

## **Finance of America Companies Inc. (Q2 2022 Earnings Call)**

**August 04, 2022**

### **Corporate Speakers:**

- Michael Fant; Finance of America Companies Inc.; SVP of Finance
- Graham Fleming; Finance of America Companies Inc.; President & Interim CEO
- Johan Gericke; Finance of America Companies Inc.; Executive VP & CFO

### **Participants:**

- Unidentified Participant; Credit Suisse; Analyst
- Unidentified Participant; Unknown Company; Analyst

## **PRESENTATION**

Operator^ Good afternoon. My name is Chelsea, and I will be your conference operator today. At this time, I would like to welcome everyone to the Finance of America 2022 Second Quarter Earnings Call and Webcast. (Operator Instructions) And I will now turn the call over to Michael Fant, Senior Vice President of Finance with Finance of America. Sir, please go ahead.

Michael Fant^ Thank you, and good afternoon, everyone, and welcome to Finance of America's Second Quarter 2022 Earnings Call. With me today are Graham Fleming, President and Interim Chief Executive Officer; and Johan Gericke, Chief Financial Officer.

As a reminder, this call is being recorded, and you can find the earnings release and presentation on our Investor Relations website at [www.financeofamerica.com](http://www.financeofamerica.com).

In addition, we will refer to certain non-GAAP financial metrics on this call. You can find reconciliations of non-GAAP to GAAP financial metrics to the extent available without unreasonable efforts discussed on today's call in our earnings press release and presentation on the Investor Relations page of our website.

Also, I would like to remind everyone that comments on this conference call may be forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 regarding the company's expected operating and financial performance for future periods. These statements are based on the company's current expectations and are subject to the safe harbor statement for forward-looking statements that you will find in today's earnings release.

Actual results for future periods may differ materially from those expressed or implied by these forward-looking statements due to a number of risks or other factors, including those that are described in the Risk Factors section of Finance of America's annual report on Form 10-K for the year ended December 31, 2021, originally filed with the SEC on

March 15, 2022, and such, risk factors may be amended and updated in our subsequent filings with the SEC. We are not taking any commitment to update these statements if conditions change.

Please note these are interim period financials and are unaudited. Now I would like to turn the call over to Finance of America's President and Interim Chief Executive Officer, Graham Fleming. Graham?

Graham Fleming^ Thanks, Michael. Good afternoon, everyone, and thank you for joining us on our second quarter '22 earnings call. I am pleased to be here and to be serving as FOA's Interim CEO. Since joining the company back in 2013, and I've witnessed the evolution of this business and believe there is more opportunity ahead. Finance of America exists to help our customers use equity to thrive and discover pathways to achieve lasting financial freedom.

Before we start with an update on the business, I want to mention how proud I am with the team's resilience and unwavering commitment to our customers. Despite current market conditions, I am confident we will meet our challenges head on while continuing to build for tomorrow.

Given the negative impact of rates and spreads on our business, we recorded a net loss of \$168 million or \$0.70 per fully diluted share for the second quarter. The impact on earnings fell into two categories, operating losses and balance sheet write-downs. The write-downs on the balance sheet were a result of negative fair value marks due to spread widening and if spreads return to the mean, we would recoup these losses. Johan will discuss these write-downs in greater detail in a few moments.

On an adjusted basis, excluding fair value marks and other items, the company generated an adjusted net loss of \$22 million. The loss was caused by the rapid increase in rates and widening of spreads and is almost entirely attributable to our Mortgage Origination segment due to precipitous drop-off in refinance volumes.

To combat the operating pressures on our business, we are prudently managing costs across the company and continue to implement expense initiatives to right-size the business as we expect current volume levels to persist into the second half of the year.

We reduced our workforce and mortgage originations to match capacity with current market demand, taking out roughly 35% in costs on a run rate basis, equating to over \$100 million annualized. These reductions will be realized over the remainder of the year.

Since the beginning of the year, we have reduced overall company headcount and expenses by roughly 20%. In Reverse and Commercial Originations, rates and spreads increased at such a rapid pace that we could not reprice loans in the pipeline at the same velocity with which the market moved. In addition, funded loans deteriorated in value

between the time of funding and eventual sale or securitization. As a result, we saw a substantial decline in margins for those 2 businesses.

In order to combat this margin compression, we repriced loans and raised coupons several times. And yet despite these increases, we saw a record origination volumes in Reverse and another strong quarter from Commercial. As the capital markets stabilize, we expect margins in these businesses to return closer to historical averages, and we will take any additional actions necessary to improve profitability.

To summarize, we believe the long-term fundamentals underlying our businesses remain sound and will allow Finance of America to generate returns in line with expectations. Finance of America was built to strategically deliver a wide range of products to customers at all stages of life under a variety of economic conditions.

We are focused on executing against our three strategic priorities to set FOA up for long-term success, and these are: one, optimizing our mortgage business; two, investing in a Reverse, Commercial, Lender Services and capital markets capabilities, that collectively form SFS and separate us from other lenders in the category; and three, leveraging our technology, data and operating model to transform from a product to customer-centric company.

I want to underscore that we remain steadfast in executing against these priorities despite the current cyclical headwinds and not because of them. Our vision for FOA is bringing our entire industry-leading suite of products and services to consumers in more compelling ways. We are going to turn their experiences with us from onetime transactions into lifelong journeys.

First, let's start with optimizing our mortgage business. Overall, mortgage volume, mortgage volumes decreased as the rapid rise in rates led to a steep decline in refinance volumes. As I discussed earlier, we are optimizing our cost structure through reductions in headcount and other cost management efforts.

We have moved out of the consumer-direct channel that was heavily reliant on refinance leads and are actively rightsizing each of our branches. As the purchase market continues to become a larger part of origination volume, our distributed retail business remains poised to take advantage of this shift.

Currently, purchase originations comprised roughly 85% of our volume. We also believe there remains substantial opportunity to sell non-mortgage products through our mortgage channel and are focused on building out this opportunity. Our home improvement business, which is included in our Mortgage Origination segment, continues to see steady improvement.

In June and July, home improvement saw its highest funding months ever, putting it on pace to achieve operational breakeven later this summer. We believe home improvement can become a very effective customer acquisition channel at essentially 0 cost. This is an

exciting development as we think about the various cross-sell opportunities that exist within this business.

With the average age of a home improvement customer being roughly 52 years old, there is an opportunity to sell additional products like Reverse, offering borrowers yet another option to leverage the equity in their homes.

Our second strategic priority is to invest in specialty finance and services businesses, comprised primarily of Reverse, Commercial and Lender Services. Reverse origination volumes of \$1.58 billion in Q2 set yet another quarterly funding record and was roughly \$100 million above the first quarter. This growth is attributable primarily to market penetration in first-time Reverse customers. As a result, we have seen a decrease in prepayment rates as production shifts from refinance to new volume.

Last month, Finance of America Reverse published its inaugural home equity punch list research study, which found that despite having the most equity in their homes, older Americans are also the least likely cohort to consider using their home equity as part of financial planning. These results underscore not only the massive market opportunity, but also the need for greater consumer education and awareness to fuel product adoption.

We are actively working on a strategic partnership to unlock a new origination channel that will target Reverse as an efficient financial planning tool, and we are very excited about the prospect of growing this over time.

In our Commercial segment, we originated \$540 million of funded volume in the second quarter, a slight decline from Q1. Due to product rate increases, we do expect to see lower volumes in Q3. However, we continue to add new products that appeal to our customers and have maintained a robust pipeline.

In addition, early in Q3, we took actions to reduce the quarterly expense run rate by roughly 25% and expect the segment to show improved profitability for the quarter. It's important to note that our commercial customers are seasoned and sophisticated, with over 50% of our borrowers since the beginning of 2021 completing 10-plus transactions. The quality of our customers stand out as a key advantage to our commercial portfolio.

In our Lender Services business, we continue to introduce new products to diversify our income stream and offset the pullback in the refinance market. In particular, MSR Advisory had a record quarter as customers are actively trading assets. We also continue to build on our existing customer relationships, adding new third-party customers in Q2 and expect these relationships to add incremental revenue over time.

Finally, turning to our third strategic priority. We continue to invest in technology, data and our operating models to capture the inherent household value in their respective FOA businesses.

As a customer-centric organization, we can benefit from efficiencies in marketing and streamline technology on the back end, providing a digital mobile-first experience that offers seamless capabilities between each of our offerings. This will help us unlock lifetime household value across our entire customer base. I will elaborate more on our plans and goals towards these objectives over the coming quarters.

Looking ahead, we will continue to navigate evolving macro conditions including further deleveraging the balance sheet and managing our expenses. We believe that our retail distribution model is well positioned to capture purchase volume. And in addition, we see massive tailwinds on for both our reverse and commercial business over the long term. All of these factors leave us well positioned for future growth. I will now pass the call to Johan to discuss the financial results. Johan?

Johan Gericke^ Thank you, Graham, and good afternoon, everyone. As Greg mentioned, we faced several macro headwinds this quarter, which had a direct impact on our operating results and the value of the balance sheet. Despite these challenges, we remain committed to our business strategy and delivering for our customers. Before I dive into the numbers, I want to touch briefly on the impact that market volatility continues to have on our results. We generated a headline loss, predominantly due to negative fair value marks on the balance sheet.

As a reminder, we account for fair value marks on the balance sheet in the Portfolio Management segment, whereas revenue impacts on newly originated assets are reflected in their respective origination segments.

In Q2, rates continued to be volatile as the tenure increased by 115 basis points to 3.49% on June 14, ending decreased by 51 basis points to close the quarter at #2.98 [ph], up 64 basis points for the quarter. In addition, spreads on both agency and non-agency mortgages increased to new highs in a matter of weeks. This meteoric rise in both rates and credit spreads put tremendous pressures on our origination businesses and also negatively impacted the balance sheet.

We hedged the balance sheet against rising interest rates using a combination of mortgage MSR assets, PBAs and swaps. The fair value marks are net of hedge gains and consists predominantly of spread impacts as we are unable to efficiently hedge the balance sheet against spread movements.

It is important to note that the fair value marks due to widening spreads have not directly impacted liquidity as these are noncash. We also continue to see demand for our private label securitizations, albeit at a higher cost. It is also important to note that we adjusted spreads through the lifetime of the underlying assets and liabilities rather than reverting spreads to the mean.

Any future reduction in spreads would result in positive fair value marks, allowing us to recoup these losses.

Turning to the operating results. The company generated an adjusted net loss of \$22 million and a fully diluted adjusted loss per share of \$0.12 as our Mortgage Origination segment continued to be pressured by the rising rate environment. During the second quarter, mortgage originations accounted for \$21 million of the \$22 million in adjusted net loss. I will discuss revenue and other financial impacts in detail when I cover the individual segments in a moment.

From a balance sheet perspective, cash remained relatively flat in Q2, decreasing by \$8 million as hedge gains recognized in the quarter, were used to deleverage and strengthen our balance sheet. Year-to-date, we have paid down over \$110 million of secured lines of credit.

In addition, we are focused on preserving liquidity in this volatile environment. MSR balances declined as we executed a bulk MSR sale in Q2 that more than offset new production. Tangible equity decreased by \$155 million predominantly due to the impact of noncash fair value marks from wider spreads.

Turning to our individual reporting segments. Revenue in Mortgage Originations decreased by 24% relative to the first quarter due to a 29% decline in net rate lock volume as a steep decline in refinance volumes more than offset the 21% growth we saw in purchase volume quarter-over-quarter. As a result, we recorded a \$21 million adjusted net loss. As Graham mentioned earlier, we have taken decisive action to manage expenses in this business to return to profitability at lower volumes.

We expect the full impact of these expense reductions to be realized over the remainder of the year. In addition, we are encouraged by the strong quarter-over-quarter growth in funded purchase volume, and our distributed retail model is well suited to capitalize on this market.

Our Reverse Originations segment saw 7% quarter-over-quarter growth in funded volumes, setting yet another quarterly funded volume record. However, rapidly widening spreads had a substantial negative impact on margins despite repricing the pipeline and increasing rates multiple times. As a result, revenue of \$80 million was down 26% relative to the last quarter.

The Reverse Originations segment generated pretax income of \$36 million, down 32% from Q2 last year as a substantial increase in volume was more than offset by lower margins. We are actively monitoring and adjusting product guidelines and pricing to return margins closer to historical averages.

Similar to what happened in Reverse, our Commercial Originations segment was significantly impacted by market volatility this quarter. Volumes were down modestly compared to Q1 2022, and up 35% compared to the same period last year.

Margins decreased despite repricing the pipeline multiple times throughout the quarter as rapidly widening spreads impacted secondary market execution. We expect to see

volumes softening in Q3 as rising rates ultimately impact refinance activity for this business. However, we also expect margins to improve in Q3.

Lender Services revenue was down 24% quarter-over-quarter as lower refinance volumes impacted our title agency and underwriting businesses. We saw strong growth in advisory income given active trading in MSR assets. The segment generated a \$5 million pretax loss as the revenue decline more than offset a \$7 million quarter-over-quarter reduction in expenses.

Lastly, looking at Portfolio Management segment. Pretax income was negatively impacted by the fair value marks on our assets.

In closing, the first half of 2022 has tested the strength of our model as we continue to navigate rapidly changing market conditions. Our asset finance businesses faced consistent pressure yet remained essentially breakeven in Q2 and on an adjusted basis against the backdrop of non-agency credit spreads at new highs.

On a year-to-date basis, Finance of America has generated \$15 million in adjusted net income, and we will continue to take the necessary actions to improve profitability and ensure the long-term success of the company. With that, let me now hand it back to Graham for closing remarks.

Graham Fleming^ Thanks, Johan. Before we take your questions, I want to briefly touch on our outlook. Given the significant volatility in the market today, we are not providing any specific financial guidance at this time. While we do believe conditions will settle, and we will see a reversion to the mean, it is difficult to say when.

As we look to the third quarter, we do expect volumes in Reverse to come down from recent record highs in response to lower refinancing activity. Similarly, we expect volumes in Commercial to decline as a result of higher rates, yet we expect to see better margins reverting closer to historical averages, assuming the market ultimately stabilizes at this level.

In general, we expect profitability levels for the third quarter to fall somewhere between Q1 and Q2 for both mortgage and SF&S, given our expectation that our increased margins will not be fully realized until the latter half of Q3. And so, in closing, I feel strongly that we are well positioned for long-term growth across the organization. And with that, let's open it up for questions. Operator?

## QUESTIONS AND ANSWERS

Operator^ (Operator Instructions) Our first question will come from Doug Harter with Credit Suisse.

Unidentified Participant^ This is John Kosowsky on for Doug. Just a quick question. Could you kind of give us an idea of your ability to kind of grow customers here for the rest of the year?

Johan Gericke^ Customers for the rest of the year.

Graham Fleming^ Yes. As I mentioned, right, in our reverse channel, right, we're continuing our education seniors. We're looking to partner with some strategic relationships that will help improve the penetration. So we're very optimistic that we can grow customers in the Reverse space.

In our Mortgage business, we're actively looking to fill in areas of white space in the country where we don't currently have a presence, and with that with some additional customers into the organization as well. So a combination of geographic diversification in Mortgage and continued education in the Reverse space.

I'd also add to that, right, our ability to grow our customer base to the Home Improvement segment and bringing additional borrowers in via the home improvement loans that we do today via contractors. So we do have 3 ways they are identified to increase our customer base.

Unidentified Participant^ Got it. And then if I can ask 1 more. I know we talked about sort of directionally where Reverse volumes are going, but could you size that for us kind of next quarter? Or is that something that you're not willing to disclose at this moment?

Johan Gericke^ You're talking about reverse volume?

Unidentified Participant^ Yes.

Johan Gericke^ Yes. No, we're not going to give a specific number on that. It's relatively early in the quarter, and a lot can happen, but we do have some visibility in terms of what we can see in our submissions in our pipelines.

And so as we are seeing a shift away from refinance into new to Reverse, there will be some softening of volumes, but we still feel optimistic that we're going to see good business in that channel. The macro tailwinds for that business is really big. If you think about the record amount of home equity that seniors have and that just creates a substantial market, right? So I guess -- I think that channel is going to see persistent long-term volume levels growing.

Operator^ (Operator Instructions) And at this time, we have no further questions in the queue. We do have another question from Don Casey [ph].

Unidentified Participant^ Yes. I just -- first of all, thank you, gentlemen, for a personal investor, substantial amount of shares. I'm looking at defense of the stock. You're in a position right now where you've got \$219 million in cash or cash equivalents. And you



got a short position ranging of 3% on the stock. And I think all of your upside is in front of you. Just listening to your narration, your articulation relative to the scope of the business.

Is there any thought process of strategy to announce some sort of repurchase of shares? You have the ability to (inaudible) repurchase shares at your option. And I think if you defend the stock, I think you're going to get a little bit more momentum and -- especially with your ability to execute on your strategy in the reverse mortgage market, which I think is -- I think is totally correct with that.

But I just think people looking, can you defend the stock? You've obviously cleaned up the balance sheet, you've paid a lot of debt and you're suffering the consequence of everybody in this space. But do you have a strategy to defend the stock?

Johan Gericke^ Yes. Don, I appreciate the question. I would say a couple of things. We don't, at this point, have an intention to buyback stock for 2 reasons. The first reason is, we see, as you mentioned, continued growth in the Reverse business. And we need equity to be able to fund that growth.

There is a moment here where we have a huge market that needs penetration and that growth comes at the cost of investing in the business on an ongoing basis, not only in people and capabilities, but also in equity in the loans that we make before we can securitize them.

The second thing I'd say is, until we can see some stability or less volatility in the market, I think our collective management team thinks it's prudent and better for us to maintain liquidity. Until we see things stabilize it just creates a little bit more stability and take some risk out of the balance sheet and the operations on a day-to-day basis.

Operator^ I will now turn the call back over to Graham Fleming to make a few closing remarks.

Graham Fleming^ So I want to thank everybody for their time today and participating on this call. We look forward to our Q3 earnings and our updated call in November. So with that, I would like to wrap it up, and thank you all very much.

Operator^ Ladies and gentlemen, this does conclude the Finance of America's Second Quarter 2022 Earnings Call and Webcast. Please disconnect your line at this time, and have a wonderful day.