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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Impac Mortgage Holdings 2017 Year-end Conference Call. (Operator Instructions) As a reminder, this call is being recorded.

I would now like to turn the conference over to Justin Moisio, Vice President of Investor Relations. Sir, you may begin.

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

Thank you. Good morning, everyone. Thank you for joining Impac Mortgage Holdings Year-end 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 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 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 Mortgage Holdings.

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

Good morning, everyone. Welcome, and thank you for joining Impac's Year-End 2017 Earnings Call. With me, I have George Mangiaracina, our President; Todd Taylor, our Chief Financial Officer; Ron Morrison, our General Counsel; and Rian Furey, our Chief Operating Officer.

I'm going to begin with a brief review of the results in 2017. For the year ended December 31, 2017, GAAP net earnings was a loss of $31.5 million or $1.62 per diluted common share, and this is compared to net earnings of $46.7 million or $3.31 per diluted common share in 2016. In 2017, adjusted operating income decreased to a loss of $29 million or $1.49 per diluted common share as compared to income of $96.9 million or $6.52 per diluted common share in 2016. This loss was primarily due to $174.9 million decline in gain on sale revenues.

Origination volume declined 45% in 2017 to $7.1 billion as compared to $12.9 billion in 2016. Gain on sale margins declined to 191 basis points in 2017 from 241 basis points in 2016, resulting in gain on sale revenues declining 56% in 2017. Offsetting the decline in gain on sale revenues included an increase in servicing fees and a decrease in operating expenses.

As we have been recently focused on retaining servicing, our servicing portfolio increased 32% to $16.3 billion at the end of 2017 from $12.4 billion at the end of 2016. The increase in the portfolio resulted in an increase in net servicing fees of 132% to $31.9 million in 2017 from $13.7 million in 2016.

Furthermore, although NonQM volume levels in 2017 were a little lower than anticipated, the NonQM originations increased to $891 million as compared to $289 million of NonQM production in 2016. In 2017, the combined NonQM and government-insured originations represented approximately 41% of the total originations as compared to just 16% of the total originations in 2016. Additionally, we have been marketing our NonQM product as iQM, which more closely aligns with Impac's traditional product branding.

As of December 31, 2017, the CashCall Mortgage earn-out has been concluded, with the final earn-out payment of $550,000 being made in February. Going forward, we will retain 100% of all the CashCall Mortgage earnings, with no further earn-out payments.

Contributing to the loss in 2017 was a number of noncash items, including an increase in income tax expense and changes in the estimated fair value of mortgage servicing rights. With the new tax laws significantly reducing corporate income tax rates, we decreased the deferred tax asset on the balance sheet, resulting in income tax expense increasing by $19 million in 2017 to $20 million from $1.1 million in 2016.

The loss on mortgage servicing rights in 2017 includes a $38 million decline in the estimated fair value of mortgage servicing rights due to mark-to-market changes from changes in interest rates as well as changes associated with ongoing run-off of the portfolio. With the rise in rates in 2018, the run-off has slowed and the estimated fair value of the portfolio has increased.

Lastly, in our earnings release yesterday, I announced that as of July 31, I would be stepping down as CEO. When we took Impac public in 1995, I could never have imagined what a tremendous journey we would all be embarking on. Through the good times and the difficult times, I've always tried to do what is in the best interest of our shareholders and our employees. Looking back, I can honestly say that I have given Impac all that I have, and I'm very proud of what we've accomplished.

When we hired George Mangiaracina in 2015, we began to prepare the company succession plan. George has been a part of the Impac family since its inception. From being one of our bankers involved in taking the company back -- public in 1995 to providing the company with its first warehouse line of credit and helping the company to navigate the financial crisis in 2007. And finally, being one of the architects of the CashCall Mortgage transaction, George has been an integral part of the company for over 22 years. It gives me a lot of pride to turn the company over to George and so many of our talented young leaders, enabling them to grow the company into their own vision. I will continue to provide leadership in whatever capacity is needed as I maintain my position on the Impac Board of Directors.

I'd like to now turn the call over to our newly appointed President, George Mangiaracina. George?

George A. Mangiaracina - *Impac Mortgage Holdings, Inc. - President*

Good morning, everyone. Joe, I'd like to start by thanking you for your commitment and dedication to the Impac family. I'm pleased to have earned the Board of Directors' and your confidence to lead the company in the future.

In this endeavor, I will be guided by the core principles you've instilled in the organization: integrity, indomitable spirit, respect for employees and counterparties and creation of shareholder value. On a personal note, what will endure is our friendship. For over 2 decades, I benefited from your counsel and wisdom and have gained immeasurable lessons in life as well as in business. For this, I am forever grateful.

We have already begun to take significant steps to change the trajectory of the company, which I will now review. In December of 2017, Rian Furey joined the company as President of CashCall Mortgage, our direct-to-consumer channel. Effective today, we've decided to expand Rian's role in the organization to include that of Chief Operating Officer of Impac Mortgage Holdings. Together, Rian and I will focus on reengineering the company's origination activities across all of our channels. Particular attention will be given to future technology initiatives and attribution of our marketing spend, with the goal of improving metrics on customer acquisition and operating efficiencies.

In February, the first stage of that reengineering was implemented in our business-to-business channel. We restructured our operations and sales organizations, eliminated layers of redundant management and sales cost overrides and empowered the account executives and relationship managers with a revised compensation plan that's more aligned with our origination objectives. We estimate that this first stage, coupled with natural workforce attrition, will result in $6 million to $8 million in annual cost savings to the company. More importantly, we expect these changes to improve the B2B's operating efficiencies and competitive positioning on loan origination and acquisition.

With respect to the CashCall Mortgage platform, several developments since the third quarter earnings call are noteworthy. The company had been operating under CashCall -- had been operating CashCall Mortgage under a 3-year earn-out provision since its acquisition in January of 2015. That earn-out provision expired on December 31, 2017. The final earn-out payment in the amount of $550,000 was made in February. Effective January 1, 2018, Impac Mortgage Holdings will be the beneficiary of all and any future operating income derived from CashCall Mortgage.

As previously noted, Rian Furey joined the company in December 2017 as President of CashCall Mortgage. Rian's additional role as COO of Impac will enable the company to provide integrated and consistent operations, technology, marketing and other traditional foundational support services across all of our origination channels. In his limited tenure at the company, Rian has already instituted a number of changes to the operating model of CashCall.

These initiatives are consistent with our goal of repositioning the platform from a California refinance-centric business model to one that is more geographically diverse by state and loan type; refinanced versus purchased; Fannie and Freddie versus government; and, of course, our proprietary iQM product. Balanced origination volume should, on an aggregate basis, have a positive effect in reducing the company's prepay speeds on our MSR portfolio and result in more advantageous execution levels on our loan deliveries to the agencies and other capital market participants.

I'll now turn the discussion over to Rian Furey for some of the specifics.

Rian Furey - *Impac Mortgage Holdings, Inc. - COO and President of Direct Lending*

Thanks, George, and good morning. As we mentioned, the CashCall Mortgage platform traditionally originated almost exclusively refinanced, conforming, agency product in California and did so in most cases, while paying third-party closing costs for its borrowers. That pricing and the positioning of the CashCall Mortgage brand contributed not only into the platform's impressive credit performance but also its problematic prepayment speeds. In the fourth quarter and continuing in 2018, we focused our commissioned loan agents on new customer acquisition, with lead traffic driven primarily by our TV and radio marketing campaigns and, to a smaller extent, purchased online leads, organic Web traffic and customer referrals.

For our existing portfolios, we've also maintained servicing defense group, made up of salaried originators skilled at recapturing transactions from borrowers who have indicated their intent to prepay. To reduce prepayment speeds, the company has previously expressed its desire to expand diversity of its product mix and the geography of the borrowers that it serves. To that end, we've increased our non-California marketing spend by testing and targeting additional states and specific markets. Today, approximately 40% of our new originations come from outside California.

We're also evolving the positioning of the CashCall Mortgage marketing to introduce messages that emphasize: a, the flexibility of our diverse product set; and b, feature very competitive rate and price options for our customers through pricing that may include borrower-paid fees or prepaid interest.

Now the CashCall Mortgage platform has reduced in size in lockstep with market volumes and the rest of Impac. But in my few -- short time there, I'm impressed with the core team that I joined late last year as they're proving highly adaptable to these changes. I look forward to sharing more with you later in the year as our initiatives continue to change the complexion of CashCall Mortgage's product mix and performance.

George A. Mangiaracina - *Impac Mortgage Holdings, Inc. - President*

Thank you, Rian, for that update. I'll now spend some time discussing the company's activities and what we believe to be our most promising ongoing initiative, Impac's iQM origination business.

Impac in early 2014 was one of the first mortgage companies to anticipate and actively pursue the revival of an alternative nonqualified mortgage market. Since the company's founding in 1995, we've been recognized as a leader in providing creative loan products to borrowers in need of alternatives to traditional Fannie, Freddie and government offerings. The design, underwrite, origination, securitization and master servicing of these products have historically been a core competency of the company. We consider this to be part our DNA.

After the financial crisis of 2006 and 2008, the company consciously maintained resources across these disciplines to manage our pre-crisis legacy Alt-A portfolio. The company naturally extended this existing franchise intact to the reemerging iQM market, providing us with significant competitive advantages over any new entrant. We have steadily increased iQM production from $130 million in 2015 to over $900 million in 2017.

Along the way, we have achieved proof of concept, expanding our investor base and successfully working with rating agencies to enable securitization of our loans. We expect one of our key investor partners to issue a deal backed solely by Impac collateral no later than the end of the second quarter of 2018.

While we are pleased with our accomplishments to date, achieving scale in the iQM business is our next focus and key strategic initiative for the company. Resources have been committed across several areas.

With respect to customer acquisition, we now conduct on-site iQM training programs across the country to educate our clients as to the nuances and successful origination of these products. With respect to loan processing and pipeline management, we've created an internal iQM sales support team to ensure data and documentation quality, to clear underwriting conditions and to improve application-to-close times and pull-through percentages. And with respect to technology, we've concentrated our efforts on automating our underwriting process; initially, credit conditioning and, ultimately, credit decisioning. These collective efforts should enable the company to scale the iQM franchise and capture market share in the expanding alternative market segment.

I will now shift to the last topic for discussion before opening the call for questions. The company's mortgage servicing rights or MSRs as of December 31, 2017, were approximately $16.3 billion in notional and carried at a fair value of $154 million. Conventional wisdom holds that an MSR portfolio in a rising rate environment is a natural offset to a reduction in origination volume, margin and profitability.

The market sentiment calls for continued higher rates in 2018. 10-year treasury has traded this year in a range as wide as 40 to 60 basis points above 2017 year-end levels. These market conditions have resulted in a year-to-date mark-to-market gain on the company's MSRs of approximately $12 million, a positive contribution to early 2018 GAAP earnings.

In terms of liquidity, the MSR portfolio contributed approximately $32 million of net servicing cash flows to the company in 2017. As of December 31, 2017, the company had borrowed approximately $35 million against the MSRs, with flexibility to borrow approximately an additional $30 million. We intend to continue to accumulate MSRs as long as the economic value of this asset satisfies the company's return profile and strategic objectives.

The company has been successful in recapturing loans that would otherwise prepay, a critical defense against portfolio runoff. Additionally, the credit quality of our MSRs remains strong, with a weighted average coupon of approximately 3 3/4%, weighted average LTV in the mid-60s and a weighted average FICO above 730 as of December 31, 2017.

In summary, the MSR should provide the company with liquidity and GAAP earnings resilience, if faced with a difficult origination environment in 2018.

That concludes our prepared remarks. We will now open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Trevor Cranston of JMP Securities.

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

First question on the MSR write-down in the fourth quarter. Can you give some additional details on what exactly drove that write-down and particularly the magnitude of it? It was a little surprising, I guess, given that interest rates increased marginally in the quarter. So just any additional color you can give around that would be useful.

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

Trevor, this is Todd Taylor. Yes, half of that is really due to runoff/amortization charges. The other half is due to a true -- sort of mark to market associated with the changes in interest rates. We -- I think, at the end of the year, we actually took a look at the assumptions, and we ended up scrubbing the assumptions. And it ended up aligning some of our prepay assumptions to things that we've seen more close -- or more recently in our experience, and so that probably was attributed to that. So today, going forward, we feel very comfortable about those items, and we have seen -- as a result, we've seen some good pickup, as George mentioned, in the first part of 2018.

George A. Mangiaracina - *Impac Mortgage Holdings, Inc. - President*

Yes. And I'll also just add that correctly noting that rates have gapped up, but our portfolio is primarily focused in California. We've had some very healthy housing market here, and there's been some HBI gains. And so we're seeing home sale activity that's increased our paid in fulls on the servicing. And we've also seen refinance activity that's not rate and term refinance, which you see in a low rate environment, but is actually cash-out refinance which you see in an uprate positive housing appreciation environment.

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

Okay. So as a follow-up to that, I guess, if around half of the write-down was sort of amortization/runoff and half is mark to market, that would put -- the amortization would basically offset the net servicing fees for the quarter, so it'd be sort of a 0 net line item. Are you guys anticipating that sort of pace of runoff and amortization to slow down at all over the next couple of quarters? Or do you think that's going to sort of continue as long as the California housing market is reasonably strong?

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

It's -- in general, it is going to slow down, and that's what we have seen in the first part of 2018. So the rate of amortization, if you will, has slowed down slightly. But George is right; there is a factor in there relative to what's going on with the housing market. But I can tell you what we have seen in the first 2 months is it's slower than what we saw in the fourth quarter and all of '17.

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

Okay. Then on the expenses, so the commentary about the changes you guys have made so far this year were helpful, and I think the number you gave was $6 million to $8 million in annual expense savings. So a question related to that. Looking at the income statement for this quarter, if you add back the mark-to-market impact of the servicing, the total revenue number was still meaningfully lower than what the total expense level was.

So when you guys are thinking about that going forward this year and trying to return to the state of profitability, are there sort of incremental areas where you guys think there's room to improve on the expense side in addition to the adjustments you've made so far this year? Or sort of how are you guys thinking about getting that back to a more profitable level?

George A. Mangiaracina - *Impac Mortgage Holdings, Inc. - President*

Well, the $6 million to $8 million is simply in the third-party origination channel. There have also been reductions in force and cost savings over the CashCall platform, which we did not highlight here. And I think you'll see us continue to refine the overhead supporting businesses, and I think you'll continue to see us rightsizing the infrastructure for the volume. We've -- this first stage was a very early, quick decision to head in that direction, but there's more work to be done there, and I don't have specific numbers on that yet.

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

Okay, that's fair enough. And just on the market -- the gain on sale margins, it looked like there was some compression in the fourth quarter just based on the amount of decline in the gain on sale revenue relative to the decline in origination volume. Can you share sort of how those have been trending so far in the first quarter and if you guys anticipate any further compression in margins, given the increasing rate so far this year and presumably incrementally lower volumes and increased competition?

Rian Furey - *Impac Mortgage Holdings, Inc. - COO and President of Direct Lending*

Yes. It's Rian Furey. We have seen, with the [backup] in rates, increased competition, and competitors accepting lower margins in the direct lending channel in particular. That tends to happen as there's capacity available widely in the industry and volumes start to decline. It tends to even out as folks reduce their capacity, which we've already seen that starting to happen. But we did definitely go through an inflection in the fourth quarter, where margin compression was noticeable. And we anticipate, again, as these folks reduce their capacity, we'll start to see that as well.

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

Got it, okay. And then a question on the -- you guys mentioned that one of the investors in your NonQM product is anticipating completing a securitization backed by your loans by the end of the second quarter. Just to clarify, are those going to be -- is there going to be any retention from that securitization deal for Impac's balance sheet? Or would that just be completely sold and off the books by that point?

George A. Mangiaracina - *Impac Mortgage Holdings, Inc. - President*

We've sold -- all these loans that we've sold to this particular investor, we've sold on service released basis, and we have no retention requirements as a result of that activity.

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

Okay. And as you look forward strategically for 2018, is there any sort of thought or planning around potentially completing securitization on your own balance sheet and retaining subordinate investments? Or do you guys anticipate continuing to pursue the gain on sale approach with the NonQM loans?

George A. Mangiaracina - *Impac Mortgage Holdings, Inc. - President*

Well, Trevor, we put our product out for competitive bid. And the way we measure [best x], the whole-loan service release bid is superior to any securitization that we could avail ourselves of. And again, there are other issues associated with us securitizing. We need to aggregate product for a period of time. This is not easy product to hedge from a credit perspective. It would require a lot of liquidity to hold that product; and then upon securitization, we have the retention requirements. We think, currently, best x whole-loan sale is superior to anything we can do in securitization in this space. But at the same time, having gone through the rating agency reviews, we're positioned to be able to securitize. It's just not economic and beneficial at the moment for us.

Operator

(Operator Instructions) And I'm showing no further questions at this time. I'd like to turn the call back to Impac for closing remarks.

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

Well, if there's no other calls, then this concludes our 2017 earnings call, and I appreciate everyone's participation. And next call will be for the first quarter. So thank you very much.

Operator

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