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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Impac Mortgage Holdings Second Quarter 2021 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Justin Moisio. Please go ahead.

Justin R. Moisio - *Impac Mortgage Holdings, Inc. - Chief Administrative Officer & Corporate Secretary*

Thank you. Good afternoon, everyone. Thank you for joining Impac Mortgage Holdings Second Quarter 2021 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 and 10-Qs filed 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 and 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. With me today for prepared remarks are Jon Gloeckner, our Treasurer and Principal Accounting Officer; Obi Nwokorie, our EVP and Head of Alternative Credit Products. They're with me for prepared remarks. Later for the Q&A session, Tiffany Entsminger, Joe Joffrion and Tom Donatacci will join us.

Approximately 3 months ago, during our Q1 2021 earnings call, we discussed that the company continued to grow its retail and TPO platforms and recorded the third consecutive quarter of growth while continuing to remain focused on liquidity and risk management following the 2020 COVID crisis. The company's last business update expressed the view that market conditions in the GSE space had continued to normalize with margins narrowing as the capacity to originate and process loans in the industry began to catch up with consumer demand. The company is not immune to the margin compression that affected the entire industry throughout the second quarter of 2021.

We previously referenced the increasing investor demand, expansion of and normalization of guidelines as well as improved margins for our NonQM production, a competency of the firm that we are currently investing in with capital market, securitization talent, product innovation, risk-based pricing enhancements and a growing sales and operations team. Justin will expand on these initiatives and investments across products and channels in further detail a little bit later on in the call.

The company reported net GAAP loss of approximately $9 million or $0.42 per diluted common share and a core loss of approximately $7 million or $0.32 per diluted common for the second quarter of 2021. Core earnings or loss are an alternative measure of results that senior management utilizes to gauge the company's performance. Core earnings or loss isolates results from recurring business activities by adjusting for certain nonrecurring items such as changes in the fair value of long-term debt and trust assets, gain or loss on mortgage servicing rights held for sale and other nonrecurring legacy matters.

As it relates to production volume, we generated originations of approximately $600 million in Q2 '21 versus $850 million in Q1 '21. While typically, we do not provide forward-looking guidance, we will note that our NonQM pipeline, as measured by submissions and locks, stood at only $10 million at the end of 2020, a little bit over $80 million at the end of the second quarter and currently stand at $90 million at the end of July. This product increase in the pipeline demonstrates the recent pivot towards NonQM originations, both in our retail channel and historically NonQM-focused TPO channel. The pipeline growth was sequenced after having achieved a sustainable monthly run rate of $200 million to $300 million in GSE products during the past 3 quarters.

Historically, we've had good success delivering NonQM through the retail channel as well as TPO. The significant decrease in GSE margins in addition to the shift in marketing resources for the retail channel fueled a rapid increase in NonQM activity. We anticipate continued growth in NonQM at healthy margins in all of our origination channels and from NonQM product ramp in TPO to accelerate as our new account executive additions acclimate their customers to our products, competitive pricing and market-leading service levels.

The 10-year treasury rate has drifted down from 170 at the end of the first quarter of '21 to 150 at the end of the second quarter of '21 and recently dropped below 120. In recent weeks, the range that should support improved GSE origination levels at Impac for the third quarter as the firm's non-investment -- NonQM investments continue to take hold.

While the NonQM market is not fully returned to pre-crisis levels, it's close. We are encouraged by continued growth in borrower and investor demand, resulting in consistent and solid pricing as well as strong capital markets execution for our current originations. The NonQM market is characterized by moderately tighter lending standards across the industry, which are in line with our firm's long-term view on alternative credit lending anchored in quality, consistency, performance and adherence to ability to repay our APR guidelines.

We continue to believe in the market opportunity and demand for NonQM and the company's ability to be an innovative market leader in this segment. The origination, securitization and asset management of these products is core competency of the company, having originated over $90 billion of such loans from 1995 to 2007. Post the sub-prime financial crisis, the company consciously maintained resources across these disciplines to manage legacy Alt-A portfolios and in early 2014, extended that infrastructure as one of the first mortgage companies to anticipate and actively pursue the revival of NonQM mortgage market.

Since 2014, we have originated in excess of $4 billion of NonQM, steadily yet responsibly increasing our production from $130 million in 2015 to over $1.25 billion annually in the 2 consecutive years leading up to the COVID crisis.

The company has not only maintained but added to both the number of warehouse relationships and available credit and liquidity to comfortably support existing future growth targets for NonQM. We have also recently distributed NonQM loans to a wide range of investors on both a flow and bulk basis, including Wall Street firms, hedge funds and alternative capital partners. We continue to receive market feedback that the production profile of our NonQM is considered at the top of the quality ranking available in the marketplace. Impac's NonQM collateral performance, originator rankings and adjustment factors with the rating agencies continue to result in efficient permanent capital structures for our investors.

As we noted in the Q&A session during our previous earnings call, the company has now established a seasoned structured products capital markets team, led by Obi Nwokorie, based in New York City. This enables the company to directly or synthetically access the securitization market and opportunistically retain economic interest in the subordinated tranches and asset management and servicing fees of our offerings, which evidenced our confidence in the long-term performance and risk-related returns of the loans we originate. Obi is going to speak to these initiatives later during his prepared remarks.

The company continues to monitor developments across a range of macroeconomic and pandemic-related factors, including trends in inflation, housing affordability and the credit and interest rate environment. Our risk management and product offerings will evolve with the marketplace to successfully navigate these challenges and see opportunity where risk reward is properly balanced.

As stated earlier, protecting the firm's liquidity continues to be a primary objective for the firm. Firm's cash position was approximately $50 million or $2.34 per common share at the end of the second quarter. We believe this liquidity position as well as a continued focus on strong risk management has prepared the firm to navigate any future market volatility.

Turning now to our long-standing preferred B litigation. As we disclosed in our 8-K filing on July 19, 2021, the Maryland Court of Appeals issued an order which affirmed lower court's rulings, specifically that the proposed 2009 amendment to the preferred B articles did not receive the required votes, and therefore, the original preferred B articles remain in place. As a result of the court's order, the company will be required to pay approximately $1.2 million in unpaid dividends to certain preferred B stockholders. This amount was previously accrued by the company in 2018. And in addition, the preferred stockholders are now entitled to call a special meeting for the election of 2 additional directors to the company's Board.

Although disappointed in the court's order, it does bring closure to over a decade of litigation and adds certainty to the terms and rights of that portion of the company's capital structure. The company will welcome the new directors once elected and look forward to their contributions, especially in aligning the company's stakeholders to create an efficient and sustainable capital structure and common strategic vision for the future.

With respect to payment of future dividends on preferred B stock, such dividends are cumulative. They're not payable unless declared by the Board. The preferred B stock is perpetual with respect to voters' liquidation preference and payment of dividends. At this time, there is no intent to declare any dividends on the preferred B stock, especially in light of short- and long-term debt that has a seniority to the preferreds in the company's capital structure. Additional information on the company's capital structure in the court's ruling can be found in our 10-Ks, Qs and 8-K filings.

I will now hand the call over to Jon Gloeckner to discuss operating results from the first quarter. Jon?

Jon Gloeckner - *Impac Mortgage Holdings, Inc. - Senior VP of Treasury & Financial Reporting, Principal Financial and Accounting Officer*

Thank you, George. For the second quarter, the company reported a GAAP loss of $8.9 million as compared to a loss of $683,000 in the first quarter and a loss of $22.8 million in the second quarter of 2020.

For the second quarter, core earnings were a loss of $6.9 million as compared to a loss of $262,000 in the first quarter and a loss of $10.4 million in the second quarter of 2020. The second quarter appeared to be a transitional quarter for many mortgage originators, including ourselves, as we were not immune from the margin compression seen throughout the industry.

During the second quarter, our originations were $611 million, with margins of 175 basis points as compared to originations of $850 million with margins of 237 basis points in the first quarter. As we had indicated on the first quarter call, we shifted our focus to NonQM production as a result of the margin compression seen in conventional originations. Despite the decline in both origination volume and margin seen during the second quarter, we were able to grow our NonQM production to $100 million as compared to $15 million during the first quarter.

The shift in our production mix during the first quarter and subsequent increase in NonQM production during the second quarter helped to offset the impending decline in conventional originations and margin many originators in the industry experienced during the second quarter, ourselves included. As a result, gain on sale of loans decreased by $9.4 million from the first quarter to the second quarter.

Operating expenses decreased from $21.3 million in the first quarter to $19.6 million in the second quarter. This was led by a decrease in personnel costs from $14.9 million in the first quarter to $12 million in the second quarter, which was primarily the result of a reduction in variable compensation as a result of the decrease in origination volume.

Due to the continued competition for talent, despite the decline in personnel expense as compared to the first quarter, personnel costs continue to remain elevated across the industry. Additionally, our personnel expense associated with the rebuild of our NonQM platform has contributed to elevated personnel costs as we continue to add new talent to the team.

Our business promotion expense increased to $1.8 million in the second quarter as compared to $1.2 million in the first quarter. This was primarily the result of the aforementioned increase in competitive pressures during the quarter. While the company previously experienced a substantial amount of organic lead flow, the increase in competition has prompted an increase in marketing spend to maintain a consistent level of lead volume.

We currently have warehouse lines with a combined borrowing capacity of $550 million, with an additional $25 million of warehouse capacity coming online in the third quarter. Within the call center, our funding-to-settle turn times continue to be just under 20 days. However, this remains subject to the risk of increased turn times and capacity constraints inherent in an aggregation execution model. Our funding-to-settle turn times on NonQM are just under 40 days with our goal to reduce the settlement turn times to 20 days or less by year's end.

We continue to carefully manage our liquidity as evidenced by our unrestricted cash position of $50 million on the balance sheet at the end of the second quarter. Our strong liquidity position gives us the flexibility to continue to increase production and invest capital in our NonQM franchise for continued growth. Based on our current cash position, turn times and borrowing resources, we feel we have the liquidity necessary to meet our near-term production goals.

I will now turn it over to Justin to discuss production mix and product focus.

Justin R. Moisio - *Impac Mortgage Holdings, Inc. - Chief Administrative Officer & Corporate Secretary*

Thank you, Jon. As we discussed last quarter, the guidelines and overlays impacting Fannie and Freddie eligible borrowers begin to lift in the fourth quarter of 2020, leading to a more normalized underwrite. Alongside the shift in a more open credit box, competition amongst lenders contributed significantly to reduce margins across the board. Borrowers are able to shop, and lenders find themselves competing aggressively on rate. The result has been a significant decrease in GSE volume across the industry.

During the second quarter, these competitive and market-driven challenges resulted in approximately 60 to 70 basis points of margin compression within our retail channel when compared to the first quarter.

Our retail consumer direct channel, the primary driver of GSE originations, saw a decrease of approximately 33% in production from the second quarter as compared to the first quarter. Impac will continue to originate in the GSE space, but will remain diligent around market conditions impacting margin and competition. Business promotion expense, attributed almost entirely to our retail call center, increased by approximately $600,000 in the second quarter. During the second quarter, we increased our business promotion to maintain our lead volume in the call center and began targeting NonQM production in the retail call center.

Although we continue to source leads through digital campaigns, which allows for a more cost-effective approach, the competitiveness within the California market has driven up our advertisement costs. Despite these challenges in the GSE space, we remain committed to serving consumers in the GSE and government lending spaces while also growing our NonQM opportunities across all channels.

This is an important pivot for the company, allowing it to navigate shrinking GSE margins while driving revenue in the NonQM space. NonQM's reemergence across the market was met with credit and pricing disadvantages that restricted the addressable market of consumers and investors. However, as mentioned on our last call, during the first quarter of this year, credit, pricing and overall investor interest returned, allowing Impac to resume one of its core competencies and product offerings. Gross margins for NonQM returned to healthy 400 to 500 basis point range by the end of the first quarter, and they've stayed those same levels at the start of the third quarter.

With the aforementioned increase in business promotion related to NonQM marketing in the consumer direct channel, we've seen a corresponding shift in the pipeline composition. Currently, NonQM originations represent approximately 13% of our locked consumer direct pipeline. Historically, the retail consumer direct channel has contributed to Impac's overall NonQM originations.

Since 2016, our call center has originated approximately $1 billion of NonQM production. Additional marketing allocations have been deployed to leverage the expertise in the call center to drive this business once again. The primary driver and focal point in ramping up our NonQM production remains within our third-party origination channel. The momentum around relaunching NonQM products within TPO has grown considerably since we relaunched this program in the first quarter.

The company originated $100 million of NonQM production in the second quarter, as Jon mentioned, compared to just $15 million in the first quarter. Over 90% of this NonQM production volume was generated through our TPO channel. Currently, the overall composition of the TPO pipeline was approximately 85% NonQM. With a $50 million current monthly run rate of NonQM production out of our TPO channel, we have demonstrated the ability to organically generate significant momentum around this product. Further, to build upon this momentum, we continue to invest in resources around operational improvements and technology aimed at increasing volume and counterparty experience as well as some recent account executive hires that will continue to boost business in previously underserved regions of the country.

We took an iterative and risk-based approach to updating our credit box, guidelines and pricing during the second quarter to provide a competitive offering to the market while maintaining a high-quality credit standard.

Obi Nwokorie will provide specific commentary around NonQM capital markets philosophy here at Impac. Obi?

Obi Nwokorie - *Impac Mortgage Holdings, Inc. - Executive VP of Alternative Credit Products & CIO*

Thank you, Justin. Over the past 2 months, the teams and credit and capital markets have been focused on expanding our NonQM products and offering more aggressive pricing across the board. We rolled out the enhanced NonQM underwriting guidelines, which are a return to our pre-COVID product matrix and further our underwriting philosophy of providing quality loans to a broad section of NonQM borrowers.

We also added to a range of investor property-focused loan products by offering a no-ratio product to tap into the large demand for single-family rental investors with strong personal credit and low loan-to-value ratios.

In addition to the enhanced underwriting guidelines, the team in capital markets has also rolled out more aggressive pricing across both our bank statement and property-focused products. We have developed analytical tools that enable us to better project prepayment speeds and default probabilities on each loan, which will in turn allow us to use our rate sheets to target the optimal product mix. We have also developed tools that allow us to monitor our pricing and compare it in real time with other NonQM lenders and adjust our pricing accordingly.

These actions have been very well received by our brokers and account executives. As has been mentioned previously, submissions, locks and fundings are significantly higher since these changes were rolled out. We've also continued to explore structural options for an alternative investment vehicle. The goal for this vehicle will be to allow the company to participate in some of the economics associated with retaining an interest in securitizations as either a stand-alone investor or as part of a joint venture.

And that concludes the financial results and our prepared remarks. We will now open the call for questions.

Operator

(Operator Instructions) I'm showing no questions at this time. Speakers, you may continue.

Justin R. Moisio - *Impac Mortgage Holdings, Inc. - Chief Administrative Officer & Corporate Secretary*

Okay. Well, thank you, everyone, for joining us today. We look forward to speaking with the market in early November and reporting our third quarter results. Thank you, everyone.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.
