Velocity Financial, Inc.

Third Quarter 2024 Conference Call

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CORPORATE PARTICIPANTS

Chris Farrar - *President, Chief Executive Officer*

Mark Szczepaniak - *Chief Financial Officer*

Chris Oltmann – *Treasurer and Director of Investor Relations*

PRESENTATION

Operator
Good day, and welcome to the Velocity Financial Third Quarter 2024 Conference Call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing the "*" key followed by "0." After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press "*" then "1" on your touchtone phone, to withdraw your question, please press "*" then "2." Please note, this event is being recorded.

I would now like to turn the conference over to Mr. Chris Oltmann, Director of Investor Relations. Please go ahead.

Chris Oltmann
Thanks, Denielle. Hello everyone, and thank you for joining us today for the discussion of Velocity's Third Quarter 2024 Results. Joining me today are Chris Farrar, Velocity's President and Chief Executive Officer; and Mark Szczepaniak, Velocity's Chief Financial Officer.

Earlier this afternoon, we released our third quarter results, and you can find the press release and accompanying presentation, we will refer to during this call, on our Investor Relations website at www.velfinance.com.

I'd like to remind everyone that today's call may include forward-looking statements, which are uncertain and outside of the company's control, and actual results may differ materially. For a discussion of some of the risks and other factors that could affect results, please see the risk factors and other cautionary statements made in our communications with shareholders, including the risk factors disclosed in our filings with the Securities and Exchange Commission.

Please also note that the content of this conference call contains time-sensitive information that is accurate only as of today, and we do not undertake any duty to update forward-looking statements. We may also refer to certain non-GAAP measures on this call. For reconciliations of these non-GAAP measures, you should refer to the earnings materials in our Investor Relations website. And finally, today's call is being recorded and will be available on the company's website later today.

And with that, I will now turn the call over to Chris Farrar.

Chris Farrar
Thanks Chris, and thank you all for joining our third quarter earnings call. After the close, we reported another record quarter for the company as our team continues to execute well across the board. We saw strong demand for new loans as our origination volumes grew by 64% over the prior year quarter, and our net portfolio growth was $876 million or 22% in total UPB.

I want to congratulate our production team on closing just under 1,200 loans in the quarter while maintaining our margins and credit standards as the weighted average LTV actually dropped to 63%. In terms of the financials, our net interest income increased by 29%. Our NIM was up 26 basis points and earnings grew by 31%.

Turning to credit performance, our special servicing team delivered another great quarter by successfully resolving delinquent assets favorably. And we continue to see healthy real estate markets in our niche, especially with stable rising values and plenty of liquidity from new investors.

From a financing perspective, we're well positioned to fund our growth as our capital markets team continues to take advantage of the very strong market conditions. Our most recent deal closed in early October and was 6x oversubscribed on the AAA bonds, which allowed us to realize an excellent cost of funds of approximately 6%.

Looking forward, our pipeline is healthy and growing, and we received a new company record of over 900 applications for more than $450 million in UPB in the month of October alone, as borrowers look to finance…sorry, look to lock in financing by year-end. Obviously, as our momentum continues, we will exceed our portfolio goal of $5 billion of UPB by 2025, and the future is bright. As always, we appreciate all the support we have from our partners and shareholders as we work every day to create long-term value for all.

With that, we'll turn to our earnings presentation materials that were released after the close, starting on page three. As we take a look, as I mentioned, earnings were up significantly, really seeing nice portfolio growth in the income coming off that portfolio. NIM up to 3.6%, which was great for the quarter.

In terms of production, $476.8 million, which is really just an incredible quarter for us. The team is doing a great job. In terms of nonperforming loans, relatively flat with where we were last quarter and most importantly, continue to see very healthy resolutions with a 3.4% gain over UPB.

Turning to the financing and capital part of the business, I mentioned that we completed a couple of securitizations. The market there is very healthy and very strong, and we see a lot of demand from investors. We also collapsed the 2020-2 securitization during the quarter, which was underlevered and had about $25 million of retained equity that we were able to redeploy. So that's a great transaction for us. Very good in terms of liquidity and warehouse capacity. So we've got plenty of room there to grow the business. And as I mentioned, the October securitization really went off well.

On page four, we reconciled to core net income with some of the adjustments there and then obviously grow through a bar chart here, the book value, again, significantly in the quarter. And as in prior periods, reflect the adjusted book value, reminding everybody, if we were allowed under GAAP to mark the rest of the portfolio to what we think is fair value, you'd come up with an adjusted book value of $17.76. So, again, we think there's significant embedded gains in the legacy amortized cost portfolio that is continuing to run off.

With that, I'll turn it over to Mark.

Mark Szczepaniak
Thanks, Chris. Hi, everybody. The third quarter continued to reflect Velocity's strong 2024 performance. We go to page five. The loan production for Q3, as Chris mentioned, was almost $477 million in UPB. That's almost a 13% increase over the $422 million from Q2. There are over 1,100 loans funded in the quarter. This healthy production growth during Q3 included the weighted average coupon on new held-for-investment originations remaining strong at about 10.8%. And the weighted average coupon on HFI originations for the last 5 quarter trend has been right around 11%. This growth in originations in Q3 also continued at tight credit levels with our weighted average LTV for the quarter at 63% and the last 5-quarter trend at about

64.4%, so a strong Q3 production with a healthy WAC and the low LTV continues to demonstrate borrower demand for our product.

On page six, as a result of the healthy growth in production, we see a similar growth in Q3 for our overall loan portfolio. The total loan portfolio as of September 30 was almost $4.8 billion. That's a 6.1% increase from Q2 and a 22.6% increase year-over-year. The weighted average coupon on the portfolio as of September 30 was 9.37%, which is a 12 basis point increase from Q2 and a 74 year-over-year basis point increase. Our total portfolio weighted average LTV remains consistently low at 67% at the end of the quarter.

If you flip to page seven, our third quarter net interest margin increased 6 basis points from Q2 and 26 basis points year-over-year as our portfolio yield increased 20 basis points quarter-over-quarter and 80 basis points year-over-year, while the cost of funds increased only 14 basis points quarter-over-quarter and 52 basis points year-over-year. The quarter-over-quarter increase in net interest margin is mainly driven by the strong loan production that we just mentioned in the quarter at healthy spreads from the higher WACs, coupled with the continued favorable execution in the securitization markets.

On page eight, our nonperforming loan rate at the end of Q3 was 10.6%, relatively flat to Q2 at 10.5%. And our nonperforming loan rate has remained consistent for the last 5 quarters, averaging just over 10%. The strong collection efforts by our special servicing department continues to result in resolutions of our NPL loans at favorable gains, which is better illustrated on page nine. Our Q3 NPL resolution gains were $2.3 million or 3.4% of the total UPB resolved. We resolved almost $69 million of UPB in the quarter. And on a trend basis, if you look back at the last 5 quarters, we've averaged about a 2.2% gain on our NPL resolutions per quarter.

Moving to page 10, we take a look at our CECL loan loss reserve and also our net loan charge-off and gain loss on REO activity. On the left-hand side, the CECL reserve at the end of the quarter was $4.9 million. or 19 basis points of our outstanding non-fair value HFI portfolio. Our CECL Reserve remains within the expected range of 15 to 20 basis points. Keep in mind that CECL Reserve does not include loans being carried at fair value.

The right-hand side table shows our net gain loss from loan charge-offs and REO related activities during the quarter. For Q3, we had a net gain of $900,000. And on the last three quarters, if you take a look at it on average, we're averaging about a $1.5 million average gain per quarter over the last three quarters.

Page 11 shows our durable funding and liquidity position at the end of Q3. Our total liquidity at the end of the quarter was almost $93 million, comprised of about $44 million in cash and cash equivalents and almost $49 million in available liquidity on unfinanced collateral. In addition, we had available warehouse capacity at the end of the quarter of $349 million.

Maximum line capacity was $785 million. As Chris mentioned, in August during the quarter, we issued our fourth securitization of the year with just over $253 million in securities issued. In September during the quarter, we did collapse the 2020-2 security, freeing up $25 million in collateral that was then subsequently refinanced on warehouse lines.

And we'll also be able to take most of this collateral and put it into future securitizations. Then in October, after following the quarter, we have issued our fifth securitization in October, and that issue was over $300 million in securities issued.

So with that, I'd like to turn the presentation back to Chris for an overview of Velocity's outlook on key business drivers. Chris?

Chris Farrar
Thanks Mark. As we look forward, we think the market is healthy and functioning well. We are very happy with our credit performance and the continued resolution of delinquent assets.

The capital markets are very robust and we think we've got a lot of support there. And from an earnings perspective, as we continue to grow, we should be able to continue to grow the earnings and that should show up not only in our NIM, but in the overall results of the business. So with that, we'll open it up for questions.

QUESTION AND ANSWER

Operator
Thank you. We will now begin the question and answer session. To ask a question, you may press "*" then "1" on your touchtone phone. If you're using a speakerphone, please pick up your handset before pressing the keys. If at any time your question has been addressed and you would like to withdraw your question, please press "*" then "2."

The first question comes from Stephen Laws from Raymond James. Please go ahead.

Stephen Laws
Hi, good afternoon. Mark, hey, congrats on another great quarter. I feel like, man, you guys are really consistent through a volatile rate environment and a lot of things going on the last year or two and you've done really well. So I guess with that statement can you talk about the recent volatility and rates clearly probably good timing. You got a securitization done in October and probably cleared a lot of those warehouse loans that you had on it at quarter end. But can you talk about how the volatility might impact your origination pipeline or anything we need to think about as far as the move we've seen both up and down the last few months in rates?

Mark Szczepaniak
Yes, sure. Hi, Stephen. Thanks for the question. We're very fortunate in that the niche that we're in typically remains pretty stable in terms of rates to the end user. And you can see that over the five quarter average we're in the very high 10s, low 11s. We move rates a little bit, I think only one time during the quarter. So we're not changing rates daily and not ultra-sensitive to that. And then, just to remind everyone, we also hedge our production. So some months that'll be favorable, some months it'll be unfavorable in terms of where those marks are, but we've kind of hedged out interest rate volatility.

And so as we're putting loans on, we're hedging out that bread. And so that kind of dampens some of the volatility. And in terms of your question about the pipeline, as I mentioned, October was really, really strong. So even though rates have been bouncing around quite a bit, we're not seeing it impact the pipeline and we think we're going to continue to have strong origination levels?

Stephen Laws
Yes, I know you mentioned October was a great month in your prepared remarks. Around the pipeline, I noticed the government insured multi-loans. Can you talk a little bit more about that? How big of an opportunity could that be as you think about a contributor to monthly or quarterly production going forward?

Mark Szczepaniak
Sure. It's a great niche of the market. Our Century Division has a very robust pipeline of well-established borrowers that are high net worth folks and they're very patient. They don't have to do anything immediately and they are very, very rate sensitive. So, unlike the core velocity business, hey are kind of at the other end of the spectrum, if you will, in terms of rate sensitivity. And so, in the last 12 months or so, we haven't seen them transact a lot. As we look into '25, we do think that's going to increase, and we've got a healthy pipeline there of deals. The interesting thing there is, all of those loans that we originate will sell immediately for cash and we'll just recognize that as cash gain on sale. So those won't sit on the balance sheet for more than 30 to 60 days. But I think going into next year, we're very comfortable that we'll see north of $150 million in originations. It's kind of a high ROE, capital-light execution that will add to our earnings growth.

Stephan Laws
Its sounds like a great niche you've carved out there. Lastly, if I may get one more end on the collapse of 2020-2, how do we think about that as far as accretion to earnings, or is it kind of just a normal seasoning process of the portfolio, but more deals can probably collapse in the next year or so, year or two, you know, how do we think about the potential impact on earnings there?

Mark Szczepaniak
Yes, that particular deal, I would say will... by collapsing, will probably have a positive lift to earnings because we'll be able to re-lever that equity more efficiently and effectively. I wouldn't say that's true of the vast majority of our, the rest of, remainder of our deal. That deal was somewhat unique. It was done during COVID at kind of a low advance rate. The others are fairly well levered and because of their pro-rata pay down structure, we get good leverage throughout the duration. So I would not expect much of an earnings delta from the vast majority of deals collapsing or going away in the future. It's probably not material.

Stephen Laws
Great. Understood. I appreciate the color on that, and thanks for all the comments this afternoon.

Mark Szczepaniak
Thank you.

Operator
The next question comes from Don Fandetti from Wells Fargo. Please go ahead.

Don Fandetti
Hi Chris. The competitive dynamic has been very favorable. It's a fragmented market. You guys continue to see very strong origination volumes. I was just curious if you're seeing any new players come in, if you expect them to or is this the type of thing that's just too nichey and I assume you have some barriers to entry, in terms of doing this for a while, you have good securitization assurance as well? Can you just talk about those dynamics?

Chris Farrar
Sure Don, thanks for the question. Yes, yes, I would say we hear rumblings of people starting or coming in or wanting to, but we haven't seen any material competitors that design their program exactly like ours to go after this niche. So I don't want to say that there are no

competitors because there certainly are. And as you mentioned, it's fragmented. But, we feel like we've got a lot of runway to continue to develop new clients and new customers and grow. So we don't see a lot of pressure from the competitive set there. And I'd say also...banks, most of the banks and credit unions are still very cautious and constrained based on their balance sheets. So, I think that's also a tailwind that we think will continue for some time.

Don Fandetti
John, and the NPLs have been pretty steady. Are you thinking you're going to stay in this range? And is there anything to watch on collateral values or you are feeling pretty good on that front?

Chris Farrar
Yes. I think our view is that they will stay in this range. I think a lot obviously depends on the economy going forward. But we are not seeing anything concerning, no dangerous exposures or anything that's giving us indigestion. We think real estate markets are holding up well and we are doing a good job of managing risk, so there is nothing that we see that's concerning in the pipeline right now.

Don Fandetti
Thanks.

Chris Farrar
Thank you.

Operator
The next question comes from Steve Delaney from Citizens JMP Securities. Please go ahead.

Steve Delaney
Hey, hello everyone and congrats on another…yet another great quarter. Chris, there seems to be just such a strong core demand for your product. I heard you mentioned your WACC, your average coupon has actually gone up. I think you mentioned a 9% figure. You know, at the heart of that, you know, we've got a helping issue in the country in terms of supply…for rental housing in particular and when we get to the bottom of it, is it really your borrowers feed this incredible opportunity to acquire real properties with rents going up, properties appreciating and even your pricing they still look at that as one of the best investments they can make. So I am trying to just bring it back to why this opportunity exists and prosit to you guys for figuring it out and getting in front of the right people and being able to exploit it.

Chris Farrar
Yes, thanks Steve, appreciate that. It is a unique niche. It is definitely underserved. When you look at our average loan size, it's not for a lot of financial institutions, banks, credit unions, it's not super-exciting to originate a $350,000 loan and they tend to be slower and take their time at it and that was really kind of our corn thesis and it's proven out over time. I think we've built a good reputation for being able to do what we say we'll do and our clients trust us for that and there is a lot of different reasons why a borrower needs access to capital. You mentioned one of them but there is a broad spectrum of reasons and we feel like we've been a steady consistent provider of capital to the markets that over time, people recognize us as reliable and that certainty of execution is something that they really put a premium on.

Steve Delaney
Do you have a lot of repeat borrowers? And your borrowers, like just the basic resi agency loans, you know that volume tenure goes up 50 basis points, but you know, refi stop you know everything is closed down. If your borrower were just far less rate sensitive and you don't see like when the tenure moves, and in October here, did you see your applications fall off dramatically.

Chris Farrar
Yes, it is a unique segment of market. Just to give your perspective, we changed rates one time during the quarter. So, you know, whereas I think most lenders you know are maybe changing rates daily or weekly. We changed it once, so it's just a different segment of the market and there is less rate sensitivity and much more transaction sensitivity here for our borrowers. And then to your second question, you know, in terms of applications, October was actually a new record for the company. Nine hundred applications for more than 450 million EPV so we are actually seeing growth there, so even though I know the rates have moved dramatically just from the end of September, it's not impacting our origination pipeline.

Steve Delaney
Well, congratulations. Keep it rolling?

Company Representative
Thank you, Steve. We appreciate it.

Operator
As a reminder, if you have a question, please press "*", "1." The next question comes from Eric Hagen from BTIG. Please go ahead.

Eric Hagen
Hey, thanks. Good afternoon. Following up on the NPL pipeline. For the NPLs which are in foreclosure, I mean how long are the loans typically in foreclosure for and do you think about the foreclosure timeline itself being maybe a source of risk at all going forward? And then a follow-up to that, I mean, in the case where there's a sale of the property, in most cases, who's the counter-party? Like is it another SFR investor? Like how durable do you think the demand is for resolving these NPLs especially at higher interest rates?

Chris Farrar
Sure, Eric. So, a couple of things there. One, in terms of foreclosure timeline, you can foreclose…it depends…its state dependent. In Texas, you can foreclose in 60 days. A lot of the non-legal foreclosure states, you're in the, call it, 90 to 150 days' time frame. If you get into the nonjudicial foreclosure states, you get quicker resolutions. When you go for a judicial foreclosure, those can extend out two, three years in New Jersey, New York type things. So, weighted average, where our assets sit in foreclosure probably somewhere around 9 to 10 months, there is some risk of deterioration there. We've got a very good hands-on special servicing team that stays on top of those assets and makes sure that the assets are being preserved, the rents are being protected and properties are in good condition. So, we do our best to manage that.

But I think the other sort of important part to understand there is…there's two different products sets here. On the one to four properties, that end buyer can be anybody. That can be a family buying a home. It can be an investor investing in the neighborhood. There are a lot of different users for a single-family home. So, that's kind of unique in that part of the portfolio. On the small commercial side, almost always, you tend to see some type of real estate investor or owner user who's either using that real estate in their business and it's…let's say, it's an automotive repair shop that goes out of business, and there's a dozen people waiting to get to that location. So, the commercial is a little more investor oriented and business oriented. But the 1 to 4s, those end buyers can be literally just people looking for a home.

Eric Hagen
Got you. Yes, interesting stuff. Thank you for answering that. Going back to the October securitization, when we think about the total return there, what is the total return that you feel like you eclipse? Is there a way to actually tease apart or at least think about like the value or the return you get from delivering the loans into the securitization versus capitalizing the credit risk on the balance sheet and how that's maybe changed at all?

Chris Farrar
Yes. Yes, I mean when you get an execution like that, the ROEs are well north of 25%. So, I mean that's just an outstanding execution. We're not going to get that every time in every deal. It moves around, but we're in the market frequently enough that sometimes you get incredibly great execution. Other times, you get on average and sometimes you get poor execution. But on a blended basis, all in, we think we're doing very well. And even when you bake in sort of losses for credit and that type of thing. So, well each deal, the market is a little different each time, and you have to see. So, overall, though, I think if we do our job right and manage the portfolio properly and the originations, the ROEs are very compelling.

Eric Hagen
Got you. Appreciate it. Congrats on a great quarter.

Chris Farrar
Thanks. Thanks so much.

Operator
This concludes our question and answer session. I would like to turn the conference back over to Chris Farrar for closing remarks.

CONCLUSION

Chris Farrar
Thanks, everyone, for joining the call. Thanks to everybody at Velocity for continuing to do a great job, and we look forward to speaking to everyone at the end or I guess, at the beginning of next year for the fourth quarter. So, thank you all.

Mark Szczepaniak
Thank you, everybody.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.