Two Harbors Investment Corp. First Quarter 2018 Financial Results

Wednesday, May 9th, 2018

Operator: Good morning. My name is Carmen and I will be your conference facilitator. At this time, I would like to welcome everyone to Two Harbors' first quarter 2018 financial results conference call. All participants will be on a listen-only mode. After the speaker's remarks, there will be a question and answer period. I would now like to turn over the call to Maggie Field with investor relations for Two Harbors.

Margaret Field

Investor Relations, Two Harbors

Thank you and good morning everyone. Thank you for joining our call to discuss Two Harbor's first quarter 2018 financial results. With me on the call this morning are Tom Siering, our president and CEO, Brad Farrell, our CFO, and Bill Roth, our CIO. After my introductory comments, Tom will provide an overview of our quarterly results, Brad will highlight key items from our financials and Bill will review our portfolio performance. The press release and financial tables associated with today's call were filed yesterday with the SEC. If you do not have a copy you might find them on our website or on the SEC's website at SEC.gov. In our earnings release and slide, which are now posted in the investor relations section of our website, we have provided a reconciliation of GAAP to non-GAAP financial measures. We urge you to review this information in conjunction with today's call.

I would also like to mention that this call is being webcast and may be accessed on our website in the same location. Before I turn the call over to Tom, I would like to remind you that remarks made by management during this conference call and the supporting slides may include forward-looking statements. Forward-looking statements are based on the current beliefs and expectations of management and actual results may be materially different because of a variety of risks and other factors. Such statements are typically associated with the words such as 'anticipate', 'expect', 'estimate' and 'believe' or other such words. We caution investors not to rely unduly on forward-looking statements. Two Harbors describes these risks and uncertainties in its annual report on form 10K for the fiscal year ended December 31st, 2017 and in other filings it makes or may make with the SEC from time to time which are available in the investor relations section of Two Harbors' website and on the SEC's website at SEC.gov. Except as may be required by law, Two Harbors does not update forward-looking statements and expressly disclaims any obligation to do so.

I'd also like to inform you that in connection with the proposed merger between Two Harbors and CYS Investments Inc. Two Harbors and CYS will file with the SEC a registration statement for the transaction which will include a joint proxy statement relating to the shareholder meetings of Two Harbors and CYS Investments. This registration statement and joint proxy statement will contain important information about the transaction. Investors are urged to read these materials when they become available. I will now turn the call over to Tom.

Tom Siering

President & CEO, Two Harbors

Thank you, Maggie, and good morning, everyone. We hope that you had a chance to review our earnings press release and presentation that we issued last night. Please turn to slide three as we take a moment to review our results. At March 31st, our book value was $15.63 per share which represented a -1.3% total return on book value inclusive of our $0.47 quarterly dividend. Our book value declined quarter over quarter primarily due to spread widening in the latter half of March and higher coupons especially specified pools. Bill will detail this further in his remarks.

Beginning this quarter, we will report core earnings including TBA dollar roll income. As Brad will discuss shortly, we believe this metric is a better representation of our underlying earnings power and provides our stockholders with greater transparency. Core earnings, including dollar roll income, was $0.48 per basic share in the first quarter in line with our projections when we declared our quarterly dividend.

On April 26th, we announced our proposed acquisition of CYS Investments Inc. As we turn to slide four, I'd like to highlight some of the details of this transaction and why we believe this will be beneficial to our stockholders. As we stated on the joint conference call with CYS, we expect this transaction to close in the third quarter.

After the transaction closes, we expect to reallocate the capital from CYS's portfolio into our target asset classes. In 2019, we anticipate that the combined companie's capital allocation to agencies MSR and Credit will look substantially similar to how Two Harbors looks today. Bill will highlight this in further details in his remarks. Furthermore, the combination of Two Harbors and CYS should create operating cost efficiencies, lowering our other operating expense ratio by approximately 30-40 basis points. This transaction represents a unique opportunity to create value for our stockholders. We believe our stockholders will benefit from the enhanced scale and liquidity of the combined companies including a larger capital base that supports continued growth in our target investments. As we anticipate and prove agency spreads in 2018, we believe this deal could be accretive to our earnings and endorses the capital raising attendant to this transaction. Importantly, as we stated on a joint conference call with CYS, we expect to maintain our quarterly dividend of $0.47 per share through 2018 subject to market conditions and the discretion and approval of our board of directors.

Please turn to slide five. The foundation of our success in 2018 and beyond is rooted in our key areas of focus each of which supports our overall goal to provide book value stability through a variety of interest rate environments. Following the close of the proposed merger, we believe the larger combined company will enhance our ability to deliver strong stockholder returns. I will now turn the call over to Brad for a review of our financial results.

Brad Farrell

CFO, Two Harbors

Thank you, Tom. Turning to slide six, let's review our quarterly results. We incurred a comprehensive loss of 23.7 million or $0.14 per basic share which represented a return on average common equity of -3.3%. Our book value at March 31st was $15.63 per share as compared to $16.31 in the fourth quarter. After accounting for our first quarter dividend of $0.47, we incurred a negative return on book value of 1.3%. As we turn to slide seven, let's review our core earnings results. As Tom mentioned, beginning this quarter we will report core earnings including dollar roll income. In the first quarter, our investment team chose to take a net long position in TBAs rather than agency pools for the various liquidity, hedging and leverage benefits.

Historically, we did not view our TBA investment activities as meaningful enough to include. Additionally, our ability to invest in more significant TBA exposure over time, benefits from our recent receipt of a tax opinion that allows us to hold these investments in the REIT and avoid any tax friction. As a result of these factors and our view that TBAs will continue to be a part of our investment strategy over time, we believe the net TBA dollar roll income combined with our core earnings is a meaningful indicator of our underlying earnings in 2018 and going forward. Core earnings of $0.46 per basic common share plus dollar roll income of $0.02 combined for $0.48 on the first quarter representing a return on average common equity of 11.8%.

Our earnings were driven by MSR portfolio growth and additional servicing income combined with slower prepayment speeds. Additionally, our earnings benefited from favorable spread income on our swaps due to increases in LIBOR. This was offset by increased financing expenses on agencies as well as higher servicing expenses due to some seasonal adjustments and higher other operating expenses. Our other operating expense ratio, excluding non-cash LTIP amortization, was 1.4% up from 1.1% in the fourth quarter. These higher expenses were driven primarily by brokerage and trading fees due to the active management of our hedging position to protect book value in a changing rate environment.

As we turn to slide eight, I'd like to highlight some of our accomplishments in the first quarter with respect to how we've optimized our financing profile to benefit future earnings performance. Our debt to equity ratio was 5.9x at March 31st, unchanged from December 31st. We are comfortable with this level of debt to equity and maintain plenty of liquidity to take advantage of market opportunities as they arise in 2018. The repo markets have continued to function efficiently for RMBS with new counterparties entering the market. We believe that our diversified financing profile and, more specifically, recent positive changes in a non-agency and MSR financing space will be a positive to our future earnings performance.

As we noted on our fourth quarter earnings call, we have seen the repo market for non-agencies become more competitive recently resulting in improvements in advanced rates and spreads. We are consistently seeing spreads offered between 100-125 basis points over LIBOR whereas a year ago these spreads were approximately 150-175 basis points. We expect this positive trend to continue in 2018. In the first quarter, we increased the capacity of one of our MSR financing facility's that we announced in the fourth quarter by 100 million dollars rating the facility's total capacity to 400 million. As of March 31st, we had 250 million outstanding on this facility.

As a reminder, this facility finances Fannie Mae MSR collateral and offers three distinct competitive advantages. First, MSR financing allows us to generate incremental MSR returns on a levered basis. Second, the multiyear financing term is at a favorable spread to LIBOR of 225 basis points. Third, and importantly, the facility features two-way margining. The two-way margining feature allows us to better manage our liquidity in a changing interest rate environment such as the first quarter when we experienced increases in the value of our MSR collateral. We continue to advance other MSR financing discussions focused on substantially similar terms. I will now turn the call over to Bill for a portfolio update.

Bill Roth

CIO, Two Harbors

Thank you, Brad, and good morning, everyone. Please turn to slide nine. As of March 31st, our investment portfolio was 22.4 billion with substantially similar capital allocation as last quarter. 69% of capital was allocated to our rate strategy and 31% to credit. Let's turn to slide ten. As Tom noted in his remarks, we are excited about the investment opportunity presented by our proposed acquisition of CYS. We believe that the additional capital will support continued growth in our target assets and allow us to take advantage of market opportunities as they arise.

I would like to highlight two key strategic portfolio considerations related to this acquisition. First, we intend to reallocate the capital from CYS's current portfolio into Two Harbors target assets. As we execute on this plan, we anticipate that approximately 50% of our capital will be allocated to MSR and credit which leads to roughly the same capital allocation that we have today. We expect to reach this target allocation in 2019. Second, upon closing, we intend to have a similar hedging strategy that is in line with our current low level of exposure. As we have emphasized frequently over the years, one distinguishing factor about Two Harbors is our acute focus on protecting book value and part of this involves not taking undue interest rate risk.

Moving to slide eleven, I'd like to switch gears to discuss some of the drivers of our portfolio performance in the first quarter. Our net interest spread was 1.93% down slightly quarter over quarter. In our rate strategy, our hedges and MSR performed as we expected them to in a rising rate environment. However, in the latter half of the quarter as agency spreads widened, higher coupon agencies particularly specified pools underperformed lower coupon agencies. While the impact of interest rate and mortgage spread moves on our book value was consistent with our estimations from the fourth quarter, the underperformance of higher coupon agencies in specified pools, which is the majority of what we own, led to a further diminution of book value.

On the other hand, residential credit continued to perform well with spreads generally stable. As to performance so far this quarter, we have seen a modest reversal of the underperformance of both higher coupons and specified pools. In that light, despite interest rates being up over 25 basis points in April, our book value, after accruing for the dividend, is roughly flat since quarter end. As we move to slide twelve, let's discuss our rate strategy. Our agency position didn't change substantially, and we ended the quarter with approximately 18 billion of agency pools and 450 million net long TBAs. As Brad mentioned in his remarks, we used TBAs as both a pool substitute and to manage our overall portfolio positioning.

Going forward, we don't expect our TBA position to be a material part of our investment strategy unless the rolls become very special. With respect to MSR investment activity, we added 13.6 billion UPB through both a bulk purchase and our monthly flow sale arrangements. MSR is now about 20% of our equity capital allocation and we expect that this allocation will remain similar as we redeploy capital following the closing of the merger with CYS. Over the long-term, we expect the amount of capital allocated to MSR will continue to grow. MSR is a key component of our hedging strategy driving strong returns while mitigating both interest rate and spread risk.

This segues into our discussion about our current risk positioning highlighted on slide thirteen. We continue to maintain a prudent approach to interest rate and spread exposure by actively managing our hedge positioning, utilizing a variety of tools including swaps, swaptions and MSR; we believe that we will be able to continue to minimize book value volatility. Looking at the left-hand side of this slide, you can see that in the rates up 25 basis points scenario, we expect that our book value would increase by 0.7%. On the top right-hand side of this slide, you can see that our net interest income would decline by 1.6%. We anticipate that both of these exposures will continue to be in a relatively neutral position and, as I mentioned earlier, we intend to maintain similar positioning after we close the CYS transaction.

Turning to net income exposure, a key contributor to our net income stability is MSR float income which increases in value when rates rise. Consistent with the rise in short-term rates in the first quarter, our float income increased to 4.4 million dollars compared to 1.1 million for the first quarter of 2017. We expect that for every 25 basis points increase in short-term rates, we would make an additional 3.2 million dollars of income annually which helps stabilize our income as short-term rates move higher. Finally, from a spread widening perspective, you can see on the bottom of this slide that if agency spreads widen 25 basis points, we would expect our book value to be down by a relatively small 3.8%.

Moving to slide fourteen, let’s discuss our credit strategy. Residential credit performed well generating a positive return each month of the quarter. On prior earnings calls, we’ve highlighted the benefits of our credit strategy to book value and often get asked the question if there are opportunities to add more of these deeply discounted legacy assets at attractive levels. The answer to that is ‘yes’. We continue to find and add to our portfolio non-agency bonds that we think generate low to mid double digit total returns. Importantly, this is in the absence of any real dislocation in the credit markets when we believe there would be an even greater opportunity to add legacy non-agencies.

Additionally, as Brad mentioned in his remarks, improvements in financing for legacy non-agencies has allowed us to allocate capital to our credit strategy in a much more efficient way. At a higher level, residential credit continues to benefit from fundamental improvement in the housing market including re-equification by borrowers resulting in increased prepayments, lower loan to value ratios and fewer delinquencies, defaults and severities. As an illustration of how that helps drive strong returns, let’s take a look at the bottom left of this slide. Our current portfolio LTV is around 70%. If we apply assumptions of 3% HPA per year in the base case and 6% per year in an upside scenario, you can see that our LTV can drop substantially over the next three years- in the upside scenarioto 53% this would lead to lower default and losses.

As you can see on the bottom right of this slide, subprime non-agency CPRs also continue to increase. This clearly benefits our deeply discounted bonds. We believe these positive tailwinds can benefit our credit strategy by driving bond prices higher and generating strong total returns benefiting our book value going forward. I would now like to turn the call back to the operator for Q&A.

Q&A

Operator: Thank you and ladies and gentlemen, if you have a question at this time just press star and the one key of your touchtone telephone. If your question has been answered or you wish to remove yourself from the queue, press the pound key. Again, to ask a question just press star and one. And our first question is from the line of Bose George with KBW.

Bose George (KBW): Hey guys, good morning. In terms of the timing for reaching the allocation of post deal, , getting the allocation back to where, , it was pre-deal; I'm just curious in terms of asset classes like MSRs where, , it might be harder to ramp up–I mean, could we see more sort of bulk purchases and, and also just in terms of the timing–the 2019, is that like beginning of the year, end of the year or is that, , just any sort of timeline–a little more specific timeline would be great.

Bill Roth: Good morning and thanks for joining us. This is Bill. Yeah, so, we said on our call last month that we estimated around six months to get back to our current–roughly our current allocations and that's six months from closing. So, it's a little hard to tell exactly when in 2019, but obviously we'll know more as we get closer to that. In terms of servicing, we've been continuing to grow our servicing book both through flow and bulk. Bulk opportunities this year have been running very strong at over 100 billion on an annualized basis. As you know we closed a decent size deal in the first quarter and we continue to look at those opportunities as, as they come about. So, I would say that we're pretty excited about that. I think the main point, as I mentioned earlier, is just that we expect to look substantially the same as we do now roughly six months after closing.

Bose George: Oh, okay. Great. Thanks. And then actually one clarification. On slide thirteen, when you showed the spread impact – you showed the agencies, the MSRs – it doesn't mention credit. Is, is credit sort of expected to be neutral in that scenario?

Bill Roth: Yes. We're just trying to isolate–that's correct. We're trying to just isolate the sensitivity to agency spreads and what we've seen in the last six months to twelve–two years is as agency spreads have widened and tightened, non-agencies especially the legacy, don't seem to have moved when agencies move. So we're just trying to isolate that.

Bose George: Okay. Thanks. And then actually one more just back on the deal. The proforma of book value for the deal – is that roughly stable?

Tom Siering: Well, sure. So, good morning, Bose, this is Tom. So, Bill made the comment on our book value in respect of what the ultimate consideration is, it'll be the function of the book values of the respective companies at the time. The exchange consideration of that.

Brad Farrell: Yeah. And, and one comment, we noted in our kickoff on the announcement that we would expect it to be less than 2% dilution which was noted in the public domain. But given the relative benefits, we wanted to comment on that.

Bose George: Okay. Great. Thanks.

Operator: Thank you. Our next question comes from Rick Shane with J.P. Morgan.

Rick Shane (J.P. Morgan): Hey guys. Thanks for taking my questions. Your presentation answered a lot and the timeline to deploying or re-deploying the capital after the acquisition's helpful. I am curious about one thing. Presumably, given liquidity and the need to or desire to be fully deployed following the acquisition, I'm assuming you will be relatively overconcentrated in rate strategy as you re-deploy the capital. I want to understand how we should think about the hedging strategy during that period because presumably, you will need to add some relatively long duration swaps and then will be in a position once you re-deploy where those swaps are still in place. Help us understand sort of the implications of that or how you mitigate during that six-month window the risks from a rate shock.

Bill Roth: Yeah, sure. Hey, Rick. Thanks for for joining us this morning. So, I think there's a couple different parts to that. I think the first thing CYS is - they're managing their book right up until the deal closes and I think - so their thing. And then one of the considerations is what the exposure is when the deal closes which, obviously we don't know what that is today. But let me talk about our philosophy is basically that, we don't, as you know, tend to take much interest rate risk and our intended rate exposure will be similarly low both before the deal closes and after the deal closes. So right now we're seeing agencies hedge with interest rate products roughly around the 10% area. So, we'll have to see what the CYS book looks like when the deal closes and we'll have to just adjust from there, but basically, we have been growing our MSR and credit book all along and we intend to continue to do that right up until close. So you can expect those allocations to move higher then you'll see things drop down and then they'll move back up higher over time. So, I think the main thing is that whatever the combined position is at close, we will be making sure that we're maintaining the same low level of rate exposure that we have today as well as historically.

Rick Shane: That's very helpful and actually it probably suggests how correctly and incorrectly I'm looking at this which is – I was thinking about this almost exclusively from the acquisition of capital, but I've been ignoring the fact that you are in fact acquiring assets that are coming on hedged and so the differential between how you might hedge those assets and how the CYS team might hedge them is probably not as – it's a narrower gap than I'm giving you credit for.

Tom Siering: Okay. All right. I think that's right so – but the punch – this is Tom. Good morning, Rick. The punchline is you shouldn't expect our interest rate exposure to look measurably different at post closing than it looks today.

Rick Shane: Got it. Good morning, Tom. Thank you, guys.

Tom Siering: Thanks, Rick.

Operator: Thank you. Our next question is from Fred Small with Compass Point.

Fred Small (Compass Point): Hey, good morning. Thanks for taking my questions on – just following up on, on Bose's question, the 2% or under 2% dilution on the – following the deal. You're confirming that or is that still the case? That's still your current thinking?

Tom Siering: It will be very close to that we believe. Yes.

Fred Small: Okay. And then on the –you mentioned that the financing costs of the repo market for non-agencies has become more favorable over the past few months or the past year. What's driving that?

Brad Farrell: I think it's a combination of factors. One, it's – to a certain degree, the focus of lenders moving toward kind of higher spread products combined with more comfort in those asset classes as home prices are improved, credit has stabilized - employment metrics. So, I think it's a combination of the meaningful lenders moving toward that because of various regulatory requirements as well as getting comfortable at the asset classes. And then, more competition coming into the space as well. So, with all things combined, we're seeing – and to a certain degree rightfully so - the spreads did not really come in for quite some time as we saw the growth and evaluation of those products. The market's kind of adjusting and catching up for that at about the past six months.

Tom Siering: To add to what Brad said, Fred, one of the chief determinants of the spread in financing has to do with the volatility of the assets and non-agencies have gone through quite an evolution the last four of five years to where they're much more stable from a price standpoint and with good reason because the underlying fundamentals have been rock solid and to the extent that there have been surprises – there have been surprises to the upside. So, it's all the things that Brad said, but the price volatility of non-agencies has become very muted over time.

Tom Siering: One thing too, Fred, that I wanted to clear up. You wrote a note in respect of the merger. To remove any ambiguity in CY – as Kevin said on our joint call - CYS had received an unsolicited inquiry from a third-party, but that third-party was not us. We were brought into the process ex-post that and the details of this will be outlined much in a much more fulsome way in the proxy statement.

Fred Small: Okay. Awesome. That's helpful and thank you for the clarification. Then, on – just I think it's slide thirteen where you go through the sensitivities. I guess just in terms of the sensitivities to book and to net income, how do you anticipate those will shift following at the time of the acquisition or shortly following?

Bill Roth: This is Bill again. So, I think we mentioned that our primary focus is to maintain not just now, but post acquisition, very low exposure to both metrics. Now, obviously, those will move around as the market changes – it's in our hedge positions change, but you can expect that these numbers will remain fairly low at, not only now until the closing, but post-closing as well.

Fred Small: Okay. Got it. Is there any sort of minimum that, that you're trying to keep them to or trying to manage through the process versus where they are now?

Bill Roth: No. Not necessarily. I mean, obviously, a lot depends on the market and what's going on in the economy and our general overall views. I mean, I think - you've followed us for a long time - as some of the others on the call have. We generally are not inclined to take a lot of interest rate exposure, but sometimes those numbers are a little bigger than you see on the page. Today, it just so happens we're in an environment where the fed is raising rates, the economy is doing well and there could be continued upward pressure on rates. So, we feel particularly compelled to make sure that these numbers are pretty darn small for the time being.

Fred Small: Great. Thanks a lot.

Bill Roth: Thanks, Fred.

Operator: Thank you. Our next question is from Doug Harter with Credit Suisse.

Doug Harter (Credit Suisse): Thanks. Bill, can you talk about your comfort in the ability to find enough attractive credit assets post the merger close to get to your target allocation?

Bill Roth: Yeah, sure. Thanks for joining us. Look, we're primarily focused on the deep discount legacy assets and if you look in the presentation at slide, I think it's fourteen, if you think about how long these assets have been out there, you're talking about 10, 12, 15-year-old loans. Between all the tailwinds we discussed, if you think about on a forward basis what the scenarios are going to look like, we're still very bullish on this sector. Now, in terms of supply, this is still north of 500 billion of this stuff is still out there. There are a lot of bonds that are still at deep discounts and, frankly, we've been buying monthly a decent amount over the last year. In fact, recently, in the last few weeks we've added a reasonable amount as well. And these are assets that are still deep discounts with the upside that we've talked about. So, I'd say that we're pretty confident that we're going to be able to add enough assets to get back to where we are today and potentially further. And, the other comment I made on the call is, we haven't really seen any big credit dislocations recently and to the extent that that happens, and these things widen out, that would be really a great opportunity to add in decent size and we did that both in 2017 and 2016 in two different periods where that occurred. So, hopefully that's helpful.

Doug Harter: That is. Thank you. And, and Brad, can you just talk about the expectations for the non-management fee expenses? Should those remain elevated or will that likely come back down to kind of where it has been trending?

Brad Farrell: I'm sorry. I guess can you repeat the question? I'm not quite sure if I understand on the management fees.

Doug Harter[?]: The non-management fee expenses.

Brad Farrell: Oh. The non-management fees. Okay. I misheard you. I think we've said previously that if you exclude the LTIP, we anticipate to run between 1.1% and 1.4%. I think Q4 was a little bit on the low end for various reasons. Kind of, year end is a little bit light on transactions, etc. If we anticipate being active in our volatility and hedging practices which we would expect, as well as active in the MSR bulk and pursuing opportunities such as that, it would likely be on the higher end of that range. Possibly not as high as this quarter. So, I would kind of steer you toward probably the higher end of that, but obviously a lot of uncertainty as we navigate to protect book value and grow the portfolio. And then as we commented, the post-close, we would anticipate taking those numbers and reducing them by 30-40 basis points which is also consistent with that philosophy I just mentioned. h

Hopefully that answers your question.

Doug Harter: That does. Thank you, Brad.

Operator: Thank you. And ladies and gentlemen, I am not showing any questions in the queue. I will turn the call back to Mr. Siering for concluding comments.

Tom Siering: Thank you, Carmen, and thank all of you for joining our first quarter conference call today. We are very excited about the opportunities ahead for Two Harbors and the potential to drive enhanced value for our stockholders. We look forward to keeping you updated. Have a wonderful day.

Operator: And with that, ladies and gentlemen, we thank you for participating in today's conference. This concludes the program and you may all disconnect. Have a wonderful day.

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