Finance of America

First Quarter 2022 Earnings Call

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CORPORATE PARTICIPANTS

Michael Fant, *Senior Vice President of Finance*

Patricia Cook, *Chief Executive Officer*

Johan Gericke, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Douglas Harter*, Credit Suisse*

Stephen Laws, *Raymond James*

Blake Netter, *Morgan Stanley*

PRESENTATION

Operator

Good afternoon. Thank you for attending today's Finance of America First Quarter 2022 Earnings Call.

I would now like to pass the conference over to our host, Michael Fant, Senior Vice President of Finance with Finance of America. Please go ahead.

Michael Fant

Thank you and good afternoon everyone and welcome to Finance of America's first quarter earnings call.

With me today are Patti Cook, 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.

In addition, we will refer to certain non-GAAP financial measures on this call. You can find reconciliations of non-GAAP to GAAP financial measures to the extent available without unreasonable effort 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.

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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, filed with the SEC on March 15, 2022. As such, risks factors may be amended and updated in our subsequent filings with the SEC. We are not undertaking 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 Chief Executive Officer, Patti Cook. Patti?

Patricia Cook

Thanks Michael. Good afternoon everyone. Thank you for joining us for our first quarter 2022 earnings call.

This call marks our first full year of reporting earnings as a Public Company, and I am pleased to provide you with an update on the business. I am proud of our team's execution in what can only be described as a volatile quarter for our business and the industry as a whole. The devastating war in Ukraine and rapidly rising inflation resulted in the fastest increase in interest rates we have seen in decades. This put tremendous pressure on pricing and volumes in the industry.

In addition, credit spreads widened on most financial assets as investors perceived increased risk in the markets. While we are hedged against rising interest rates, we cannot efficiently hedge our balance sheet against widening spreads, and as a result, we incurred significant fair value adjustments as we updated model assumptions. Johan will cover this in more detail.

The fair value adjustments resulted in a headline loss. However, we generated adjusted net income of $37 million in Q1 or $0.20 in adjusted earnings per share.

Our specialty finance and service business, or SF&S, continued to perform well, generating $0.25 in adjusted earnings per share in line with guidance.

Our mortgage origination segment, however, was not immune to the impact of rising rates and recorded an adjusted loss of roughly $10 million for the quarter, or negative $0.05 in adjusted earnings per share. The mortgage origination segment was impacted by both lower-than-expected volume and a decline in non-agency pricing as many originators liquidated assets.

Despite the market volatility, we continued to execute on our strategic initiatives. We have substantially reduced run rate expenses in the mortgage business, continued to invest in SF&S to drive growth, particularly in our reverse business, and lastly, we are making progress on our efforts to build a customer-centric organization, to unlock the inherent value in our franchise, and grow lifetime household value.

It is during cycles like this, that our diversified business model allows us to generate adjusted net income despite significant headwinds in the mortgage sector. We don't expect interest rates to return to the levels seen earlier in the year and are prepared to operate the Company in this higher rate environment.

First, let's start with our mortgage business. As I mentioned earlier, this segment generated an adjusted loss of $9.5 million for the quarter, which included an adjusted loss of $1.6 million for our home improvement business. Overall, mortgage volumes were weaker than expected as the rapidly rising rates resulted in a steep decline in refinance volumes.

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Refinance as a percentage of overall volume fell to 45%. This does not fully capture the impact of the roughly 50 basis point increase in the tenure during March, and as a result, we expect that percentage to be much lower in Q2.

Our strong retail distribution channel is ideally suited to the purchase market, and as a result, we saw purchase volumes increase 4% year-over-year. Demand for our non-agency products remained strong and increased 8% year-over-year.

We have worked very hard on our customer experience and are pleased that these efforts have paid off. Recently, we were recognized as the number one mortgage company in customer satisfaction for the Jumbo division in 2021 by Experience.com.

Our non-QM product, Flex, fills an important gap in the market, and despite the current volatility impacting margins for that product, we believe over the long term, that this will be an important driver of growth in our mortgage business.

We are working across operations and distribution channels to align the organization and streamline our operating model. For example, we have consolidated our wholesale channels in mortgage and commercial, which obviously drives efficiency, but more importantly, enhances the cross-sell opportunity of commercial products to the mortgage broker network.

In addition, we also consolidated our consumer direct channels into a single operation. As a result, we have lowered our fixed and variable cost components and will continue to do so as we eliminate waste, reduce duplicate efforts, and consolidate infrastructure.

We continue to believe there is a substantial opportunity to sell non-mortgage products through our mortgage channel and are focused on this opportunity.

I want to also touch briefly on our home improvement business that is included in the mortgage origination segment. This business won't be a significant profit driver in the short term but it brings some exciting capabilities to the table. The technology platform we acquired as part of this business is modern, scalable, and we constantly hear from our customers that it is one of the best in the industry.

Not only has this helped us win new business—we added 150 new contractors to the platform in Q1—but it also gives us tremendous flexibility to add new products. Interestingly, the average age of a home improvement customer is 54 years, which allows us to introduce our reverse products, and it gives borrowers another option to use the equity in their homes. This business can become a highly effective customer acquisition channel at a zero cost of acquisition once the business reaches break-even, which we expect to happen later this year or early next.

Our second strategic priority is continued investment in specialty finance and services, or SF&S, comprised of predominantly reverse, commercial, and lender services. Reverse volumes continue to grow at a strong pace, and Q1 set yet another record origination quarter. In fact, March was our highest origination month ever.

Our reverse pipeline has never been bigger, driven by strong home price appreciation over the past couple of years, as well as continued investments in processing capacity. Margins declined more than expected as wider spreads impacted capital markets execution. Needless to say, we manage this very closely to ensure we maintain margins in this volatile market but expect margins to remain pressured in the first part of Q2 as we clear out inventory.

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We believe Finance of America has the leading reverse mortgage platform in an industry with structural tailwinds. The older population in the U.S. will continue to grow, and recent home price appreciation has increased the addressable market substantially. These factors represent customers with an effective opportunity to tap into their home equity to fund their retirement and lifestyle. We continue to invest in education and advertising to position a reverse mortgage as an efficient tool for seniors to monetize the equity in their homes.

Our commercial business originated $573 million in funded volume this quarter, a growth of 68% compared to Q1 of 2021. Like our reverse business, margins were negatively impacted by a widening of spreads. We expect margins to remain pressured in the first-half of Q2 as we liquidate inventory.

Despite a modest operating loss for the quarter, we believe this business will be driven by favorable long-term dynamics, a combination of the aging housing stock, strong household formation, and the large millennial's first-time homebuyer demographic that prefers updated or new homes.

Our lender services business is working hard to diversify its income stream to help offset the loss in business from a pullback in the refinance market. March was an encouraging month as we saw revenues pick up after slowing earlier in the year. This was partly driven by an increase in foreclosure volumes to help offset the drop in refinances.

We expect a switch away from refinance-driven revenue to continue in Q2 as several of our exciting new products enter the market. We saw substantial activity on our MSR advisory business, and our appraisal management products are gaining traction. We also continue to deepen existing customer relationships and added 300 new third-party customers in the quarter.

Lastly, our third strategic priority is focusing on investing in technology, data, and our operating model to capture the lifetime household value inherent in the Finance of America business. In Q1, Finance of America continued to pursue a centralized customer-first approach that will create seamless experiences and remove friction from their journeys.

As mentioned earlier, we consolidated our respective wholesale and consumer direct channels, to create a more consistent experience across our products.

We have also begun to lay the foundation for a unified view of all of our customers across all of the segments. This will enable Finance of America to offer our customers solutions that meet their needs and deepen household relationships. By centralizing data at an enterprise level, we can identify and provide the best products for our customers depending on their stage in life. This is a long-term commitment, and we look forward to sharing major milestones along the way.

Finally, before I turn things over to Johan, I want to quickly highlight some exciting news. In its commitment to transparency and progress around sustainability practices, I am pleased to note that Finance of America published its inaugural ESG report on April 18th. This report lays out our ESG road map and details the work we're doing to support every pillar of ESG as a business today. We hope you will take a moment to review this new report and look forward to your thoughts and feedback.

I will now pass the call to Johan to discuss the financial results.

Johan Gericke

Thank you Patti and good afternoon everyone.

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As Patti mentioned, we faced several macro headwinds for this quarter, which had a direct impact on our results. 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 had on the business. We printed a headline loss for the first quarter, entirely 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. If we look at the fair value marks on the balance sheet, we hedged the balance sheet against rising interest rates using a combination of mortgage, MSR assets, and swaps.

Given the rise in interest rates, we generated substantial hedge gains, which resulted in the growth in our cash balances. These hedge gains offset most of the decline in values, and as a result, the net impact of rising rates on the underlying assets and liabilities was minimal.

However, we are unable to efficiently hedge the balance sheet against movement in investor spread, which increased due to the aforementioned market volatility. This resulted in substantial negative fair value marks, as we updated our modeled assumptions to account for wider spreads. It is unclear when the spreads will return to prior levels.

However, it is important to note that the fair value marks due to widened spreads have not impacted liquidity, as these are non-cash, and we 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 mean.

Turning to the results, the Company generated adjusted net income of $37 million and fully diluted adjusted earnings per share of $0.20, meeting our Q1 SF&S guidance of $0.25 and missing the low-end of our mortgage outlook by $0.05.

I will discuss revenue and other financial impact in more detail when I cover the individual segments in a moment.

Cash balances increased by $86 million in Q1, mostly due to the hedge gains I mentioned earlier. MSR balances stayed flat as we executed a bulk MSR sale in Q1 that offset both new production and positive MSR fair value marks.

Tangible equity decreased by $37 million, predominantly due to the impact of fair value marks from wider spreads.

Turning to our individual reporting segments, revenue in mortgage originations decreased by 28% relative to the fourth quarter due to a decline in rate lock volume and gain-on-sale margins. As a result, we recorded a $9.5 million adjusted net loss.

Gain-on-sale margins were negatively impacted by a substantial widening of spreads for non-agency product and a glut of assets in the market as originators liquidated inventories.

Our reverse origination segment saw 12% quarter-over-quarter growth in funded volumes, setting yet another quarterly funded volume record.

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However, widening spreads had a substantial negative impact on margins, despite re-pricing the pipeline and increasing rates multiple times. As a result, revenue of $108 million was down 5% relative to the last quarter but up 57% compared to Q1 last year.

The reverse origination segment generated pre-tax income of $68 million, up 51% from Q1, 2021. Our current pipeline in reverse remains elevated, driven by strong demand for the product. Similar to what happened in reverse, our commercial origination segment was significantly impacted by market volatility this quarter. Volumes were essentially flat compared to Q4, 2021 and up 68% compared to the same period last year.

Margins decreased despite re-pricing the pipeline multiple times through the quarter as widening spreads impacted secondary market execution.

As Patti mentioned, we expect an improvement in the second half of Q2 once we clear out the current inventory.

Our pipeline remains strong, and March 2022 was our highest funding month ever. Lender services revenue was down 8% 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.

We have several new products reaching commercialization phase, and over time, we believe these will offset the decline in revenue from lower refinance volumes.

Finally, looking at our portfolio management segment, pre-tax income was negatively impacted by fair value marks on our assets. As mentioned earlier, this was mostly driven by wider spreads that we cannot efficiently hedge against. These marks are non-cash and reflect a lifetime mark at current spread levels i.e., we do not revert spreads to mean.

In closing, while this quarter tested the strength of our model as we navigated rapidly changing market conditions, our SF&S businesses met first quarter earnings guidance, and the Company generated $37 million in adjusted net income or adjusted earnings per diluted share of $0.20.

With that, let me now hand it back to Patti for closing remarks.

Patricia Cook

Thanks, Johan.

Before we take your questions, I want to provide a glimpse of what we see for the second quarter. Similar to Q1, you will see that we divide our guidance into two parts: mortgage and SF&S.

For mortgage, we expect conditions to remain challenging, and forecast revenue between $125 million and $145 million, and adjusted net income margin between 0% and 2%.

For specialty finance and services, we expect revenue between $195 million and $215 million, and adjusted net income margins between 12% and 14%. The quarter-over-quarter decrease is driven by lower margins as we clear out inventory in reverse and commercial.

In addition, we have lowered projected revenue from lenders services due to the steep decline in refinance volumes. Over time, we expect this decline to be replaced by new products, and third-party customer growth.

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In closing, Finance of America is dedicated to its unique business model of mortgage and specialty finance and services. We believe the fundamentals are solid and we are positioned to continue growing the business as we navigate a changing environment. Our distribution channels, extensive suite of products, and large customer reach, give us a distinct advantage.

As we execute our three strategic priorities, we remain focused on delivering the best experience for our customers as we build lifetime household value.

With that, let's open the call for questions.

Operator

The first question is from the line of Doug Harter with Credit Suisse. Please proceed.

Douglas Harter

Thanks. You guys talked about the expectation for reverse margins to improve in the second half of the quarter. Have you started to see that improvement already or is that expectation all still to come?

Patricia Cook

I would say that if you look at spreads, they've certainly stabilized, and I think that that bodes well for the market. It's hard to predict if things were to stay volatile but given the level of the spreads now and what we're seeing currently, it's our expectation that things are stable to improving.

Douglas Harter

Okay.

Johan Gericke

Let me just add a little bit to that also, Doug. The loans that we have originated, that we haven't sold, we have a sense of what those marks can be, and we can also see, as Patti said, if spreads stay where they are, we can also see where our production is coming in and what the coupons for those are, and so we have a high sense of what we think we can mark them at.

As we alluded to, it's going to be a little soft in April and then we expect that to pick up as we clear out the production from March.

Patricia Cook

Doug, just to clarify—go ahead. I was just going to say to clarify my comment—go ahead, Doug. I'll be quiet.

Douglas Harter

Just to be clear, you don't need spreads to improve—MBS reverse HECM spreads to improve from here for that comment to be true if they stay stable, that that comment would be true that the gain-on-sale margin would improve?

Patricia Cook

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Yes, and that's where I was going. I could have been said it a little better. It's the volatility in the spread that's hard for us to keep up with it. Once spreads stabilize, you don't have that volatility to manage and your margins return. Does that make sense?

Douglas Harter

Makes sense. A similar question about commercial, I guess. How would you expect those margins to trend?

Patricia Cook

I think it's similar. I think assuming that some of the volatility in the capital market settles down, we would expect spreads there to settle down and therefore our margins return to something more normal.

Johan, would you add anything?

Johan Gericke

Yes, no that's right, Patti.

Obviously margins on commercial are a little bit thinner than margins on the reverse assets, and it's going to be a similar pattern. April will be a little softer; we'll see a pickup in May, and if spreads stay where they are today, we'll see another pickup in June, just as we work through the assets we've originated within the inventory today.

Douglas Harter

Great. Thank you, guys.

Operator

Thank you, Mr. Harter.

The next question is from the line of Stephen Laws with Raymond James. Please proceed.

Stephen Laws

Hi. Good afternoon. To follow up I guess on Doug's comment just to make sure I understand it clearly, when you look at commercial and reverse, after you clear the pipeline in Q2, do you think you can get back to that 19% to 21% Adjusted EBITDA margin when we look at the second half of this year for the SF&S segment?

Patricia Cook

Johan?

Johan Gericke

Yes.

Patricia Cook

Generally, we… Go ahead.

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Johan Gericke

Yes. So if you just do the pure math, the difference between the Q1 guidance for adjusted net income margin and you see the guidance for Q2, it's like two-thirds of the number. So there is essentially the equivalent of one month's worth of margin that's not there.

And so as I said, there will be a step function. If spreads stay where they are today, I think we can get very close. We may be a little below the margins we saw in commercial late last year, and a little bit below what we saw late last year on reverse, but we'll be able to get pretty close in Q2.

Stephen Laws

Great. Thanks, Johan.

And to switch sides to the forward business, I appreciate the Page 8, I believe it was, on the supplement about the cost focus, but can you talk about outlook from here? It looks like about 600 in headcounts down, about 600 employees. Is there more opportunity to reduce fixed costs by further reducing headcount? Are there other expenses, ways to squeeze expenses out? Kind of thinking about what leverage you have left to pull with refi volumes likely continuing to go down in order to make the forward business remain profitable outside of what you cited, which is growing market share I guess in the non-QM business, really focused more on what can be done on the expense side of the equation to ensure profitability there.

Patricia Cook

Yes, we're monitoring volume in mortgages diligently, and with volumes at this level, if they were to decline further, there would certainly be more headcount reduction, but I think for us, equally as important, we are really taking a ruthless look at efficiencies across the business line. As we've talked before, we manage these businesses in a bit of a silo, and that creates redundancies.

So, just like we'll keep our headcount aligned with the volume we see coming through the channel, we will continue to look across the businesses like we did last quarter and the wholesale and consumer direct to drive additional efficiencies.

Stephen Laws

Thanks, Patti.

And lastly, Johan, if spreads go back to say where they were three months ago, are you going to reverse these marks and do a fair value gain, or how will you treat the valuations on the balance sheets?

Johan Gericke

Yes, in practice, that would be the case, Stephen. If spreads go back to where they were at the end of the year, we would update the model assumptions again and the marks would go in the opposite direction. As I mentioned, we don't do a mean reversion; we basically keep spreads at the absolute level through the life of the assets and liabilities. When spreads widen, you can argue that's the most conservative position you can take, but yes, if they go back to where they were, we would reverse those marks.

Stephen Laws

Great. Appreciate your time this afternoon. Thank you.

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Johan Gericke

Sure.

Operator

Thank you, Mr. Laws.

The next question is from the line of James Faucette with Morgan Stanley. Please proceed.

Blake Netter

Hi. This is Blake Netter (phon) on the line for James.

First off, I'm wondering, how do you think about capital allocation, particularly given current share prices? Strategically, where do you currently stand in terms of the balance between acquisitions, internal investments, and the potential for capital return via buybacks?

Patricia Cook

Johan, you want to take that?

Johan Gericke

Yes. I think the important note that we made when we spoke about the increase in cash balances is that we're going to use that to de-lever the balance sheet. We are going to payback some of the secured debt. That will take a meaningful amount out of the cash. It's not only prudent, but obviously when as prices decline, it's the right thing to do for our lenders.

We're going to be really cautious about distributing cash, whether it's through dividends or share buybacks or anything like that. We believe when there's volatility like this, it's critically important to maintain cash and maintain liquidity. I think quite honestly, an earnings multiple of whatever it is, two, an acquisition will be diluted most likely. So, I don't see any substantial acquisitions on the horizon.

Blake Netter

Okay, that's helpful.

Switching to a different topic, you've mentioned that there's an opportunity to leverage your loan officers and your broker network to cross-sell reverse mortgages, commercial loans, and other products. Is there anything you can share in terms of progress on that front, and how have things been trending in terms of the number of broker relationships you have and the number of products that they're selling?

Patricia Cook

So we can update you on—we can get the data on brokers, but the statistics, if you look at the number of loans per broker or number of loans per LO that are non-mortgage, it's incredibly small. I think in our mortgage channel, it's what, like a half a loan per person. What we're seeing now, which is a soft statement, but nonetheless important, is because of the decline in refinance volume, our LOs, just like the brokers, are looking for something else to sell. We have their attention today in a way we didn't a couple of months ago, and I am confident we can convert that into more volume.

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Johan, we might want to consider some sort of statistics that could show the ongoing success of our efforts.

Johan Gericke

Yes, Patti.

It's still a nascent effort. We track those statistics. It'll take a little bit of time, obviously, for those to move meaningfully, but it is an effort that's underway, and as we make progress against that, those are statistics we will share.

We have a snippet in the Investor Presentation that wasn't filed but is on the website on Page 11, and that'll give you good indication of just the power of our product set and how we can help our customers through the life of their financial journey, whether it's to refinance, do home improvement, and ultimately to use a reverse loan to help fund their retirement and lower their payments.

So that whole operating model is going to become a lot more pronounced as we make investments in our technology and our organizational structure to drive this forward.

Blake Netter

Okay. That's very helpful. Thank you.

Operator

Thank you, Mr. Netter.

There are no additional questions waiting at this time. I will turn the call over to Patti Cook for any additional remarks.

Patricia Cook

Once again, I want to thank you for your attention and focus on Finance of America. Thank you for joining our call. Have a good day.

Operator

That concludes today's call. Thank you for your participation. You may now disconnect your lines.

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