

LIVEPERSON INC
Form 10-Q
May 10, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the quarterly period ended MARCH 31, 2010

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number: 000-30141

LIVEPERSON, INC.
(Exact Name of Registrant as Specified in Its Charter)

DELAWARE
(State or Other Jurisdiction of
Incorporation or Organization)

13-3861628
(IRS Employer Identification No.)

462 SEVENTH AVENUE, 3RD FLOOR
NEW YORK, NEW YORK
(Address of Principal Executive Offices)

10018
(Zip Code)

(212) 609-4200
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one).

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Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of May 4, 2010, there were 50,882,136 shares of the issuer's common stock outstanding.

LIVEPERSON, INC.
MARCH 31, 2010
FORM 10-Q
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FORWARD-LOOKING STATEMENTS

STATEMENTS IN THIS REPORT ABOUT LIVEPERSON, INC. THAT ARE NOT HISTORICAL FACTS ARE FORWARD-LOOKING STATEMENTS BASED ON OUR CURRENT EXPECTATIONS, ASSUMPTIONS, ESTIMATES AND PROJECTIONS ABOUT LIVEPERSON AND OUR INDUSTRY. THESE FORWARD-LOOKING STATEMENTS ARE SUBJECT TO RISKS AND UNCERTAINTIES THAT COULD CAUSE ACTUAL FUTURE EVENTS OR RESULTS TO DIFFER MATERIALLY FROM SUCH STATEMENTS. ANY SUCH FORWARD-LOOKING STATEMENTS ARE MADE PURSUANT TO THE SAFE HARBOR PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995. IT IS ROUTINE FOR OUR INTERNAL PROJECTIONS AND EXPECTATIONS TO CHANGE AS THE YEAR OR EACH QUARTER IN THE YEAR PROGRESS, AND THEREFORE IT SHOULD BE CLEARLY UNDERSTOOD THAT THE INTERNAL PROJECTIONS AND BELIEFS UPON WHICH WE BASE OUR EXPECTATIONS MAY CHANGE PRIOR TO THE END OF EACH QUARTER OR THE YEAR. ALTHOUGH THESE EXPECTATIONS MAY CHANGE, WE ARE UNDER NO OBLIGATION TO INFORM YOU IF THEY DO. OUR COMPANY POLICY IS GENERALLY TO PROVIDE OUR EXPECTATIONS ONLY ONCE PER QUARTER, AND NOT TO UPDATE THAT INFORMATION UNTIL THE NEXT QUARTER. ACTUAL EVENTS OR RESULTS MAY DIFFER MATERIALLY FROM THOSE CONTAINED IN THE PROJECTIONS OR FORWARD-LOOKING STATEMENTS. FACTORS THAT COULD CAUSE OR CONTRIBUTE TO SUCH DIFFERENCES INCLUDE THOSE DISCUSSED IN PART II, ITEM 1A, "RISK FACTORS."

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LIVEPERSON, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

	March 31, 2010 (Unaudited)	December 31, 2009 (Note 1(B))
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 50,835	\$ 45,572
Accounts receivable, net of allowance for doubtful accounts of \$395 as of March 31, 2010 and December 31, 2009, respectively	12,615	10,265
Prepaid expenses and other current assets	3,189	3,661
Deferred tax assets, net	1,252	1,460
Total current assets	67,891	60,958
Property and equipment, net	10,132	9,551
Intangibles, net	2,432	2,821
Goodwill	23,920	23,920
Deferred tax assets, net	4,992	4,777
Deferred implementation costs, net of current	135	136
Security deposits	491	326
Other assets	1,948	1,792
Total assets	\$ 111,941	\$ 104,281
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 5,688	\$ 5,375
Accrued expenses	7,914	10,895
Deferred revenue	5,360	4,692
Total current liabilities	18,962	20,962
Deferred revenue, net of current	533	506
Other liabilities	1,833	1,676
Total liabilities	21,328	23,144
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$.001 par value per share; 5,000,000 shares authorized, 0 shares issued and outstanding at March 31, 2010 and December 31, 2009	—	—
Common stock, \$.001 par value per share; 100,000,000 shares authorized, 50,848,136 shares issued and outstanding at March 31, 2010 and 49,435,682 shares issued and outstanding at December 31, 2009	51	49
Additional paid-in capital	198,056	190,692
Accumulated deficit	(107,296)	(109,432)
Accumulated other comprehensive loss	(198)	(172)
Total stockholders' equity	90,613	81,137

Total liabilities and stockholders' equity	\$	111,941	\$	104,281
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SEE ACCOMPANYING NOTES TO UNAUDITED CONDENSED
CONSOLIDATED FINANCIAL STATEMENTS.

LIVEPERSON, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)
UNAUDITED

	Three Months Ended March 31,	
	2010	2009
Revenue	\$ 25,308	\$ 19,919
Operating expenses:		
Cost of revenue	6,632	4,285
Product development	3,606	2,701
Sales and marketing	7,690	6,504
General and administrative	3,792	3,521
Amortization of intangibles	83	272
Total operating expenses	21,803	17,283
Income from operations	3,505	2,636
Other (expense) income:		
Financial expense	(49)	(119)
Interest income	23	34
Total other (expense) income, net	(26)	(85)
Income before provision for income taxes	3,479	2,551
Provision for income taxes	1,343	1,280
Net income	\$ 2,136	\$ 1,271
Basic net income per common share	\$ 0.04	\$ 0.03
Diluted net income per common share	\$ 0.04	\$ 0.03
Weighted average shares outstanding used in basic net income per common share calculation	49,838,491	47,468,781
Weighted average shares outstanding used in diluted net income per common share calculation	52,193,862	48,031,054

SEE ACCOMPANYING NOTES TO UNAUDITED CONDENSED
CONSOLIDATED FINANCIAL STATEMENTS.

LIVEPERSON, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
UNAUDITED

	Three Months Ended March 31,	
	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 2,136	\$ 1,271
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Stock-based compensation expense	1,087	1,161
Depreciation	1,053	801
Amortization of intangibles	389	579
Deferred income taxes	(6)	324
CHANGES IN OPERATING ASSETS AND LIABILITIES:		
Accounts receivable	(2,350)	(1,557)
Prepaid expenses and other current assets	466	137
Deferred implementation costs	—	13
Security deposits	(166)	18
Accounts payable	(740)	497
Accrued expenses	(2,969)	(1,307)
Deferred revenue	695	896
Net cash (used in) provided by operating activities	(405)	2,833
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment, including capitalized software	(578)	(469)
Acquisition of Proficient	—	(81)
Net cash used in investing activities	(578)	(550)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repurchase of common stock	—	(28)
Excess tax benefit from the exercise of employee stock options	3	159
Proceeds from issuance of common stock in connection with the exercise of options	6,275	121
Net cash provided by financing activities	6,278	252
Effect of foreign exchange rate changes on cash and cash equivalents	(32)	(26)
Net increase in cash and cash equivalents	5,263	2,509
Cash and cash equivalents at the beginning of the period	45,572	25,500
Cash and cash equivalents at the end of the period	\$ 50,835	\$ 28,009

Supplemental disclosure of non-cash investing activities:

Cash flows from investing for the three months ended March 31, 2010 does not include the purchase of approximately \$1,315 of capitalized equipment related to the Company's collocation facility as the corresponding invoices are included in accounts payable at March 31, 2010, and therefore did not have an impact on cash flows for the period.

Cash flows from investing for the three months ended March 31, 2009 does not include the purchases of approximately \$258 of capitalized equipment related to the Company's collocation facility as the corresponding invoices are included in accounts payable at March 31, 2009, and therefore did not have an impact on cash flows for the period.

SEE ACCOMPANYING NOTES TO UNAUDITED CONDENSED
CONSOLIDATED FINANCIAL STATEMENTS.

LIVEPERSON, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

(1) SUMMARY OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

(A) SUMMARY OF OPERATIONS

LivePerson, Inc. (the “Company” or “LivePerson”) was incorporated in the State of Delaware in 1995. The Company commenced operations in 1996. LivePerson provides online engagement solutions that facilitate real-time assistance and expert advice.

The Company’s primary revenue source is from the sale of the LivePerson services to businesses of all sizes. The Company also facilitates online transactions between independent service providers (“Experts”) who provide online advice to individual consumers (“Users”). Headquartered in New York City, the Company’s product development staff, help desk, and online sales support are located in Israel. The Company also maintains sales and professional services offices in Atlanta and the United Kingdom.

(B) UNAUDITED CONDENSED CONSOLIDATED FINANCIAL INFORMATION

The accompanying condensed consolidated financial statements as of March 31, 2010 and for the three months ended March 31, 2010 and 2009 are unaudited. In the opinion of management, the unaudited condensed consolidated financial statements have been prepared on the same basis as the annual financial statements and reflect all adjustments, which include only normal recurring adjustments, necessary to present fairly the consolidated financial position of LivePerson as of March 31, 2010, and the consolidated results of operations and cash flows for the interim periods ended March 31, 2010 and 2009. The financial data and other information disclosed in these notes to the condensed consolidated financial statements related to these periods are unaudited. The results of operations for any interim period are not necessarily indicative of the results of operations for any other future interim period or for a full fiscal year. The condensed consolidated balance sheet at December 31, 2009 has been derived from audited consolidated financial statements at that date.

Certain information and note disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). These unaudited interim condensed consolidated financial statements should be read in conjunction with the Company’s audited consolidated financial statements and notes thereto for the year ended December 31, 2009, included in the Company’s Annual Report on Form 10-K filed with the SEC on March 11, 2010.

(C) REVENUE RECOGNITION

The majority of the Company’s revenue is generated from monthly service revenues and related professional services from the sale of the LivePerson services. Because the Company provides its application as a service, the Company follows the provisions of Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 605-10-S99, “Revenue Recognition” and ASC 605-25, “Revenue Recognition with Multiple-Element Arrangements.” The Company charges a monthly fee, which varies by service and client usage. The majority of the Company’s larger clients also pay a professional services fee related to implementation. The Company defers these implementation fees and associated direct costs and recognizes them ratably over the expected term of the client relationship upon

commencement of the hosting services. The Company may also charge professional service fees related to additional training, business consulting and analysis in support of the LivePerson services.

The Company also sells certain of the LivePerson services directly via Internet download. These services are marketed as LivePerson Pro and LivePerson Contact Center for small and mid-sized businesses (“SMBs”), and are paid for almost exclusively by credit card. Credit card payments accelerate cash flow and reduce the Company’s collection risk, subject to the merchant bank’s right to hold back cash pending settlement of the transactions. Sales of LivePerson Pro and LivePerson Contact Center may occur with or without the assistance of an online sales representative, rather than through face-to-face or telephone contact that is typically required for traditional direct sales.

The Company recognizes monthly service revenue based upon the fee charged for the LivePerson services, provided that there is persuasive evidence of an arrangement, no significant Company obligations remain, collection of the resulting receivable is probable and the amount of fees to be paid is fixed or determinable. The Company’s service agreements typically have twelve month terms and, in some cases, are terminable or may terminate upon 30 to 90 days’ notice without penalty. When professional service fees provide added value to the customer on a standalone basis, the Company recognizes professional service fees upon completion and customer acceptance because they have established objective and reliable evidence of the fair value of the undelivered hosting services. If a professional services arrangement does not qualify for separate accounting, the Company recognizes the fees, and the related labor costs, ratably over a period of 48 months, representing the Company’s current estimate of the term of the client relationship.

For revenue generated from online transactions between Experts and Users, the Company recognizes revenue net of the expert fees in accordance with ASC 605-45, “Principal Agent Considerations,” due to the fact that the Company performs as an agent without risk of loss for collection. The Company collects a fee from the consumer and retains a portion of the fee, and then remits the balance to the Expert. Revenue from these transactions is recognized when there is persuasive evidence of an arrangement, no significant Company obligations remain, collection of the resulting receivable is probable and the amount of fees to be paid is fixed or determinable.

(D) STOCK-BASED COMPENSATION

The Company follows FASB ASC 718-10, “Stock Compensation,” which addresses the accounting for transactions in which an entity exchanges its equity instruments for goods or services, with a primary focus on transactions in which an entity obtains employee services in share-based payment transactions. ASC 718-10 requires measurement of the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). Incremental compensation costs arising from subsequent modifications of awards after the grant date must be recognized.

ASC 718-10 requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company’s Consolidated Statements of Income. Stock-based compensation recognized in the Company’s Consolidated Statement of Income for the three months ended March 31, 2010 and 2009 includes compensation expense for share-based awards granted prior to, but not fully vested as of January 1, 2006 based on the grant date fair value estimated in accordance with ASC 718-10 as well as compensation expense for share-based awards granted subsequent to January 1, 2006 in accordance with ASC 718-10. The Company currently uses the Black-Scholes option pricing model to determine grant date fair value.

The following table summarizes stock-based compensation expense related to employee stock options under ASC 718-10 included in Company's Statement of Income for the three months ended March 31, 2010 and 2009:

	Three Months Ended March 31,	
	2010	2009
Cost of revenue	\$ 214	\$ 159
Product development expense	335	302
Sales and marketing expense	280	308
General and administrative expense	258	392
Total stock based compensation included in operating expenses	\$ 1,087	\$ 1,161

The per share weighted average fair value of stock options granted and assumed during the three months ended March 31, 2010 and 2009 was \$3.33 and \$1.05, respectively. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three Months Ended March 31,	
	2010	2009
Dividend yield	0.0%	0.0%
Risk-free interest rate	3.61% - 3.80%	2.8% - 3.1%
Expected life (in years)	5.0	5.0
Historical volatility	60.3% - 60.5%	68.1% - 68.2%

During 1998, the Company established the Stock Option and Restricted Stock Purchase Plan (the "1998 Plan"). Under the 1998 Plan, the Board of Directors could issue incentive stock options or nonqualified stock options to purchase up to 5,850,000 shares of common stock. The 2000 Stock Incentive Plan (the "2000 Plan") succeeded the 1998 Plan. Under the 2000 Plan, the options which had been outstanding under the 1998 Plan were incorporated in the 2000 Plan increasing the number of shares available for issuance under the plan by approximately 4,150,000, thereby reserving for issuance 10,000,000 shares of common stock in the aggregate.

The Company established the 2009 Stock Incentive Plan (the "2009 Plan") as a successor to the 2000 Plan. Under the 2009 Plan, the options which had been outstanding under the 2000 Plan were incorporated into the 2009 Plan and the Company increased the number of shares available for issuance under the plan by 6,000,000, thereby reserving for issuance 19,567,744 shares of common stock in the aggregate. Options to acquire common stock granted thereunder have ten-year terms. As of March 31, 2010, approximately 16,444,000 shares of common stock were reserved for issuance under the 2009 Plan (taking into account all option exercises through March 31, 2010). As of March 31, 2010, there was approximately \$8,119 of total unrecognized compensation cost related to nonvested share-based compensation arrangements. That cost, as of March 31, 2010, is expected to be recognized over a weighted average period of approximately 2.0 years.

A summary of the Company's stock option activity and weighted average exercise prices follows:

	Options	Weighted Average Exercise Price
Options outstanding at December 31, 2009	8,711,808	\$ 3.82
Options granted	737,000	6.10
Options exercised	(1,389,954)	4.54
Options cancelled	(145,200)	4.19
Options outstanding at March 31, 2010	7,913,654	3.90
Options exercisable at March 31, 2010	3,829,318	\$ 3.83

The total intrinsic value of stock options exercised during the period ended March 31, 2010 was approximately \$4,202. The total intrinsic value of options exercisable at March 31, 2010 was approximately \$14,261. The total intrinsic value of options expected to vest at March 31, 2010 is approximately \$15,142.

A summary of the status of the Company's nonvested shares as of December 31, 2009, and changes during the three months ended March 31, 2010 is as follows:

	Shares	Weighted Average Grant-Date Fair Value
Nonvested Shares at December 31, 2009	4,247,893	\$ 2.13
Granted	737,000	3.33
Vested	(776,231)	2.42
Cancelled	(124,326)	2.37
Nonvested Shares at March 31, 2010	4,084,336	\$ 2.29

(E) BASIC AND DILUTED NET INCOME PER SHARE

The Company calculates earnings per share ("EPS") in accordance with the provisions of ASC 260-10 and the guidance of SEC Staff Accounting Bulletin ("SAB") No. 98. Under ASC 260-10, basic EPS excludes dilution for common stock equivalents and is computed by dividing net income or loss attributable to common shareholders by the weighted average number of common shares outstanding for the period. All options, warrants or other potentially dilutive instruments issued for nominal consideration are required to be included in the calculation of basic and diluted net income attributable to common stockholders. Diluted EPS is calculated using the treasury stock method and reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock and resulted in the issuance of common stock.

Diluted net income per common share for the three months ended March 31, 2010 includes the effect of options to purchase 6,372,395 shares of common stock with a weighted average exercise price of \$3.34. Diluted net income per common share for the three months ended March 31, 2009 includes the effect of options to purchase 911,138 shares of common stock with a weighted average exercise price of \$1.12.

A reconciliation of shares used in calculating basic and diluted earnings per share follows:

	Three Months Ended March 31,	
	2010	2009
Basic	49,838,491	47,468,781
Effect of assumed exercised options	2,355,371	562,273
Diluted	52,193,862	48,031,054

(F) SEGMENT REPORTING

The Company accounts for its segment information in accordance with the provisions of ASC 280-10, "Segment Reporting." ASC 280-10 establishes annual and interim reporting standards for operating segments of a company. ASC 280-10 requires disclosures of selected segment-related financial information about products, major customers, and geographic areas based on the Company's internal accounting methods. Due to the acquisition of Kasamba Inc. in October 2007, the Company is organized into two operating segments for purposes of making operating decisions and assessing performance. The Business segment supports and manages real-time online interactions - chat, voice/click-to-call, email and self-service/knowledgebase and sells its products and services to global corporations of all sizes. The Consumer segment facilitates online transactions between Experts and Users and sells its services to consumers. Both segments currently generate their revenue primarily in the U.S. The chief operating decision-makers evaluate performance, make operating decisions, and allocate resources based on the operating income of each segment. The reporting segments follow the same accounting policies used in the preparation of the Company's consolidated financial statements and are described in the summary of significant accounting policies. The Company allocates cost of revenue, sales and marketing and amortization of purchased intangibles to the segments, but it does not allocate product development, general and administrative and income taxes because management does not use this information to measure performance of the operating segments. There are currently no intersegment sales.

Summarized financial information by segment for the quarter ended March 31, 2010, based on the Company's internal financial reporting system utilized by the Company's chief operating decision makers, follows:

	Consolidated	Corporate	Business	Consumer
Revenue:				
Hosted services — Business	\$ 20,913	\$ —	\$ 20,913	\$ —
Hosted services — Consumer	3,458	—	—	3,458
Professional services	937	—	937	—
Total revenue	25,308	—	21,850	3,458
Cost of revenue	6,632	—	5,684	948
Sales and marketing	7,690	—	6,028	1,662
Amortization of intangibles	83	—	11	72
Unallocated corporate expenses	7,398	7,398	—	—
Operating income (loss)	\$ 3,505	\$ (7,398)	\$ 10,127	\$ 776

Summarized financial information by segment for the quarter ended March 31, 2009, based on the Company's internal financial reporting system utilized by the Company's chief operating decision makers, follows:

	Consolidated	Corporate	Business	Consumer
Revenue:				
Hosted services — Business	\$ 16,716	\$ —	\$ 16,716	\$ —
Hosted services — Consumer	2,528	—	—	2,528
Professional services	675	—	675	—
Total revenue	19,919	—	17,391	2,528
Cost of revenue	4,285	—	3,426	859
Sales and marketing	6,504	—	4,904	1,600
Amortization of intangibles	272	—	200	72
Unallocated corporate expenses	6,222	6,222	—	—
Operating income (loss)	\$ 2,636	\$ (6,222)	\$ 8,861	\$ (3)

Revenues attributable to domestic and foreign operations follows:

	March 31,	
	2010	2009
United States	\$ 19,305	\$ 14,937
United Kingdom	3,318	2,073
Other countries	2,685	2,909
Total revenue	\$ 25,308	\$ 19,919

Long-lived assets by geographic region follows:

	March 31, 2010		December 31, 2009	
United States	\$ 30,464	\$ 29,508		
Israel	13,586	13,815		
Total long-lived assets	\$ 44,050	\$ 43,323		

(G) GOODWILL AND INTANGIBLE ASSETS

The changes in the carrying amount of goodwill for the quarter ended March 31, 2010 are as follows:

	Total	Business	Consumer
Balance as of December 31, 2009	\$ 23,920	\$ 15,896	\$ 8,024
Adjustments to goodwill:			
Contingent earnout payments	—	—	—
Balance as of March 31, 2010	\$ 23,920	\$ 15,896	\$ 8,024

The changes in the carrying amount of goodwill for the year ended December 31, 2009 are as follows:

	Total	Business	Consumer
Balance as of December 31, 2008	\$ 24,388	\$ 15,798	\$ 8,590
Adjustments to goodwill:			
Contingent earnout payments	98	98	—
Settlement of pre-acquisition contingency	(566)	—	(566)
Balance as of December 31, 2009	\$ 23,920	\$ 15,896	\$ 8,024

Intangible assets are summarized as follows (see Note 3):

Acquired Intangible Assets

	Gross Carrying Amount	As of March 31, 2010	
		Weighted Average Amortization Period	Accumulated Amortization
Amortizing intangible assets:			
Technology	\$ 5,410	3.8 years	\$ 3,569
Customer contracts	2,400	3.0 years	2,400
Trade names	630	3.0 years	525
Non-compete agreements	410	1.2 years	410
Patents	475	11.0 years	29
Other	235	3.0 years	195
Total	\$ 9,560		\$ 7,128

	Gross Carrying Amount	As of December 31, 2009	
		Weighted Average Amortization Period	Accumulated Amortization
Amortizing intangible assets:			
Technology	\$ 5,410	3.8 years	\$ 3,262
Customer contracts	2,400	3.0 years	2,400
Trade names	630	3.0 years	473
Non-compete agreements	410	1.2 years	410
Patents	475	11.0 years	18
Other	235	3.0 years	176
Total	\$ 9,560		\$ 6,739

Amortization expense is calculated on a straight-line basis over the estimated useful life of the asset. Aggregate amortization expense for intangible assets was \$389 and \$579 for the three months ended March 31, 2010 and 2009, respectively. For the three months ended March 31, 2010 and 2009, a portion of this amortization is included in cost of revenue. Estimated amortization expense for the next five years is: \$1,098 in 2010, \$964 in 2011, \$43 in 2012, \$43 in 2013, \$43 in 2014 and \$241 thereafter.

(H) RECENTLY ISSUED FASB ACCOUNTING STANDARDS UPDATES

In January 2010, the FASB published FASB Accounting Standards Update 2010-06, Fair Value Measurements and Disclosures (Topic 820) — Improving Disclosures about Fair Value Measurements. This update requires some new disclosures and clarifies some existing disclosure requirements about fair value measurement as set forth in Codification Subtopic 820-10. The FASB's objective is to improve these disclosures and, thus, increase the transparency in financial reporting. Specifically, ASU 2010-06 amends Codification Subtopic 820-10 to now require: (a) a reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers; and (b) in the reconciliation for fair value measurements using significant unobservable inputs, a reporting entity should present separately information about purchases, sales, issuances, and settlements. In addition, ASU 2010-06 clarifies the requirements of the following existing disclosures: for purposes of reporting fair value measurement for each class of assets and liabilities, a reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities and should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. As ASU 2010-06 relates specifically to disclosures, it will not have an impact on the Company

(1,747,787

)

\$

—

\$

(1,747,787

)

\$

1,694,741

\$

50,747

\$

(2,299

)

Amounts presented in these columns are limited in total to the net amount of assets or liabilities presented in the prior column by instrument. In certain cases, there is excess cash collateral or financial assets we have pledged to a counterparty (which may, in certain circumstances, be a clearinghouse) that exceed the financial liabilities subject (1) to a master netting arrangement or similar agreement. Additionally, in certain cases, counterparties may have pledged excess cash collateral to us that exceeds our corresponding financial assets. In each case, any of these excess amounts are excluded from the table although they are separately reported in our consolidated balance sheets as assets or liabilities, respectively.

Interest rate agreements, TBAs, and futures are components of derivatives instruments on our consolidated balance (2) sheets. Loan warehouse debt, which is secured by residential mortgage loans, and security repurchase agreements are components of Short-term debt on our consolidated balance sheets.

For each category of financial instrument set forth in the table above, the assets and liabilities resulting from individual transactions within that category between us and a counterparty are subject to a master netting arrangement or similar agreement with that counterparty that provides for individual transactions to be aggregated and treated as a single transaction. For certain categories of these instruments, some of our transactions are cleared and settled through one or more clearinghouses that are substituted as our counterparty. References herein to master netting arrangements or similar agreements include the arrangements and agreements governing the clearing and settlement of these transactions through the clearinghouses. In the event of the termination and close-out of any of those transactions, the corresponding master netting agreement or similar agreement provides for settlement on a net basis. Any such settlement would include the proceeds of the liquidation of any corresponding collateral, subject to certain limitations on termination, settlement, and liquidation of collateral that may apply in the event of the bankruptcy or insolvency of a party. Such limitations should not inhibit the eventual practical realization of the principal benefits of those transactions or the corresponding master netting arrangement or similar agreement and any corresponding collateral.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 4. Principles of Consolidation

GAAP requires us to consider whether securitizations we sponsor and other transfers of financial assets should be treated as sales or financings, as well as whether any VIEs that we hold variable interests in – for example, certain legal entities often used in securitization and other structured finance transactions – should be included in our consolidated financial statements. The GAAP principles we apply require us to reassess our requirement to consolidate VIEs each quarter and therefore our determination may change based upon new facts and circumstances pertaining to each VIE. This could result in a material impact to our consolidated financial statements during subsequent reporting periods.

Analysis of Consolidated VIEs

At March 31, 2018, we consolidated certain Legacy Sequoia and our Sequoia Choice securitization entities that we determined were VIEs and for which we determined we were the primary beneficiary. Each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not owned by and are not legal obligations of ours. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, servicing administrator, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities. At March 31, 2018, the estimated fair value of our investments in the consolidated Legacy Sequoia and Sequoia Choice entities was \$14 million and \$88 million, respectively. The following table presents a summary of the assets and liabilities of these VIEs.

Table 4.1 – Assets and Liabilities of Consolidated VIEs

March 31, 2018	Legacy Sequoia	Sequoia Choice	Total Consolidated VIEs
(Dollars in Thousands)			
Residential loans, held-for-investment	\$626,151	\$1,013,619	\$1,639,770
Restricted cash	148	7	155
Accrued interest receivable	753	4,057	4,810
REO	3,115	—	3,115
Total Assets	\$630,167	\$1,017,683	\$1,647,850
Accrued interest payable	\$534	\$3,438	\$3,972
Accrued expenses and other liabilities	—	7	7
Asset-backed securities issued	615,849	926,238	1,542,087
Total Liabilities	\$616,383	\$929,683	\$1,546,066
Number of VIEs	20	3	23

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 4. Principles of Consolidation - (continued)

December 31, 2017 (Dollars in Thousands)	Legacy Sequoia	Sequoia Choice	Total Consolidated VIEs
Residential loans, held-for-investment	\$632,817	\$620,062	\$ 1,252,879
Restricted cash	147	4	151
Accrued interest receivable	867	2,524	3,391
REO	3,353	—	3,353
Total Assets	\$637,184	\$622,590	\$ 1,259,774
Accrued interest payable	\$537	\$2,031	\$ 2,568
Accrued expenses and other liabilities	—	4	4
Asset-backed securities issued	622,445	542,140	1,164,585
Total Liabilities	\$622,982	\$544,175	\$ 1,167,157

Number of VIEs	20	2	22
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We consolidate the assets and liabilities of certain Sequoia securitization entities, as we did not meet the GAAP sale criteria at the time we transferred financial assets to these entities. Our involvement in consolidated Sequoia entities continues in the following ways: (i) we continue to hold subordinate investments in each entity, and for certain entities, more senior investments; (ii) we maintain certain discretionary rights associated with our sponsorship of, or our subordinate investments in, each entity; and (iii) we continue to hold a right to call the assets of certain entities (once they have been paid down below a specified threshold) at a price equal to, or in excess of, the current outstanding principal amount of the entity's asset-backed securities issued. These factors have resulted in our continuing to consolidate the assets and liabilities of these Sequoia entities in accordance with GAAP.

Analysis of Unconsolidated VIEs with Continuing Involvement

Since 2012, we have transferred residential loans to 39 Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes, in accordance with ASC 860. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For certain of these transfers to securitization entities, for the transferred loans where we held the servicing rights prior to the transfer and continued to hold the servicing rights following the transfer, we recorded MSR on our consolidated balance sheets, and classified those MSR as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classified as Level 3 assets. Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining servicing rights (which we retain a third-party sub-servicer to perform) and the receipt of interest income associated with the securities we retained.

The following table presents information related to securitization transactions that occurred during the three months ended March 31, 2018 and 2017.

Table 4.2 – Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	Three Months Ended	
	March 31, 2018	2017
Principal balance of loans transferred	\$1,280,468	\$1,035,524
Trading securities retained, at fair value	12,491	20,703
AFS securities retained, at fair value	3,905	5,155

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 4. Principles of Consolidation - (continued)

The following table summarizes the cash flows during the three months ended March 31, 2018 and 2017 between us and the unconsolidated VIEs sponsored by us and accounted for as sales since 2012.

Table 4.3 – Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	Three Months Ended	
	March 31,	
	2018	2017
Proceeds from new transfers	\$1,289,687	\$1,022,024
MSR fees received	3,414	3,475
Funding of compensating interest, net	(25) (38
Cash flows received on retained securities	7,043	6,373

The following table presents the key weighted-average assumptions used to measure MSRs and securities retained at the date of securitization for securitizations completed during the three months ended March 31, 2018 and 2017.

Table 4.4 – Assumptions Related to Assets Retained from Unconsolidated VIEs Sponsored by Redwood

At Date of Securitization	Three Months Ended March 31, 2018				Three Months Ended March 31, 2017			
	MSRs	Senior IO Securities	Subordinate Securities		MSRs	Senior Securities	Subordinate Securities	
Prepayment rates	N/A	8 %	10 %		9 %	10 %	10 %	
Discount rates	N/A	14 %	7 %		11 %	11 %	5 %	
Credit loss assumptions	N/A	0.20 %	0.20 %		N/A	0.25 %	0.25 %	

The following table presents additional information at March 31, 2018 and December 31, 2017, related to unconsolidated VIEs sponsored by Redwood and accounted for as sales since 2012.

Table 4.5 – Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	March 31, 2018	December 31, 2017
On-balance sheet assets, at fair value:		
Interest-only, senior and subordinate securities, classified as trading	\$103,854	\$101,426
Subordinate securities, classified as AFS	193,029	219,255
Mortgage servicing rights	63,915	60,980
Maximum loss exposure ⁽¹⁾	\$360,798	\$381,661
Assets transferred:		
Principal balance of loans outstanding	\$9,411,927	\$8,364,148
Principal balance of loans 30+ days delinquent	26,524	27,926

Maximum loss exposure from our involvement with unconsolidated VIEs pertains to the carrying value of our securities and MSRs retained from these VIEs and represents estimated losses that would be incurred under severe, (1) hypothetical circumstances, such as if the value of our interests and any associated collateral declines to zero. This does not include, for example, any potential exposure to representation and warranty claims associated with our initial transfer of loans into a securitization.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 4. Principles of Consolidation - (continued)

The following table presents key economic assumptions for assets retained from unconsolidated VIEs and the sensitivity of their fair values to immediate adverse changes in those assumptions at March 31, 2018 and December 31, 2017.

Table 4.6 – Key Assumptions and Sensitivity Analysis for Assets Retained from Unconsolidated VIEs Sponsored by Redwood

March 31, 2018	MSRs	Senior Securities (1)	Subordinate Securities
(Dollars in Thousands)			
Fair value at March 31, 2018	\$63,915	\$49,299	\$247,584
Expected life (in years) ⁽²⁾	8	7	14
Prepayment speed assumption (annual CPR) ⁽²⁾	7	% 9	% 10
Decrease in fair value from:			
10% adverse change	\$1,816	\$1,671	\$643
25% adverse change	4,388	4,087	1,587
Discount rate assumption ⁽²⁾	11	% 11	% 5
Decrease in fair value from:			
100 basis point increase	\$2,596	\$1,772	\$22,876
200 basis point increase	5,009	3,486	42,351
Credit loss assumption ⁽²⁾	N/A	0.20	% 0.20
Decrease in fair value from:			
10% higher losses	N/A	\$—	\$1,285
25% higher losses	N/A	—	3,213
December 31, 2017			
(Dollars in Thousands)			
Fair value at December 31, 2017	\$60,980	\$33,773	\$286,908
Expected life (in years) ⁽²⁾	8	6	13
Prepayment speed assumption (annual CPR) ⁽²⁾	9	% 10	% 11
Decrease in fair value from:			
10% adverse change	\$2,022	\$1,371	\$611
25% adverse change	4,839	3,289	1,506
Discount rate assumption ⁽²⁾	11	% 11	% 5
Decrease in fair value from:			
100 basis point increase	\$2,386	\$1,158	\$25,827
200 basis point increase	4,597	2,265	47,885
Credit loss assumption ⁽²⁾	N/A	0.25	% 0.25
Decrease in fair value from:			
10% higher losses	N/A	\$—	\$1,551
25% higher losses	N/A	—	3,873

(1) Senior securities included \$49 million and \$34 million of interest-only securities at March 31, 2018 and December 31, 2017, respectively.

(2) Expected life, prepayment speed assumption, discount rate assumption, and credit loss assumption presented in the tables above represent weighted averages.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2018
 (Unaudited)

Note 4. Principles of Consolidation - (continued)

Analysis of Third-Party VIEs

Third-party VIEs are securitization entities in which we maintain an economic interest, but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the analysis is performed in consideration of all of our interests. The following table presents a summary of our interests in third-party VIEs at March 31, 2018, grouped by security type.

Table 4.7 – Third-Party Sponsored VIE Summary

(Dollars in Thousands)	March 31, 2018
Mortgage-Backed Securities	
Senior	\$ 198,373
Mezzanine	487,679
Subordinate	374,785
Total Investments in Third-Party Sponsored VIEs	\$ 1,060,837

We determined that we are not the primary beneficiary of any third-party VIEs, as we do not have the required power to direct the activities that most significantly impact the economic performance of these entities. Specifically, we do not service or manage these entities or otherwise solely hold decision making powers that are significant. As a result of this assessment, we do not consolidate any of the underlying assets and liabilities of these third-party VIEs – we only account for our specific interests in them.

Our assessments of whether we are required to consolidate a VIE may change in subsequent reporting periods based upon changing facts and circumstances pertaining to each VIE. Any related accounting changes could result in a material impact to our financial statements.

Note 5. Fair Value of Financial Instruments

For financial reporting purposes, we follow a fair value hierarchy established under GAAP that is used to determine the fair value of financial instruments. This hierarchy prioritizes relevant market inputs in order to determine an “exit price” at the measurement date, or the price at which an asset could be sold or a liability could be transferred in an orderly process that is not a forced liquidation or distressed sale. Level 1 inputs are observable inputs that reflect quoted prices for identical assets or liabilities in active markets. Level 2 inputs are observable inputs other than quoted prices for an asset or liability that are obtained through corroboration with observable market data. Level 3 inputs are unobservable inputs (e.g., our own data or assumptions) that are used when there is little, if any, relevant market activity for the asset or liability required to be measured at fair value.

In certain cases, inputs used to measure fair value fall into different levels of the fair value hierarchy. In such cases, the level at which the fair value measurement falls is determined based on the lowest level input that is significant to the fair value measurement. Our assessment of the significance of a particular input requires judgment and considers factors specific to the asset or liability being measured.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at March 31, 2018 and December 31, 2017.

Table 5.1 – Carrying Values and Fair Values of Assets and Liabilities

(In Thousands)	March 31, 2018		December 31, 2017	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Residential loans, held-for-sale				
At fair value	\$1,129,890	\$1,129,890	\$1,427,052	\$1,427,052
At lower of cost or fair value	295	388	893	993
Residential loans, held-for-investment				
At fair value	4,015,555	4,015,555	3,687,265	3,687,265
Trading securities	907,432	907,432	968,844	968,844
Available-for-sale securities	450,288	450,288	507,666	507,666
MSRs	66,496	66,496	63,598	63,598
Cash and cash equivalents	178,562	178,562	144,663	144,663
Restricted cash	2,406	2,406	2,144	2,144
Accrued interest receivable	27,257	27,257	27,013	27,013
Derivative assets	63,544	63,544	15,718	15,718
REO ⁽¹⁾	3,115	4,651	3,354	3,806
Margin receivable ⁽¹⁾	50,200	50,200	85,044	85,044
FHLBC stock ⁽¹⁾	43,393	43,393	43,393	43,393
Guarantee asset ⁽¹⁾	3,055	3,055	2,869	2,869
Pledged collateral ⁽¹⁾	42,290	42,290	42,615	42,615
Liabilities				
Short-term debt facilities	\$1,254,076	\$1,254,076	\$1,688,412	\$1,688,412
Accrued interest payable	23,492	23,492	18,435	18,435
Margin payable ⁽²⁾	16,878	16,878	390	390
Guarantee obligation ⁽²⁾	18,931	18,551	19,487	18,878
Derivative liabilities	56,201	56,201	63,081	63,081
ABS issued at fair value, net	1,542,087	1,542,087	1,164,585	1,164,585
FHLBC long-term borrowings	1,999,999	1,999,999	1,999,999	1,999,999
Convertible notes, net	687,426	691,535	686,759	692,369
Trust preferred securities and subordinated notes, net	138,547	106,020	138,535	103,230

(1) These assets are included in Other assets on our consolidated balance sheets.

(2) These liabilities are included in Accrued expenses and other liabilities on our consolidated balance sheets.

During the three months ended March 31, 2018, we elected the fair value option for \$12 million of residential senior securities, \$128 million of subordinate securities, and \$1.80 billion of residential loans (principal balance). We anticipate electing the fair value option for all future purchases of residential loans that we intend to sell to third parties or transfer to securitizations, as well as for MSR retained from sales of residential loans, and for certain securities we purchase, including IO securities and fixed-rate securities rated investment grade or higher.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the assets and liabilities that are reported at fair value on our consolidated balance sheets on a recurring basis at March 31, 2018 and December 31, 2017, as well as the fair value hierarchy of the valuation inputs used to measure fair value.

Table 5.2 – Assets and Liabilities Measured at Fair Value on a Recurring Basis

March 31, 2018 (In Thousands)	Carrying Value	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Assets				
Residential loans	\$5,145,445	\$—	\$—	\$5,145,445
Trading securities	907,432	—	—	907,432
Available-for-sale securities	450,288	—	—	450,288
Derivative assets	63,544	8,625	50,919	4,000
MSRs	66,496	—	—	66,496
Pledged collateral	42,290	42,290	—	—
FHLBC stock	43,393	—	43,393	—
Guarantee asset	3,055	—	—	3,055
Liabilities				
Derivative liabilities	\$56,201	\$5,814	\$46,513	\$3,874
ABS issued	1,542,087	—	—	1,542,087
December 31, 2017				
(In Thousands)	Carrying Value	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
Assets				
Residential loans	\$5,114,317	\$—	\$—	\$5,114,317
Trading securities	968,844	—	—	968,844
Available-for-sale securities	507,666	—	—	507,666
Derivative assets	15,718	134	10,164	5,420
MSRs	63,598	—	—	63,598
Pledged collateral	42,615	42,615	—	—
FHLBC stock	43,393	—	43,393	—
Guarantee asset	2,869	—	—	2,869
Liabilities				
Derivative liabilities	\$63,081	\$3,808	\$55,567	\$3,706
ABS issued	1,164,585	—	—	1,164,585

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the three months ended March 31, 2018.

Table 5.3 – Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis

(In Thousands)	Assets						Liabilities
	Residential Loans	Trading Securities	AFS Securities	MSRs	Guarantee Asset	Derivatives ⁽¹⁾	ABS Issued
Beginning balance - December 31, 2017	\$5,114,317	\$968,844	\$507,666	\$63,598	\$ 2,869	\$ 1,714	\$1,164,585
Acquisitions	1,814,944	140,560	3,905	—	—	—	441,741
Sales	(1,594,521)	(193,130)	(50,742)	—	—	—	—
Principal paydowns	(175,525)	(5,834)	(10,412)	—	—	—	(84,974)
Gains (losses) in net income, net	(12,502)	(3,008)	13,423	2,898	186	(6,923)	20,735
Unrealized losses in OCI, net	—	—	(13,552)	—	—	—	—
Other settlements, net ⁽²⁾	(1,268)	—	—	—	—	5,335	—
Ending Balance - March 31, 2018	\$5,145,445	\$907,432	\$450,288	\$66,496	\$ 3,055	\$ 126	\$1,542,087

(1) For the purpose of this presentation, derivative assets and liabilities, which consist of loan purchase and forward sale commitments, are presented on a net basis.

Other settlements, net for residential loans represents the transfer of loans to REO, and for derivatives, the (2) settlement of forward sale commitments and the transfer of the fair value of loan purchase commitments at the time loans are acquired to the basis of residential loans.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and held at March 31, 2018 and 2017. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three months ended March 31, 2018 and 2017 are not included in this presentation.

Table 5.4 – Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at March 31, 2018 and 2017 Included in Net Income

(In Thousands)	Included in Net Income Three Months Ended March 31,	
	2018	2017
Assets		
Residential loans at Redwood	\$(42,195)	\$3,723
Residential loans at consolidated Sequoia entities	20,548	8,414
Trading securities	(3,951)	10,051
Available-for-sale securities	—	(117)
MSRs	3,933	(916)
Loan purchase commitments	3,919	4,823
Other assets - Guarantee asset	186	(246)
Liabilities		
Loan purchase commitments	\$(2,554)	\$—
Loan forward sale commitments	(1,269)	—
ABS issued	(20,735)	(10,538)

The following table presents information on assets recorded at fair value on a non-recurring basis at March 31, 2018. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our consolidated balance sheets at March 31, 2018.

Table 5.5 – Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at March 31, 2018

March 31, 2018	Carrying Value	Fair Value Measurements Using		Gain (Loss) for Three Months Ended March 31, 2018
		Level 1	Level 2 Level 3	
(In Thousands)				
Assets				
Residential loans, at lower of cost or fair value	\$ 251	\$ —	—\$ 251	\$ 1
REO	2,034	—	— 2,034	(146)

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

The following table presents the net market valuation gains and losses recorded in each line item of our consolidated statements of income for the three months ended March 31, 2018 and 2017.

Table 5.6 – Market Valuation Gains and Losses, Net

(In Thousands)	Three Months	
	Ended March 31, 2018	2017
Mortgage Banking Activities, Net		
Residential loans held-for-sale, at fair value	\$4,774	\$8,532
Residential loan purchase and forward sale commitments	(6,968)	10,265
Risk management derivatives, net	28,432	(1,400)
Total mortgage banking activities, net ⁽¹⁾	\$26,238	\$17,397
Investment Fair Value Changes, Net		
Residential loans held-for-investment, at Redwood	\$(38,985)	\$(2,333)
Trading securities	(2,955)	11,143
Net investments in Legacy Sequoia entities ⁽²⁾	(8)	(1,810)
Net investments in Sequoia Choice entities ⁽²⁾	(86)	—
Risk-sharing investments	(139)	(205)
Risk management derivatives, net	43,782	(5,127)
Impairments on AFS securities	—	(117)
Total investment fair value changes, net	\$1,609	\$1,551
MSR Income (Loss), Net		
MSRs	\$2,892	\$(3,070)
Risk management derivatives, net	(5,139)	(749)
Total MSR loss, net ⁽³⁾	\$(2,247)	\$(3,819)
Total Market Valuation Gains, Net	\$25,600	\$15,129

Mortgage banking activities, net presented above does not include fee income or provisions for repurchases that are (1) components of Mortgage banking activities, net presented on our consolidated statements of income, as these amounts do not represent market valuation changes.

(2) Includes changes in fair value of the residential loans held-for-investment, REO and the ABS issued at the entities, which netted together represent the change in value of our retained investments at the consolidated VIEs.

MSR income (loss), net presented above does not include net fee income or provisions for repurchases that are (3) components of MSR income, net on our consolidated statements of income, as these amounts do not represent market valuation adjustments.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

At March 31, 2018, our valuation policy and processes had not changed from those described in our Annual Report on Form 10-K for the year ended December 31, 2017. The following table provides quantitative information about the significant unobservable inputs used in the valuation of our Level 3 assets and liabilities measured at fair value.

Table 5.7 – Fair Value Methodology for Level 3 Financial Instruments

March 31, 2018 (Dollars in Thousands, except Input Values)	Fair Value	Unobservable Input	Input Values Range			Weighted Average	
Assets							
Residential loans, at fair value:							
Jumbo fixed-rate loans	\$3,162,491	Whole loan spread to TBA price	\$1.78	-\$2.97		\$2.90	
		Whole loan spread to swap rate	160	-210	bps	200	bps
Jumbo hybrid loans	258,789	Prepayment rate (annual CPR)	15	-15	%	15	%
		Whole loan spread to swap rate	90	-165	bps	148	bps
Jumbo loans committed to sell	84,395	Whole loan committed sales price	\$100.56-\$101.32			\$101.12	
Loans held by Legacy Sequoia ⁽¹⁾	626,151	Liability price	N/A			N/A	
Loans held by Sequoia Choice ⁽¹⁾	1,013,619	Liability price	N/A			N/A	
Residential loans, at lower of cost or fair value	251	Loss severity	30	-30	%	30	%
Trading and AFS securities	1,357,720	Discount rate	3	-14	%	6	%
		Prepayment rate (annual CPR)	—	-50	%	9	%
		Default rate	—	-27	%	3	%
		Loss severity	—	-40	%	22	%
MSRs	66,496	Discount rate	11	-29	%	11	%
		Prepayment rate (annual CPR)	6	-27	%	7	%
		Per loan annual cost to service	\$79	-\$82		\$82	
Guarantee asset	3,055	Discount rate	11	-11	%	11	%
		Prepayment rate (annual CPR)	9	-9	%	9	%
REO	2,260	Loss severity	12	-43	%	26	%
Loan purchase commitments, net ⁽²⁾	1,395	MSR multiple	1.0	-5.2	x	3.4	x

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Pull-through rate	9	-100	%	68	%
Whole loan spread to TBA price	\$1.78	-\$2.78		\$2.77	
Whole loan spread to swap rate - fixed rate	201	-201	bps	201	bps
Prepayment rate (annual CPR)	15	-15	%	15	%
Whole loan spread to swap rate - hybrid	90	-165	bps	119	bps

Liabilities

ABS issued ⁽¹⁾	1,542,087	Discount rate	3	-15	%	4	%
		Prepayment rate (annual CPR)	8	-25	%	18	%
		Default rate	—	-16	%	3	%
		Loss severity	20	-54	%	22	%

Loan forward sale commitments 1,269 Whole loan spread to TBA price \$2.80 \$2.80 \$2.80

The fair value of the loans held by consolidated Sequoia entities was based on the fair value of the ABS issued by (1) these entities, which we determined were more readily observable, in accordance with accounting guidance for collateralized financing entities.

(2) For the purpose of this presentation, loan purchase commitment assets and liabilities are presented net.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

Determination of Fair Value

A description of the instruments measured at fair value as well as the general classification of such instruments pursuant to the Level 1, Level 2, and Level 3 valuation hierarchy is listed herein. We generally use both market comparable information and discounted cash flow modeling techniques to determine the fair value of our Level 3 assets and liabilities. Use of these techniques requires determination of relevant inputs and assumptions, some of which represent significant unobservable inputs as indicated in the preceding table. Accordingly, a significant increase or decrease in any of these inputs – such as anticipated credit losses, prepayment rates, interest rates, or other valuation assumptions – in isolation would likely result in a significantly lower or higher fair value measurement.

Residential loans at Redwood

Estimated fair values for residential loans are determined using models that incorporate various observable inputs, including pricing information from whole loan sales and securitizations. Certain significant inputs in these models are considered unobservable and are therefore Level 3 in nature. Pricing inputs obtained from market whole loan transaction activity include indicative spreads to indexed to be announced ("TBA") prices and indexed swap rates for fixed-rate loans and indexed swap rates for hybrid loans (Level 3). Pricing inputs obtained from market securitization activity include indicative spreads to indexed TBA prices for senior residential mortgage-backed securities ("RMBS") and indexed swap rates for subordinate RMBS, and credit support levels (Level 3). Other unobservable inputs also include assumed future prepayment rates. Observable inputs include benchmark interest rates, swap rates, and TBA prices. These assets would generally decrease in value based upon an increase in the credit spread, prepayment speed, or credit support assumptions.

Residential loans at consolidated Sequoia entities

We have elected to account for the consolidated Sequoia securitization entities as collateralized financing entities ("CFEs") in accordance with GAAP. A CFE is a variable interest entity that holds financial assets and issues beneficial interests in those assets, and these beneficial interests have contractual recourse only to the related assets of the CFE. Accounting guidance for CFEs allow companies to elect to measure both the financial assets and financial liabilities of a CFE using the more observable of the fair value of the financial assets or fair value of the financial liabilities. Pursuant to this guidance, we use the fair value of the ABS issued by the Sequoia CFEs (which we determined to be more observable) to determine the fair value of the loans held at these entities, whereby the net assets we consolidate in our financial statements related to these entities represent the estimated fair value of our retained interests in the Sequoia CFEs.

Real estate securities

Real estate securities include residential, commercial, and other asset-backed securities that are generally illiquid in nature and trade infrequently. Significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the lack of readily available market quotes and related inputs. For real estate securities, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Relevant market indicators that are factored into the analysis include bid/ask spreads, the amount and timing of credit losses, interest rates, and collateral prepayment rates. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3). These cash flow models use significant unobservable inputs such as a discount rate, prepayment rate, default rate and loss severity. The estimated fair value of our securities would generally decrease based upon an increase in default rates, loss severities, or a decrease in prepayment rates.

As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at March 31, 2018, we received dealer price indications on 72% of our securities, representing 79% of our carrying value. In the aggregate, our internal valuations of the securities for which

we received dealer price indications were within 1% of the aggregate average dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

Derivative assets and liabilities

Our derivative instruments include swaps, swaptions, TBAs, financial futures, loan purchase commitments ("LPCs"), and forward sale commitments ("FSCs"). Fair values of derivative instruments are determined using quoted prices from active markets, when available, or from valuation models and are supported by valuations provided by dealers active in derivative markets. Fair values of TBAs and financial futures are generally obtained using quoted prices from active markets (Level 1). Our derivative valuation models for swaps and swaptions require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of certain inputs. Model inputs can generally be verified and model selection does not involve significant management judgment (Level 2).

LPC and FSC fair values for jumbo loans are estimated based on the estimated fair values of the underlying loans (as described in "Residential loans" above). In addition, fair values for LPCs are estimated based on the probability that the mortgage loan will be purchased (the "Pull-through rate") (Level 3).

For other derivatives, valuations are based on various factors such as liquidity, bid/ask spreads, and credit considerations for which we rely on available market inputs. In the absence of such inputs, management's best estimate is used (Level 3).

MSRs

MSRs include the rights to service jumbo and conforming residential mortgage loans. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. Changes in the fair value of MSRs occur primarily due to the collection/realization of expected cash flows, as well as changes in valuation inputs and assumptions. Estimated fair values are based on applying the inputs to generate the net present value of estimated future MSR income (Level 3). These discounted cash flow models utilize certain significant unobservable inputs including market discount rates, assumed future prepayment rates of serviced loans, and the market cost of servicing. An increase in these unobservable inputs would generally reduce the estimated fair value of the MSRs.

As part of our MSR valuation process, we received a valuation estimate from a third-party valuations firm. In the aggregate, our internal valuation of the MSRs were within 2% of the third-party valuation.

FHLBC stock

Our Federal Home Loan Bank ("FHLB") member subsidiary is required to purchase Federal Home Loan Bank of Chicago ("FHLBC") stock under a borrowing agreement between our FHLB-member subsidiary and the FHLBC. Under this agreement, the stock is redeemable at face value, which represents the carrying value and fair value of the stock (Level 2).

Guarantee asset

The guarantee asset represents the estimated fair value of cash flows we are contractually entitled to receive related to a risk-sharing arrangement with Fannie Mae. Significant inputs in the valuation analysis are Level 3, due to the nature of this asset and the lack of market quotes. The fair value of the guarantee asset is determined using a discounted cash flow model, for which significant unobservable inputs include assumed future prepayment rates and market discount rate (Level 3). An increase in prepayment rates or discount rate would generally reduce the estimated fair value of the guarantee asset.

Pledged collateral

Pledged collateral consists of cash and U.S. Treasury securities held by a custodian in association with certain agreements we have entered into. Treasury securities are carried at their fair value, which is determined using quoted prices in active markets (Level 1).

Cash and cash equivalents

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less. Fair values equal carrying values (Level 1).

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REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 5. Fair Value of Financial Instruments - (continued)

Restricted cash

Restricted cash primarily includes interest-earning cash balances related to risk-sharing transactions with the Agencies, cash held in association with borrowings from the FHLBC, and cash held at consolidated Sequoia entities for the purpose of distribution to investors and reinvestment. Due to the short-term nature of the restrictions, fair values approximate carrying values (Level 1).

Accrued interest receivable and payable

Accrued interest receivable and payable includes interest due on our assets and payable on our liabilities. Due to the short-term nature of when these interest payments will be received or paid, fair values approximate carrying values (Level 1).

REO

REO includes properties owned in satisfaction of foreclosed loans. Fair values are determined using available market quotes, appraisals, broker price opinions, comparable properties, or other indications of value (Level 3).

Margin receivable

Margin receivable reflects cash collateral we have posted with our various derivative and debt counterparties as required to satisfy margin requirements. Fair values approximate carrying values (Level 2).

Short-term debt

Short-term debt includes our credit facilities that mature within one year. As these borrowings are secured and subject to margin calls and as the rates on these borrowings reset frequently to market rates, we believe that carrying values approximate fair values (Level 2). Additionally, at March 31, 2018, short-term debt included unsecured convertible senior notes with a maturity of less than one year. The fair value of the convertible notes is determined using quoted prices in generally active markets (Level 2).

ABS issued

ABS issued includes asset-backed securities issued through the Legacy Sequoia and Sequoia Choice securitization entities. These instruments are generally illiquid in nature and trade infrequently. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. For ABS issued, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Relevant market indicators factored into the analysis include bid/ask spreads, the amount and timing of collateral credit losses, interest rates, and collateral prepayment rates. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3). These cash flow models use significant unobservable inputs such as a discount rate, prepayment rate, default rate, loss severity and credit support. A decrease in credit losses or discount rate, or an increase in prepayment rates, would generally cause the fair value of the ABS issued to decrease (i.e., become a larger liability).

FHLBC borrowings

FHLBC borrowings include amounts borrowed from the FHLBC that are secured, generally by residential mortgage loans. As these borrowings are secured and subject to margin calls and as the rates on these borrowings reset frequently to market rates, we believe that carrying values approximate fair values (Level 2).

Financial Instruments Carried at Amortized Cost

Guarantee obligations

In association with our risk-sharing transactions with the Agencies, we have made certain guarantees which are carried on our balance sheet at amortized cost (Level 3).

Convertible notes

Convertible notes include unsecured convertible and exchangeable senior notes that are carried at their unpaid principal balance net of any unamortized deferred issuance costs (Level 2).

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 5. Fair Value of Financial Instruments - (continued)

Trust preferred securities and subordinated notes

Trust preferred securities and subordinated notes are carried at their unpaid principal balance net of any unamortized deferred issuance costs (Level 3).

Note 6. Residential Loans

We acquire residential loans from third-party originators and may sell or securitize these loans or hold them for investment. The following table summarizes the classifications and carrying values of the residential loans owned at Redwood and at consolidated Sequoia entities at March 31, 2018 and December 31, 2017.

Table 6.1 – Classifications and Carrying Values of Residential Loans

March 31, 2018		Legacy		Sequoia	
(In Thousands)	Redwood	Sequoia	Choice	Total	
Held-for-sale					
At fair value	\$1,129,890	\$—	\$—		\$1,129,890
At lower of cost or fair value	295	—	—		295
Total held-for-sale	1,130,185	—	—		1,130,185
Held-for-investment at fair value	2,375,785	626,151	1,013,619		4,015,555
Total Residential Loans	\$3,505,970	\$626,151	\$1,013,619		\$5,145,740
December 31, 2017		Legacy		Sequoia	
(In Thousands)	Redwood	Sequoia	Choice	Total	
Held-for-sale					
At fair value	\$1,427,052	\$—	\$—		\$1,427,052
At lower of cost or fair value	893	—	—		893
Total held-for-sale	1,427,945	—	—		1,427,945
Held-for-investment at fair value	2,434,386	632,817	620,062		3,687,265
Total Residential Loans	\$3,862,331	\$632,817	\$620,062		\$5,115,210

At March 31, 2018, we owned mortgage servicing rights associated with \$2.81 billion (principal balance) of consolidated residential loans purchased from third-party originators. The value of these MSR's is included in the carrying value of the associated loans on our consolidated balance sheets. We contract with licensed sub-servicers that perform servicing functions for these loans.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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(Unaudited)

Note 6. Residential Loans - (continued)

Residential Loans Held-for-Sale

At Fair Value

At March 31, 2018, we owned 1,598 loans held-for-sale at fair value with an aggregate unpaid principal balance of \$1.12 billion and a fair value of \$1.13 billion, compared to 2,009 loans with an aggregate unpaid principal balance of \$1.41 billion and a fair value of \$1.43 billion at December 31, 2017. At March 31, 2018, none of these loans were greater than 90 days delinquent or in foreclosure. At December 31, 2017, one of these loans with a fair value of \$0.5 million was greater than 90 days delinquent and none of these loans were in foreclosure.

During the three months ended March 31, 2018 and 2017, we purchased \$1.80 billion and \$1.09 billion (principal balance) of loans, respectively, for which we elected the fair value option, and we sold \$2.01 billion and \$1.36 billion (principal balance) of loans, respectively, for which we recorded a net market valuation gain of \$5 million and a net market valuation loss of \$9 million, respectively, through Mortgage banking activities, net on our consolidated statements of income. At March 31, 2018, loans held-for-sale with a market value of \$718 million were pledged as collateral under short-term borrowing agreements.

At Lower of Cost or Fair Value

At March 31, 2018 and December 31, 2017, we held three and four residential loans, respectively, at the lower of cost or fair value with \$0.4 million and \$1 million in outstanding principal balance, respectively, and carrying values of \$0.3 million and \$1 million, respectively. At both March 31, 2018 and December 31, 2017, one of these loans with an unpaid principal balance of \$0.3 million was greater than 90 days delinquent and none of these loans were in foreclosure.

Residential Loans Held-for-Investment at Fair Value

At Redwood

At March 31, 2018, we owned 3,279 held-for-investment loans at Redwood with an aggregate unpaid principal balance of \$2.39 billion and a fair value of \$2.38 billion, compared to 3,292 loans with an aggregate unpaid principal balance of \$2.41 billion and a fair value of \$2.43 billion at December 31, 2017. At March 31, 2018, three of these loans with a total unpaid principal balance of \$2 million were greater than 90 days delinquent and none of these loans were in foreclosure. At December 31, 2017, none of these loans were greater than 90 days delinquent or in foreclosure.

During the three months ended March 31, 2018 and 2017, we transferred loans with a fair value of \$56 million and \$185 million, respectively, from held-for-sale to held-for-investment. During both the three months ended March 31, 2018 and 2017, we did not transfer loans from held-for-investment to held-for-sale. During the three months ended March 31, 2018 and 2017, we recorded net market valuation losses of \$39 million and \$2 million, respectively, on residential loans held-for-investment at fair value through Investment fair value changes, net on our consolidated statements of income. At March 31, 2018, loans with a fair value of \$2.37 billion were pledged as collateral under a borrowing agreement with the FHLBC.

At March 31, 2018, the outstanding loans held-for-investment at Redwood were prime-quality, first lien loans, of which 96% were originated between 2013 and 2018, and 4% were originated in 2012 and prior years. The weighted average FICO score of borrowers backing these loans was 771 (at origination) and the weighted average loan-to-value ("LTV") ratio of these loans was 66% (at origination). At March 31, 2018, these loans were comprised of 90% fixed-rate loans with a weighted average coupon of 4.08%, and the remainder were hybrid or ARM loans with a weighted average coupon of 4.10%.

At Consolidated Legacy Sequoia Entities

At March 31, 2018, we owned 3,059 held-for-investment loans at consolidated Legacy Sequoia entities, with an aggregate unpaid principal balance of \$662 million and a fair value of \$626 million, as compared to 3,178 loans at

December 31, 2017, with an aggregate unpaid principal balance of \$698 million and a fair value of \$633 million. At origination, the weighted average FICO score of borrowers backing these loans was 728, the weighted average LTV ratio of these loans was 66%, and the loans were nearly all first lien and prime-quality.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 6. Residential Loans - (continued)

At March 31, 2018 and December 31, 2017, the unpaid principal balance of loans at consolidated Legacy Sequoia entities delinquent greater than 90 days was \$23 million and \$25 million, respectively, of which the unpaid principal balance of loans in foreclosure was \$9 million and \$10 million, respectively. During the three months ended March 31, 2018 and 2017, we recorded net market valuation gains of \$29 million and \$8 million, respectively, on these loans through Investment fair value changes, net on our consolidated statements of income. Pursuant to the collateralized financing entity guidelines, the market valuation changes of these loans are based on the estimated fair value of the associated ABS issued. The net impact to our income statement associated with our retained economic investment in the Legacy Sequoia securitization entities is presented in Note 5.

At Consolidated Sequoia Choice Entities

At March 31, 2018, we owned 1,335 held-for-investment loans at the consolidated Sequoia Choice entities, with an aggregate unpaid balance of \$996 million and a fair value of \$1.01 billion, as compared to 806 loans at December 31, 2017 with an aggregate unpaid principal balance of \$605 million and a fair value of \$620 million. At origination, the weighted average FICO score of borrowers backing these loans was 742, the weighted average LTV ratio of these loans was 74%, and the loans were all first lien and prime-quality. At both March 31, 2018 and December 31, 2017, none of these loans were greater than 90 days delinquent or in foreclosure.

During the three months ended March 31, 2018, we transferred loans with a fair value of \$452 million from held-for-sale to held-for-investment associated with Choice securitizations. Pursuant to the collateralized financing entity guidelines, the market valuation changes of these loans are based on the estimated fair value of the ABS issued associated with Choice securitizations. The net impact to our income statement associated with our retained economic investment in the Sequoia Choice securitization entities is presented in Note 5.

Note 7. Real Estate Securities

We invest in real estate securities that we acquire from third parties or create and retain from our Sequoia securitizations. The following table presents the fair values of our real estate securities by type at March 31, 2018 and December 31, 2017.

Table 7.1 – Fair Values of Real Estate Securities by Type

(In Thousands)	March 31, 2018	December 31, 2017
Trading	\$907,432	\$ 968,844
Available-for-sale	450,288	507,666
Total Real Estate Securities	\$1,357,720	\$ 1,476,510

Our real estate securities include mortgage-backed securities, which are presented in accordance with their general position within a securitization structure based on their rights to cash flows. Senior securities are those interests in a securitization that generally have the first right to cash flows and are last in line to absorb losses. Mezzanine securities are interests that are generally subordinate to senior securities in their rights to receive cash flows, and have subordinate securities below them that are first to absorb losses. Our mezzanine classified securities were initially rated AA through BBB- and issued in 2012 or later. Subordinate securities are all interests below mezzanine. Nearly all of our residential securities are supported by collateral that was designated as prime at the time of issuance.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 7. Real Estate Securities - (continued)

Trading Securities

The following table presents the fair value of trading securities by position and collateral type at March 31, 2018 and December 31, 2017.

Table 7.2 – Trading Securities by Position and Collateral Type

(In Thousands)	March 31, December 31,	
	2018	2017
Senior	\$ 82,062	\$ 69,974
Mezzanine	537,831	563,475
Subordinate	287,539	335,395
Total Trading Securities	\$ 907,432	\$ 968,844

We elected the fair value option for certain securities and classify them as trading securities. Our trading securities include both residential and commercial/multifamily securities. At March 31, 2018, trading securities with a carrying value of \$486 million and \$57 million of securities retained from our consolidated Sequoia Choice securitizations were pledged as collateral under short-term borrowing agreements. See Note 11 for additional information on short-term debt.

At March 31, 2018 and December 31, 2017, our senior trading securities were comprised of interest-only securities, for which there is no principal balance, and our mezzanine and subordinate trading securities had an unpaid principal balance of \$900 million and \$943 million, respectively.

At March 31, 2018 and December 31, 2017, our mezzanine and subordinate trading securities included \$246 million and \$301 million, respectively, of Agency residential mortgage credit risk transfer (or "CRT") securities, \$54 million and \$68 million, respectively, of Sequoia securities, \$148 million and \$206 million, respectively, of other third-party residential securities, and \$377 million and \$324 million, respectively, of third-party commercial/multifamily securities.

During the three months ended March 31, 2018 and 2017, we acquired \$145 million and \$154 million (principal balance), respectively, of securities for which we elected the fair value option and classified as trading, and sold \$182 million and \$9 million, respectively, of such securities. During the three months ended March 31, 2018 and 2017, we recorded a net market valuation loss of \$3 million and a net market valuation gain of \$11 million, respectively, on trading securities, included in Investment fair value changes, net and Mortgage banking activities, net on our consolidated statements of income.

AFS Securities

The following table presents the fair value of our available-for-sale securities by position and collateral type at March 31, 2018 and December 31, 2017.

Table 7.3 – Available-for-Sale Securities by Position and Collateral Type

(In Thousands)	March 31, December 31,	
	2018	2017
Senior ⁽¹⁾	\$ 165,610	\$ 179,864
Mezzanine	67,291	92,002
Subordinate	217,387	235,800
Total AFS Securities	\$ 450,288	\$ 507,666

(1) Includes \$38 million and \$39 million of re-REMIC securities at March 31, 2018 and December 31, 2017, respectively. Re-REMIC securities were created through the resecuritization of certain senior security interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior security interests, but senior to any subordinate tranches of the securitization from which they

were created.

At March 31, 2018 and December 31, 2017, all of our available-for-sale securities were comprised of residential mortgage-backed securities. At March 31, 2018, AFS securities with a carrying value of \$178 million were pledged as collateral under short-term borrowing agreements. See Note 11 for additional information on short-term debt.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 7. Real Estate Securities - (continued)

During the three months ended March 31, 2018 and 2017, we purchased \$4 million and \$25 million of AFS securities, respectively, and sold \$51 million and \$19 million of AFS securities, respectively, which resulted in net realized gains of \$9 million and \$5 million, respectively.

We often purchase AFS securities at a discount to their outstanding principal balances. To the extent we purchase an AFS security that has a likelihood of incurring a loss, we do not amortize into income the portion of the purchase discount that we do not expect to collect due to the inherent credit risk of the security. We may also expense a portion of our investment in the security to the extent we believe that principal losses will exceed the purchase discount. We designate any amount of unpaid principal balance that we do not expect to receive and thus do not expect to earn or recover as a credit reserve on the security. Any remaining net unamortized discounts or premiums on the security are amortized into income over time using the effective yield method.

At March 31, 2018, there were \$0.1 million of AFS securities with contractual maturities less than five years, \$2 million with contractual maturities greater than five years but less than 10 years, and the remainder of our AFS securities had contractual maturities greater than 10 years.

The following table presents the components of carrying value (which equals fair value) of AFS securities at March 31, 2018 and December 31, 2017.

Table 7.4 – Carrying Value of AFS Securities

March 31, 2018

(In Thousands)	Senior	Mezzanine	Subordinate	Total
Principal balance	\$172,026	\$67,995	\$312,914	\$552,935
Credit reserve	(8,206)	—	(32,410)	(40,616)
Unamortized discount, net	(39,174)	(6,959)	(132,169)	(178,302)
Amortized cost	124,646	61,036	148,335	334,017
Gross unrealized gains	41,919	6,255	69,419	117,593
Gross unrealized losses	(955)	—	(367)	(1,322)
Carrying Value	\$165,610	\$67,291	\$217,387	\$450,288

December 31, 2017

(In Thousands)	Senior	Mezzanine	Subordinate	Total
Principal balance	\$189,125	\$91,471	\$327,549	\$608,145
Credit reserve	(8,756)	—	(37,793)	(46,549)
Unamortized discount, net	(44,041)	(9,407)	(130,305)	(183,753)
Amortized cost	136,328	82,064	159,451	377,843
Gross unrealized gains	44,771	9,938	76,481	131,190
Gross unrealized losses	(1,235)	—	(132)	(1,367)
Carrying Value	\$179,864	\$92,002	\$235,800	\$507,666

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(Unaudited)

Note 7. Real Estate Securities - (continued)

The following table presents the changes for the three months ended March 31, 2018, in unamortized discount and designated credit reserves on residential AFS securities.

Table 7.5 – Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities

(In Thousands)	Three Months Ended March 31, 2018	
	Credit Reserve	Unamortized Discount, Net
Beginning balance	\$46,549	\$ 183,753
Amortization of net discount	—	(4,060)
Realized credit losses	(956)	—
Acquisitions	2,536	1,635
Sales, calls, other	(767)	(9,772)
Transfers to (release of) credit reserves, net	(6,746)	6,746
Ending Balance	\$40,616	\$ 178,302

AFS Securities with Unrealized Losses

The following table presents the components comprising the total carrying value of residential AFS securities that were in a gross unrealized loss position at March 31, 2018 and December 31, 2017.

Table 7.6 – Components of Fair Value of Residential AFS Securities by Holding Periods

(In Thousands)	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
	Amortize	Unrealized	Fair	Amortize	Unrealized	Fair
	Cost	Losses	Value	Cost	Losses	Value
March 31, 2018	\$12,799	\$ (367)	\$12,432	\$27,186	\$ (955)	\$26,231
December 31, 2017	8,637	(132)	8,505	28,557	(1,235)	27,322

At March 31, 2018, after giving effect to purchases, sales, and extinguishment due to credit losses, our consolidated balance sheet included 152 AFS securities, of which 13 were in an unrealized loss position and three were in a continuous unrealized loss position for 12 consecutive months or longer. At December 31, 2017, our consolidated balance sheet included 167 AFS securities, of which nine were in an unrealized loss position and three were in a continuous unrealized loss position for 12 consecutive months or longer.

Evaluating AFS Securities for Other-than-Temporary Impairments

Gross unrealized losses on our AFS securities were \$1 million at March 31, 2018. We evaluate all securities in an unrealized loss position to determine if the impairment is temporary or other-than-temporary (resulting in an OTTI). At March 31, 2018, we did not intend to sell any of our AFS securities that were in an unrealized loss position, and it is more likely than not that we will not be required to sell these securities before recovery of their amortized cost basis, which may be at their maturity. We review our AFS securities that are in an unrealized loss position to identify those securities with losses that are other-than-temporary based on an assessment of changes in expected cash flows for such securities, which considers recent security performance and expected future performance of the underlying collateral.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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(Unaudited)

Note 7. Real Estate Securities - (continued)

For the three months ended March 31, 2018, there were no other-than-temporary impairments related to our AFS securities. For the three months ended March 31, 2017, other-than-temporary impairments were \$0.2 million, of which \$0.1 million were recognized through our consolidated statements of income and \$0.1 million were recognized in Accumulated other comprehensive income, a component of our consolidated balance sheet. AFS securities for which OTTI is recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. In determining our estimate of cash flows for AFS securities we may consider factors such as structural credit enhancement, past and expected future performance of underlying mortgage loans, including timing of expected future cash flows, which are informed by prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, FICO scores at loan origination, year of origination, loan-to-value ratios, and geographic concentrations, as well as general market assessments. Changes in our evaluation of these factors impacted the cash flows expected to be collected at the OTTI assessment date and were used to determine if there were credit-related adverse cash flows and if so, the amount of credit related losses. Significant judgment is used in both our analysis of the expected cash flows for our AFS securities and any determination of the credit loss component of OTTI. The table below summarizes the significant valuation assumptions we used for our AFS securities in unrealized loss positions at March 31, 2018.

Table 7.7 – Significant Valuation Assumptions

March 31, 2018	Range for Securities
Prepayment rates	8% -20%
Projected losses	0.20%-5.25%

The following table details the activity related to the credit loss component of OTTI (i.e., OTTI recognized through earnings) for AFS securities held at March 31, 2018 and 2017, for which a portion of an OTTI was recognized in other comprehensive income.

Table 7.8 – Activity of the Credit Component of Other-than-Temporary Impairments

(In Thousands)	Three Months Ended March 31,	
	2018	2017
Balance at beginning of period	\$21,037	\$28,261
Additions		
Initial credit impairments	—	97
Reductions		
Securities sold, or expected to sell	(99)	(1,566)
Securities with no outstanding principal at period end	(14)	(402)
Balance at End of Period	\$20,924	\$26,390

Gains and losses from the sale of AFS securities are recorded as Realized gains, net, in our consolidated statements of income. The following table presents the gross realized gains and losses on sales and calls of AFS securities for the three months ended March 31, 2018 and 2017.

Table 7.9 – Gross Realized Gains and Losses on AFS Securities

(In Thousands)	Three Months Ended March 31,	
	2018	2017
Gross realized gains - sales	\$9,363	\$5,092

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Gross realized gains - calls	—	611
Total Realized Gains on Sales and Calls of AFS Securities, net	\$9,363	\$5,703

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REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 8. Mortgage Servicing Rights

We invest in mortgage servicing rights associated with residential mortgage loans and contract with licensed sub-servicers to perform all servicing functions for these loans. The majority of our investments in MSR were made through the retention of servicing rights associated with the residential jumbo mortgage loans that we acquire and subsequently transfer to third parties. We hold our MSR investments at our taxable REIT subsidiary.

At March 31, 2018 and December 31, 2017, our MSRs had a fair value of \$66 million and \$64 million, respectively, and were associated with loans with an aggregate principal balance of \$5.42 billion and \$5.56 billion, respectively. The following table presents activity for MSRs for the three months ended March 31, 2018 and 2017.

Table 8.1 – Activity for MSRs

(In Thousands)	Three Months Ended	
	March 31,	
	2018	2017
Balance at beginning of period	\$63,598	\$118,526
Additions	—	7,485
Sales	—	(11,928)
Changes in fair value due to:		
Changes in assumptions ⁽¹⁾	4,346	(657)
Other changes ⁽²⁾	(1,448)	(2,413)
Balance at End of Period	\$66,496	\$111,013

(1) Primarily reflects changes in prepayment assumptions due to changes in market interest rates.

(2) Represents changes due to the realization of expected cash flows.

The following table presents the components of our MSR income for the three months ended March 31, 2018 and 2017.

Table 8.2 – Components of MSR Income, net

(In Thousands)	Three Months	
	Ended March 31,	
	2018	2017
Servicing income	\$3,796	\$6,907
Cost of sub-servicer	(592)	(1,380)
Net servicing fee income	3,204	5,527
Market valuation changes of MSRs	2,892	(3,070)
Market valuation changes of associated derivatives	(5,139)	(749)
MSR reversal of provision for repurchases	—	5
MSR Income, Net	\$957	\$1,713

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 9. Derivative Financial Instruments

The following table presents the fair value and notional amount of our derivative financial instruments at March 31, 2018 and December 31, 2017.

Table 9.1 – Fair Value and Notional Amount of Derivative Financial Instruments

(In Thousands)	March 31, 2018		December 31, 2017	
	Fair Value	Notional Amount	Fair Value	Notional Amount
Assets - Risk Management Derivatives				
Interest rate swaps	\$50,919	\$2,869,500	\$10,122	\$1,765,000
TBAs	8,625	1,515,000	133	295,000
Futures	—	—	1	7,500
Swaptions	—	—	42	200,000
Assets - Other Derivatives				
Loan purchase commitments	4,000	570,552	3,243	547,434
Loan forward sale commitments	—	—	2,177	343,681
Total Assets	\$63,544	\$4,955,052	\$15,718	\$3,158,615
Liabilities - Cash Flow Hedges				
Interest rate swaps	\$(35,167)	\$139,500	\$(43,679)	\$139,500
Liabilities - Risk Management Derivatives				
Interest rate swaps	(11,346)	451,500	(11,888)	1,248,000
TBAs	(5,457)	1,110,000	(3,808)	1,400,000
Futures	(357)	15,000	—	—
Liabilities - Other Derivatives				
Loan purchase commitments	(2,605)	627,803	(3,706)	697,966
Loan forward sale commitments	(1,269)	340,320	—	—
Total Liabilities	\$(56,201)	\$2,684,123	\$(63,081)	\$3,485,466
Total Derivative Financial Instruments, Net	\$7,343	\$7,639,175	\$(47,363)	\$6,644,081
Risk Management Derivatives				

To manage, to varying degrees, risks associated with certain assets and liabilities on our consolidated balance sheets, we may enter into derivative contracts. At March 31, 2018, we were party to swaps and swaptions with an aggregate notional amount of \$3.32 billion, TBA agreements sold with an aggregate notional amount of \$2.63 billion, and financial futures contracts with an aggregate notional amount of \$15 million. At December 31, 2017, we were party to swaps and swaptions with an aggregate notional amount of \$3.21 billion, TBA agreements sold with an aggregate notional amount of \$1.70 billion, and financial futures contracts with an aggregate notional amount of \$8 million. During the three months ended March 31, 2018 and 2017, risk management derivatives had a net market valuation gain of \$67 million and a net market valuation loss of \$7 million, respectively. These market valuation gains and losses are recorded in Mortgage banking activities, net, Investment fair value changes, net, and MSR income, net on our consolidated statements of income.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 9. Derivative Financial Instruments - (continued)

Loan Purchase and Forward Sale Commitments

LPCs and FSCs that qualify as derivatives are recorded at their estimated fair values. For the three months ended March 31, 2018 and 2017, a net market valuation loss on LPCs and FSCs of \$7 million and a net market valuation gain on LPCs of \$10 million, respectively, were recorded in Mortgage banking activities, net on our consolidated statements of income.

Derivatives Designated as Cash Flow Hedges

To manage the variability in interest expense related to portions of our long-term debt and certain adjustable-rate securitization entity liabilities that are included in our consolidated balance sheets for financial reporting purposes, we designated certain interest rate swaps as cash flow hedges with an aggregate notional balance of \$140 million.

For the three months ended March 31, 2018 and 2017, changes in the values of designated cash flow hedges were positive \$8 million and positive \$2 million, respectively, and were recorded in Accumulated other comprehensive income, a component of equity. For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in Accumulated other comprehensive income was \$35 million and \$43 million at March 31, 2018 and December 31, 2017, respectively.

The following table illustrates the impact on interest expense of our interest rate agreements accounted for as cash flow hedges for the three months ended March 31, 2018 and 2017.

Table 9.2 – Impact on Interest Expense of Interest Rate Agreements Accounted for as Cash Flow Hedges

(In Thousands)	Three Months Ended March 31,	
	2018	2017
Net interest expense on cash flows hedges	\$(998)	\$(1,225)
Realized net losses reclassified from other comprehensive income	—	(14)
Total Interest Expense	\$(998)	\$(1,239)

Derivative Counterparty Credit Risk

As discussed in our Annual Report on Form 10-K for the year ended December 31, 2017, we consider counterparty risk as part of our fair value assessments of all derivative financial instruments at each quarter-end. At March 31, 2018, we assessed this risk as remote and did not record a specific valuation adjustment.

At March 31, 2018, we had outstanding derivative agreements with two counterparties (other than clearinghouses) and were in compliance with ISDA agreements governing our open derivative positions.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 10. Other Assets and Liabilities

Other assets at March 31, 2018 and December 31, 2017, are summarized in the following table.

Table 10.1 – Components of Other Assets

(In Thousands)	March 31, December 31,	
	2018	2017
Margin receivable	\$ 50,200	\$ 85,044
FHLBC stock	43,393	43,393
Pledged collateral	42,290	42,615
MSR holdback receivable	3,952	8,141
Fixed assets and leasehold improvements ⁽¹⁾	3,794	2,645
REO	3,115	3,354
Guarantee asset	3,055	2,869
Other	8,049	6,905
Total Other Assets	\$ 157,848	\$ 194,966

⁽¹⁾ Fixed assets and leasehold improvements had a basis of \$8 million and accumulated depreciation of \$4 million at March 31, 2018.

Accrued expenses and other liabilities at March 31, 2018 and December 31, 2017 are summarized in the following table.

Table 10.2 – Components of Accrued Expenses and Other Liabilities

(In Thousands)	March 31, December 31,	
	2018	2017
Guarantee obligations	\$ 18,931	\$ 19,487
Margin payable	16,878	390
Accrued compensation	11,982	24,025
Deferred tax liabilities	11,764	11,764
Residential loan and MSR repurchase reserve	5,197	4,916
Accrued income taxes payable	4,950	—
Legal reserve	2,000	2,000
Other	6,060	5,147
Total Accrued Expenses and Other Liabilities	\$ 77,762	\$ 67,729

Margin Receivable and Payable

Margin receivable and payable resulted from margin calls between us and our counterparties under derivatives, master repurchase agreements, and warehouse facilities, whereby we or the counterparty posted collateral.

FHLB Stock

In accordance with our FHLB-member subsidiary's borrowing agreement with the FHLBC, our subsidiary is required to purchase and hold stock in the FHLBC. See Note 3 and Note 13 for additional information on this borrowing agreement.

Guarantee Asset, Pledged Collateral, and Guarantee Obligations

The pledged collateral, guarantee asset, and guarantee obligations presented in the tables above are related to our risk-sharing arrangements with Fannie Mae and Freddie Mac. In accordance with these arrangements, we are required to pledge collateral to secure our guarantee obligations. See Note 14 for additional information on our risk-sharing arrangements.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 10. Other Assets and Liabilities - (continued)

MSR Holdback Receivable

MSR holdback receivable represents amounts owed to us from third parties related to the sale of MSRs.

REO

The carrying value of REO at March 31, 2018 was \$3 million, which includes the net effect of \$1 million related to transfers into REO during the three months ended March 31, 2018, offset by \$2 million of REO liquidations, and \$0.1 million of unrealized gains resulting from market valuation adjustments. At March 31, 2018 and December 31, 2017, there were 11 and 14 REO properties, respectively, recorded on our consolidated balance sheets, all of which were owned at consolidated Legacy Sequoia entities.

Legal and Repurchase Reserves

See Note 14 for additional information on the legal and residential repurchase reserves.

Note 11. Short-Term Debt

We enter into repurchase agreements, bank warehouse agreements, and other forms of collateralized (and generally uncommitted) short-term borrowings with several banks and major investment banking firms. At March 31, 2018, we had outstanding agreements with several counterparties and we were in compliance with all of the related covenants. For additional information about these financial covenants and our short-term debt, see Part I, Item 2 – Management’s Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q and Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2017.

The table below summarizes our short-term debt, including the facilities that are available to us, the outstanding balances, the weighted average interest rate, and the maturity information at March 31, 2018 and December 31, 2017.

Table 11.1 – Short-Term Debt

(Dollars in Thousands)	March 31, 2018			Weighted Average Interest Rate	Maturity	Weighted Average Days Until Maturity
	Number of Facilities	Outstanding Balance	Limit			
Facilities						
Residential loan warehouse	4	\$661,782	\$1,425,000	3.51 %	8/2018-3/2019	246
Real estate securities repo	8	592,294	—	3.03 %	4/2018-6/2018	27
Total Short-Term Debt Facilities	12	1,254,076				
Convertible notes, net	N/A	250,384	—	4.63 %	4/2018	15
Total Short-Term Debt		\$1,504,460				

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Note 11. Short-Term Debt - (continued)

(Dollars in Thousands)	December 31, 2017			Weighted Average Interest Rate	Maturity	Weighted Average Days Until Maturity
	Number of Facilities	Outstanding Balance	Limit			
Facilities						
Residential loan warehouse	4	\$ 1,039,666	\$ 1,575,000	3.17 %	1/2018-12/2018	197
Real estate securities repo	9	648,746	—	2.69 %	1/2018-3/2018	28
Total Short-Term Debt Facilities	13	1,688,412				
Convertible notes, net	N/A	250,270	—	4.63 %	4/2018	105
Total Short-Term Debt		\$ 1,938,682				

Borrowings under our facilities are generally charged interest based on a specified margin over the one-month LIBOR interest rate. At March 31, 2018, all of these borrowings were under uncommitted facilities and were due within 364 days (or less) of the borrowing date.

The fair value of held-for-sale residential loans and real estate securities pledged as collateral under our short-term debt facilities was \$718 million and \$721 million, respectively, at March 31, 2018 and \$1.15 billion and \$788 million, respectively, at December 31, 2017. At March 31, 2018, the fair value of our real estate securities pledged as collateral included \$57 million of securities retained from our consolidated Sequoia Choice securitizations. For the three months ended March 31, 2018 and 2017, the average balances of our short-term debt facilities were \$1.37 billion and \$794 million, respectively. At both March 31, 2018 and December 31, 2017, accrued interest payable on our short-term debt facilities was \$2 million.

During the second quarter of 2017, \$288 million principal amount of 4.625% convertible senior notes and \$2 million of unamortized deferred issuance costs were reclassified from long-term debt to short-term debt, as the maturity of the notes was less than one year as of April 2017. Additionally, during the second quarter of 2017, we repurchased \$37 million par value of these notes at a premium and recorded a loss on extinguishment of debt of \$1 million in Realized gains, net on our consolidated statements of income. At March 31, 2018, the accrued interest payable balance on this debt was \$5 million. In April 2018, we repaid these \$250 million convertible notes and all related accrued interest in full. See Note 13 for additional information on our convertible notes.

We also maintain a \$10 million committed line of credit with a financial institution that is secured by certain mortgage-backed securities with a fair market value of \$5 million at March 31, 2018. At both March 31, 2018 and December 31, 2017, we had no outstanding borrowings on this facility.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 11. Short-Term Debt - (continued)

Remaining Maturities of Short-Term Debt

The following table presents the remaining maturities of our secured short-term debt by the type of collateral securing the debt as well as our convertible notes at March 31, 2018.

Table 11.2 – Short-Term Debt by Collateral Type and Remaining Maturities

(In Thousands)	March 31, 2018			Total
	Within 30 days	31 to 90 days	Over 90 days	
Collateral Type				
Held-for-sale residential loans	\$—	\$—	\$661,782	\$661,782
Real estate securities	445,380	146,914	—	592,294
Total Secured Short-Term Debt	445,380	146,914	661,782	1,254,076
Convertible notes, net	250,384	—	—	250,384
Total Short-Term Debt	\$695,764	\$146,914	\$661,782	\$1,504,460

Note 12. Asset-Backed Securities Issued

Through our Sequoia securitization program, we sponsor securitization transactions in which ABS backed by residential mortgage loans are issued by Sequoia entities. We consolidated the Legacy Sequoia securitization entities, and beginning in September 2017, the Sequoia Choice securitization entities, that we determined were VIEs and for which we determined we were the primary beneficiary. Each consolidated securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, servicing administrator, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

We account for the ABS issued under our consolidated Sequoia entities at fair value, with periodic changes in fair value recorded in Investment fair value changes, net on our consolidated statements of income. Pursuant to the CFE guidelines, the market valuation changes on our Sequoia loans are based on the estimated fair value of the associated ABS issued. The net impact to our income statement associated with our retained economic investment in the Sequoia securitization entities is presented in Note 5.

The ABS issued by these entities consist of various classes of securities that pay interest on a monthly or quarterly basis. All ABS issued by the Sequoia Choice entities pay fixed rates of interest and substantially all ABS issued by the Legacy Sequoia entities pay variable rates of interest, which are indexed to one-, three-, or six-month LIBOR. ABS issued also includes some interest-only classes with coupons set at a fixed spread to a benchmark rate, or set at a spread to the interest rates earned on the assets less the interest rates paid on the liabilities of a securitization entity.

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Note 12. Asset-Backed Securities Issued - (continued)

The carrying values of ABS issued by Sequoia securitization entities we sponsored at March 31, 2018 and December 31, 2017, along with other selected information, are summarized in the following table.

Table 12.1 – Asset-Backed Securities Issued

March 31, 2018	Legacy	Sequoia	Total
(Dollars in Thousands)	Sequoia	Choice	
Certificates with principal balance	\$655,188	\$905,713	\$1,560,901
Interest-only certificates	1,809	13,641	15,450
Market valuation adjustments	(41,148)	6,884	(34,264)
ABS Issued, Net	\$615,849	\$926,238	\$1,542,087
Range of weighted average interest rates, by series	1.77% to 2.83%	4.49% to 4.66%	
Stated maturities	2024 - 2036	2047 - 2048	
Number of series	20	3	
December 31, 2017	Legacy	Sequoia	Total
(Dollars in Thousands)	Sequoia	Choice	
Certificates with principal balance	\$691,125	\$526,657	\$1,217,782
Interest-only certificates	1,972	7,695	9,667
Market valuation adjustments	(70,652)	7,788	(62,864)
ABS Issued, Net	\$622,445	\$542,140	\$1,164,585
Range of weighted average interest rates, by series	1.46% to 2.78%	4.52% to 4.73%	
Stated maturities	2024 - 2036	2047	
Number of series	20	2	

The actual maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption prior to the stated maturity according to the terms of the respective governing documents of each ABS issuing entity. As a result, the actual maturity of ABS issued may occur earlier than its stated maturity. At March 31, 2018, all of the ABS issued and outstanding had contractual maturities beyond five years.

At both March 31, 2018 and December 31, 2017, accrued interest payable on ABS issued by the Legacy Sequoia entities was \$1 million. At March 31, 2018 and December 31, 2017, accrued interest payable on ABS issued by the Sequoia Choice entities was \$3 million and \$2 million, respectively. Interest due on consolidated ABS issued is payable monthly.

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Note 12. Asset-Backed Securities Issued - (continued)

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at March 31, 2018 and December 31, 2017.

Table 12.2 – Collateral for Asset-Backed Securities Issued

March 31, 2018 (In Thousands)	Legacy Sequoia	Sequoia Choice	Total
Residential loans	\$626,151	\$1,013,619	\$1,639,770
Restricted cash	148	7	155
Accrued interest receivable	753	4,057	4,810
REO	3,115	—	3,115
Total Collateral for ABS Issued	\$630,167	\$1,017,683	\$1,647,850
December 31, 2017 (In Thousands)	Legacy Sequoia	Sequoia Choice	Total
Residential loans	\$632,817	\$620,062	\$1,252,879
Restricted cash	147	4	151
Accrued interest receivable	867	2,524	3,391
REO	3,353	—	3,353
Total Collateral for ABS Issued	\$637,184	\$622,590	\$1,259,774

Note 13. Long-Term Debt

FHLBC Borrowings

In July 2014, our FHLB-member subsidiary entered into a borrowing agreement with the Federal Home Loan Bank of Chicago. At March 31, 2018, under this agreement, our subsidiary could incur borrowings up to \$2.00 billion, also referred to as “advances,” from the FHLBC secured by eligible collateral, including residential mortgage loans. During the three months ended March 31, 2018, our FHLB-member subsidiary made no additional borrowings under this agreement. Under a final rule published by the Federal Housing Finance Agency in January 2016, our FHLB-member subsidiary will remain an FHLB member through the five-year transition period for captive insurance companies. Our FHLB-member subsidiary's existing \$2.00 billion of FHLB debt, which matures beyond this transition period, is permitted to remain outstanding until its stated maturity. As residential loans pledged as collateral for this debt pay down, we are permitted to pledge additional loans or other eligible assets to collateralize this debt; however, we do not expect to be able to increase our subsidiary's FHLB debt above the existing \$2.00 billion maximum.

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Note 13. Long-Term Debt - (continued)

At March 31, 2018, \$2.00 billion of advances were outstanding under this agreement, which were classified as long-term debt, with a weighted average interest rate of 1.74% and a weighted average maturity of approximately seven years. At December 31, 2017, \$2.00 billion of advances were outstanding under this agreement, which were classified as long-term debt, with a weighted average interest rate of 1.38% and a weighted average maturity of eight years. Advances under this agreement incur interest charges based on a specified margin over the FHLBC's 13-week discount note rate, which resets every 13 weeks. Total advances under this agreement were secured by residential mortgage loans with a fair value of \$2.37 billion at March 31, 2018. This agreement also requires our subsidiary to purchase and hold stock in the FHLBC in an amount equal to a specified percentage of outstanding advances. At March 31, 2018, our subsidiary held \$43 million of FHLBC stock that is included in Other assets in our consolidated balance sheets.

The following table presents maturities of our FHLBC borrowings by year at March 31, 2018.

Table 13.1 – Maturities of FHLBC Borrowings by Year

(In Thousands)	March 31, 2018
2024	\$470,171
2025	887,639
2026	642,189
Total FHLBC Borrowings	\$1,999,999

For additional information about our FHLBC borrowings, see Part I, Item 2 of Quarterly Report on Form 10-Q under the heading "Risks Relating to Debt Incurred under Short- and Long-Term Borrowing Facilities."

Convertible Notes

In August 2017, we issued \$245 million principal amount of 4.75% convertible senior notes due 2023. These convertible notes require semi-annual interest payments at a fixed coupon rate of 4.75% until maturity or conversion, which will be no later than August 15, 2023. After deducting the underwriting discount and offering costs, we received \$238 million of net proceeds. Including amortization of deferred debt issuance costs, the weighted average interest expense yield on these convertible notes is approximately 5.3% per annum. At March 31, 2018, these notes were convertible at the option of the holder at a conversion rate of 53.8394 common shares per \$1,000 principal amount of convertible senior notes (equivalent to a conversion price of \$18.57 per common share). Upon conversion of these notes by a holder, the holder will receive shares of our common stock. At March 31, 2018, the outstanding principal amount of these notes was \$245 million. At March 31, 2018, the accrued interest payable balance on this debt was \$1 million and the unamortized deferred issuance costs were \$7 million.

In November 2014, RWT Holdings, Inc., a wholly-owned subsidiary of Redwood Trust, Inc., issued \$205 million principal amount of 5.625% exchangeable senior notes due 2019. These exchangeable notes require semi-annual interest payments at a fixed coupon rate of 5.625% until maturity or exchange, which will be no later than November 15, 2019. After deducting the underwriting discount and offering costs, we received \$198 million of net proceeds. Including amortization of deferred debt issuance costs, the weighted average interest expense yield on these exchangeable notes is approximately 6.3% per annum. At March 31, 2018, these notes were exchangeable at the option of the holder at an exchange rate of 46.1798 common shares per \$1,000 principal amount of exchangeable senior notes (equivalent to an exchange price of \$21.65 per common share). Upon exchange of these notes by a holder, the holder will receive shares of our common stock. During the first quarter of 2016, we repurchased \$4 million par value of these notes at a discount and recorded a gain on extinguishment of debt of \$0.3 million in Realized gains, net on our consolidated statements of income. At March 31, 2018, the outstanding principal amount of these notes was \$201 million. At March 31, 2018, the accrued interest payable balance on this debt was \$4 million and

the unamortized deferred issuance costs were \$2 million.

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REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 13. Long-Term Debt - (continued)

In March 2013, we issued \$288 million principal amount of 4.625% convertible senior notes due in April 2018. These convertible notes require semi-annual interest payments at a fixed coupon rate of 4.625% until maturity or conversion, which will be no later than April 15, 2018. After deducting the underwriting discount and offering costs, we received \$279 million of net proceeds. Including amortization of deferred debt issuance costs, the weighted average interest expense yield on these convertible notes is approximately 4.8% per annum. At March 31, 2018, these notes were convertible at the option of the holder at a conversion rate of 41.1320 common shares per \$1,000 principal amount of convertible senior notes (equivalent to a conversion price of \$24.31 per common share). Upon conversion of these notes by a holder, the holder will receive shares of our common stock. During the second quarter of 2017, \$288 million principal amount of these convertible notes and \$2 million of unamortized deferred issuance costs were reclassified from long-term debt to short-term debt, as the maturity of the notes was less than one year as of April 2017. Additionally, during the second quarter of 2017, we repurchased \$37 million par value of these notes at a premium and recorded a loss on extinguishment of debt of \$1 million in Realized gains, net on our consolidated statements of income. At March 31, 2018, the outstanding principal amount of these notes was \$250 million. At March 31, 2018, the accrued interest payable balance on this debt was \$5 million and the unamortized deferred issuance costs were \$0.1 million. In April 2018, we repaid these \$250 million convertible notes and all related accrued interest in full.

Trust Preferred Securities and Subordinated Notes

At March 31, 2018, we had trust preferred securities and subordinated notes outstanding of \$100 million and \$40 million, respectively. This debt requires quarterly interest payments at a floating rate equal to three-month LIBOR plus 2.25% until the notes are redeemed. The \$100 million trust preferred securities will be redeemed no later than January 30, 2037, and the \$40 million subordinated notes will be redeemed no later than July 30, 2037. Prior to 2014, we entered into interest rate swaps with aggregate notional values totaling \$140 million to hedge the variability in this long-term debt interest expense. Including hedging costs and amortization of deferred debt issuance costs, the weighted average interest expense yield on our trust preferred securities and subordinated notes is approximately 6.8% per annum. At both March 31, 2018 and December 31, 2017, the accrued interest payable balance on our trust preferred securities and subordinated notes was \$1 million.

Under the terms of this debt, we covenant, among other things, to use our best efforts to continue to qualify as a REIT. If an event of default were to occur in respect of this debt, we would generally be restricted under its terms (subject to certain exceptions) from making dividend distributions to stockholders, from repurchasing common stock or repurchasing or redeeming any other then-outstanding equity securities, and from making any other payments in respect of any equity interests in us or in respect of any then-outstanding debt that is pari passu or subordinate to this debt.

Note 14. Commitments and Contingencies

Lease Commitments

At March 31, 2018, we were obligated under four non-cancelable operating leases with expiration dates through 2028 for \$17 million of cumulative lease payments. Our operating lease expense was \$1 million for both three-month periods ended March 31, 2018 and 2017.

The following table presents our future lease commitments at March 31, 2018.

Table 14.1 – Future Lease Commitments by Year

(In Thousands)	March 31, 2018
2018 (9 months)	\$ 1,467
2019	1,987

2020	1,965
2021	1,474
2022 and thereafter	10,217
Total Lease Commitments	\$ 17,110

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REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 14. Commitments and Contingencies - (continued)

Commitments to Fund Equity Investments

At March 31, 2018, we had committed to fund \$50 million to a limited partnership created to finance clean energy projects. This obligation may be requested at any time by the investment manager, and will be recorded on our balance sheet as an equity method investment upon funding. At March 31, 2018, no investments in this partnership had been funded.

Loss Contingencies — Risk-Sharing

During 2015 and 2016, we sold conforming loans to the Agencies with an original unpaid principal balance of \$3.19 billion, subject to our risk-sharing arrangements with the Agencies. At March 31, 2018, the maximum potential amount of future payments we could be required to make under these arrangements was \$44 million and this amount was fully collateralized by assets we transferred to pledged accounts and is presented as pledged collateral in Other assets on our consolidated balance sheets. We have no recourse to any third parties that would allow us to recover any amounts related to our obligations under the arrangements. At March 31, 2018, we had not incurred any losses under these arrangements. For the three months ended March 31, 2018 and 2017, other income related to these arrangements was \$1 million for both periods, and net market valuation losses related to these investments were \$0.1 million and \$0.2 million, respectively.

All of the loans in the reference pools subject to these risk-sharing arrangements were originated in 2014 and 2015, and at March 31, 2018, the loans had an unpaid principal balance of \$2.03 billion and a weighted average FICO score of 758 (at origination) and LTV of 76% (at origination). At March 31, 2018, \$8 million of the loans were 90 days or more delinquent, and \$1 million were in foreclosure. At March 31, 2018, the carrying value of our guarantee obligation was \$19 million and included \$10 million designated as a non-amortizing credit reserve, which we believe is sufficient to cover current expected losses under these obligations.

Our consolidated balance sheets include assets of special purpose entities ("SPEs") associated with these risk-sharing arrangements (i.e., the "pledged collateral" referred to above) that can only be used to settle obligations of these SPEs for which the creditors of these SPEs (the Agencies) do not have recourse to Redwood Trust, Inc. or its affiliates. At both March 31, 2018 and December 31, 2017, assets of such SPEs totaled \$48 million and liabilities of such SPEs totaled \$19 million.

Loss Contingencies — Residential Repurchase Reserve

We maintain a repurchase reserve for potential obligations arising from representation and warranty violations related to residential loans we have sold to securitization trusts or third parties and for conforming residential loans associated with MSR that we have purchased from third parties. We do not originate residential loans and we believe the initial risk of loss due to loan repurchases (i.e., due to a breach of representations and warranties) would generally be a contingency to the companies from whom we acquired the loans. However, in some cases, for example, where loans were acquired from companies that have since become insolvent, repurchase claims may result in our being liable for a repurchase obligation.

At both March 31, 2018 and December 31, 2017, our repurchase reserve associated with our residential loans and MSR was \$5 million and was recorded in Accrued expenses and other liabilities on our consolidated balance sheets. We received two and three repurchase requests during the three months ended March 31, 2018 and 2017, respectively, and did not repurchase any loans during either of these periods. During the three months ended March 31, 2018 and 2017, we recorded repurchase provisions of \$0.3 million and \$0.2 million, respectively, that were recorded in Mortgage banking activities, net and MSR income, net on our consolidated statements of income.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Note 14. Commitments and Contingencies - (continued)

Loss Contingencies — Litigation

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the “FHLB-Seattle”) filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (“SRF”), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the “FHLB-Seattle Defendants”), which alleged that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Seattle Certificate”) issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the “2005-4 RMBS”) and purchased by the FHLB-Seattle. Specifically, the complaint alleged that the alleged misstatements concerned the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleged claims under the Securities Act of Washington (Section 21.20.005, et seq.) and sought to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys’ fees and costs. The Seattle Certificate was issued with an original principal amount of approximately \$133 million, and, at March 31, 2018, approximately \$126 million of principal and \$11 million of interest payments had been made in respect of the Seattle Certificate. The matter was subsequently resolved and the claims were dismissed by the FHLB Seattle as to all the FHLB Seattle Defendants. At the time the Seattle Certificate was issued, Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were named as defendants in the action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the resolution of this litigation, we could incur a loss as a result of these indemnities.

On or about July 15, 2010, The Charles Schwab Corporation (“Schwab”) filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the “Schwab Defendants”), which alleged that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. Schwab alleged only a claim for negligent misrepresentation under California state law against SRF and sought unspecified damages and attorneys’ fees and costs from SRF. Schwab claimed that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Schwab Certificate”) issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleged that the misstatements for the 2005-4 RMBS concerned the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. The Schwab Certificate was issued with an original principal amount of approximately \$15 million, and, at March 31, 2018, approximately \$14 million of principal and \$1 million of interest payments had been made in respect of the Schwab Certificate. On November 14, 2014, Schwab voluntarily dismissed with prejudice its negligent misrepresentation claim, which resulted in the dismissal with prejudice of SRF from the action. Subsequently, the matter was resolved and Schwab dismissed its claims against the lead underwriter of the 2005-4 RMBS. At the time the Schwab Certificate was issued, Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were also named as defendants in the action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the resolution of this litigation, Redwood could incur a loss as a result of these indemnities. Through certain of our wholly-owned subsidiaries, we have in the past engaged in, and expect to continue to engage in, activities relating to the acquisition and securitization of residential mortgage loans. In addition, certain of our wholly-owned subsidiaries have in the past engaged in activities relating to the acquisition and securitization of debt

obligations and other assets through the issuance of collateralized debt obligations (commonly referred to as CDO transactions). Because of this involvement in the securitization and CDO businesses, we could become the subject of litigation relating to these businesses, including additional litigation of the type described above, and we could also become the subject of governmental investigations, enforcement actions, or lawsuits, and governmental authorities could allege that we violated applicable law or regulation in the conduct of our business. As an example, in July 2016 we became aware of a complaint filed by the State of California on April 1, 2016 against Morgan Stanley & Co. and certain of its affiliates alleging, among other things, that there were misleading statements contained in offering materials for 28 different mortgage pass-through certificates purchased by various California investors, including various California public pension systems, from Morgan Stanley and alleging that Morgan Stanley made false or fraudulent claims in connection with the sale of those certificates. Of the 28 mortgage pass-through certificates that were the subject of the complaint, two were Sequoia mortgage pass-through certificates issued in 2004 and two were Sequoia mortgage pass-through certificates issued in 2007. With respect to each of those certificates, our wholly-owned subsidiary, RWT Holdings, Inc., was the sponsor and our wholly-owned subsidiary, Sequoia Residential Funding, Inc., was the depositor. The

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 14. Commitments and Contingencies - (continued)

plaintiffs subsequently withdrew from the litigation their claims based on eight of the 28 mortgage pass-through certificates, including one of the Sequoia mortgage pass-through certificates issued in 2004. At the time these Sequoia mortgage pass-through certificates were issued, Sequoia Residential Funding, Inc. and Redwood Trust agreed to indemnify the underwriters of these certificates for certain losses and expenses they might incur as a result of claims made against them relating to these certificates, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, we could incur a loss as a result of these indemnities.

In accordance with GAAP, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. At March 31, 2018, the aggregate amount of loss contingency reserves established in respect of the FHLB-Seattle and Schwab litigation matters described above was \$2 million. We review our litigation matters each quarter to assess these loss contingency reserves and make adjustments in these reserves, upwards or downwards, as appropriate, in accordance with GAAP based on our review.

In the ordinary course of any litigation matter, including certain of the above-referenced matters, we have engaged and may continue to engage in formal or informal settlement communications with the plaintiffs or co-defendants.

Settlement communications we have engaged in relating to certain of the above-referenced litigation matters are one of the factors that have resulted in our determination to establish the loss contingency reserves described above. We cannot be certain that any of these matters will be resolved through a settlement prior to trial and we cannot be certain that the resolution of these matters, whether through trial or settlement, will not have a material adverse effect on our financial condition or results of operations in any future period.

Future developments (including resolution of substantive pre-trial motions relating to these matters, receipt of additional information and documents relating to these matters (such as through pre-trial discovery), new or additional settlement communications with plaintiffs relating to these matters, or resolutions of similar claims against other defendants in these matters) could result in our concluding in the future to establish additional loss contingency reserves or to disclose an estimate of reasonably possible losses in excess of our established reserves with respect to these matters. Our actual losses with respect to the above-referenced litigation matters may be materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters, including in the event that any of these matters proceeds to trial and the plaintiff prevails. Other factors that could result in our concluding to establish additional loss contingency reserves or estimate additional reasonably possible losses, or could result in our actual losses with respect to the above-referenced litigation matters being materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters include that: there are significant factual and legal issues to be resolved; information obtained or rulings made during the lawsuits could affect the methodology for calculation of the available remedies; and we may have additional obligations pursuant to indemnity agreements, representations and warranties, and other contractual provisions with other parties relating to these litigation matters that could increase our potential losses.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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(Unaudited)

Note 15. Equity

The following table provides a summary of changes to accumulated other comprehensive income by component for the three months ended March 31, 2018 and 2017.

Table 15.1 – Changes in Accumulated Other Comprehensive Income by Component

	Three Months Ended March 31, 2018		Three Months Ended March 31, 2017	
	Net Unrealized Net Unrealized Gains on Available-for-Sale Securities	Interest Rate Agreements for as Cash Flow Hedges	Net Unrealized Net Unrealized Gains on Available-for-Sale Securities	Interest Rate Agreements for as Cash Flow Hedges
(In Thousands)				
Balance at beginning of period	\$128,201	\$ (42,953)	\$115,873	\$ (44,020)
Other comprehensive (loss) income before reclassifications ⁽¹⁾	(4,237)	8,431	2,930	1,733
Amounts reclassified from other accumulated comprehensive income	(9,387)	—	(3,928)	14
Net current-period other comprehensive (loss) income	(13,624)	8,431	(998)	1,747
Balance at End of Period	\$114,577	\$ (34,522)	\$114,875	\$ (42,273)

⁽¹⁾ Amounts presented for net unrealized gains on available-for-sale securities are net of tax provision of \$0.1 million for both the three months ended March 31, 2018 and 2017.

The following table provides a summary of reclassifications out of accumulated other comprehensive income for three months ended March 31, 2018 and 2017.

Table 15.2 – Reclassifications Out of Accumulated Other Comprehensive Income

	Affected Line Item in the Income Statement	Amount Reclassified From Accumulated Other Comprehensive Income Three Months Ended March 31,	
		2018	2017
(In Thousands)			
Net Realized (Gain) Loss on AFS Securities Other than temporary impairment ⁽¹⁾	Investment fair value changes, net	\$—	\$117
Gain on sale of AFS securities	Realized gains, net	(9,387)	(4,045)
		\$(9,387)	\$(3,928)
Net Realized Loss on Interest Rate Agreements Designated as Cash Flow Hedges			
Amortization of deferred loss	Interest expense	\$—	\$14
		\$—	\$14

(1) For the three months ended March 31, 2018, there were no other-than-temporary impairments. For the three months ended March 31, 2017, other-than-temporary impairments were \$0.2 million, of which \$0.1 million were recognized through our consolidated statements of income and \$0.1 million were recognized in Accumulated other comprehensive income, a component of our consolidated balance sheet.

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 15. Equity - (continued)

Earnings per Common Share

The following table provides the basic and diluted earnings per common share computations for the three months ended March 31, 2018 and 2017.

Table 15.3 – Basic and Diluted Earnings per Common Share

(In Thousands, except Share Data)	Three Months Ended	
	March 31, 2018	2017
Basic Earnings per Common Share:		
Net income attributable to Redwood	\$46,845	\$ 36,969
Less: Dividends and undistributed earnings allocated to participating securities	(1,433)	(968)
Net income allocated to common shareholders	\$45,412	\$ 36,001
Basic weighted average common shares outstanding	75,396,649	76,738,202
Basic Earnings per Common Share	\$0.60	\$ 0.47
Diluted Earnings per Common Share:		
Net income attributable to Redwood	\$46,845	\$ 36,969
Less: Dividends and undistributed earnings allocated to participating securities	(1,394)	(1,005)
Add back: Interest expense on convertible notes for the period, net of tax	8,641	5,870
Net income allocated to common shareholders	\$54,092	\$ 41,834
Weighted average common shares outstanding	75,396,649	76,738,202
Net effect of dilutive equity awards	34,827	111,197
Net effect of assumed convertible notes conversion to common shares	32,763,121	21,096,738
Diluted weighted average common shares outstanding	108,194,597	97,946,137
Diluted Earnings per Common Share	\$0.50	\$ 0.43

We included participating securities, which are certain equity awards that have non-forfeitable dividend participation rights, in the calculations of basic and diluted earnings per common share as we determined that the two-class method was more dilutive than the alternative treasury stock method for these shares. Dividends and undistributed earnings allocated to participating securities under the basic and diluted earnings per share calculations require specific shares to be included that may differ in certain circumstances.

During the three months ended March 31, 2018 and 2017, certain of our convertible notes were determined to be dilutive and were included in the calculation of diluted EPS under the "if-converted" method. Under this method, the periodic interest expense (net of applicable taxes) for dilutive notes is added back to the numerator and the weighted average number of shares that the notes are entitled to (if converted, regardless of whether they are in or out of the money) are included in the denominator.

For the three months ended March 31, 2018 and 2017, the number of outstanding equity awards that were antidilutive totaled 6,838 and 5,826, respectively.

Stock Repurchases

In February 2016, our Board of Directors approved an authorization for the repurchase of up to \$100 million of our common stock and also authorized the repurchase of outstanding debt securities, including convertible and exchangeable debt. This authorization replaced all previous share repurchase plans and has no expiration date. During the year ended December 31, 2017, we repurchased 610,342 shares of common stock pursuant to this authorization for \$9 million. At December 31, 2017, approximately \$77 million of this current authorization remained available for the repurchase of shares of our common stock. During January 2018, we repurchased 1,040,829 shares of our common stock pursuant to this authorization for \$16 million.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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(Unaudited)

Note 15. Equity - (continued)

In February 2018, our Board of Directors approved an authorization for the repurchase of an additional \$39 million of our common stock, increasing the total amount authorized for repurchases of common stock to \$100 million, and also authorized the repurchase of outstanding debt securities, including convertible and exchangeable debt. As noted above, this authorization increased the previous share repurchase authorization approved in February 2016 and has no expiration date. This repurchase authorization does not obligate us to acquire any specific number of shares or securities. Under this authorization, shares or securities may be repurchased in privately negotiated and/or open market transactions, including under plans complying with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. At March 31, 2018, \$100 million of the current authorization remained available for the repurchase of shares of our common stock.

Note 16. Equity Compensation Plans

At March 31, 2018 and December 31, 2017, 999,636 and 1,356,438 shares of common stock, respectively, were available for grant under our Incentive Plan. The unamortized compensation cost of awards issued under the Incentive Plan and purchases under the Employee Stock Purchase Plan totaled \$25 million at March 31, 2018, as shown in the following table.

Table 16.1 – Activities of Equity Compensation Costs by Award Type

(In Thousands)	Three Months Ended March 31, 2018				Total
	Restricted Stock	Deferred Stock Units	Performance Stock Units	Employee Stock Purchase Plan	
Unrecognized compensation cost at beginning of period	\$2,808	\$13,364	\$ 5,298	\$ —	\$21,470
Equity grants	2,380	3,450	—	136	5,966
Equity grant forfeitures	—	—	—	—	—
Equity compensation expense	(353)	(1,673)	(637)	(34)	(2,697)
Unrecognized Compensation Cost at End of Period	\$4,835	\$15,141	\$ 4,661	\$ 102	\$24,739

At March 31, 2018, the weighted average amortization period remaining for all of our equity awards was less than two years.

Restricted Stock

At March 31, 2018 and December 31, 2017, there were 337,253 and 257,507 shares, respectively, of restricted stock outstanding. Restrictions on these shares lapse through 2022. During the three months ended March 31, 2018, there were 162,330 shares of restricted stock granted, restrictions on 82,584 shares of restricted stock lapsed and those shares were distributed, and no shares of restricted stock awards were forfeited.

Deferred Stock Units (“DSUs”)

At March 31, 2018 and December 31, 2017, there were 2,179,977 and 1,878,491 DSUs, respectively, outstanding of which 1,050,211 and 889,835, respectively, had vested. During the three months ended March 31, 2018, there were 301,485 DSUs granted, no DSUs distributed, and no DSUs forfeited. Unvested DSUs at March 31, 2018 vest through 2022.

Performance Stock Units (“PSUs”)

At both March 31, 2018 and December 31, 2017, the target number of PSUs that were unvested was 704,270. Vesting for PSUs will generally occur at the end of three years from their grant date based on various total shareholder return (“TSR”) performance calculations, as discussed in our Annual Report on Form 10-K for the year ended December 31, 2017.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 16. Equity Compensation Plans - (continued)

Employee Stock Purchase Plan ("ESPP")

The ESPP allows a maximum of 450,000 shares of common stock to be purchased in aggregate for all employees. As of March 31, 2018 and December 31, 2017, 367,844 and 361,006 shares had been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP at March 31, 2018.

Note 17. Mortgage Banking Activities, Net

The following table presents the components of Mortgage banking activities, net, recorded in our consolidated statements of income for the three months ended March 31, 2018 and 2017.

Table 17.1 – Mortgage Banking Activities

(In Thousands)	Three Months Ended March 31,	
	2018	2017
Mortgage Banking Activities, Net		
Changes in fair value of:		
Residential loans, at fair value ⁽¹⁾	\$(2,194)	\$18,797
Risk management derivatives ⁽²⁾	28,432	(1,400)
Other income, net ⁽³⁾	338	207
Mortgage Banking Activities, Net	\$26,576	\$17,604

(1) Includes changes in fair value for associated loan purchase and forward sale commitments.

(2) Represents market valuation changes of derivatives that were used to manage risks associated with our accumulation of residential loans.

(3) Amounts in this line item include other fee income from loan acquisitions and the provision for repurchases expense, presented net.

Note 18. Investment Fair Value Changes, Net

The following table presents the components of Investment fair value changes, net, recorded in our consolidated statements of income for the three months ended March 31, 2018 and 2017.

Table 18.1 – Investment Fair Value Changes

(In Thousands)	Three Months Ended March 31,	
	2018	2017
Investment Fair Value Changes, Net		
Changes in fair value of:		
Residential loans held-for-investment, at Redwood	\$(38,985)	\$(2,333)
Trading securities	(2,955)	11,143
Net investments in Legacy Sequoia entities ⁽¹⁾	(8)	(1,810)
Net investments in Sequoia Choice entities ⁽¹⁾	(86)	—
Risk-sharing investments	(139)	(205)
Risk management derivatives, net	43,782	(5,127)
Impairments on AFS securities	—	(117)
Investment Fair Value Changes, Net	\$1,609	\$1,551

(1) Includes changes in fair value of the residential loans held-for-investment, REO and the ABS issued at the entities, which netted together represent the change in value of our retained investments at the consolidated VIEs.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 19. Operating Expenses

Components of our operating expenses for the three months ended March 31, 2018 and 2017 are presented in the following table.

Table 19.1 – Components of Operating Expenses

(In Thousands)	Three Months	
	Ended March 31,	
	2018	2017
Fixed compensation expense	\$6,439	\$6,002
Variable compensation expense	6,907	3,933
Equity compensation expense	2,697	2,176
Total compensation expense	16,043	12,111
Systems and consulting	1,866	1,638
Loan acquisition costs ⁽¹⁾	1,818	1,205
Office costs	1,140	1,103
Accounting and legal	834	926
Corporate costs	504	440
Other operating expenses	825	803
Total Operating Expenses	\$23,030	\$18,226

(1) Loan acquisition costs primarily includes underwriting and due diligence costs related to the acquisition of residential loans held-for-sale at fair value.

Note 20. Taxes

For the three months ended March 31, 2018 and 2017, we recognized a provision for income taxes of \$5 million and \$6 million, respectively. The following is a reconciliation of the statutory federal and state tax rates to our effective tax rate at March 31, 2018 and 2017.

Table 20.1 – Reconciliation of Statutory Tax Rate to Effective Tax Rate

	March 31, 2018	March 31, 2017
Federal statutory rate	21.0 %	34.0 %
State statutory rate, net of Federal tax effect	8.6 %	7.2 %
Differences in taxable (loss) income from GAAP income	(4.1)%	(8.5)%
Change in valuation allowance	(3.9)%	(3.0)%
Dividends paid deduction	(12.1)%	(15.4)%
Effective Tax Rate	9.5 %	14.3 %

The reduction of the federal statutory rate from 34% to 21% is due to the enactment of the Tax Act.

We assessed our tax positions for all open tax years (i.e., Federal, 2014 to 2018, and State, 2013 to 2018) at March 31, 2018 and December 31, 2017, and concluded that we had no uncertain tax positions that resulted in material unrecognized tax benefits.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 21. Segment Information

Redwood operates in two segments: Investment Portfolio and Residential Mortgage Banking. Our segments are based on our organizational and management structure, which aligns with how our results are monitored and performance is assessed. For a full description of our segments, see Item 1—Business in our Annual Report on Form 10-K for the year ended December 31, 2017.

Segment contribution represents the measure of profit that management uses to assess the performance of our business segments and make resource allocation and operating decisions. Certain corporate expenses not directly assigned or allocated to one of our two segments, as well as activity from certain consolidated Sequoia entities, are included in the Corporate/Other column as reconciling items to our consolidated financial statements. These unallocated corporate expenses primarily include interest expense associated with certain long-term debt, indirect operating expenses, and other expense.

The following tables present financial information by segment for the three months ended March 31, 2018 and 2017.

Table 21.1 – Business Segment Financial Information

(In Thousands)	Three Months Ended March 31, 2018			
	Investment Portfolio	Residential Mortgage Banking	Corporate/ Other	Total
Interest income	\$58,757	\$ 12,897	\$4,965	\$76,619
Interest expense	(19,863)	(6,137)	(15,514)	(41,514)
Net interest income (loss)	38,894	6,760	(10,549)	35,105
Non-interest income				
Mortgage banking activities, net	—	26,576	—	26,576
MSR income, net	957	—	—	957
Investment fair value changes, net	1,590	—	19	1,609
Other income	1,161	—	—	1,161
Realized gains, net	9,363	—	—	9,363
Total non-interest income, net	13,071	26,576	19	39,666
Direct operating expenses	(2,007)	(8,632)	(12,391)	(23,030)
Provision for income taxes	(888)	(4,008)	—	(4,896)
Segment Contribution	\$49,070	\$ 20,696	\$ (22,921)	
Net Income				\$46,845
Non-cash amortization income (expense), net	\$4,617	\$ (22)	\$ (858)	\$3,737

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2018
 (Unaudited)

Note 21. Segment Information - (continued)

(In Thousands)	Three Months Ended March 31, 2017			
	Investment Portfolio	Residential Mortgage Banking	Corporate/ Other	Total
Interest income	\$42,250	\$ 7,474	\$ 4,904	\$54,628
Interest expense	(5,264)	(2,924)	(12,843)	(21,031)
Net interest income (loss)	36,986	4,550	(7,939)	33,597
Non-interest income				
Mortgage banking activities, net	—	17,604	—	17,604
MSR income, net	1,713	—	—	1,713
Investment fair value changes, net	3,359	—	(1,808)	1,551
Other income	1,184	—	—	1,184
Realized gains, net	5,703	—	—	5,703
Total non-interest income, net	11,959	17,604	(1,808)	27,755
Direct operating expenses	(1,593)	(5,881)	(10,752)	(18,226)
Provision for income taxes	(1,737)	(4,420)	—	(6,157)
Segment Contribution	\$45,615	\$ 11,853	\$ (20,499)	
Net Income				\$36,969
Non-cash amortization income (expense)	\$5,847	\$ (27)	\$ (997)	\$4,823

The following table presents the components of Corporate/Other for the three months ended March 31, 2018 and 2017.

Table 21.2 – Components of Corporate/Other

(In Thousands)	Three Months Ended March 31, 2018			Three Months Ended March 31, 2017		
	Legacy Consolidated VIEs (1)	Other	Total	Legacy Consolidated VIEs (1)	Other	Total
Interest income	\$4,812	\$ 153	\$4,965	\$4,838	\$ 66	\$4,904
Interest expense	(3,852)	(11,662)	(15,514)	(3,516)	(9,327)	(12,843)
Net interest income (loss)	960	(11,509)	(10,549)	1,322	(9,261)	(7,939)
Non-interest income						
Investment fair value changes, net	(8)	27	19	(1,810)	2	(1,808)
Total non-interest income, net	(8)	27	19	(1,810)	2	(1,808)
Direct operating expenses	—	(12,391)	(12,391)	—	(10,752)	(10,752)
Total	\$952	\$ (23,873)	\$ (22,921)	\$ (488)	\$ (20,011)	\$ (20,499)

(1) Legacy consolidated VIEs represent Legacy Sequoia entities that are consolidated for GAAP financial reporting purposes. See Note 4 for further discussion on VIEs.

REDWOOD TRUST, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2018
 (Unaudited)

Note 21. Segment Information - (continued)

The following table presents supplemental information by segment at March 31, 2018 and December 31, 2017.
 Table 21.3 – Supplemental Segment Information

(In Thousands)	Investment Portfolio	Residential Mortgage Banking	Corporate/ Other	Total
March 31, 2018				
Residential loans	\$3,389,404	\$1,130,185	\$626,151	\$5,145,740
Real estate securities	1,357,720	—	—	1,357,720
Mortgage servicing rights	66,496	—	—	66,496
Total assets	5,012,235	1,154,413	832,925	6,999,573
December 31, 2017				
Residential loans	\$3,054,448	\$1,427,945	\$632,817	\$5,115,210
Real estate securities	1,476,510	—	—	1,476,510
Mortgage servicing rights	63,598	—	—	63,598
Total assets	4,743,873	1,453,069	842,880	7,039,822

Note 22. Subsequent Events

Upon its scheduled maturity in April 2018, we repaid the \$250 million principal amount of our 4.625% convertible notes and all related accrued interest in full.

In May 2018, we entered into an agreement to acquire a 20% minority interest in 5 Arches, LLC for \$10 million, with a one-year option to purchase all remaining equity in the company for \$40 million. In connection with this investment, we also entered into a loan purchase agreement with 5 Arches, LLC establishing a flow relationship to purchase business-purpose real estate loans originated by the company.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

INTRODUCTION

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to provide a reader of our financial statements with a narrative from the perspective of our management on our financial condition, results of operations, liquidity and certain other factors that may affect our future results. Our MD&A is presented in six main sections:

• Overview

• Results of Operations

• Liquidity and Capital Resources

• Off-Balance Sheet Arrangements and Contractual Obligations

• Critical Accounting Policies and Estimates

• New Accounting Standards

Our MD&A should be read in conjunction with the Consolidated Financial Statements and related Notes included in Part I, Item 1 of this Quarterly Report on Form 10-Q and in Part II, Item 8, Financial Statements and Supplementary Data in our most recent Annual Report on Form 10-K, as well as the sections entitled "Risk Factors" in Part I, Item 1A of our most recent Annual Report on Form 10-K and Part II, Item 1A of this Quarterly Report on Form 10-Q, as well as other cautionary statements and risks described elsewhere in this report and our most recent Annual Report on Form 10-K. The discussion in this MD&A contains forward-looking statements that involve substantial risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, such as those discussed in the Cautionary Statement below.

References herein to "Redwood," the "company," "we," "us," and "our" include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires. Financial information concerning our business is set forth in this "Management's Discussion and Analysis of Financial Condition and Results of Operations," and our consolidated financial statements and notes thereto, which are included in Part I, Item 1 of this Quarterly Report on Form 10-Q. Our website can be found at www.redwoodtrust.com. We make available, free of charge through the investor information section of our website, access to our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the U.S. Securities Exchange Act of 1934, as well as proxy statements, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the U.S. Securities and Exchange Commission ("SEC"). We also make available, free of charge, access to our charters for our Audit Committee, Compensation Committee, and Governance and Nominating Committee, our Corporate Governance Standards, and our Code of Ethics governing our directors, officers, and employees. Within the time period required by the SEC and the New York Stock Exchange, we will post on our website any amendment to the Code of Ethics and any waiver applicable to any executive officer or director of Redwood. In addition, our website includes information concerning purchases and sales of our equity securities by our executive officers and directors, and may include disclosure relating to certain non-GAAP financial measures (as defined in the SEC's Regulation G) that we may make public orally, telephonically, by webcast, by broadcast, or by similar means from time to time. The information on our website is not part of this Quarterly Report on Form 10-Q.

Our Investor Relations Department can be contacted at One Belvedere Place, Suite 300, Mill Valley, CA 94941, Attn: Investor Relations, telephone (866) 269-4976.

Our Business

Redwood Trust, Inc., together with its subsidiaries, is a specialty finance company focused on making credit-sensitive investments in residential mortgages and related assets and engaging in mortgage banking activities. Our goal is to provide attractive returns to shareholders through a stable and growing stream of earnings and dividends, as well as through capital appreciation. We operate our business in two segments: Investment Portfolio and Residential Mortgage Banking. Our segments are based on our organizational and management structure, which aligns with how our results are monitored and performance is assessed. For a full description of our segments, see Item 1—Business in our Annual Report on Form 10-K for the year ended December 31, 2017.

Our primary sources of income are net interest income from our investment portfolio and non-interest income from our mortgage banking activities. Net interest income consists of the interest income we earn on investments less the interest expense we incur on borrowed funds and other liabilities. Income from mortgage banking activities consists of the profit we seek to generate through the acquisition of loans and their subsequent sale or securitization.

Redwood Trust, Inc. has elected to be taxed as a real estate investment trust (“REIT”) under the Internal Revenue Code of 1986, as amended (the “Internal Revenue Code”), beginning with its taxable year ended December 31, 1994. We generally refer, collectively, to Redwood Trust, Inc. and those of its subsidiaries that are not subject to subsidiary-level corporate income tax as “the REIT” or “our REIT.” We generally refer to subsidiaries of Redwood Trust, Inc. that are subject to subsidiary-level corporate income tax as “our operating subsidiaries” or “our taxable REIT subsidiaries” or “TRS.” Our mortgage banking activities and investments in MSRs are generally carried out through our taxable REIT subsidiaries, while our portfolio of mortgage- and other real estate-related investments is primarily held at our REIT. We generally intend to retain profits generated and taxed at our taxable REIT subsidiaries, and to distribute as dividends at least 90% of the taxable income we generate at our REIT.

Redwood Trust, Inc. was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. Our executive offices are located at One Belvedere Place, Suite 300, Mill Valley, California 94941.

Cautionary Statement

This Quarterly Report on Form 10-Q and the documents incorporated by reference herein contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as “anticipate,” “estimate,” “will,” “should,” “expect,” “believe,” “intend,” “seek,” “plan” and similar expressions or their forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017 and this Quarterly Report on Form 10-Q, in each case under the caption “Risk Factors.” Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected may be described from time to time in reports we file with the SEC, including reports on Forms 10-Q and 8-K. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Statements regarding the following subjects, among others, are forward-looking by their nature: (i) statements we make regarding Redwood’s business strategy and strategic focus, including statements relating to our overall market position, strategy and long-term prospects; (ii) statements related to expanding our mortgage banking activities and investment portfolio to include mortgage loans secured by single-family rental properties; (iii) statements regarding our mortgage banking activities, including expectations relating to residential mortgage banking margins, securitization execution, loan purchase volume, and our expanded-prime Redwood Choice loan program; (iv) statements relating to acquiring residential mortgage loans in the future that we have identified for purchase or plan to purchase, including the amount of such loans that we identified for purchase during the first quarter of 2018 and at March 31, 2018, and expected fallout and the corresponding volume of residential mortgage loans expected to be available for purchase; (v) statements relating to our estimate of our available capital (including that we estimate our available capital at March 31, 2018 was approximately \$380 million), and expectations relating to sourcing additional capital from continued optimization of our investment portfolio and from capital markets; (vi) statements we make regarding our dividend policy, including our intention to pay a regular dividend of \$0.28 per share per quarter in 2018;

and (vii) statements regarding our expectations and estimates relating to the characterization for income tax purposes of our dividend distributions, our expectations and estimates relating to tax accounting, tax liabilities and tax savings, and GAAP tax provisions, and our estimates of REIT taxable income and TRS taxable income.

Important factors, among others, that may affect our actual results include:

- the pace at which we redeploy our available capital into new investments;
- interest rate volatility, changes in credit spreads, and changes in liquidity in the market for real estate securities and loans;
- changes in the demand from investors for residential mortgages and investments, and our ability to distribute residential mortgages through our whole-loan distribution channel;
- our ability to finance our investments in securities and our acquisition of residential mortgages with short-term debt;
- changes in the values of assets we own;
- general economic trends, the performance of the housing, real estate, mortgage, credit, and broader financial markets, and their effects on the prices of earning assets and the credit status of borrowers;
- federal and state legislative and regulatory developments, and the actions of governmental authorities, including the new U.S. presidential administration, and in particular those affecting the mortgage industry or our business (including, but not limited to, the Federal Housing Finance Agency's rules relating to FHLB membership requirements and the implications for our captive insurance subsidiary's membership in the FHLB);
- strategic business and capital deployment decisions we make;
- developments related to the fixed income and mortgage finance markets and the Federal Reserve's statements regarding its future open market activity and monetary policy;
- our exposure to credit risk and the timing of credit losses within our portfolio;
- the concentration of the credit risks we are exposed to, including due to the structure of assets we hold and the geographical concentration of real estate underlying assets we own;
- our exposure to adjustable-rate mortgage loans;
- the efficacy and expense of our efforts to manage or hedge credit risk, interest rate risk, and other financial and operational risks;
- changes in credit ratings on assets we own and changes in the rating agencies' credit rating methodologies;
- changes in interest rates; changes in mortgage prepayment rates;
- changes in liquidity in the market for real estate securities and loans;
- our ability to finance the acquisition of real estate-related assets with short-term debt;
- the ability of counterparties to satisfy their obligations to us;
- our involvement in securitization transactions, the profitability of those transactions, and the risks we are exposed to in engaging in securitization transactions;
- exposure to claims and litigation, including litigation arising from our involvement in securitization transactions;
- ongoing litigation against various trustees of RMBS transactions;
- whether we have sufficient liquid assets to meet short-term needs;
- our ability to successfully compete and retain or attract key personnel;
- our ability to adapt our business model and strategies to changing circumstances;
- changes in our investment, financing, and hedging strategies and new risks we may be exposed to if we expand our business activities;
- our exposure to a disruption or breach of the security of our technology infrastructure and systems;
- exposure to environmental liabilities;
- our failure to comply with applicable laws and regulations;
- our failure to maintain appropriate internal controls over financial reporting and disclosure controls and procedures;
- the impact on our reputation that could result from our actions or omissions or from those of others; changes in accounting principles and tax rules;
- our ability to maintain our status as a REIT for tax purposes;
- limitations imposed on our business due to our REIT status and our status as exempt from registration under the Investment Company Act of 1940;
- decisions about raising, managing, and distributing capital; and
- other factors not presently identified.

This Quarterly Report on Form 10-Q may contain statistics and other data that in some cases have been obtained from or compiled from information made available by servicers and other third-party service providers.

OVERVIEW

Business Update

The first quarter of 2018 was very productive for Redwood. Financially, we generated strong GAAP earnings and grew book value almost 2%, which represented our eighth consecutive quarterly book value increase after paying our regular dividends. Operationally, we continued to optimize our long-term portfolio investments, our mortgage banking business completed four Sequoia securitizations, and our Redwood Choice loan program represented about one-third of our jumbo lock volume during the first quarter of 2018. Additionally, in May we made a strategic minority investment in a business-purpose real estate loan originator and asset manager.

The first quarter also provided an opportunity to highlight the differences between our business model and that of many other residential mortgage REITs. While many of these REITs assume significant exposure to interest rates and rely on the slope of the yield curve as a primary driver of earnings, Redwood's returns generally correlate to the credit performance of our portfolio investments, with supplemental income generated through mortgage banking activities. Amidst volatility in the financial markets in the first quarter, particularly with regard to interest rates, we continued to execute on our strategy, delivering strong and diversified earnings and managing risk. Ultimately, the impact to our earnings in the first quarter from changes in interest rates was minimal.

Investment Portfolio

Our investment portfolio performed well in the first quarter of 2018, generating an annualized return on allocated capital of 12%. This return resulted from higher than normal realized gains driven by our portfolio optimization activities, as well as spread tightening in parts of our portfolio. During the first quarter of 2018, we continued to optimize our portfolio by selling lower-yielding CRT, mezzanine, and third-party legacy securities and redeploying proceeds into higher yielding alternatives in our Sequoia and multifamily portfolios. We expect to continue to optimize our portfolio throughout 2018, and beginning in the second quarter, we expect to deploy an increasing amount of capital towards new investment initiatives in the single-family rental and multifamily housing sectors.

Residential Mortgage Banking

Our mortgage banking business had strong performance in the first quarter of 2018. We completed three Select securitizations and our third Choice securitization (since the inception of our Choice program), and total loan sales were \$2.05 billion (inclusive of securitized loans). Our first quarter purchase volume of \$1.82 billion (including \$550 million of Redwood Choice loans) puts us on track to exceed our volumes from 2017 both overall and for Choice loans. While gross margins were well above our long-term expected range of 75 to 100 basis points in the first quarter of 2018, we expect margins for the remainder of the year to normalize and fall within this range.

New Business

Effective on May 1, 2018, we acquired a 20% minority investment in 5 Arches, LLC, a business-purpose real estate loan originator and asset manager. Through our new relationship with 5 Arches, we will serve housing investors focused on renting out or potentially rehabilitating residential homes. As part of the transaction, we have exclusive rights to purchase 5 Arches' single-family rental loan originations, and a 12-month option to purchase the remainder of the 5 Arches' platform for a mix of cash and Redwood stock. While we currently expect loan purchase volumes under this agreement to ramp up over time, this investment jump starts our strategic expansion into this developing area of housing finance, and over the longer-term we expect to create scalable and accretive investments for our portfolio.

Financial and Operational Overview - First Quarter of 2018

Highlights

Our GAAP earnings were \$0.50 per share for the first quarter of 2018, as compared with \$0.35 per share for the fourth quarter of 2017. This increase was primarily driven by higher mortgage banking income, as well as higher realized gains from the sale of securities relative to the fourth quarter.

Our GAAP book value was \$16.12 per share at March 31, 2018, an increase of \$0.29 per share from the fourth quarter, representing an economic return of 3.6% for the quarter (economic return on book value is based on the change in GAAP book value per common share plus the dividend declared per common share during the quarter). This increase was driven primarily by our quarterly earnings exceeding our dividend and an increase in the value of our long-term debt hedge.

We deployed \$92 million of capital in the first quarter of 2018 toward new investments, including \$49 million in Sequoia and third-party RMBS, \$26 million in Agency residential CRT securities, and \$18 million in Agency multifamily securities.

We also deployed \$16 million of capital to repurchase shares of Redwood stock at an average price of \$14.93 per share during the first quarter. In February 2018, Redwood's Board of Directors approved \$39 million of additional share repurchases, increasing the total amount authorized for repurchases to \$100 million, all of which remained outstanding as of March 31, 2018.

We sold \$244 million of securities during the first quarter of 2018, generating \$141 million of capital for reinvestment after the repayment of associated debt.

We purchased \$1.82 billion of residential jumbo loans during the first quarter of 2018. At March 31, 2018, our pipeline of jumbo residential loans identified for purchase was \$1.20 billion.

Residential loan sales totaled \$2.05 billion during the first quarter of 2018 and included \$1.75 billion of loans that were securitized and \$295 million of whole loan sales to third parties.

Our recourse debt to equity leverage ratio was 3.4x at the end of the first quarter of 2018.

Key Earnings Metrics

The following table presents key earnings metrics for the three months ended March 31, 2018.

Table 1 – Key Earnings and Return Metrics

	Three Months Ended March 31, 2018
(In Thousands, except per Share Data)	
Net income	\$46,845
Net income per diluted common share	\$0.50
Annualized GAAP return on equity	15 %
REIT taxable income per share	\$0.44
Dividends per share	\$0.28

A detailed discussion of our first quarter of 2018 net income is included in the Results of Operations section of this MD&A that follows.

Book Value per Share

At March 31, 2018, our book value was \$1.22 billion, or \$16.12 per share, an increase from \$15.83 per share at December 31, 2017. The following table sets forth the changes in our book value per share for the three months ended March 31, 2018.

Table 2 – Changes in Book Value per Share

	Three Months Ended March 31, 2018
(In Dollars, per share basis)	
Beginning book value per share	\$ 15.83
Net income	0.50
Changes in unrealized gains on securities, net, from:	
Realized gains recognized in net income	(0.09)
Amortization income recognized in net income	(0.04)
Total change in unrealized gains on securities, net	(0.13)
Dividends	(0.28)
Share repurchases	0.01
Equity compensation, net	0.03
Changes in unrealized losses on derivatives hedging long-term debt	0.11
Other, net	0.05
Ending Book Value per Share	\$ 16.12

Our GAAP book value per share increased \$0.29 per share to \$16.12 per share during the first three months of 2018. This increase was driven primarily by earnings exceeding the dividend payment and an increase in the value of our long-term debt hedge.

Unrealized gains on our available-for-sale securities decreased \$0.13 per share during the three months ended March 31, 2018. This decrease primarily resulted from \$0.09 per share of previously unrealized net gains that were realized as income from the sale of securities, as well as \$0.04 per share of discount accretion income recognized in earnings from the appreciation in the amortized cost basis of our available-for-sale securities.

Higher benchmark interest rates during the first quarter of 2018 resulted in a \$0.11 per share increase to book value due to a decrease in unrealized losses on the derivatives hedging a portion of our long-term debt. At March 31, 2018, the cumulative unrealized loss on these derivatives, which is included in our GAAP book value per share, was \$0.46 per share.

Capital Allocation Summary

This section provides an overview of our capital position and how it was allocated at March 31, 2018. A detailed discussion of our liquidity and capital resources is provided in the Liquidity and Capital Resources section of this MD&A that follows.

We use a combination of equity and corporate debt (which we collectively refer to as “capital”) to fund our business. Our total capital was \$1.80 billion at March 31, 2018, and included \$1.22 billion of equity capital and \$0.58 billion of the total \$2.58 billion of long-term debt on our consolidated balance sheet. This portion of debt included \$201 million of exchangeable debt due in 2019, \$245 million of convertible debt due in 2023, and \$140 million of trust-preferred securities due in 2037.

We also utilize various forms of collateralized short-term and long-term debt to finance certain investments and to warehouse some of our inventory of residential loans held-for-sale. We do not consider this collateralized debt as "capital" and, therefore, it is presented separately from allocated capital in the table below. The following table presents how our capital was allocated between business segments and investment types at March 31, 2018.

Table 3 – Capital Allocation Summary

At March 31, 2018

(Dollars in Thousands)	Fair Value	Collateralized Debt	Allocated Capital	% of Total Capital
Investment portfolio				
Residential loans ⁽¹⁾	\$2,418,805	\$(1,999,999)	\$418,806	23 %
Securities portfolio				
Third party residential securities	683,829	(185,629)	498,200	28 %
Sequoia residential securities ⁽²⁾	384,263	(126,966)	257,297	14 %
Multifamily securities ⁽³⁾	377,008	(279,699)	97,309	5 %
Total securities portfolio	1,445,100	(592,294)	852,806	47 %
Mortgage servicing rights	66,496	—	66,496	4 %
Other assets/(liabilities)	155,596	(43,451)	112,145	6 %
Cash and liquidity capital			395,319	N/A
(Capital allocated to convertible notes repayment)			(250,000)	N/A
Total investment portfolio	\$4,085,997	\$(2,635,744)	1,595,572	90 %
Residential mortgage banking			200,000	10 %
Total			\$1,795,572	100 %

(1) Includes \$43 million of FHLB stock.

Sequoia residential securities presented above includes \$87 million of securities retained from our consolidated (2) Sequoia Choice securitizations. For GAAP purposes we consolidated \$1.01 billion of residential loans and \$926 million of non-recourse ABS debt associated with these retained securities.

(3) Includes \$350 million of multifamily securities, \$11 million of investment grade CMBS, and \$16 million of single-family securities.

Of our \$1.80 billion of total capital at March 31, 2018, \$1.60 billion (or 90%) was allocated to our investments with the remaining \$200 million (or 10%) allocated to our residential mortgage banking activities.

As of March 31, 2018, our cash and liquidity capital included \$380 million of capital available for investment or debt repayment. We used a portion of this capital to repay our \$250 million of convertible debt that matured in April 2018. To fund new investments going forward, we will consider the most efficient sources of capital both from optimization within our portfolio and from the capital markets.

RESULTS OF OPERATIONS

Within this Results of Operations section, we provide commentary that compares results year-over-year for the first quarter of 2018 and 2017. Most tables include a "change" column that shows the amount by which the results from 2018 are greater or less than the results from the respective period in 2017. Unless otherwise specified, references in this section to increases or decreases during the "three-month periods" refer to the change in results for the first quarter of 2018, compared to the first quarter of 2017.

The following table presents the components of our net income for the three months ended March 31, 2018 and 2017.

Table 4 – Net Income

(In Thousands, except per Share Data)	Three Months		
	Ended March 31,		
	2018	2017	Change
Net Interest Income	\$35,105	\$33,597	\$1,508
Non-interest Income			
Mortgage banking activities, net	26,576	17,604	8,972
MSR income, net	957	1,713	(756)
Investment fair value changes, net	1,609	1,551	58
Other income	1,161	1,184	(23)
Realized gains, net	9,363	5,703	3,660
Total non-interest income, net	39,666	27,755	11,911
Operating expenses	(23,030)	(18,226)	(4,804)
Net income before income taxes	51,741	43,126	8,615
Provision for income taxes	(4,896)	(6,157)	1,261
Net Income	\$46,845	\$36,969	\$9,876
Diluted earnings per common share	\$0.50	\$0.43	\$0.07

Net Interest Income

The increase in net interest income during the three-month period ended March 31, 2018 primarily resulted from higher interest income driven by both a higher average balance of residential loans held-for-sale and a higher average balance of securities in our investment portfolio from increased capital deployment year over year. These increases were partially offset by higher interest expense on our FHLBC borrowings and higher average balances as well as higher rates on our short-term facilities. A more detailed analysis of the changes in net interest income is presented in the "Net Interest Income" section that follows.

Mortgage Banking Activities, Net

The increase in mortgage banking activities during the three-month periods was predominantly due to higher loan purchase volume in 2018, relative to 2017. A more detailed analysis of the changes in this line item is included in Residential Mortgage Banking portion of the "Results of Operations by Segment" section that follows.

MSR Income, Net

MSR income, net is comprised of the net fee income we earn from our MSR investments as well as changes in their market value and the market value of their associated derivatives. MSR income decreased in 2018, primarily due to lower average balances of MSRs outstanding during 2018, as a result of sales and paydowns.

Investment Fair Value Changes, Net

Investment fair value changes, net, is primarily comprised of the change in fair values of our residential loans held-for-investment and financed with FHLB borrowings, our investment securities classified as trading, and interest rate hedges associated with each of these investments.

During both three-month periods, the positive investment fair value changes primarily resulted from net increases in the fair value of our trading securities due to tightening credit spreads during each of the periods. In both periods, these increases were partially offset by fair value decreases from principal repayments on loans and securities as well as hedging costs.

Additional detail on our investment fair value changes is included in the Investment Portfolio portion of the “Results of Operations by Segment” section that follows.

Other Income

Other income in both periods presented was primarily comprised of income from our residential loan risk-sharing arrangements with Fannie Mae and Freddie Mac.

Realized Gains, Net

During the first quarter of 2018, we realized gains of \$9 million, primarily from the sale of \$51 million of AFS securities as part of our portfolio optimization. During the first quarter of 2017, we realized gains of \$6 million, primarily from the sale of \$19 million of AFS securities.

Operating Expenses

The increase in operating expenses during the three months ended March 31, 2018 was primarily due to an increase in variable compensation expense associated with higher net income for the period. Our variable compensation expense is accrued for ratably over the year as our total projected net income for the year is earned.

Provision for Income Taxes

Our provision for income taxes related almost entirely to activity at our taxable REIT subsidiaries, which primarily includes our mortgage banking activities and MSR investments, as well as certain other investment and hedging activities. For the three-month period ended March 31, 2018, the decrease in provision for income taxes was driven primarily by the reduction in the federal corporate tax rate in 2018 resulting from the Tax Cuts and Jobs Act of 2017 (the "Tax Act"). For additional detail on income taxes, see the “Taxable Income and Tax Provision” section that follows.

Net Interest Income

The following tables present the components of net interest income for the three months ended March 31, 2018 and 2017.

Table 5 – Net Interest Income

(Dollars in Thousands)	Three Months Ended March 31,					
	2018			2017		
	Interest	Average	Yield	Interest	Average	Yield
	Income/ (Expense) ⁽¹⁾	Balance		Income/ (Expense) ⁽¹⁾	Balance	
Interest Income						
Residential loans, held-for-sale	\$12,686	\$1,201,028	4.2 %	\$7,486	\$747,148	4.0 %
Residential loans - HFI at Redwood ⁽²⁾	23,799	2,395,596	4.0 %	22,038	2,250,377	3.9 %
Residential loans - HFI at Legacy Sequoia ⁽²⁾	4,811	616,499	3.1 %	4,838	757,342	2.6 %
Residential loans - HFI at Sequoia Choice ⁽²⁾	8,935	747,875	4.8 %	—	—	— %
Trading securities	16,166	918,197	7.0 %	8,217	525,688	6.3 %
Available-for-sale securities	9,529	363,266	10.5 %	11,600	458,450	10.1 %
Other interest income	693	239,439	1.2 %	449	241,660	0.7 %
Total interest income	76,619	6,481,900	4.7 %	54,628	4,980,665	4.4 %
Interest Expense						
Short-term debt facilities	(10,424)	1,369,437	(3.0)%	(4,453)	794,072	(2.2)%
Short-term debt - convertible notes, net	(3,011)	250,346	(4.8)%	—	—	— %
ABS issued - Legacy Sequoia ⁽²⁾	(3,852)	606,551	(2.5)%	(3,530)	739,430	(1.9)%
ABS issued - Sequoia Choice ⁽²⁾	(7,549)	671,881	(4.5)%	—	—	— %
Long-term debt - FHLBC	(8,027)	1,999,999	(1.6)%	(3,735)	1,999,999	(0.7)%
Long-term debt - other	(8,651)	575,400	(6.0)%	(9,313)	621,224	(6.0)%
Total interest expense	(41,514)	5,473,614	(3.0)%	(21,031)	4,154,725	(2.0)%
Net Interest Income	\$35,105			\$33,597		

(1) Average balances for residential loans held-for-sale, residential loans held-for-investment, and trading securities are calculated based upon carrying values, which represent estimated fair values. Average balances for available-for-sale securities and debt are calculated based upon amortized historical cost, except for ABS issued, which is based upon fair value.

Interest income from residential loans held-for-investment ("HFI") at Redwood exclude loans HFI at consolidated Sequoia entities. Interest income from residential loans - HFI at Legacy Sequoia and the interest expense from (2) ABS issued - Legacy Sequoia represent activity from our consolidated Legacy Sequoia entities. Interest income from residential loans - HFI at Sequoia Choice and the interest expense from ABS issued - Sequoia Choice represent activity from our consolidated Sequoia Choice entities.

The following table presents net interest income by segment for the three months ended March 31, 2018 and 2017.

Table 6 – Net Interest Income by Segment

(In Thousands)	Three Months		
	Ended March 31,		
	2018	2017	Change
Net Interest Income by Segment			
Investment Portfolio	\$38,894	\$36,986	\$1,908
Residential Mortgage Banking	6,760	4,550	2,210
Corporate/Other	(10,549)	(7,939)	(2,610)
Net Interest Income	\$35,105	\$33,597	\$1,508

Additional details regarding the activities impacting net interest income at each segment are included in the "Results of Operations by Segment" section that follows.

The Corporate/Other line item in the table above primarily includes interest expense related to long-term debt not directly allocated to our segments and net interest income from consolidated Legacy Sequoia entities. The decrease in corporate net interest income during the three-month period was primarily due to the issuance of \$245 million of convertible notes in August 2017. Details regarding consolidated Legacy Sequoia entities are included in the "Results of Consolidated Legacy Sequoia Entities" section that follows.

The following table presents the net interest rate spread between the yield on unsecuritized loans and securities and the debt yield of the short-term debt used in part to finance each investment type at March 31, 2018.

Table 7 – Interest Expense — Specific Borrowing Costs

March 31, 2018	Residential Loans		Residential Securities	
	Held-for-Sale			
Asset yield	4.34	%	6.36	%
Short-term debt yield	3.51	%	3.03	%
Net Spread	0.83	%	3.33	%

For additional discussion on short-term debt, including information regarding margin requirements and financial covenants, see "Risks Relating to Debt Incurred under Short-Term and Long-Term Borrowing Facilities" in the Liquidity and Capital Resources section of this MD&A.

Results of Operations by Segment

We report on our business using two distinct segments: Investment Portfolio and Residential Mortgage Banking. Our segments are based on our organizational and management structure, which aligns with how our results are monitored and performance is assessed. For additional information on our segments, refer to Note 21 of our Notes to Consolidated Financial Statements in Part I, Item I of this Quarterly Report on Form 10-Q. The following table presents the segment contribution from our two segments, reconciled to our consolidated net income, for the three months ended March 31, 2018 and 2017.

Table 8 – Segment Results Summary

(In Thousands)	Three Months Ended March 31,		
	2018	2017	Change
Segment Contribution from:			
Investment Portfolio	\$49,070	\$45,615	\$3,455
Residential Mortgage Banking	20,696	11,853	8,843
Corporate/Other	(22,921)	(20,499)	(2,422)
Net Income	\$46,845	\$36,969	\$9,876

The following sections provide a detailed discussion of the results of operations at each of our two business segments for the three months ended March 31, 2018 and 2017.

The \$2 million decrease in net income from Corporate/Other for the three-month periods was primarily due to a \$2 million increase in interest expense from convertible debt issued in the third quarter of 2017, and a \$2 million increase in corporate operating expenses due to a higher variable compensation accrual commensurate with higher earnings during the first quarter of 2018. This decrease was partially offset by higher income from consolidated Legacy Sequoia entities (the details of which are discussed in the "Results of Consolidated Legacy Sequoia Entities" section that follows).

Investment Portfolio Segment

Our Investment Portfolio segment is primarily comprised of our portfolio of residential mortgage loans held-for-investment and financed through the FHLBC and our real estate securities portfolio. Additionally, beginning in the third quarter of 2017, this segment includes residential loans held-for-investment at our consolidated Sequoia Choice entities.

The following table presents the components of segment contribution for the Investment Portfolio segment for the three months ended March 31, 2018 and 2017.

Table 9 – Investment Portfolio Segment Contribution

(In Thousands)	Three Months Ended March 31,		
	2018	2017	Change
Interest income	\$58,757	\$42,250	\$16,507
Interest expense	(19,863)	(5,264)	(14,599)
Net interest income	38,894	36,986	1,908
Non-interest income			
MSR income, net	957	1,713	(756)
Investment fair value changes, net	1,590	3,359	(1,769)
Other income	1,161	1,184	(23)
Realized gains, net	9,363	5,703	3,660
Total non-interest income, net	13,071	11,959	1,112
Direct operating expenses	(2,007)	(1,593)	(414)
Segment contribution before income taxes	49,958	47,352	2,606
Provision for income taxes	(888)	(1,737)	849
Total Segment Contribution	\$49,070	\$45,615	\$3,455

The following table presents our primary portfolios of investment assets in our Investment Portfolio segment at March 31, 2018 and December 31, 2017.

Table 10 – Investment Portfolio

(In Thousands)	March 31, 2018	December 31, 2017	Change
Residential loans held-for-investment at Redwood	\$2,375,785	\$2,434,386	\$(58,601)
Residential securities	980,712	1,152,485	(171,773)
Commercial/Multifamily securities	377,008	324,025	52,983
Residential loans held-for-investment at Sequoia Choice ⁽¹⁾	1,013,619	620,062	393,557
Mortgage servicing rights	66,496	63,598	2,898
Other assets	198,615	149,317	49,298
Total Assets at Investment Portfolio	\$5,012,235	\$4,743,873	\$268,362

Our economic investment in the consolidated Sequoia Choice entities at March 31, 2018 and December 31, 2017 (1) was \$88 million and \$78 million, respectively. For additional details on our Choice loans, see the subsection titled "Residential Loans Held-for-Investment at Sequoia Choice Portfolio" that follows.

Overview

During the first quarter of 2018, we continued our focus on optimizing our investment portfolio by selling assets that had appreciated in value with lower current yields, and redeployed capital into higher-yielding opportunities. Our sales were mostly comprised of Agency CRT, mezzanine, and legacy securities and our purchases mostly comprised of Sequoia and multifamily securities. Through these sales, we captured previously unrealized appreciation, which increased our realized gains during the first quarter of 2018, contributing to the increase in segment contribution for the three-month periods. While benchmark interest rates rose during the first quarter, negatively impacting the fair values of our loan investments and some of our securities, our interest rate hedges offset most of this decline and we saw positive overall net investment fair value changes, resulting from tightening spreads on our loans and multifamily securities.

Net Interest Income

Net interest income from our Investment Portfolio primarily includes interest income from our residential loans held-for-investment and our securities, as well as the associated interest expense from short-term debt, FHLBC borrowings, and ABS issued. The following table presents the components of net interest income for our Investment Portfolio segment for the three months ended March 31, 2018 and 2017.

Table 11 - Net Interest Income ("NII") from Investment Portfolio

(In Thousands)	Three Months		
	Ended March 31,		
	2018	2017	Change
Net interest income from:			
HFI residential loans at Redwood	\$15,772	\$18,303	\$(2,531)
HFI residential loans at Sequoia Choice	1,386	—	1,386
Residential securities	19,520	16,913	2,607
Commercial/Multifamily securities	1,888	1,375	513
Other interest income	328	395	(67)
NII from Investment Portfolio	\$38,894	\$36,986	\$1,908

The increase in net interest income from our Investment Portfolio segment during the three-month periods was primarily due to higher net interest income from real estate securities, which mostly resulted from higher average balances in addition to higher yields on these investments. Net interest income also increased from our economic investments in Sequoia Choice securitizations we issued during the last nine months that we consolidate for GAAP purposes. These increases were partially offset by lower net interest income from residential loans HFI, which decreased primarily as a result of higher interest costs from rising benchmark interest rates during the past 12 months.

Investment fair value changes, net

Market valuation changes included in Investment fair value changes, net, result from changes in the fair value of investments and their associated hedges, generally due to changes in market interest rates, changes in credit spreads, and reductions in the basis of investments due to changes in principal balances. See Note 18 of our Notes to Consolidated Financial Statements in Part I, Item I of this Quarterly Report on Form 10-Q for additional detail regarding the components of Investment fair value changes, net presented on our consolidated statements of income.

The following table presents the components of investment fair value changes for our Investment Portfolio segment, which is comprised of market valuation gains and losses by investment type, inclusive of fair value changes of associated risk management derivatives, for the three months ended March 31, 2018 and 2017.

Table 12 - Investment Portfolio Fair Value Changes, Net by Investment Type

(In Thousands)	Three Months		
	Ended March 31,		
	2018	2017	Change
Market valuation changes:			
Residential loans held-for-investment at Redwood	\$(2,738)	\$(6,399)	\$3,661
Net investments in Sequoia Choice entities ⁽¹⁾	(86)	—	(86)
Residential trading securities	912	3,960	(3,048)
Commercial/Multifamily trading securities	3,641	6,120	(2,479)
Other valuation changes	(139)	(322)	183
Investment Fair Value Changes, Net	\$1,590	\$3,359	\$(1,769)

Includes changes in fair value of the residential loans held-for-investment and the ABS issued at the entities, which (1) netted together represent the change in value of our retained investments (senior and subordinate securities) at the consolidated VIEs.

During the three months ended March 31, 2018 and 2017, the negative investment fair value changes from loans and their associated derivatives primarily resulted from reductions in the fair value of loans from the loss of premium from principal repayments as well as hedging costs, partially offset by increases in fair value from tighter spreads on these investments during those periods. The increase in fair values from securities and their associated derivatives during both periods primarily resulted from tighter spreads on these investments, partially offset by hedging costs and decreases in fair value from reductions in the basis of IO securities from associated principal repayments.

MSR Income, net

The following table presents the components of MSR income, net for the three months ended March 31, 2018 and 2017.

Table 13 – MSR Income, net

(In Thousands)	Three Months	
	Ended March 31,	
	2018	2017
Net servicing fee income	\$3,204	\$5,527
Changes in fair value of MSR from the receipt of expected cash flows	(1,454)	(2,413)
MSR reversal of provision for repurchases	—	5
MSR income before the effect of changes in interest rates and other assumptions	1,750	3,119
Changes in fair value of MSR from interest rates and other assumptions ⁽¹⁾	4,346	(657)
Changes in fair value of associated derivatives	(5,139)	(749)
Total net effect of changes in assumptions and rates	(793)	(1,406)
MSR Income, Net	\$957	\$1,713

(1) Primarily reflects changes in prepayment assumptions on our MSRs due to changes in benchmark interest rates.

MSR income declined for the first three months of 2018 as compared with the same period last year, primarily due to the sale of our conforming MSRs in 2017.

Realized Gains, net

During the three months ended March 31, 2018, we realized gains of \$9 million, primarily from the sale of \$51 million of AFS securities. During the three months ended March 31, 2017, we realized gains of \$6 million, primarily from the sale of \$19 million of AFS securities.

Direct Operating Expenses and Provision for Income Taxes

The increase in operating expenses at our Investment Portfolio segment for the three-month periods was primarily attributable to higher variable compensation that was accrued in-line with higher overall net income earned during the first quarter of 2018.

The provision for income taxes at our Investment Portfolio segment primarily results from GAAP income earned at our TRS from MSRs and certain securities. For the three-month period ended March 31, 2018, the decrease in the tax provision primarily resulted from the reduction of the federal corporate tax rate due to the Tax Act.

Residential Loans Held-for-Investment at Redwood Portfolio

The following table provides the activity of residential loans held-for-investment at Redwood during the three months ended March 31, 2018 and 2017.

Table 14 – Residential Loans Held-for-Investment at Redwood - Activity

(In Thousands)	Three Months Ended	
	March 31,	
	2018	2017
Fair value at beginning of period	\$2,434,386	\$2,261,016
Transfers between portfolios ⁽¹⁾	55,775	184,996
Principal repayments	(74,954)	(93,666)
Changes in fair value, net	(39,422)	(2,333)
Fair Value at End of Period	\$2,375,785	\$2,350,013

⁽¹⁾ Represents the net transfers of loans into our Investment Portfolio segment from our Residential Mortgage Banking segment and their reclassification from held-for-sale to held-for-investment.

The decrease in the balance of loans held-for-investment during the three months ended March 31, 2018 was primarily due to a decrease in fair value of the loans during this period, resulting from rising benchmark interest rates. As our loans held-for-investment are generally fixed-rate and sensitive to changes in interest rates, we utilize various interest rate derivatives to hedge our interest rate risk for these investments. As a result of rising interest rates during the three months ended March 31, 2018, interest rate derivatives associated with these investments increased in value by \$36 million.

At March 31, 2018, \$2.38 billion of loans were held by our FHLB-member subsidiary and were financed with \$2.00 billion of borrowings from the FHLBC. In connection with these borrowings, our FHLB-member subsidiary is required to hold \$43 million of FHLB stock.

At March 31, 2018, the weighted average maturity of these FHLB borrowings was approximately seven years and they had a weighted average cost of 1.74% per annum. This interest cost resets every 13 weeks and we seek to fix the interest cost of these FHLB borrowings over their weighted average maturity by using a combination of swaps, TBAs and other derivatives.

Under a final rule published by the Federal Housing Finance Agency in January 2016, our FHLB-member subsidiary will remain an FHLB member through the five-year transition period for captive insurance companies. Our FHLB-member subsidiary's existing \$2.00 billion of FHLB debt, which matures beyond this transition period, is permitted to remain outstanding until its stated maturity. As residential loans pledged as collateral for this debt pay down, we are permitted to pledge additional loans or other eligible assets to collateralize this debt; however, we do not expect to be able to increase our subsidiary's FHLB debt above the existing \$2.00 billion.

The following table presents the unpaid principal balances for residential real estate loans held-for-investment at fair value by product type at March 31, 2018.

Table 15 – Characteristics of Residential Real Estate Loans Held-for-Investment at Redwood March 31, 2018

(Dollars in Thousands)	Principal Balance	Weighted Average Coupon
Fixed - 30 year	\$2,076,772	4.09 %
Fixed - 15, 20, & 25 year	69,003	3.66 %
Hybrid	242,818	4.10 %
Total Outstanding Principal	\$2,388,593	

The outstanding loans held-for-investment at Redwood at March 31, 2018 were prime-quality, first lien loans, of which 96% were originated between 2013 and 2018 and 4% were originated in 2012 and prior years. The weighted average FICO score of borrowers backing these loans was 771 (at origination) and the weighted average loan-to-value ("LTV") ratio was 66% (at origination). At March 31, 2018, three of these loans with a total unpaid principal balance of \$2 million were greater than 90 days delinquent and none of these loans were in foreclosure.

Real Estate Securities Portfolio

The following table sets forth our real estate securities activity by collateral type in our Investment Portfolio segment for the three months ended March 31, 2018.

Table 16 – Real Estate Securities Activity by Collateral Type

Three Months Ended March 31, 2018 (In Thousands)	Residential			Commercial (2)	Total
	Senior (1)	Mezzanine	Subordinate	Mezzanine	
Beginning fair value	\$249,838	\$331,452	\$571,195	\$324,025	\$1,476,510
Acquisitions					
Sequoia securities	12,491	—	3,905	—	16,396
Third-party securities	—	11,344	33,438	83,287	128,069
Sales					
Sequoia securities	—	(26,082)	(12,052)	—	(38,134)
Third-party securities	(9,155)	(81,432)	(88,488)	(26,663)	(205,738)
Gains on sales and calls, net	2,492	2,081	4,790	—	9,363
Effect of principal payments (3)	(7,348)	(2,811)	(2,362)	(3,186)	(15,707)
Change in fair value, net	(646)	(6,438)	(5,500)	(455)	(13,039)
Ending Fair Value (4)	\$247,672	\$228,114	\$504,926	\$377,008	\$1,357,720

(1) Includes \$38 million of re-REMIC securities at March 31, 2018.

(2) Our commercial securities are primarily comprised of Agency multifamily securities.

The effect of principal payments reflects the change in fair value due to principal payments, which is calculated as (3) the cash principal received on a given security during the period multiplied by the prior quarter ending price or acquisition price for that security.

Excludes \$87 million of securities retained from our consolidated Sequoia Choice securitizations at March 31,

(4) 2018. For additional details on our Choice loans, see the subsection titled "Residential Loans Held-for-Investment at Sequoia Choice Portfolio" that follows.

During the three months ended March 31, 2018, we sold \$244 million of mostly lower-yielding securities as part of our ongoing portfolio optimization activities.

At March 31, 2018, our securities consisted of fixed-rate assets (62%), adjustable-rate assets (30%), hybrid assets that reset within the next year (7%), and hybrid assets that reset between 12 and 36 months (1%). For the portions of our securities portfolio that are sensitive to changes in interest rates, we seek to minimize this interest rate risk by using various derivative instruments.

We directly finance our holdings of real estate securities with a combination of capital and collateralized debt in the form of repurchase (or “repo”) financing. The following table presents the fair value of our residential securities that were financed with repurchase debt at March 31, 2018.

Table 17 – Real Estate Securities Financed with Repurchase Debt

March 31, 2018	Real Estate Securities (1)	Repurchase Debt	Allocated Capital	Weighted Average Price ⁽²⁾	Financing Haircut ⁽³⁾
(Dollars in Thousands, except Weighted Average Price)					
Residential Securities					
Senior	\$ 127,240	\$(112,142)	\$15,098	\$ 98	12 %
Mezzanine ⁽⁴⁾	236,854	(200,453)	36,401	96	15 %
Total Residential Securities	364,094	(312,595)	51,499	97	14 %
Commercial/Multifamily Securities	356,619	(279,699)	76,920	95	22 %
Total	\$ 720,713	\$(592,294)	\$ 128,419		

(1) Amounts represent carrying value of securities, which are held at GAAP fair value.

(2) GAAP fair value per \$100 of principal.

(3) Allocated capital divided by GAAP fair value.

(4) Includes \$57 million of securities retained from our consolidated Sequoia Choice securitizations at March 31, 2018.

At March 31, 2018, we had short-term debt incurred through repurchase facilities of \$592 million, which was secured by \$721 million of real estate securities. The remaining \$724 million of our securities were financed with capital. Our repo borrowings were made under facilities with eight different counterparties, and the weighted average cost of funds for these facilities during the first quarter of 2018 was approximately 2.81% per annum.

At March 31, 2018, the securities we financed through repurchase facilities had no material credit issues. In addition to the allocated capital listed in the table above that directly supports our repurchase facilities (the “financing haircut”), we continue to hold a designated amount of supplemental risk capital available for potential margin calls or future obligations relating to these facilities.

The majority of the \$127 million of senior securities noted in the table above are supported by seasoned residential loans originated prior to 2008. The \$237 million of mezzanine securities financed through repurchase facilities at March 31, 2018 carry investment grade credit ratings and are supported by residential loans originated between 2012 and 2018. The loans underlying these securities have experienced minimal delinquencies to date. The \$357 million of multifamily securities financed through repurchase facilities at March 31, 2018 carry investment grade credit ratings with 7%-8% of structural credit enhancement.

The following table presents our real estate securities at March 31, 2018 and December 31, 2017, categorized by portfolio vintage (the years the securities were issued), and by priority of cash flows (senior, mezzanine, and subordinate). We have additionally separated securities issued through our Sequoia platform or by third parties, including the Agencies.

Table 18 – Real Estate Securities by Vintage and Type

March 31, 2018 (In Thousands)	Sequoia 2012-2018	Third Party 2013-2018	Agency CRT 2013-2018	Third Party ≤2008	Total Residential Securities	Commercial 2015-2018	Total Real Estate Securities
Senior ⁽¹⁾	\$ 49,299	\$ 30,734	\$ —	\$ 167,639	\$ 247,672	\$ —	\$ 247,672
Mezzanine ⁽²⁾	117,443	110,671	—	—	228,114	377,008	605,122
Subordinate ⁽¹⁾	130,141	109,424	245,654	19,707	504,926	—	504,926
Total Securities ⁽³⁾	\$ 296,883	\$ 250,829	\$ 245,654	\$ 187,346	\$ 980,712	\$ 377,008	\$ 1,357,720
December 31, 2017 (In Thousands)	Sequoia 2012-2017	Third Party 2013-2017	Agency CRT 2013-2017	Third Party ≤2008	Total Residential Securities	Commercial 2015-2017	Total Real Estate Securities
Senior ⁽¹⁾	\$ 33,773	\$ 33,517	\$ —	\$ 182,548	\$ 249,838	\$ —	\$ 249,838
Mezzanine ⁽²⁾	147,466	183,985	—	—	331,451	324,025	655,476
Subordinate ⁽¹⁾	139,442	108,455	300,713	22,586	571,196	—	571,196
Total Securities ⁽³⁾	\$ 320,681	\$ 325,957	\$ 300,713	\$ 205,134	\$ 1,152,485	\$ 324,025	\$ 1,476,510

At March 31, 2018 and December 31, 2017, senior Sequoia and third-party securities included \$82 million and \$70 million of IO securities, respectively. At both March 31, 2018 and December 31, 2017, subordinate third-party securities included \$12 million of IO securities.

(2) Mezzanine includes securities initially rated AA through BBB- and issued in 2012 or later.

Excludes \$87 million and \$78 million of securities retained from our consolidated Sequoia Choice securitizations (3) at March 31, 2018 and December 31, 2017, respectively. For GAAP purposes we consolidated \$1.01 billion of residential loans and \$926 million of non-recourse ABS debt associated with these retained securities.

The following tables present the components of the interest income we earned on AFS securities for the three months ended March 31, 2018 and 2017.

Table 19 – Interest Income — AFS Securities

Three Months Ended March 31, 2018

(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of			
					Interest Income	Discount (Premium) Amortization	Total Interest Income	
Residential								
Senior	\$ 1,826	\$ 2,486	\$ 4,312	\$ 131,064	5.57%	7.59%	13.16%	
Mezzanine	766	316	1,082	73,112	4.19%	1.73%	5.92%	
Subordinate	2,877	1,258	4,135	159,090	7.23%	3.16%	10.39%	
Total AFS Securities	\$ 5,469	\$ 4,060	\$ 9,529	\$ 363,266	6.02%	4.47%	10.49%	

Three Months Ended March 31, 2017

(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of			
					Interest Income	Discount (Premium) Amortization	Total Interest Income	
Residential								
Senior	\$ 2,209	\$ 3,116	\$ 5,325	\$ 165,351	5.34%	7.54%	12.88%	
Mezzanine	1,419	654	2,073	147,592	3.85%	1.77%	5.62%	
Subordinate	2,711	1,491	4,202	145,507	7.45%	4.10%	11.55%	
Total AFS Securities	\$ 6,339	\$ 5,261	\$ 11,600	\$ 458,450	5.53%	4.59%	10.12%	

Residential Loans Held-for-Investment at Sequoia Choice Portfolio

During the third and fourth quarters of 2017 and the three months ended March 31, 2018, we issued three securitizations primarily comprised of expanded-prime Choice loans. We consolidate the Sequoia Choice securitization entities for financial reporting purposes in accordance with GAAP. These entities are independent of Redwood and the assets and liabilities of these entities are not, respectively, owned by us or legal obligations of ours. We record the assets and liabilities of the consolidated Sequoia Choice entities at fair value, based on the estimated fair value of the debt securities (ABS) issued from the securitizations, in accordance with GAAP provisions for collateralized financing entities. At March 31, 2018, the estimated fair value of our economic investments in the consolidated Sequoia Choice entities was \$88 million, and was comprised of retained senior and subordinate securities.

The following tables present the statements of income for the three months ended March 31, 2018 and 2017 and the balance sheets of the consolidated Sequoia Choice entities at March 31, 2018 and December 31, 2017. All amounts in the statements of income and balance sheets presented below are included in our consolidated financial statements and are included in our Investment Portfolio segment.

Table 20 – Consolidated Sequoia Choice Entities Statements of Income

(In Thousands)	Three Months Ended March 31,		
	2018	2017	Change
Interest income	\$8,935	\$ —	—\$8,935
Interest expense	(7,549)	—	(7,549)
Net interest income	1,386	—	1,386
Investment fair value changes, net	(86)	—	(86)
Net Income from Consolidated Sequoia Choice Entities	\$1,300	\$ —	—\$1,300

Table 21 – Consolidated Sequoia Choice Entities Balance Sheets

(In Thousands)	March 31, 2018	December 31, 2017
Residential loans, held-for-investment, at fair value	\$1,013,619	\$620,062
Other assets	4,064	2,528
Total Assets	\$1,017,683	\$622,590
Other liabilities	\$3,445	\$2,035
Asset-backed securities issued, at fair value	926,238	542,140
Total liabilities	929,683	544,175
Equity (fair value of Redwood's retained investments in entities)	88,000	78,415
Total Liabilities and Equity	\$1,017,683	\$622,590

The following table presents residential loan activity at the consolidated Sequoia Choice entities for the three months ended March 31, 2018 and 2017.

Table 22 – Residential Loans Held-for-Investment at Sequoia Choice - Activity

(In Thousands)	Three Months Ended March 31,	
	2018	2017
Balance at beginning of period	\$620,062	\$ —
New securitization issuance	451,860	—
Principal repayments	(50,027)	—
Changes in fair value, net	(8,276)	—
Balance at End of Period	\$1,013,619	\$ —

During the three months ended March 31, 2018, we had net transfers of \$452 million of consolidated Sequoia Choice loans from our Residential Mortgage banking segment to our Investment Portfolio segment. The outstanding loans held-for-investment at our Sequoia Choice entities at March 31, 2018 were primarily comprised of prime-quality, first lien, 30-year, fixed-rate loans and were originated in 2012 or later. The gross weighted average coupon of these loans was 4.62%, the weighted average FICO score of borrowers backing these loans was 742 (at origination) and the weighted average original LTV ratio was 74% (at origination). At both March 31, 2018 and December 31, 2017, none of these loans were greater than 90 days delinquent or in foreclosure.

Mortgage Servicing Rights Portfolio

Our MSR's are held and managed at our taxable REIT subsidiary and typically are acquired together with loans from originators and then separately recognized under GAAP when the MSR is retained and the associated loan is sold to a third party or transferred to a Sequoia residential securitization sponsored by us that meets the GAAP criteria for sale. In addition, we have also purchased MSR's on a flow basis from third parties that sold the associated loans directly to the Agencies. Although we own the rights to service loans, we contract with sub-servicers to perform these activities. Our receipt of MSR income is not subject to any covenants other than customary performance obligations associated with servicing residential loans. If a sub-servicer we contract with was to fail to perform these obligations, our servicing rights could be terminated and we would evaluate our MSR asset for impairment at that time.

The following table provides the activity for MSR's for the three months ended March 31, 2018.

Table 23 – MSR Activity

(In Thousands)	Three Months Ended March 31, 2018
Balance at beginning of period	\$63,598
Market valuation adjustments	2,898
Balance at End of Period	\$66,496

The following table presents characteristics of our MSR investments and their associated loans at March 31, 2018.

Table 24 – Characteristics of MSR Investments Portfolio

(Dollars in Thousands)	March 31, 2018	
Unpaid principal balance	\$5,421,541	
Fair value of MSR's	\$66,496	
MSR values as percent of unpaid principal balance	1.23	%
Gross cash yield ⁽¹⁾	0.27	%
Number of loans	8,528	
Average loan size	\$636	
Average coupon	3.96	%
Average loan age (months)	44	
Average original loan-to-value	67	%
Average original FICO score	770	
60+ day delinquencies	0.20	%

Gross cash yield is calculated by dividing the annualized quarterly gross servicing fees we received for the three (1) months ended March 31, 2018, by the weighted average notional balance of loans associated with MSR's we owned during that period.

At March 31, 2018, nearly all of our MSR's were comprised of base MSR's and we did not own any portion of a servicing right related to any loan where we did not own the entire servicing right. At both March 31, 2018 and December 31, 2017, we had \$1 million of servicer advances outstanding related to our MSR's, which are presented in Other assets on our consolidated balance sheets.

Residential Mortgage Banking Segment

The following table presents the components of segment contribution for the Residential Mortgage Banking segment for the three months ended March 31, 2018 and 2017.

Table 25 – Residential Mortgage Banking Segment Contribution

(In Thousands)	Three Months Ended March 31,		
	2018	2017	Change
Interest income	\$12,897	\$7,474	\$5,423
Interest expense	(6,137)	(2,924)	(3,213)
Net interest income	6,760	4,550	2,210
Mortgage banking activities, net	26,576	17,604	8,972
Direct operating expenses	(8,632)	(5,881)	(2,751)
Segment contribution before income taxes	24,704	16,273	8,431
Provision for income taxes	(4,008)	(4,420)	412
Segment Contribution	\$20,696	\$11,853	\$8,843

The following tables provide the activity of unsecuritized residential loans during the three months ended March 31, 2018 and 2017.

Table 26 – Residential Loans Held-for-Sale — Activity

(In Thousands)	Three Months Ended March 31,					
	2018			2017		
	Select	Choice	Total	Select	Choice	Total
Balance at beginning of period	\$1,101,356	\$326,589	\$1,427,945	\$765,058	\$70,341	\$835,399
Acquisitions	1,267,930	547,364	1,815,294	966,837	141,468	1,108,305
Sales	(1,590,741)	(3,790)	(1,594,531)	(1,275,133)	(102,505)	(1,377,638)
Transfers between portfolios ⁽¹⁾	—	(507,616)	(507,616)	(107,313)	(77,683)	(184,996)
Principal repayments	(13,234)	(3,783)	(17,017)	(10,876)	(2,118)	(12,994)
Changes in fair value, net	794	5,316	6,110	6,824	1,707	8,531
Balance at End of Period	\$766,105	\$364,080	\$1,130,185	\$345,397	\$31,210	\$376,607

Represents the net transfers of loans out of our Residential Mortgage Banking segment into our Investment Portfolio segment and their reclassification from held-for-sale to held-for-investment. Includes \$452 million of ⁽¹⁾Choice loans securitized during the first quarter of 2018, which were not treated as sales for GAAP purposes and continue to be reported on our consolidated balance sheets within our Investment Portfolio segment.

Overview

During the first three months of 2018, we purchased \$1.82 billion of predominately prime residential jumbo loans, securitized \$1.30 billion of jumbo Select loans that were accounted for as sales, and sold \$295 million of jumbo loans to third parties. Additionally, we transferred \$452 million of jumbo Choice loans that did not qualify for sales accounting treatment under GAAP to Sequoia securitization entities and we had net transfers of \$56 million of loans to our Investment Portfolio segment that were financed with borrowings from the FHLBC. Our pipeline of loans identified for purchase at March 31, 2018 included \$1.20 billion of jumbo loans.

We utilize a combination of capital and our residential loan warehouse facilities to manage our inventory of residential loans held-for-sale. At March 31, 2018, we had \$662 million of warehouse debt outstanding to fund our residential loans held-for-sale. The weighted average cost of the borrowings outstanding under these facilities during the first quarter of 2018 was 3.23% per annum. Our warehouse capacity at March 31, 2018 totaled \$1.43 billion across four separate counterparties, which should continue to provide sufficient liquidity to fund our residential mortgage banking operations in the near-term.

Our residential mortgage banking operations created investments that allowed us to deploy \$30 million of capital into our investment portfolio during the first three months of 2018. At March 31, 2018, we had 454 loan sellers, up from 451 at the end of 2017. This included 178 jumbo sellers and 276 sellers from various FHLB districts participating in the FHLB's MPF Direct program.

Net Interest Income

Net interest income from residential mortgage banking is primarily comprised of interest income earned on residential loans from the time we purchase the loans to when we sell or securitize them, offset by interest expense incurred on short-term warehouse debt used in part to finance the loans while we hold them on our consolidated balance sheet. The increase in net interest income during the three-month periods was primarily due to a higher average balance of residential loans held in inventory net of higher warehouse borrowings used to finance our residential loans held-for-sale during the first three months of 2018.

The amount of net interest income we earn on loans held-for-sale is dependent on many variables, including the amount of loans and the time they are outstanding on our consolidated balance sheet and their interest rates, as well as the amount of leverage we employ through the use of short-term debt to finance the loans and the interest rates on that debt. These factors will impact net interest income in future periods.

Mortgage Banking Activities, Net

Mortgage banking activities, net, includes the changes in market value of both the loans we hold for sale and commitments for loans we intend to purchase (collectively, our loan pipeline), as well as the effect of hedges we utilize to manage risks associated with our loan pipeline. Our loan sale profit margins are measured over the period from when we commit to purchase a loan and subsequently sell or securitize the loan. Accordingly, these profit margins may encompass positive or negative market valuation adjustments on loans, hedging gains or losses associated with our loan pipeline, and any other related transaction expenses, and may be realized over the course of one or more quarters for financial reporting purposes.

The following table presents the components of residential mortgage banking activities, net. Amounts presented include both the changes in market values for loans that were sold and associated derivative positions that were settled during the periods presented, as well as changes in market values of loans, derivatives and hedges outstanding at the end of each period.

Table 27 – Components of Residential Mortgage Banking Activities, Net

(In Thousands)	Three Months		
	Ended March 31,		
	2018	2017	Change
Changes in fair value of:			
Residential loans, at fair value ⁽¹⁾	\$(2,194)	\$18,797	\$(20,991)
Risk management derivatives ⁽²⁾	28,432	(1,400)	29,832
Other income, net ⁽³⁾	338	207	131
Total Residential Mortgage Banking Activities, Net	\$26,576	\$17,604	\$8,972

(1) Includes changes in fair value for loan purchase and forward sale commitments.

(2) Represents market valuation changes of derivatives that are used to manage risks associated with our accumulation of residential loans.

(3) Amounts in this line include other fee income from loan acquisitions and the provision for repurchase expense, presented net.

The increase in mortgage banking activities, net for the three-month period ended March 31, 2018 as compared to the prior year period, was mostly the result of higher loan purchase volume in the first quarter of 2018 as compared to 2017, with the majority of the increase being from Choice loans.

Loan purchase commitments ("LPCs"), adjusted for fallout expectations, were \$1.72 billion for the three months ended March 31, 2018. Our gross margins for our jumbo loans, which we define as net interest income plus income from mortgage banking activities, divided by LPCs, benefited from tightening credit spreads on securitizations during the first three months of 2018 and remained above our long-term expectations.

At both March 31, 2018 and December 31, 2017, we had repurchase reserves of \$4 million outstanding related to residential loans sold through this segment. For the three months ended March 31, 2018 and 2017, we recorded repurchase provisions of \$0.3 million and \$0.2 million, respectively, that were included in income from mortgage banking activities, net, in this segment. We review our loan repurchase reserves each quarter and adjust them as necessary based on current information available at each reporting date.

The following table details outstanding principal balances for residential loans held-for-sale by product type at March 31, 2018.

Table 28 – Characteristics of Residential Loans Held-for-Sale

March 31, 2018 (Dollars in Thousands)	Principal Value	Weighted Average Coupon
First Lien Prime		
Fixed - 30 year	\$1,063,061	4.42 %
Fixed - 10, 15, 20, & 25 year	23,154	4.09 %
Hybrid	36,750	3.78 %
ARM	441	2.32 %
Total Outstanding Principal	\$1,123,406	

Operating Expenses and Taxes

Operating expenses for this segment primarily include costs associated with the underwriting, purchase and sale of jumbo residential loans. Operating expenses increased primarily as a result of higher variable compensation expenses which was commensurate with higher overall company earnings during the three months ended March 31, 2018.

All residential mortgage banking activities are performed at our taxable REIT subsidiary and the provision for income taxes is generally correlated to the amount of this segment's contribution before income taxes in relation to the TRS's overall GAAP income and associated tax provision. The decrease in provision for income taxes resulted primarily from the reduction of the federal corporate tax rate due to the Tax Act.

Results of Consolidated Legacy Sequoia Entities

We sponsored Sequoia securitization entities prior to 2012 that are reported on our consolidated balance sheets for financial reporting purposes in accordance with GAAP. Each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not, respectively, owned by us or legal obligations of ours. We record the assets and liabilities of the consolidated Legacy Sequoia entities at fair value, based on the estimated fair value of the debt securities (ABS) issued from the securitizations, in accordance with GAAP provisions for collateralized financing entities. At March 31, 2018, the estimated fair value of our investments in the consolidated Legacy Sequoia entities was \$14 million.

The following tables present the statements of income (loss) for the three months ended March 31, 2018 and 2017 and the balance sheets of the consolidated Legacy Sequoia entities at March 31, 2018 and December 31, 2017. All amounts in the statements of income and balance sheets presented below are included in our consolidated financial statements.

Table 29 – Consolidated Legacy Sequoia Entities Statements of Income (Loss)

(In Thousands)	Three Months Ended March 31,		
	2018	2017	Change
Interest income	\$4,812	\$4,838	\$(26)
Interest expense	(3,852)	(3,516)	(336)
Net interest income	960	1,322	(362)
Investment fair value changes, net	(8)	(1,810)	1,802
Net Income (Loss) from Consolidated Legacy Sequoia Entities	\$952	\$(488)	\$1,440

Table 30 – Consolidated Legacy Sequoia Entities Balance Sheets

(In Thousands)	March 31, 2018	December 31, 2017
Residential loans, held-for-investment, at fair value	\$626,151	\$632,817
Other assets	4,016	4,367
Total Assets	\$630,167	\$637,184
Other liabilities	\$534	\$537
Asset-backed securities issued, at fair value	615,849	622,445
Total liabilities	616,383	622,982
Equity (fair value of Redwood's retained investments in entities)	13,784	14,202
Total Liabilities and Equity	\$630,167	\$637,184

Net Interest Income at Consolidated Legacy Sequoia Entities

The decrease in net interest income for the three-month periods was primarily attributable to the continued paydown of loans at the consolidated entities.

Investment Fair Value Changes, net at Consolidated Legacy Sequoia Entities

Investment fair value changes, net at consolidated Legacy Sequoia entities includes the change in fair value of the residential loans held-for-investment, REO, and the ABS issued at the entities, which netted together represent the change in value of our retained investments in the consolidated Legacy Sequoia entities. The decrease in negative investment fair value changes in the three-month periods was primarily related to the decline in fair value changes on retained IO securities, as prepayments on the loans underlying these securities slowed in 2018.

Residential Loans at Consolidated Legacy Sequoia Entities

The following table provides details of residential loan activity at consolidated Legacy Sequoia entities for the three months ended March 31, 2018 and 2017.

Table 31 – Residential Loans at Consolidated Legacy Sequoia Entities — Activity

(In Thousands)	Three Months Ended	
	March 31, 2018	2017
Balance at beginning of period	\$632,817	\$791,636
Principal repayments	(34,222)	(53,461)
Transfers to REO	(1,268)	(968)
Changes in fair value, net	28,824	8,414
Balance at End of Period	\$626,151	\$745,621

First lien adjustable rate mortgage ("ARM") and hybrid loans comprise all of the loans in the consolidated Legacy Sequoia entities and were primarily originated in 2006 or prior. For outstanding loans at consolidated Legacy Sequoia entities at March 31, 2018, the weighted average FICO score of borrowers backing these loans was 728 (at origination) and the weighted average original LTV ratio was 66% (at origination). At March 31, 2018 and December 31, 2017, the unpaid principal balance of loans at consolidated Legacy Sequoia entities delinquent greater than 90 days was \$23 million and \$25 million, respectively, of which the unpaid principal balance of loans in foreclosure was \$9 million and \$10 million, respectively.

Taxable Income and Tax Provision

Taxable Income

The following table summarizes our taxable income and distributions to shareholders for the three months ended March 31, 2018 and 2017.

Table 32 – Taxable Income

(In Thousands, except per Share Data)	Three Months Ended March 31,	
	2018 est. ⁽¹⁾	2017 est. ⁽¹⁾
REIT taxable income	\$33,474	\$16,679
Taxable REIT subsidiary income	24,081	5,215
Total Taxable Income	\$57,555	\$21,894
REIT taxable income per share	\$0.44	\$0.22
Total taxable income per share	\$0.76	\$0.29

Distributions to shareholders	\$21,195	\$21,569
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Distributions to shareholders per share	\$0.28	\$0.28
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(1) Our tax results for the three months ended March 31, 2018 and 2017 are estimates until we file tax returns for these years.

Under normal circumstances, our minimum REIT dividend requirement would be 90% of our annual REIT taxable income. However, we currently maintain a \$57 million federal net operating loss carry forward (NOL) at the REIT that affords us the option of retaining REIT taxable income up to the NOL amount, tax free, rather than distributing it as dividends. Federal income tax rules require the dividends paid deduction to be applied to reduce REIT taxable income before the applicability of NOLs is considered. It is possible that our estimated REIT taxable income will exceed our dividend distributions in 2018; therefore, we may utilize a portion of our NOL in 2018 and any remaining amount will carry forward into 2019.

We currently expect all or nearly all of the distributions to shareholders in 2018 will be taxable as dividend income and a smaller portion, if any, will be a return of capital, which is generally non-taxable. Additionally, a portion of our 2018 dividend distributions are expected to be characterized as long-term capital gains for federal income tax purposes.

Tax Provision under GAAP

For the three months ended March 31, 2018 and 2017, we recorded tax provisions of \$5 million and \$6 million, respectively. Our tax provision is primarily derived from the activities at our TRS as we do not book a material tax provision associated with income generated at our REIT. The reduction in tax provision year-over-year was primarily the result of the lower federal corporate tax rate resulting from the Tax Act, even though the GAAP income earned at our TRS was higher than the prior year period. Our TRS effective tax rate in 2018 is expected to be approximately equal to the federal corporate tax rate. The income or loss generated at our TRS will not directly affect the tax characterization of our 2018 dividends.

Realization of our DTAs is dependent on many factors, including generating sufficient taxable income prior to the expiration of NOL carryforwards and generating sufficient capital gains in future periods prior to the expiration of capital loss carryforwards. We determine the extent to which realization of our DTAs is not assured and establish a valuation allowance accordingly. At December 31, 2017, we reported net federal ordinary and capital deferred tax liabilities ("DTLs"), and, as such, had no associated valuation allowance. As a result of GAAP income at our TRS, we forecast that we will report net federal ordinary and capital DTLs at December 31, 2018 and consequently no valuation allowance is expected to be recorded against any federal DTA. Consistent with prior periods, we continued

to maintain a valuation allowance against our net state DTAs. Our estimate of net deferred tax assets could change in future periods to the extent that actual or revised estimates of future taxable income during the carryforward periods change from current expectations.

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Differences between Estimated Total Taxable Income and GAAP Income

Differences between estimated taxable income and GAAP income are largely due to the following: (i) we cannot establish loss reserves for future anticipated events for tax but we can for GAAP, as realized credit losses are expensed when incurred for tax and these losses are anticipated through lower yields on assets or through loss provisions for GAAP; (ii) the timing, and possibly the amount, of some expenses (e.g., certain compensation expenses) are different for tax than for GAAP; (iii) since amortization and impairments differ for tax and GAAP, the tax and GAAP gains and losses on sales may differ, resulting in differences in realized gains on sale; (iv) at the REIT and certain TRS entities, unrealized gains and losses on market valuation adjustments of securities and derivatives are not recognized for tax until the instrument is sold or extinguished; (v) for tax, basis may not be assigned to mortgage servicing rights retained when whole loans are sold resulting in lower tax gain on sale; (vi) for tax, we do not consolidate securitization entities as we do under GAAP; and, (vii) dividend distributions to our REIT from our TRS are included in REIT taxable income, but not GAAP income. As a result of these differences in accounting, our estimated taxable income can vary significantly from our GAAP income during certain reporting periods.

The table below reconciles our estimated total taxable income to our GAAP income for the three months ended March 31, 2018.

Table 33 – Differences between Estimated Total Taxable Income and GAAP Net Income
Three Months Ended March 31, 2018

(In Thousands, except per Share Data)	REIT (Est.)	TRS (Est.)	Total Tax (Est.)	GAAP	Differences
Interest income	\$51,501	\$10,851	\$62,352	\$76,619	\$(14,267)
Interest expense	(20,913)	(9,353)	(30,266)	(41,514)	11,248
Net interest income	30,588	1,498	32,086	35,105	(3,019)
Realized credit losses	(736)	—	(736)	—	(736)
Mortgage banking activities, net	—	26,530	26,530	26,576	(46)
MSR income, net	—	3,746	3,746	957	2,789
Investment fair value changes, net	397	(100)	297	1,609	(1,312)
Operating expenses	(13,355)	(8,316)	(21,671)	(23,030)	1,359
Other income	383	222	605	1,161	(556)
Realized gains, net	16,285	542	16,827	9,363	7,464
Provision for income taxes	(88)	(41)	(129)	(4,896)	4,767
Net Income	\$33,474	\$24,081	\$57,555	\$46,845	\$10,710
Income per basic common share	\$0.44	\$0.32	\$0.76	\$0.60	\$0.16

Potential Taxable Income Volatility

We expect period-to-period volatility in our estimated taxable income. A description of the factors that can cause this volatility is described in the Taxable Income portion of the Results of Operations section in the MD&A included in Part II, Item 7, of our Annual Report on Form 10-K.

LIQUIDITY AND CAPITAL RESOURCES

Summary

Our principal sources of cash consist of borrowings under mortgage loan warehouse facilities, securities repurchase agreements, payments of principal and interest we receive from our investment portfolios, and cash generated from our operating activities. Our most significant uses of cash are to purchase mortgage loans for our mortgage banking operations, to fund investments in residential loans, to purchase investment securities, to repay principal and interest on our warehouse facilities, repurchase agreements, and long-term debt, to make dividend payments on our capital stock, and to fund our operations.

Our total capital was \$1.80 billion at March 31, 2018, and included \$1.22 billion of equity capital and \$0.58 billion of the total \$2.58 billion of long-term debt on our consolidated balance sheet. This portion of debt included \$201 million of exchangeable debt due in 2019, \$245 million of convertible debt due in 2023, and \$140 million of trust-preferred securities due in 2037.

As of March 31, 2018, we estimate that our available capital was approximately \$380 million. We used a portion of this capital to repay our \$250 million of convertible debt that matured in April 2018.

In February 2016, our Board of Directors approved an authorization for the repurchase of up to \$100 million of our common stock and also authorized the repurchase of outstanding debt securities, including convertible and exchangeable debt. This authorization replaced all previous share repurchase plans and has no expiration date. During the year ended December 31, 2017, we repurchased 610,342 shares of our common stock pursuant to this authorization for \$9 million. At December 31, 2017, approximately \$77 million of this current authorization remained available for the repurchase of shares of our common stock. During January 2018, we repurchased 1,040,829 shares of our common stock pursuant to this authorization for \$16 million.

In February 2018, our Board of Directors approved an authorization for the repurchase of an additional \$39 million of our common stock, increasing the total amount authorized for repurchases of common stock to \$100 million, and also authorized the repurchase of outstanding debt securities, including convertible and exchangeable debt. As noted above, this authorization increased the previous share repurchase authorization approved in February 2016 and has no expiration date. This repurchase authorization does not obligate us to acquire any specific number of shares or securities. Under this authorization, shares or securities may be repurchased in privately negotiated and/or open market transactions, including under plans complying with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. At March 31, 2018, \$100 million of the current authorization remained available for the repurchase of shares of our common stock. Like other investments we may make, any repurchases of our common stock or debt securities under this authorization would reduce our available capital described above.

While we believe our available capital is sufficient to fund our currently contemplated investment activities and repay existing debt, we may raise capital from time-to-time to make long-term investments or for other purposes. To the extent we seek additional capital to fund our operations and investment activities, our approach to raising capital will continue to be based on what we believe to be in the best long-term interests of shareholders.

We are subject to risks relating to our liquidity and capital resources, including risks relating to incurring debt under residential loan warehouse facilities, securities repurchase facilities, and other short- and long-term debt facilities and other risks relating to our use of derivatives. A further discussion of these risks is set forth below under the heading "Risks Relating to Debt Incurred under Short-and Long-Term Borrowing Facilities."

Cash Flows and Liquidity for the Three Months Ended March 31, 2018

Cash flows from our mortgage banking activities and our investments can be volatile from quarter to quarter depending on many factors, including the timing and amount of loan and securities acquisitions and sales and repayments, the profitability of mortgage banking activities, as well as changes in interest rates, prepayments, and credit losses. Therefore, cash flows generated in the current period are not necessarily reflective of the long-term cash flows we will receive from these investments or activities.

Cash Flows from Operating Activities

Cash flows from operating activities were negative \$143 million during the three months ended March 31, 2018. This amount includes the net cash utilized during the period from the purchase and sale of residential mortgage loans associated with our mortgage banking activities. Purchases of loans are financed to a large extent with short-term debt, for which changes in cash are included as a component of financing activities. Excluding cash flows from the purchase, sale, and principal payments of loans classified as held-for-sale, cash flows from operating activities were positive \$79 million and negative \$4 million during the first three months of 2018 and 2017, respectively. Offsetting the negative cash flows from operating activities during the first three months of 2018 were \$51 million of net cash inflows associated with margin funding requirements for our derivatives and short-term debt, which are presented as Other assets and Accrued expenses and other liabilities on our consolidated balance sheets.

Cash Flows from Investing Activities

During the three months ended March 31, 2018, our net cash provided by investing activities was \$293 million and primarily resulted from principal payments on loans held-for-investment at Redwood and at our consolidated Sequoia entities, and principal payments from, and proceeds from net sales of, real estate securities. Although we generally intend to hold our investment securities as long-term investments, we may sell certain of these securities in order to meet our operating objectives, and to adapt to market conditions. We cannot predict the timing and impact of future sales of investment securities.

Because many of our investment securities are financed through repurchase agreements, a significant portion of the proceeds from any sales or principal payments of our investment securities could be used to repay balances under these financing sources. Similarly, all or a significant portion of cash flows from principal payments of loans at consolidated Sequoia entities would generally be used to repay ABS issued by those entities.

As presented in the "Supplemental Noncash Information" subsection of our consolidated statements of cash flows, during the three months ended March 31, 2018, we had transfers of residential loans from held-for-sale to held-for-investment classification, and also retained securities from Sequoia securitizations we sponsored, which represent non-cash transactions that were not included in cash flows from investing activities.

Cash Flows from Financing Activities

During the three months ended March 31, 2018, our net cash used in financing activities was \$116 million. This primarily resulted from \$434 million of net repayments of short-term debt and \$85 million of repayments of ABS issued. These cash outflows were partially offset by proceeds of \$442 million from the issuance of asset-backed securities from our Sequoia Choice securitization.

In December 2017, our Board of Directors announced its intention to pay a regular dividend of \$0.28 per share per quarter in 2018. In February 2018, the Board of Directors declared a regular dividend of \$0.28 per share for the first quarter of 2018, which was payable on March 29, 2018 to shareholders of record on March 15, 2018. As a result, during the three months ended March 31, 2018, we paid \$22 million of cash dividends on our common stock.

In accordance with the terms of our outstanding deferred stock units, which are stock-based compensation awards, each time we declare and pay a dividend on our common stock, we are required to make a dividend equivalent payment in that same per share amount on each outstanding deferred stock unit.

Short-Term Debt

In the ordinary course of our business, we use recourse debt through several different types of borrowing facilities and use cash borrowings under these facilities to, among other things, fund the acquisition of residential loans (including those we acquire and originate in anticipation of securitization), finance investments in securities and other investments, and otherwise fund our business and operations.

At March 31, 2018, we had four short-term residential loan warehouse facilities with a total outstanding debt balance of \$662 million (secured by residential loans with an aggregate fair value of \$718 million) and a total uncommitted borrowing limit of \$1.43 billion. In addition, at March 31, 2018, we had an aggregate outstanding short-term debt balance of \$592 million under eight securities repurchase facilities, which were secured by securities with a fair market value of \$721 million. At March 31, 2018, the fair value of our real estate securities pledged as collateral included \$57 million of securities retained from our consolidated Sequoia Choice securitizations. We also had a secured line of credit with no outstanding debt balance and a total borrowing limit of \$10 million (secured by

securities with a fair market value of \$5 million) at March 31, 2018.

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During the second quarter of 2017, \$288 million principal amount of our convertible notes due in 2018 and \$2 million of associated unamortized deferred issuance costs were reclassified from long-term debt to short-term debt, as the maturity of the notes was less than one year as of April 2017. Additionally, during the second quarter of 2017, we repurchased \$37 million par value of these notes at a premium and recorded a loss on extinguishment of debt of \$1 million in Realized gains, net on our consolidated statements of income. At March 31, 2018, the outstanding principal amount of these notes was \$250 million. In April 2018, we repaid these \$250 million convertible notes and all related accrued interest in full.

At March 31, 2018, we had \$1.50 billion of short-term debt outstanding. During the first three months of 2018, the highest balance of our short-term debt outstanding was \$2.26 billion.

Long-Term Debt

FHLBC Borrowings

In July 2014, our FHLB-member subsidiary entered into a borrowing agreement with the Federal Home Loan Bank of Chicago. At March 31, 2018, under this agreement, our subsidiary could incur borrowings up to \$2.00 billion, also referred to as “advances,” from the FHLBC secured by eligible collateral, including, but not limited to residential mortgage loans. During the three months ended March 31, 2018, our FHLB-member subsidiary made no additional borrowings under this agreement. Under a final rule published by the Federal Housing Finance Agency in January 2016, our FHLB-member subsidiary will remain an FHLB member through a five-year transition period for captive insurance companies. Our FHLB-member subsidiary's existing \$2.00 billion of FHLB debt, which matures beyond this transition period, is permitted to remain outstanding until stated maturity. As residential loans pledged as collateral for this debt pay down, we are permitted to pledge additional loans or other eligible assets to collateralize this debt; however, we do not expect to be able to increase our subsidiary's FHLB debt above the existing \$2.00 billion maximum.

At March 31, 2018, \$2.00 billion of advances were outstanding under this agreement, which were classified as long-term debt, with a weighted average interest rate of 1.74% per annum and a weighted average maturity of seven years. At March 31, 2018, accrued interest payable on these borrowings was \$5 million. Advances under this agreement are charged interest based on a specified margin over the FHLBC's 13-week discount note rate, which resets every 13 weeks. Our total advances under this agreement were secured by residential mortgage loans with a fair value of \$2.37 billion at March 31, 2018. This agreement also requires our subsidiary to purchase and hold stock in the FHLBC in an amount equal to a specified percentage of outstanding advances. At March 31, 2018, our subsidiary held \$43 million of FHLBC stock that is included in Other assets on our consolidated balance sheets.

Convertible Notes

In August 2017, we issued \$245 million principal amount of 4.75% convertible senior notes due 2023. After deducting the underwriting discount and issuance costs, we received approximately \$238 million of net proceeds. Including amortization of deferred debt issuance costs, the weighted average interest expense yield on these convertible notes is approximately 5.3% per annum. At March 31, 2018, the outstanding principal amount of these notes was \$245 million. At March 31, 2018, the accrued interest payable balance on this debt was \$1 million.

In November 2014, one of our taxable subsidiaries issued \$205 million principal amount of 5.625% exchangeable senior notes due 2019. After deducting the underwriting discount and issuance costs, we received approximately \$198 million of net proceeds. Including amortization of deferred debt issuance costs, the weighted average interest expense yield on these exchangeable notes is approximately 6.3% per annum. During the first quarter of 2016, we repurchased \$4 million par value of these notes at a discount and recorded a gain on extinguishment of debt of \$0.3 million in Realized gains, net on our consolidated statements of income. At March 31, 2018, the outstanding principal amount of these notes was \$201 million. At March 31, 2018, the accrued interest payable balance on this debt was \$4 million.

In March 2013, we issued \$288 million principal amount of 4.625% convertible senior notes due 2018. After deducting the underwriting discount and issuance costs, we received approximately \$279 million of net proceeds. Including amortization of deferred debt issuance costs, the weighted average interest expense yield on these convertible notes was approximately 4.8% per annum. During the second quarter of 2017, \$288 million principal amount of these convertible notes and \$2 million of unamortized deferred issuance costs were reclassified from

long-term debt to short-term debt, as the maturity of the notes was less than one year as of April 2017. Additionally, during the second quarter of 2017, we repurchased \$37 million par value of these notes at a premium and recorded a loss on extinguishment of debt of \$1 million in Realized gains, net on our consolidated statements of income. At March 31, 2018, the outstanding principal amount of these notes was \$250 million. At March 31, 2018, the accrued interest payable balance on this debt was \$5 million. In April 2018, we repaid these \$250 million convertible notes and all related accrued interest in full.

Trust Preferred Securities and Subordinated Notes

At March 31, 2018, we had trust preferred securities and subordinated notes outstanding of \$100 million and \$40 million, respectively, issued by us in 2006 and 2007. This debt requires quarterly interest payments at a floating rate equal to three-month LIBOR plus 2.25% and must be redeemed no later than 2037. Prior to 2014, we entered into interest rate swaps with aggregate notional values totaling \$140 million to hedge the variability in this long-term debt interest expense. Including hedging costs and amortization of deferred debt issuance costs, the weighted average interest expense yield on our trust preferred securities and subordinated notes is approximately 6.8% per annum. These swaps are accounted for as cash flow hedges with all interest recorded as a component of net interest income and other valuation changes recorded as a component of equity.

Asset-Backed Securities

At March 31, 2018, there were \$662 million (principal balance) of loans owned at consolidated Legacy Sequoia securitization entities, which were funded with \$655 million (principal balance) of ABS issued at these entities. In addition, at March 31, 2018, there were \$996 million (principal balance) of loans owned at the consolidated Sequoia Choice securitization entities, which were funded with \$906 million (principal balance) of ABS issued at these entities. The loans and ABS issued from these entities are reported at estimated fair value. See the subsections titled "Residential Loans Held-for-Investment at Sequoia Choice Portfolio" and "Results of Consolidated Legacy Sequoia Entities" in the Results of Operations section of this MD&A for additional details on these entities.

Risks Relating to Debt Incurred under Short- and Long-Term Borrowing Facilities

As described above under the heading "Results of Operations," in the ordinary course of our business, we use debt financing obtained through several different types of borrowing facilities to, among other things, finance the acquisition of residential mortgage loans (including those we acquire in anticipation of sale or securitization), and finance investments in securities and other investments. We may also use short- and long-term borrowings to fund other aspects of our business and operations, including the repurchase of shares of our common stock. Debt incurred under these facilities is generally either the direct obligation of Redwood Trust, Inc., or the direct obligation of subsidiaries of Redwood Trust, Inc. and guaranteed by Redwood Trust, Inc. Risks relating to debt incurred under these facilities are described in Part I, Item 2 of our Annual Report on Form 10-K for the year ended December 31, 2017, under the caption "Risks Relating to Debt Incurred under Short- and Long-Term Borrowing Facilities."

Our sources of debt financing include short-term secured borrowings under residential loan warehouse facilities, short-term securities repurchase facilities, a \$10 million committed line of short-term secured credit from a bank, and secured borrowings by our wholly-owned subsidiary, RWT Financial, LLC, under its borrowing facility with the FHLBC.

Aggregate borrowing limits are stated under certain of these facilities, and certain other facilities have no stated borrowing limit, but each of the facilities (with the exception of the \$10 million committed line of short-term secured credit) is uncommitted, which means that any request we make to borrow funds under these uncommitted facilities may be declined for any reason, even if at the time of the borrowing request we have then-outstanding borrowings that are less than the borrowing limits under these facilities. In general, financing under these facilities is obtained by transferring or pledging mortgage loans or securities to the counterparty in exchange for cash proceeds (in an amount less than 100% of the principal amount of the transferred or pledged assets). While transferred or pledged assets are financed under a facility, to the extent the market value of the assets declines, we are generally required to either immediately reacquire the assets or meet a margin requirement to transfer or pledge additional assets or cash in an amount at least equal to the decline in value. Margin call provisions under these facilities are further described in Part I, Item 2 of our Annual Report on Form 10-K for the year ended December 31, 2017 under the caption "Risks Relating to Debt Incurred under Short- and Long-Term Borrowing Facilities - Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing." Financial covenants included in these facilities are further described Part I, Item 2 of our Annual Report on Form 10-K for the year ended December 31, 2017 under the caption "Risks Relating to Debt Incurred under Short- and Long-Term Borrowing Facilities - Financial Covenants Associated with Short-Term Debt and Other Debt Financing." Financial covenants included in these facilities are further described Part I, Item 2 of our Annual Report on Form 10-K for the year ended December 31, 2017 under the caption "Risks Relating

to Debt Incurred under Short- and Long-Term Borrowing Facilities - Financial Covenants Associated with Short-Term Debt and Other Debt Financing.”

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Because these warehouse facilities are uncommitted, at any given time we may not be able to obtain additional financing under them when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017 under the heading “Risk Factors,” and in Part II, Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2017 under the heading “Market Risks.” In addition, with respect to residential loans that at any given time are already being financed through these warehouse facilities, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017 under the heading “Risk Factors,” and in Part II, Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2017 under the heading “Market Risks,” if and when those loans or securities become ineligible to be financed, decline in value, or have been financed for the maximum term permitted under the applicable facility. Additionally, our access to financing under the borrowing facility with the FHLBC is subject to the risks described under the heading “Risk Factors - Recently adopted Federal regulations may limit, eliminate, or reduce the attractiveness of our subsidiary’s ability to use borrowings from the Federal Home Loan Bank of Chicago to finance the mortgage loans and securities it holds and acquires, which could negatively impact our business and operating results” in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017.

At March 31, 2018, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with the financial covenants associated with our short-term debt and other debt financing facilities. In particular, with respect to: (i) financial covenants that require us to maintain a minimum dollar amount of stockholders’ equity or tangible net worth, at March 31, 2018 our level of stockholders’ equity and tangible net worth resulted in our being in compliance with these covenants by more than \$200 million; and (ii) financial covenants that require us to maintain recourse indebtedness below a specified ratio, at March 31, 2018 our level of recourse indebtedness resulted in our being in compliance with these covenants at a level such that we could incur at least \$600 million in additional recourse indebtedness.

OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

In the ordinary course of business, we enter into transactions that may require future cash payments. As required by GAAP, some of these obligations are recorded on the balance sheet, while others are off-balance sheet or recorded on the balance sheet in amounts different from the full contract or notional amount of the transaction.

For additional information on our contractual obligations, see the Off-Balance Sheet Arrangements and Contractual Obligations section in the MD&A included in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2017.

For additional information on our commitments and contingencies as of March 31, 2018, see Note 14 of our Notes to Consolidated Financial Statements in Part I, Item I of this Quarterly Report on Form 10-Q.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates. A discussion of critical accounting policies and the possible effects of changes in estimates on our consolidated financial statements is included in Note 3 — Summary of Significant Accounting Policies included in Part I, Item 1 of this Quarterly Report on Form 10-Q and in Part I, Item 8 of our Annual Report on Form 10-K for the year ended December 31, 2017. Management discusses the ongoing development and selection of these critical accounting policies with the audit committee of the board of directors.

We expect quarter-to-quarter GAAP earnings volatility from our business activities. This volatility can occur for a variety of reasons, including the timing and amount of purchases, sales, calls, and repayment of consolidated assets, changes in the fair values of consolidated assets and liabilities, increases or decreases in earnings from mortgage banking activities, and certain non-recurring events. In addition, the amount or timing of our reported earnings may be impacted by technical accounting issues and estimates. Our critical accounting policies and the possible effects of changes in estimates on our consolidated financial statements are included in the "Critical Accounting Policies and Estimates" section of Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2017.

Market Risks

We seek to manage risks inherent in our business — including but not limited to credit risk, interest rate risk, prepayment risk, liquidity risk, and fair value risk — in a prudent manner designed to enhance our earnings and dividends and preserve our capital. In general, we seek to assume risks that can be quantified from historical experience, to actively manage such risks, and to maintain capital levels consistent with these risks. Information concerning the risks we are managing, how these risks are changing over time, and potential GAAP earnings and taxable income volatility we may experience as a result of these risks is discussed in Part II, Item 7A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

Other Risks

In addition to the market and other risks described above, our business and results of operations are subject to a variety of types of risks and uncertainties, including, among other things, those described under the caption "Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

NEW ACCOUNTING STANDARDS

A discussion of new accounting standards and the possible effects of these standards on our consolidated financial statements is included in Note 3 — Summary of Significant Accounting Policies included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Information concerning market risk is incorporated herein by reference to Part II, Item 7A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2017, as supplemented by the information under "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Market Risks" within Item 2 above. Other than the developments described thereunder, including changes in the fair values of our assets, there have been no other material changes in our quantitative or qualitative exposure to market risk since December 31, 2017.

Item 4. Controls and Procedures

We have adopted and maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed on our reports under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized, and reported within the time periods specified in the U.S. Securities and Exchange Commission's rules and forms and that the information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Rule 13a-15(b) of the Exchange Act, we have carried out an evaluation, under the supervision and with the participation of management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective at a reasonable assurance level.

There have been no changes in our internal control over financial reporting during the first quarter of 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the “FHLB-Seattle”) filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (“SRF”), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the “FHLB-Seattle Defendants”), which alleged that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Seattle Certificate”) issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the “2005-4 RMBS”) and purchased by the FHLB-Seattle. Specifically, the complaint alleged that the alleged misstatements concerned the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleged claims under the Securities Act of Washington (Section 21.20.005, et seq.) and sought to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys’ fees and costs. The Seattle Certificate was issued with an original principal amount of approximately \$133 million, and, at March 31, 2018, approximately \$126 million of principal and \$11 million of interest payments had been made in respect of the Seattle Certificate. As of March 31, 2018, the Seattle Certificate had a remaining outstanding principal amount of approximately \$8 million. The matter was subsequently resolved and the claims were dismissed by the FHLB Seattle as to all the FHLB Seattle Defendants. At the time the Seattle Certificate was issued, Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were named as defendants in the action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the resolution of this litigation, we could incur a loss as a result of these indemnities.

On or about July 15, 2010, The Charles Schwab Corporation (“Schwab”) filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the “Schwab Defendants”), which alleged that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. Schwab alleged only a claim for negligent misrepresentation under California state law against SRF and sought unspecified damages and attorneys’ fees and costs from SRF. Schwab claimed that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the “Schwab Certificate”) issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleged that the misstatements for the 2005-4 RMBS concerned the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. The Schwab Certificate was issued with an original principal amount of approximately \$15 million, and, at March 31, 2018, approximately \$14 million of principal and \$1 million of interest payments had been made in respect of the Schwab Certificate. As of March 31, 2018, the Schwab Certificate had a remaining outstanding principal amount of approximately \$1 million. On November 14, 2014, Schwab voluntarily dismissed with prejudice its negligent misrepresentation claim, which resulted in the dismissal with prejudice of SRF from the action. Subsequently, the matter was resolved and Schwab dismissed its claims against the lead underwriter of the 2005-4 RMBS. At the time the Schwab Certificate was issued, Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were also named as defendants in the action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the resolution of this litigation, Redwood could incur a loss as a result of these indemnities.

Through certain of our wholly-owned subsidiaries, we have in the past engaged in, and expect to continue to engage in, activities relating to the acquisition and securitization of residential mortgage loans. In addition, certain of our wholly-owned subsidiaries have in the past engaged in activities relating to the acquisition and securitization of debt obligations and other assets through the issuance of collateralized debt obligations (commonly referred to as CDO transactions). Because of this involvement in the securitization and CDO businesses, we could become the subject of litigation relating to these businesses, including additional litigation of the type described above, and we could also become the subject of governmental investigations, enforcement actions, or lawsuits, and governmental authorities could allege that we violated applicable law or regulation in the conduct of our business. As an example, in July 2016 we became aware of a complaint filed by the State of California on April 1, 2016 against Morgan Stanley & Co. and certain of its affiliates alleging, among other things, that there were misleading statements contained in offering materials for 28 different mortgage pass-through certificates purchased by various California investors, including various California public pension systems, from Morgan Stanley and alleging that Morgan Stanley made false or fraudulent claims in connection with the sale of those certificates. Of the 28 mortgage pass-through certificates that were the subject of the complaint, two were Sequoia mortgage pass-through certificates issued in 2004 and two were Sequoia mortgage pass-through certificates issued in 2007. With respect to each of those certificates, our wholly-owned subsidiary, RWT Holdings, Inc., was the sponsor and our wholly-owned subsidiary, Sequoia Residential Funding, Inc., was the depositor. The plaintiffs subsequently withdrew from the litigation their claims based on eight of the 28 mortgage pass-through certificates, including one of the Sequoia mortgage pass-through certificates issued in 2004. At the time these Sequoia mortgage pass-through certificates were issued, Sequoia Residential Funding, Inc. and Redwood Trust agreed to indemnify the underwriters of these certificates for certain losses and expenses they might incur as a result of claims made against them relating to these certificates, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, we could incur a loss as a result of these indemnities.

In accordance with GAAP, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. At March 31, 2018, the aggregate amount of loss contingency reserves established in respect of the FHLB-Seattle and Schwab litigation matters described above was \$2 million. We review our litigation matters each quarter to assess these loss contingency reserves and make adjustments in these reserves, upwards or downwards, as appropriate, in accordance with GAAP based on our review.

In the ordinary course of any litigation matter, including certain of the above-referenced matters, we have engaged and may continue to engage in formal or informal settlement communications with the plaintiffs or co-defendants. Settlement communications we have engaged in relating to certain of the above-referenced litigation matters are one of the factors that have resulted in our determination to establish the loss contingency reserves described above. We cannot be certain that any of these matters will be resolved through a settlement prior to trial and we cannot be certain that the resolution of these matters, whether through trial or settlement, will not have a material adverse effect on our financial condition or results of operations in any future period.

Future developments (including resolution of substantive pre-trial motions relating to these matters, receipt of additional information and documents relating to these matters (such as through pre-trial discovery), new or additional settlement communications with plaintiffs relating to these matters, or resolutions of similar claims against other defendants in these matters) could result in our concluding in the future to establish additional loss contingency reserves or to disclose an estimate of reasonably possible losses in excess of our established reserves with respect to these matters. Our actual losses with respect to the above-referenced litigation matters may be materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters, including in the event that any of these matters proceeds to trial and the plaintiff prevails. Other factors that could result in our concluding to establish additional loss contingency reserves or estimate additional reasonably possible losses, or could result in our actual losses with respect to the above-referenced litigation matters being materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters include that: there are significant factual and legal issues to be resolved; information obtained or rulings made during the lawsuits

could affect the methodology for calculation of the available remedies; and we may have additional obligations pursuant to indemnity agreements, representations and warranties, and other contractual provisions with other parties relating to these litigation matters that could increase our potential losses.

Item 1A. Risk Factors

Our risk factors are discussed under Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

During the three months ended March 31, 2018, we did not sell any equity securities that were not registered under the Securities Act of 1933, as amended.

In February 2016, our Board of Directors approved an authorization for the repurchase of up to \$100 million of our common stock and also authorized the repurchase of outstanding debt securities, including convertible and exchangeable debt. This authorization replaced all previous share repurchase plans and has no expiration date. During the year ended December 31, 2017, we repurchased 610,342 shares of common stock pursuant to this authorization for \$9 million. At December 31, 2017, approximately \$77 million of this current authorization remained available for the repurchase of shares of our common stock. During January 2018, we repurchased 1,040,829 shares of our common stock pursuant to this authorization for \$16 million.

In February 2018, our Board of Directors approved an authorization for the repurchase of an additional \$39 million of our common stock, increasing the total amount authorized for repurchases of common stock to \$100 million, and also authorized the repurchase of outstanding debt securities, including convertible and exchangeable debt. As noted above, this authorization increased the previous share repurchase authorization approved in February 2016 and has no expiration date. This repurchase authorization does not obligate us to acquire any specific number of shares or securities. Under this authorization, shares or securities may be repurchased in privately negotiated and/or open market transactions, including under plans complying with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. At March 31, 2018, \$100 million of this current authorization remained available for the repurchase of shares of our common stock.

The following table contains information on the shares of our common stock that we purchased or otherwise acquired during the three months ended March 31, 2018.

(In Thousands, except per Share Data)	Total Number of Shares Purchased or Acquired	Average Price per Share Paid	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or approximate dollar value) of Shares that May Yet be Purchased under the Plans or Programs
January 1, 2018 - January 31, 2018	1,043	\$ 14.93	1,041	\$ —
February 1, 2018 - February 28, 2018	—	\$ —	—	\$ —
March 1, 2018 - March 31, 2018	23	\$ 14.65	—	\$ 100,000
Total	1,066	\$ 14.93	1,041	\$ 100,000

Item 3. Defaults Upon Senior Securities

None.

Item 4. Not Applicable

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit
Number

Exhibit

- 3.1 Articles of Amendment and Restatement of the Registrant, effective July 6, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1, filed on August 6, 2008)
- 3.1.1 Articles Supplementary of the Registrant, effective August 10, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.1, filed on August 6, 2008)
- 3.1.2 Articles Supplementary of the Registrant, effective August 11, 1995 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.2, filed on August 6, 2008)
- 3.1.3 Articles Supplementary of the Registrant, effective August 9, 1996 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.3, filed on August 6, 2008)
- 3.1.4 Certificate of Amendment of the Registrant, effective June 30, 1998 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.4, filed on August 6, 2008)
- 3.1.5 Articles Supplementary of the Registrant, effective April 7, 2003 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.5, filed on August 6, 2008)
- 3.1.6 Articles of Amendment of the Registrant, effective June 12, 2008 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.6, filed on August 6, 2008)
- 3.1.7 Articles of Amendment of the Registrant, effective May 19, 2009 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2009)
- 3.1.8 Articles of Amendment of the Registrant, effective May 24, 2011 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 20, 2011)
- 3.1.9 Articles of Amendment of the Registrant, effective May 18, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2012)
- 3.1.10 Articles of Amendment of the Registrant, effective May 16, 2013 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2013)
- 3.2.1 Amended and Restated Bylaws of the Registrant, as adopted on March 5, 2008 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on March 11, 2008)
- 3.2.2 First Amendment to Amended and Restated Bylaws of the Registrant, as adopted on May 17, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.2, filed on May 21, 2012)
- 31.1 Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2018, is filed in XBRL-formatted interactive data files:
- 101 (i) Consolidated Balance Sheets at March 31, 2018 and December 31, 2017;
- (ii) Consolidated Statements of Income for the three months ended March 31, 2018 and 2017;
- (iii) Statements of Consolidated Comprehensive Income for the three months ended March 31, 2018 and 2017;
- (iv) Consolidated Statements of Changes in Stockholders' Equity for the three months ended March 31, 2018 and 2017;
- (v) Consolidated Statements of Cash Flows for the three months ended March 31, 2018 and 2017; and
- (vi) Notes to Consolidated Financial Statements.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

REDWOOD TRUST, INC.

Date: May 8, 2018 By: /s/ Martin S. Hughes
Martin S. Hughes
Chief Executive Officer
(Principal Executive Officer)

Date: May 8, 2018 By: /s/ Collin L. Cochrane
Collin L. Cochrane
Chief Financial Officer
(Principal Financial and Accounting Officer)

EXHIBIT INDEX

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3.1.3	<u>Articles Supplementary of the Registrant, effective August 9, 1996 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.3, filed on August 6, 2008)</u>
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3.1.6	<u>Articles of Amendment of the Registrant, effective June 12, 2008 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.6, filed on August 6, 2008)</u>
3.1.7	<u>Articles of Amendment of the Registrant, effective May 19, 2009 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2009)</u>
3.1.8	<u>Articles of Amendment of the Registrant, effective May 24, 2011 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 20, 2011)</u>
3.1.9	<u>Articles of Amendment of the Registrant, effective May 18, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2012)</u>
3.1.10	<u>Articles of Amendment of the Registrant, effective May 16, 2013 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2013)</u>
3.2.1	<u>Amended and Restated Bylaws of the Registrant, as adopted on March 5, 2008 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on March 11, 2008)</u>
3.2.2	<u>First Amendment to Amended and Restated Bylaws of the Registrant, as adopted on May 17, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.2, filed on May 21, 2012)</u>
31.1	<u>Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>
31.2	<u>Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>
32.1	<u>Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>
32.2	<u>Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>
	Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2018, is filed in XBRL-formatted interactive data files:
101	(i) Consolidated Balance Sheets at March 31, 2018 and December 31, 2017;
	(ii) Consolidated Statements of Income for the three months ended March 31, 2018 and 2017;
	(iii) Statements of Consolidated Comprehensive Income for the three months ended March 31, 2018 and 2017;
	(iv) Consolidated Statements of Changes in Stockholders' Equity for the three months ended March 31, 2018 and 2017;
	(v) Consolidated Statements of Cash Flows for the three months ended March 31, 2018 and 2017; and
	(vi) Notes to Consolidated Financial Statements.