Two Harbors | Subprime Bond Case Study

August 6, 2014

TWO HARBORS
Investment Corp.
A Pine River Capital Managed Company

Safe Harbor Statement

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Subprime Bond Overview

MARKET CHARACTERISTICS

- Subprime sector since the crisis has functioned like a distressed market
- Legacy subprime bonds have been purchased at a significant discount to par due to the credit sensitivities of the security
  - Became deeply discounted as borrower performance deteriorated during the housing/financial crisis
- Mispricing of credit risk presents an opportunity for investors with strong expertise in credit analysis
- Subordination and excess spread built into the capital structure can provide sub-prime bonds protection against substantial losses on the underlying loans.
- Performance of underlying collateral is driver of realized yield on the asset; not all bonds are created equal

BORROWER CHARACTERISTICS

- Low credit score
- Impaired or limited credit history
- High debt-to-income ratio
- Undisclosed or verified income
- Minimal down payment (e.g. high loan-to-value ratio)

Two Harbors Subprime Bond Portfolio

SUBPRIME HOLDINGS(1)

- Approximately 80% of non-Agency RMBS portfolio
- Carrying value of $2.4 billion
- Face value of $3.5 billion
- Average purchase price $47.50
- Average coupon of 1.3%
  - Approximately 87% of subprime holdings have floating rate(2)
  - Average floating coupon rate 0.62%
- 60+ day delinquencies 31.2%
- 3-month Constant Prepayment Rate (CPR) 3.2%
- Credit enhancement 11.1%
  - Not including excess interest spread that offsets credit losses

(1) As of June 30, 2014.
(2) Floating rate is based on carrying value.

Home Equity Asset Trust (HEAT) 2006-3 at Issuance(1)

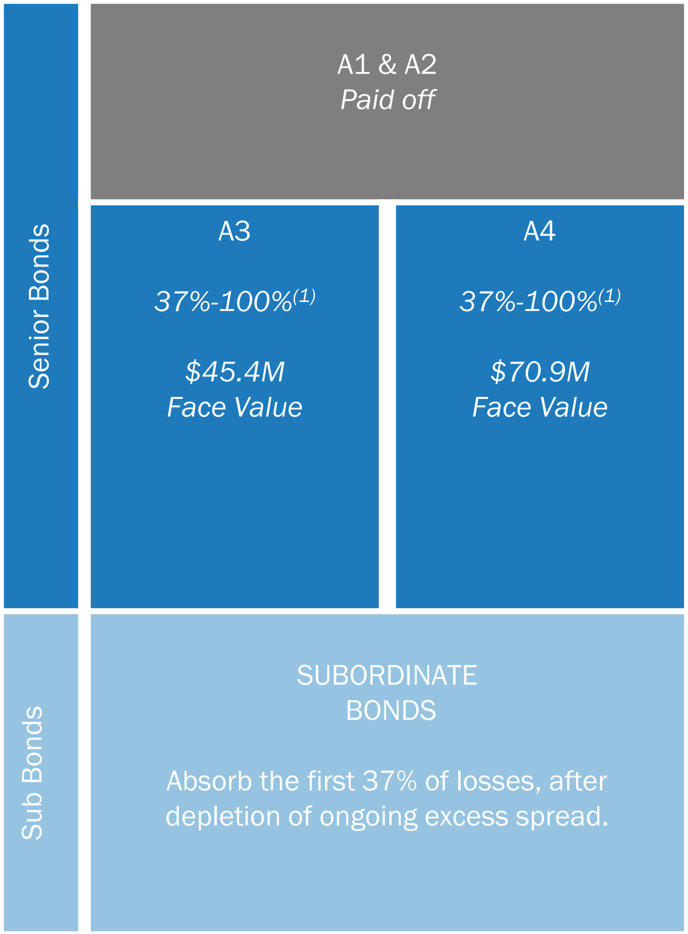
	A1	A2	A3	A4
Senior Bonds(2)	$345 million Face Value	$90 million Face Value	$101 million Face Value	$70.9 million Face Value
Subordinate Bonds – 19.2% at Issuance(3)(4)				

Bond and Collateral Characteristics at Issuance

- Senior bonds pay sequentially; A1 through A4
  - Backed by group 2 collateral
- Senior bonds initially AAA rated
- Receives protection from credit losses from the subordinate bonds and ongoing excess interest
- Original group 2 collateral summary:(4)
  - Vintages: 2005 to 2006
  - Over 83% single-family properties
  - Over 89% with 30-year amortization period
  - 29% located in California; 12% in Florida; 4% in Georgia
  - 45% with LTV of 71% to 80%; 31% with LTV of 81% to 90%(5)

(1) As it pertains to this presentation, HEAT 2006-3 will be used to reference the senior bonds backed by group 2 collateral, as well as the corresponding subordinate bonds.
(2) Represents senior bonds backed by second collateral group. HEAT 2006-3 1A1, a senior bond, was also issued but is backed by group 1 collateral.
(3) Subordinated bonds protect all senior bonds regardless if they are backed by either group 1 or group 2 collateral.
(4) Source: Bloomberg.
(5) “LTV” is defined as original Loan-to-Value.

HEAT 2006-3 at Two Harbors Acquisition in 2011



DEAL SUMMARY[1]

- A1 and A2 were paid off
- A3 was receiving principal payments
- A4 downgraded to "C" rating

COLLATERAL SUMMARY[2]

- 60+ day delinquencies 32%
- 6-month severities 71%
- Credit enhancement 37%
  - Not including excess interest spread of approximately 4%

TWO HARBORS PURCHASE SUMMARY

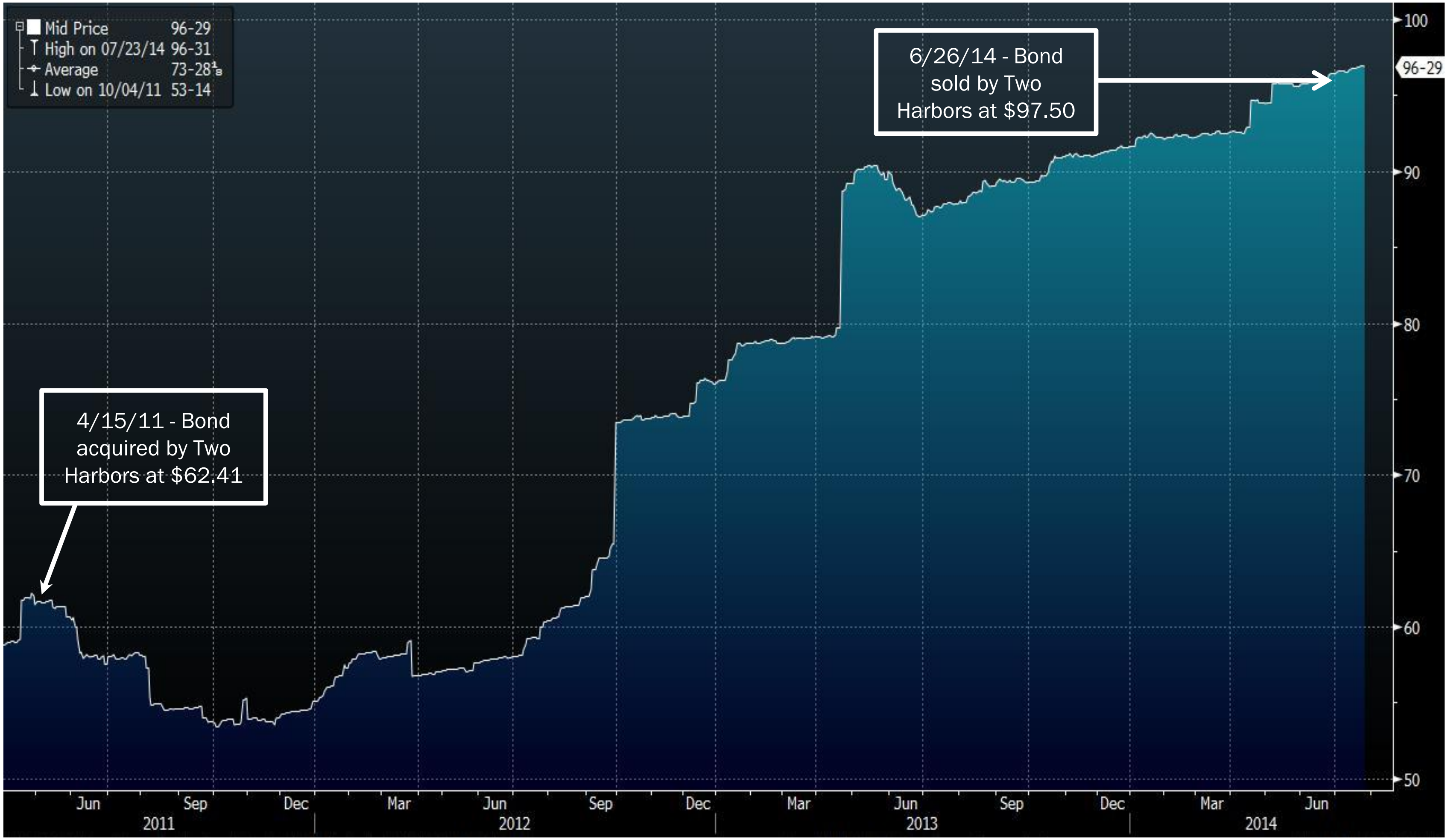
- Purchased A4 at a price of $62.41 in April 2011
  - Expected returns were approximately 10%
  - Pays a coupon of LIBOR +0.31%

MSA VIDEO LINK

http://vimeo.com/102537046

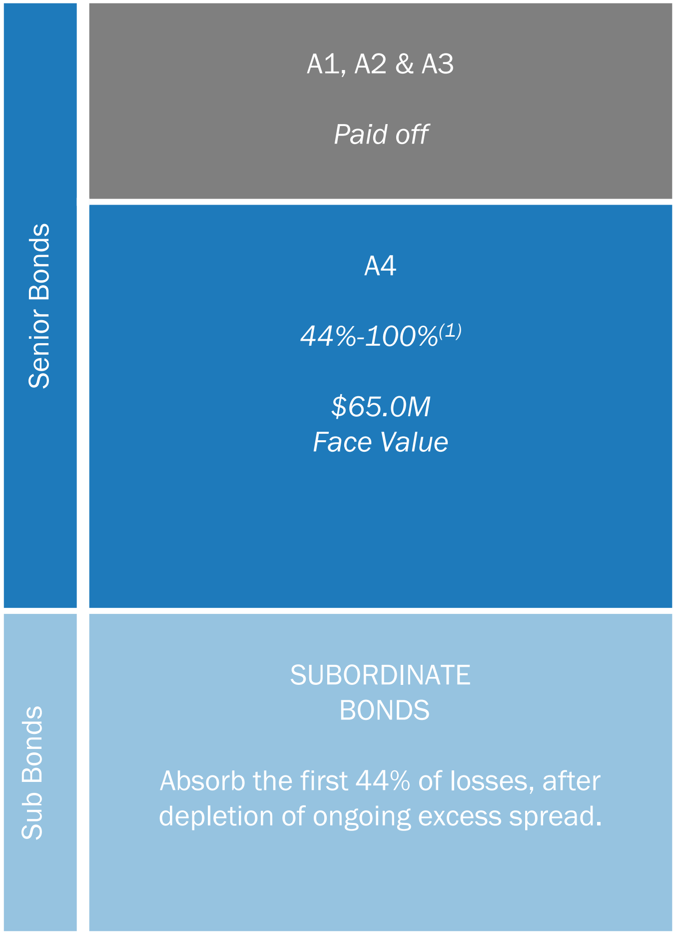
(1) Senior bonds absorb losses 37%-100%.
(2) Source: Bloomberg.

HEAT 2006-3 2A4 Price Path – 4/1/2011 to 6/30/2014



(1) Source: Bloomberg

HEAT 2006-3 at Two Harbors Sale in 2014



DEAL SUMMARY(1)

- A1, A2 and A3 were paid off
- A4 had been upgraded to “B” rating
- A4 started receiving principal payments in March 2014

COLLATERAL SUMMARY(2)

- 60+ day delinquencies 26%
- 6-month severities 59%
- Credit enhancement 44%
  - Not including excess interest spread of approximately 1%

TWO HARBORS SALE SUMMARY

- Sold A4 at a price of $97.50 in June 2014
  - Up 56% in approximately 3 years
  - Yield was low; minimal upside remaining

(1) Senior bonds absorb losses 44%-100%.
(2) Source: Bloomberg.

Outlook for Subprime Bond Portfolio

WE BELIEVE UPSIDE POTENTIAL REMAINS IN OUR SUBPRIME PORTFOLIO

- Conservative prepay/default assumptions
- Higher prepayment behavior and potential servicing actions could provide value in the future
  - Refinancing due to low interest rates
  - Better economic growth
  - Home Price Appreciation (HPA)
  - Increasing housing turnover from better mobility as employment metrics improve
- Servicer actions are helping borrowers
- Consider other plausible scenarios when reviewing the expected fundamental performance of these bonds
- Legacy subprime bonds provide attractive loss-adjusted yields against a backdrop of improving loan performance

RISK CONSIDERATIONS THAT MAY RESULT IN VALUATION DECLINES

- Potential HPA declines; increased delinquencies and defaults
- Uncertain cash flow because of potential servicer actions

Contact Information

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