup of about $700,000. So the real mark-to-market number, what you're trying to get to is -- kind of the noncash piece is the $1.5 million.

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

Okay. So $1.5 million was -- that was a hedging gain?

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

Yes.

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

So the $10.5 million, right?

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

Right.

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

$9.7 million was amortization?

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

Right.

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

And then the rest, which is approximately $800,000, was the combined fair value marks and net of hedging?

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

Yes, that's correct.

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

So you're not seeing any operational impairment in the portfolio? You're just dealing with too much refi?

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

Yes, too much runoff. Yes.

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

What is your own -- can you give us a sense of what the MSR's coupons stack looks like? And what's your own recapture rate has been like on that portfolio?

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

Well, the weighted average coupon is 3.8%. The FICO is, as I mentioned earlier, is 735 and the LTV is 67%. Our recapture rate is huge. I don't have exact percentage. But historically, it's been about 84%.

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

So a lot of the lost -- yes. You're recapturing a lot of the lost value?

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

Yes.

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

And then, I just missed the numbers. But you were talking about the mix at retail, of govi and non-agency?

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

20%? 26%? Yes. It's -- 26% is non-agency.

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

And then what percentage was govi related, Ginnie Mae…

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

I don't have it. In the retail the…

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

And then CashCall, what's been the financial impact, not the fair value adjustments, but the financial impact of the earn-out? What has sort of been either the dollar number or -- what have you been paying out on that side of the deal that's going to go away next year?

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

The payout in terms of percentage of earning the last year was -- 45%? 35%?

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

45%.

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

45%.

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

That's 45% of CashCall's earnings, right?

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

Right. So that goes away completely.

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

And what was that in dollar terms, either for the 9 months or the quarter?

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

For the quarter, that was about -- after we do the adjustments and so forth, about $3.5 million.

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

So that's about $3.5 million a quarter that comes back into the numbers next year?

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

That's correct. From a cash basis.

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

When you say cash basis, does that mean GAAP earnings? Or it's something different?

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

That's earnings. That's the earnings. The earnings you're going to see stay the same, it's just the cash.

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

Maybe we should go into that offline.

The other thing is they have an installment loan -- do they have an installment loan product? I could be completely wrong on that.

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

No.

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

No.

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

No. They -- just mortgage?

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

Yes. Yes. Everything is -- all just mortgages.

Operator

(Operator Instructions) And I'm showing no further questions at this time. So with that, I'd like to turn the call back over to CEO, Mr. Joe Tomkinson for closing remarks.

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

Well, I have no other closing remarks. Thank you for participating in the call. And we'll reconvene in the next quarter. Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program. You may all disconnect. Everyone, have a wonderful day.
