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RWT - Redwood Trust Inc to Acquire CoreVest American Finance Lender LLC - Conference Call

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CORPORATE PARTICIPANTS

Christopher J. Abate *Redwood Trust, Inc. - CEO & Director*

Collin Lee Cochrane *Redwood Trust, Inc. - CFO*

Dashiell I. Robinson *Redwood Trust, Inc. - President*

Lisa Hartman *Redwood Trust, Inc. - Senior VP & Head of IR*

CONFERENCE CALL PARTICIPANTS

Bose Thomas George *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Douglas Michael Harter *Crédit Suisse AG, Research Division - Director*

Stephen Albert Laws *Raymond James & Associates, Inc., Research Division - Research Analyst*

Steven Cole Delaney *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research & Senior Research Analyst*

PRESENTATION

Operator

Good morning, and welcome to the Redwood Trust, Inc. Management Discussion on Redwood's Definitive Agreement to Acquire CoreVest. (Operator Instructions) Today's conference is being recorded.

And now I'll turn the call over to Lisa Hartman, Redwood's Senior Vice President and Head of Investor Relations, for opening remarks and introductions. Please go ahead.

Lisa Hartman - *Redwood Trust, Inc. - Senior VP & Head of IR*

Thank you, Melissa. Hello, everyone, and thank you for joining us for today's conference call. Joining me on the call are Chris Abate, Redwood's Chief Executive Officer; Dash Robinson, Redwood's President; and Collin Cochrane, Redwood's Chief Financial Officer.

Before we begin, I want to remind you that certain statements made during management's presentation, with respect to future financial or business performance, may constitute forward-looking statements. Forward-looking statements are based on current expectations, forecasts and assumptions and involve risks and uncertainties that could cause actual results to differ materially. We encourage you to read the company's annual report on Form 10-K, which provides a description of some of the factors that could have a material impact on the company's performance and could cause actual results to differ from those that may be expressed in forward-looking statements.

Also note that the content of this conference call contains time-sensitive information that is accurate only as of today, October 15, 2019.

The company does not intend and undertakes no obligation to update this information to reflect subsequent events or circumstances.

Finally, today's call is being recorded and will be available on the company's website later today.

I will now turn the call over to Chris Abate, Redwood's Chief Executive Officer.

Christopher J. Abate - *Redwood Trust, Inc. - CEO & Director*

Thanks, Lisa, and good morning, everyone. Yesterday afternoon, we announced that we have entered into a definitive agreement to acquire CoreVest, a best-in-class operator in the business-purpose lending sector. Business-purpose lending, which we refer to as BPL, is an area of residential lending that is focused on financing housing investors who purchase single-family and multifamily homes for rent or refurbishment rather than traditional homeowners. This transaction marks an exciting time on Redwood's history as it significantly expands our presence in the BPL market while advancing several of the corporate strategic initiatives that we announced in the beginning of last year.

To rewind a bit, a few years ago, we recognized shifts in the housing market that have informed our strategy, namely, the significant imbalance that exists between the rate of new household formation in the United States and the rate of new home building. A lack of adequate new home supply has led to large number of new households towards apartments or existing single-family homes for rent. The relative shortage of new homes has also driven the need to refurbish existing homes, resulting in durable demand for bridge and lending products. A few years later, we continue to see a large and growing market opportunity in the BPL space, indicating to us that the shifts we saw were truly secular rather than cyclical.

The acquisition of CoreVest includes its operating platform and over $900 million of related financial assets, including funded SFR loans and inventory and over $580 million of BPL investments that are expected to be immediately accretive to our portfolio. Since inception, CoreVest has funded over $4 billion of business-purpose loans and recently completed its ninth securitization of SFR loans, more such transactions than any other issuer.

CoreVest also brings an extremely talented team that shares our values of working with integrity and fostering deep relationships with our customers and business partners.

When we think about the strategic fit with CoreVest, there's a lot to like if you are a shareholder. First off, we expect the transaction to be very accretive to earnings over time, with the investments CoreVest creates expected to yield in the 12% to 15% ROE range. We also expect revenues attributable to the operating platform, most notably origination points and gain on sale, to be very attractive as well.

More strategically, our 25-year track record speaks to our ability to turn nascent emerging products into scalable funding solutions that are transformative in nature. That's what we are known for in the jumbo space and what we are working to do in the BPL world.

To this end, we were fortunate to develop a great head start through our partnership with 5 Arches. Over the course of the past 18 months, we've developed the skills and operations necessary to grow our business in this market, and we can now take the next step towards building a best-in-class platform that serves the liquidity needs of all homebuyers, homeowners and investors alike.

A significant strategic element in this acquisition is CoreVest's best-in-class BPL securitization platform. Having completed more single-family rental loan securitizations than any other issuer, we can't help but be excited for this great platform to join forces with ours. As you may recall, we recently completed our 100th securitization in August. Over time, we'll work towards fully incorporating BPL products to our best-in-class mortgage banking correspondent network.

While some of our peers identify their business by way of their tax designation, we aim to be much more than another mortgage REIT. We are building a solution-based specialty finance platform that is bridging the gap between the customized needs and nonagency borrowers, whether BPL, non-QM or traditional jumbo and the liquidity options available to them in the marketplace. Together with 5 Arches, integrating the CoreVest operations and suite of products will further position Redwood as the preeminent specialty financed operator in our industry.

With that, I'm going to hand the call off now to Dash Robinson, Redwood's President.

Dashiell I. Robinson - *Redwood Trust, Inc. - President*

Thank you, Chris, and good morning, everyone. The acquisition of CoreVest reflects our strong belief that this area of housing credit offers substantial opportunity for growth and accretive returns for our shareholders.

While increasing amounts of sophisticated capital are deployed into the housing market, financing alternatives for housing investors remain sparse. As Chris alluded to, we made meaningful strategic progress in this line of business since acquiring the 5 Arches platform earlier this year. Today, the success of that partnership drives our conviction to continue growing this part of our business and to lead the market in serving a rapidly growing segment of high-quality borrowers.

CoreVest has emerged as a top-tier originator in the BPL space through a data-driven approach to lead generation and an ability to efficiently meet borrower needs. Of the $1.1 billion the platform has funded year-to-date through September 30th, almost 70% is comprised of single-family rental loan, substantial volume in the marketplace still in growth mode. This track record represents a compelling strategic moat that we believe will be highly accretive to our operations and investment creation capabilities.

We believe having both the CoreVest and the 5 Arches platform under the Redwood umbrella positions us firmly as the leading BPL lender in the marketplace. The 2 platforms will not compete. We will leverage each one's core strengths to offer borrowers a diverse suite of financing options, creating investments with compelling-risk-return profiles for our investment portfolio in the process. We will have more to say in the coming months as the integration progresses.

In addition to continuing to diversify our earning streams, this acquisition, in conjunction with the strategic progress made by 5 Arches, also advances the recent evolution of our investment portfolio. We have spoken frequently in recent quarters about our ongoing efforts to optimize our portfolio, with an aim of increasing long-term and cash-on-cash returns without meaningfully changing our approach to financial leverage. Upon closing, we estimate business purpose real estate investments will total over 15% of our investment portfolio, a concentration that we expect will continue to organically grow over time.

Now I will turn to some key highlights of the acquisition. Under the terms of the agreement, we will acquire CoreVest's operating platform and over $900 million of related financial assets. CoreVest's balance sheet is principally comprised of subordinate securities retained from the company's SFR securitization, SFR loans held in pipeline slated for inclusion in an upcoming securitization and short-term bridge loans made to investors seeking to stabilize or sell their portfolios. A meaningful portion of CoreVest's bridge lending is done on a cross-collateralized basis to borrowers seeking to stabilize, lease up and retain portfolios of single-family homes, a valuable end-to-end approach to deepening the borrower relationship.

The aggregate purchase price of $490 million, which we plan to fund largely with cash on-hand, represents our investment in the financial assets net of in place of financing and approximately $130 million of value ascribed to the platform. The remaining portion of the consideration will be payable to the CoreVest executive management team in shares of Redwood Trust common stock that vest over a 2-year period. Over time, we will look to further enhance projected returns by improving financing terms on the underlying assets.

In closing, I would like to join Chris in welcoming the CoreVest team to Redwood. We will share more information about the expected impact of the acquisition on our full year 2019 financial results and provide a full overview of Redwood's third quarter financial results during our third quarter earnings announcement and conference call to be announced in the coming weeks.

And with that, I'll conclude our prepared remarks. Operator, please open the call for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Doug Harter with Credit Suisse.

Douglas Michael Harter - *Crédit Suisse AG, Research Division - Director*

I was hoping, could you talk a little bit about kind of the profitability of the origination business for CoreVest and kind of how that would compare to 5 Arches and your existing mortgage banking platform?

Dashiell I. Robinson - *Redwood Trust, Inc. - President*

Sure. I can take that, Doug. It's Dash. The margins, I would say, are generally similar from a borrower points and gain on sale perspective. CoreVest is at slightly higher scale, particularly on single-family rental, from an origination perspective. So the operating efficiency or the efficiency ratio of the CoreVest platform is slightly better than 5 Arches just as a function of where they are from a scale perspective. The actual returns, on a gross basis revenue-wise from the SFR loans and some of the bridge that they do, are very comparable to what we're earning with 5 Arches' production.

Douglas Michael Harter - *Crédit Suisse AG, Research Division - Director*

And then, I guess, how should we think about kind of the scale opportunity kind of as you're able to kind of put the 2 businesses together? Can 1 plus 1 equal more than 2 from a scale benefit there?

Dashiell I. Robinson - *Redwood Trust, Inc. - President*

That's certainly the goal, in part, in doing this acquisition. When you think about the suite of products that each platform brings to the table, there certainly is some overlap, which will be part of our integration going forward. But 5 Arches has an incredibly strong footprint in the bridge business, has been that way for several years. And that's a strategic advantage we continue to push for that platform. CoreVest has strong bridge capabilities as well. Like I mentioned, a lot of it is in an effort to help borrowers lease up portfolios and stabilize them over time to be taken out into a term product.

When we think about the power of the depth in the market of -- in those products across both platforms the power of the sales forces, our expectation is that the scale opportunity over time will hopefully be more than the sum of the parts, to your point.

Christopher J. Abate - *Redwood Trust, Inc. - CEO & Director*

Yes. And I'd add to that. There's an estimated $30 million investor properties in the United States. When we think about the SFR opportunities specifically, and we still refer to it as a nascent market, there's just a ton of green space. When we think about the total opportunity for Redwood and 5 Arches and CoreVest, there is more than enough to go around, candidly. And based on trends we see and our opportunity to institutionalize certain products, and eventually over time, integrate them with our consumer products, we really like the big picture that we see.

Operator

Our next question comes from the line of Bose George with KBW.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Actually, a couple of things. You might have given this in your prepared remarks. But what was the mix of cash versus shares? And also, what was the tangible book versus the value of the platform?

Dashiell I. Robinson - *Redwood Trust, Inc. - President*

The -- Bose, it's Dash. Given how -- what a high percentage of the transaction is actual financial assets, the majority of the consideration is in cash. The executive management team is receiving a portion of the transaction consideration as well as part of their deal, and a portion of that will be in stock, obviously, to enhance alignment. However, the vast asset majority is in cash, again, driven by the preponderance of financial assets that are part of the acquisition.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay. And then just in terms of the tangible book, is there much good -- intangibles? Or is it largely financial assets?

Dashiell I. Robinson - *Redwood Trust, Inc. - President*

So the book, is -- the tangible book is about $360 million. It's -- there's no meaningful intangibles, goodwill or anything on the balance sheet. It is essentially the financial assets.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay. So just -- so the goodwill from the deal just would be the $490 million minus $360 million?

Dashiell I. Robinson - *Redwood Trust, Inc. - President*

Yes. Correct. Yes. We'll have -- it would certainly be all that reflected in our 12/31 financials. But that's about right, George -- Bose.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay. And then just on the ROE, the 12% to 15% that you guys noted in the presentation, is that at the asset level? Like should we think about -- when we think about this coming on to your platform, is that the way we should think about the accretion from the investment? Or should we think about sort of corporate level expenses as well?

Dashiell I. Robinson - *Redwood Trust, Inc. - President*

I would think about it in a couple of different ways. The 12% to 15%, I would think of as net of the operating revenues of the actual origination process. So that -- those numbers do not include, for instance, borrower points and some of the other revenue associated with originating these types of loans. So that's more a stand-alone return on investment, analogous to how we traditionally think about the return to our portfolio on our Sequoia subordinate bonds, for instance. Away from that, as Chris alluded to, there are revenue expectations as well associated with originating the loans that we expect to also deliver an accretive return on the platform premium that we're paying.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay. I just want to ask one last one.

Christopher J. Abate - *Redwood Trust, Inc. - CEO & Director*

But when you --

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Sorry. Go ahead.

Christopher J. Abate - *Redwood Trust, Inc. - CEO & Director*

I was just going to note when you -- and some of this needs to be released. But when we add it all up and we look at the accretive value of the platform, we certainly expect it to be in the double digits. It's been a very profitable and successful platform, and we're hoping to add further scale, and like I said, roll out and integrate more products with the consumer business over time. So we're pretty excited about the potential for a really accretive partner here.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay. Great. Actually, just one on the expenses. Going forward, once this is incorporated, are you -- is the OpEx still going to flow through the same line item? Are you going to break this out separately? Or how is that going to work?

Collin Lee Cochrane - *Redwood Trust, Inc. - CFO*

Bose, this is Collin. I think we'll continue to expect to see the OpEx for this business and 5 Arches as part of our overall OpEx. Obviously, in our segment reporting, we do distinguish and show and allocate those expenses to the different business lines. So this would flow into the mortgage banking part of the business. And we will segregate the cost there along with the 5 Arches and our residential cost.

Operator

Our next question comes from the line of Stephen Laws with Raymond James.

Stephen Albert Laws - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Let's see. Chris and Dash, I guess to start off with, maybe thinking about the magnitude of the proprietary investments you can create, I think, from 5 Arches, if I remember correctly, kind of run rate volume of $700 million or $800 million a year. It looks like CoreVest is around $1.4 billion, so $2 billion to $2.5 billion. As you finance that, will you retain 10%, 20%? How should I think about the annual run rate of proprietary credit investments that you'll be able create from this BPL pipeline?

Dashiell I. Robinson - *Redwood Trust, Inc. - President*

Thanks, Steve. The -- I think a couple of different ways. The SFR loans that CoreVest securitizes, we expect to continue to have them to -- have them do that. And the retained investments, you can think there is probably between 6% and 10% of total production. With the bridge loans that they produce and the large amount of bridge loans that 5 Arches produces, our capital allocation there is typically around 20% to 25%, depending on the haircut of the financing lines that we have. So it's somewhere in the range you quoted depending upon the asset type.

Stephen Albert Laws - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Appreciate that color. And you talked about the pro forma mix at about 15% of the portfolio. How do you think about that growing? Are you looking for other acquisitions to continue to tack on here? I realize that 15% of mix largely depends on how things move in your other business lines as well. But how should we think about how large you'd like to grow this pipeline and whether or not that's going to come from additional acquisitions?

Christopher J. Abate - *Redwood Trust, Inc. - CEO & Director*

Stephen, I'll answer that. I think the big picture is we are certainly in growth mode with respect to the portfolio. One of our big goals over the past few years is scaling the -- further scaling the platform and building efficiencies. And I think our capacity to manage more assets is definitely there. And what this really does is it grows the book first and foremost.

As far as the percentage mix, in the long run, I could see the percentage growing, certainly in the BPL space. You just take a look at the homeownership rate. And if you're at 65-35 and we're involved in each business, you could see the portfolio grow towards BPL. But I think overall, we have great things happening in our consumer business today as well.

We've talked a lot about choice and some of the products we're rolling out through to our Denver operations. And I think our portfolio has been very successful adding multifamily assets over the past few years. So overall, we don't have a target mix per se. It's going to be opportunity-driven. But certainly, we're excited about growing the percentage of BPL. We do expect that.

Stephen Albert Laws - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Great. And one last question. And at the risk of asking too much about financials, but are there any potential cost synergies given the 5 Arches platform that you can discuss, either redundancy on sales or other things? Or is this really more about top line growth and increasing volume? Can you maybe give us a little color on where we're going to see any synergies?

Christopher J. Abate - *Redwood Trust, Inc. - CEO & Director*

It's really much more, at this point, about top line growth. What's important to us is that each platform is running efficiently. So we expect both to be very profitable just like we expect our consumer business to be profitable. I think over time, the real synergies will certainly emerge through our back-office operations. We've essentially completed the integration of 5 Arches. And once we've completed the integration of CoreVest, I think, we'll be able to lay out specifically where those efficiencies are.

But we talked about our own efficiency ratio and leveraging our platform, so it's a certainly a goal over time to find those synergies. But I think what was driving this acquisition was the potential to grow our investment portfolio, first and foremost, and just broaden our footprint.

Operator

(Operator Instructions) Our next question comes from the line of Steve Delaney with JMP Securities.

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research & Senior Research Analyst*

Thank you for the deck, and a lot of things have been covered. I saw one subtle reference in the press release I'd like to ask about. I think it was in Dash's comments, and you mentioned the possibility of leveraging some competencies that are unique to each of the 2 separate BPL platforms. I wondered if you could just give us a little color on that and kind of what do you see as the important differences between 5 Arches and this one in CoreVest?

Dashiell I. Robinson - *Redwood Trust, Inc. - President*

Sure, Steve. I'll -- since it was my quote, I'll happily take the question. I appreciate it. I think the -- in some ways, the differences are subtle. But in some ways, they're also important and very tangible. First and foremost, the origination footprint mix is thematically similar. But if you sort of dig deep into the submarkets, it is different.

Obviously, CoreVest's core product is the single-family rental long-duration loan. As I mentioned, they've -- over 70% or about 70% of their production year-to-date has been in that product. That puts them far and away ahead of any other platform we're aware of from an SFR production perspective. And that creates brand value and franchise value that keeps those sorts of customers coming back and has a very positive effect in terms of overall production trends.

Similarly, 5 Arches, while we have certainly built up the SFR capability there, the market penetration, from a bridge respective, has been one that they have had for several years. And you sort of see it in the progress we've made across the board and the bridge space, the -- what we call standard, which is a bridge loan on a single home, some of the more involved projects and transitional multifamily, things of that nature. Those are areas in which 5 Arches, for quite some time, has had important inroads. And when you think about the borrower community that we're ultimately trying to serve, it is, to Chris' point, extremely vast. There are certainly some borrowers whose business models entail meeting both short-term and long-term products. And now we have a fully loaded platform that can serve sort of all of those borrowers in a very efficient way.

But then there are also borrowers that are much more niche-y in their needs, that frankly, each respective platform has been serving maybe a click or two more deeply these past several years that the other one has. And those are really the nuances. I mean, one of the things we've really observed in this market the past couple of years is just the incredible depth and breadth of borrower needs. And being able to put these things together, these two platforms together, from our perspective, they overlay very, very well. And I think that's the key message. There's such a diversity of needs in this market to Chris's point in terms of the capital flowing in these borrower business plans. That's really the essence of what I was trying to get at.

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research & Senior Research Analyst*

Okay. That's helpful. And with the 5 Arches platform and the shorter term duration, should we think that, that will operate more on a gain-on-sale type of concept? Obviously, you had a much more modest amount of capital investment, $50 million in that transaction. And it sounds like the CoreVest is very much a NIM strategy, where you're basically looking to securitize and hold those longer duration assets as long-term core investments for Redwood.

Christopher J. Abate - *Redwood Trust, Inc. - CEO & Director*

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Yes. And Steve, I think it's more a function of where each platform is at from a scaling perspective. So CoreVest, obviously, is quite developed with a full-blown securitization platform and has been a consistent issuer in the capital markets.

I think with 5 Arches, we're still growing that platform in many respects. But when we think about asset creation, I think we have big plans for both. As you know, we've got our home loan bank portfolio, and we've got opportunities there to potentially finance both SFR, bridge and multifamily loans, potentially replacing some of the jumbo product that's there today. So that could be a very good outlet for us. And then we've got, obviously, big plans for the securitization markets and creating more and more transactions.

So to me, right now it's -- the mix is more a function of where each platform is at from a scaling perspective than it is any long-term plan on our part.

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research & Senior Research Analyst*

Got it. So both -- I mean, the fix-and-flip product could be attractive for your balance sheet as well is what I'm hearing you say, at the right time.

Christopher J. Abate - *Redwood Trust, Inc. - CEO & Director*

Absolutely.

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research & Senior Research Analyst*

Okay. And final thing for me. Did I hear you indicate, Chris, in your remarks, that over time, the longer the SFR product, that you guys will consider opening that up to Redwood's existing correspondent loan selling network?

Christopher J. Abate - *Redwood Trust, Inc. - CEO & Director*

Yes. I mean at the end of the day, we've got a pretty good group of correspondence that we work with on the jumbo side every day that I think would really benefit from these products. As you know, the big challenge is it's a different underwrite. It's a different process. And for a loan officer, that takes time. And you need to implement technology that makes it seamless. So it's not something that you flick a switch and it happens. But if we are able to put -- integrate these products with what we've done in the consumer side, it would be very, very powerful and very scalable. So when we think about the big picture for Redwood and really the value we deliver to the market, I think, marrying those up is a big goal of ours.

Today, they're largely independent markets, and there's growth opportunities involved. We've -- we'll talk more in the earnings call, but we've got a lot going on with the QM patch expiration on the consumer side. So there's a lot of growth initiatives there that we'll talk about in a few weeks. But I do think over time, unifying the products and having different fulfillment channels but having 1 branded execution with loan officers would be a long-term strategic goal.

Steven Cole Delaney - *JMP Securities LLC, Research Division - MD, Director of Specialty Finance Research & Senior Research Analyst*

Right. Well, exciting times there. And thank you for the comments.

Christopher J. Abate - *Redwood Trust, Inc. - CEO & Director*

Thanks.

Operator

Our next question is a follow-up from the line of Doug Harter with Credit Suisse.

Douglas Michael Harter - *Crédit Suisse AG, Research Division - Director*

We've seen more and more of mortgage REITs, kind of, securitizing investor property. Can you talk about kind of the dynamics of kind of sell versus retain on these types of properties as you originate them?

Christopher J. Abate - *Redwood Trust, Inc. - CEO & Director*

As far as, Doug, whether or not we'll choose to securitize them versus just sell from a profitability perspective. Is that your question?

Douglas Michael Harter - *Crédit Suisse AG, Research Division - Director*

Yes.

Christopher J. Abate - *Redwood Trust, Inc. - CEO & Director*

I think the partnership with CoreVest really fast-forwards our ability to securitize certainly SFR. But over time, potentially bridge as well. So that was a longer-term goal of ours as we stated in the past, and we were probably looking towards some time next year to be able to complete an investor -- a purely investor securitization. And I think that process has obviously pulled forward. And I would suspect that we're going to have a bias towards creating investments through that channel versus just a pure gain on sale opportunity. In the long run though, and as we've demonstrated with the jumbo business, having good distributions, both those -- through home loan sales and securitization has really helped us and where some platforms have not been successful because they've been sort of beholden to a single execution. We've really been able to manage risk well, especially as rates have been volatile and those executions at times have diverged. So I think the long-term bias will continue to be to create assets for the portfolio. But the margins, the gain on sale margins, we expect to be strong. And certainly, we'll continue to build up a good home loan distribution to the extent the economics of securitization aren't attractive.

Operator

Ladies and gentlemen, that concludes our Q&A session today and thus concludes our conference call. Thank you for your participation and your interest. You may now disconnect your lines, and have a wonderful day.