

An aerial photograph of a residential neighborhood with a semi-transparent blue overlay. The houses are mostly white with dark roofs, and there are many green trees. A road curves through the middle of the neighborhood.

Two Harbors Investment Corp. Fourth Quarter 2023 Earnings Call Transcript

January 30, 2024



TWO HARBORS
Investment Corp.

PRESENTERS

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Bill Greenberg, President and Chief Executive Officer
Nick Letica, Chief Investment Officer
Mary Risky, Chief Financial Officer

Q&A PARTICIPANTS

Doug Harter – UBS
Trevor Cranston – JMP Securities
Eric Hagen – BTIG
Ken Lee – RBC Capital Markets
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Rick Shane – JPMorgan
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PREPARED REMARKS

Operator Hello and welcome to the Two Harbors Investment Corp. Fourth Quarter 2023 Financial Results Conference Call and Webcast.

If anyone should require operator assistance, please press “*”, “0” on your telephone keypad. A question-and-answer session will follow the formal presentation. You may be placed in the question queue, at any time, by pressing “*”, “1” on your telephone keypad. As a reminder, this conference is being recorded.

It is now my pleasure to turn the call over to Maggie Karr, Head of Investor Relations. Please go ahead, Maggie.

Maggie Karr Good morning, everyone, and welcome to our call to discuss Two Harbors' fourth quarter 2023 financial results. With me on the call this morning are Bill Greenberg, our President and Chief Executive Officer; Nick Letica, our Chief Investment Officer; and Mary Risky, our Chief Financial Officer.

The earnings press release and presentation associated with today's call have been filed with the SEC and are available on the SEC's website, as well as the Investor Relations page of our website at twoharborsinvestment.com. In our earnings release and presentation, we have provided reconciliations of GAAP to non-GAAP financial measures, and we urge you to review this information in conjunction with today's call.

As a reminder, our comments today will include forward-looking statements, which are subject to risks and uncertainties that may cause our results to differ, materially, from expectations. These are described on Page 2 of the presentation and in our Form 10-K and subsequent reports filed with the SEC. Except as may be required by law, Two Harbors does not update forward-looking statements and disclaims any obligation to do so.

I will now turn the call over to Bill.

Bill Greenberg

Thank you, Maggie. Good morning, everyone, and welcome to our fourth quarter earnings call.

Today, I'll provide an overview of our quarterly and annual performance. Then I will spend a few moments discussing the markets and finish with an update on RoundPoint operations. Mary will cover our financial results in detail and Nick will discuss our investment portfolio and return outlook.

Let's begin with Slide 3. Our book value at December 31st was \$15.21 per share, representing a positive 2.0% total economic return for the quarter. IXM was \$0.39 per share, representing a 10.3% annualized return. In the fourth quarter we issued 7.0 million shares through our ATM program, raising \$97.8 million in common equity.

Taking a step back and looking at 2023, I'm proud of what our company achieved for the benefit of our stockholders, both through the active management of our portfolio and our capital structure, and through the addition of our new operational platform. In February, we raised \$176 million in common equity and allocated all of those funds to investments in MSR, which increased our capital allocation to this asset class to 62%. Without a doubt, however, the highlight of our year was the acquisition of RoundPoint Mortgage Servicing, which reinforced our commitment to MSR as a core and essential part of our business.

Please turn to Slide 4 for a brief discussion on the markets. The fourth quarter of 2023 was punctuated by continued volatility in rates and spreads. On the back of a stronger than expected September jobs reports, coupled with the outbreak of war in the Middle East, interest rates moved steadily higher in early October. At its peak, the 10-year Treasury yield briefly touched 5%, approximately 40 basis points higher than it was at the beginning of the quarter. An abrupt turn of sentiment followed in early November after Chairman Powell's optimistic assessment of the Fed's efforts to bring down inflation and engineer a soft landing. Interest rates quickly reversed course and declined 36 basis points over the next three trading sessions. Supportive economic data in November, as well as dovish Fed commentary, drove the market to price in as many as six interest rate cuts in 2024. The entire yield curve responded, as the 10-year Treasury rate finished the quarter at a yield of 3.88%, 59 basis points lower than it started at the beginning of the quarter. And the 2-year Treasury rate declined 79 basis points to 4.25%, resulting in a net 10 basis points steepening of the yield curve. You can see these changes in Figure 1 on the slide. From peak to trough, the 5-year and 10-year Treasury yields moved a jaw dropping 120 basis points in the quarter. It's interesting to look at these rate moves in a historical context, which you can see in Figure 2 on the bottom of this slide. Market practitioners often quote measures of realized volatility as the variance or standard deviations of historical price movements, or sometimes their percentage changes, and that's meaningful for those who are adept in statistics. In this chart, we aim to show something simpler and, we believe, more intuitive. We simply look at how many days over the past 20 years had a move in the 5-year Treasury rate of more than 10 basis points. In 2023, the market

experienced more than 50 days of such moves. That is, the 5-year rate moved more than 10 basis points on more than 20% of the trading sessions during the year. This was the second highest instance of this metric, right behind 2008 during the Great Financial Crisis. For essentially a decade prior to 2022, there were only two years where there were ten such days. Many years during that period had less than five. There are, of course, many differences between then and now, but this time series plot is meant to provide some perspective on the market that we have been managing through.

Please turn to Slide 5 for a brief discussion on RoundPoint's operations. We closed the acquisition of RoundPoint effective September 30th, and have been actively integrating all systems and people. The 10th transfer of our servicing to RoundPoint's platform is expected to occur on February 1st, and we will have one final "clean up" of 60,000 loans in early June, as shown in Figure 1. In all, we expect the total number of loans on the RoundPoint platform to be just north of 900,000, making it the 8th largest conventional servicer in the country. Transferring almost a million loans in this time frame is quite an accomplishment, and the team at RoundPoint has done an excellent job of keeping up with the expanding portfolio, while maintaining a commitment to delivering exceptional service to every homeowner.

Since the closing of the acquisition, we have made large strides in integrating RoundPoint's functions, operations and overall platform into Two Harbors. We continue to see this acquisition as providing a lot of opportunity going forward for our shareholders. In particular, we still believe that the RoundPoint servicing platform should benefit the combined company by approximately \$25 million in pretax income in 2024, the result of both incremental revenue and cost savings.

Figure 2 on the bottom right of this slide highlights our top key strategic initiatives for RoundPoint for 2024. Our first focus is to render additional cost savings and economies of scale from the platform. This involves being smart about our technology, knowing when to buy versus build, and to streamline processes and create additional efficiencies.

The second area of focus is to develop a best-in-class direct-to-consumer originations channel to provide recapture on our portfolio. The note rate on our MSR portfolio is below 3.5% and so, with mortgage rates north of 6.5%, we are a long way away from serious refinancing activity. Unless interest rates fall precipitously, we think that we have the time to build the platform that we want. We have hired a very experienced individual to lead this effort who has spent his entire 30-year career building and running direct-to-consumer businesses. We are in the process of expanding the team, and we expect to be able to begin making loans in the second quarter. The ability to create something from scratch without any legacy issues or risks is tremendously exciting and few companies get the chance to do that. With a direct-to-consumer origination platform, we also expect to be able to offer our borrowers second liens, home equity loans and other ancillary products.

Lastly, we are keenly focused on the growth of RoundPoint's third-party subservicing business. As of yearend, RoundPoint serviced a total of seven true third-party clients, including one new client added in the fourth quarter. This new client is the operator of a newly formed MSR exchange, which matches MSR buyers and sellers. While they have yet to add any new loans to our platform, we are optimistic about this new partnership.

Additionally, there has been increasing demand and activity from institutional investors who are participating in the MSR market through separately managed accounts. The opportunity exists because the market has never before seen a risk profile like the current MSR asset class, with most of the universe being far away from the refinance window. We believe the best way to grow our subservicing business is by being the servicer of choice for this new capital. We think there are many reasons why we are a great partner for this new capital, and we are actively working to ensure that we have the ability to support various structures. Indeed, we recently signed a term sheet to sell a small pool of our own MSR to a nontraditional market participant on a servicing retained basis, which will bring the number of true third-party subservicing clients up to eight, once that deal closes.

Bringing this all together, let's discuss how we are thinking about our portfolio of securities and MSR, and our operational platform in the current environment. While Agency spreads are attractive, especially in a historical context, the market is in the midst of transitioning from a period of Fed tightening to one with a more neutral posture and one where we think spreads on RMBS are roughly fair. Therefore, we do not think this is a great time to climb far out on a limb in terms of risk or leverage. Second, the current environment reinforces why MSR is such a valuable asset in our portfolio, having low prepayment and convexity risks, and producing a highly positive cash flow and attractive yield. Whether or not the Fed cuts three times or six times or zero times in 2024, we still expect prepayment speeds on our MSR portfolio to remain slow for quite some time, though we are preparing for the unexpected through the development of our direct-to-consumer recapture channel.

The nature of our portfolio construction means that when MBS underperform, our capital allocation will outperform pure Agency strategies, and when MBS outperform, our portfolio will underperform pure Agency strategies. This is by choice and by design. A good example of this can be seen in just the last two quarters. While we expect to have underperformed pure Agency strategies this quarter as MBS tightened, we significantly outperformed last quarter when they widened. Our high capital allocation to MSR acts as a ballast to our portfolio when Agency spreads fluctuate.

Looking further ahead, we are forging a path that lies not merely in watching mortgage spreads flicker by on the screen, but rather through the financial investment in an asset class – MSR – where we can more meaningfully impact our results through our actions. The uniqueness of Two Harbors is that we are not a pure agency only REIT. We have built our portfolio with the intent of delivering high quality returns, not just over the next quarter or even the next rate cutting cycle, but over the long-term, despite interim interest rate and spread volatility. Ours is not a stagnant portfolio, and we

constantly evaluate opportunities across our core competencies, all through the lens of creating sustainable shareholder value.

With that, I'd like to hand the call over to Mary to discuss our financial results.

Mary Risky

Thank you, Bill, and good morning.

Please turn to Slide 6. The company generated comprehensive income of \$38.9 million, or \$0.40 per weighted average share in the fourth quarter. Our book value was \$15.21 per share at December 31st, compared to \$15.36 at September 30th. Including the \$0.45 common dividend results in a quarterly economic return of positive 2.0%. Before turning to Slide 7, I'd like to call your attention to Appendix Slide 30, where we have included the customary information on REIT taxable income and the tax characterization of our dividend distributions. For additional information regarding the distributions and tax treatment, please refer to the dividend information found in the Investor Relations section of our website.

Please turn to Slide 7. IXM for the fourth quarter was \$38.2 million or \$0.39 per share, representing an annualized return of 10.3%. Lower IXM quarter-over-quarter was impacted primarily by spread volatility and related portfolio activity.

Moving to Slide 8, let's look at some detail of the quarter-over-quarter variances in IXM. IXM is lower, quarter-over-quarter, by \$11.1 million. This was driven primarily by decreased income on RMBS from lower balances and moving our mortgage investments down in coupon. Additionally, IXM was affected by certain yearend expense accrual adjustments.

As a reminder, IXM reflects our daily adjusted holdings over the quarter. There can be quarterly distortions in IXM like coupon positioning, timing of MSR cash flows, funding rates and leverage and expense adjustments, but we believe that it is the most helpful way for our investors and analysts to understand the current quarter return contributions. IXM is complementary to the return potential and outlook slide later in the presentation, which reflects our view on prospective returns.

Please turn to Slide 9. RMBS funding markets remained stable and liquid throughout the quarter with ample balance sheet available. Spreads on repurchase agreements widened slightly into the fourth quarter and year-end, with financing for RMBS between SOFR, plus 23 to 25 basis points. At quarter-end, our weighted average days to maturity for our agency repo was 48 days. Our days to maturity are typically lower at December 31st, as we intentionally roll repos past year end to avoid any disruption in funding that can occur in December. Post quarter-end, we've rolled repos at very attractive spreads, given that even longer term repos are pricing in five to six rate cuts into 2024. Currently, about 16% of our repos have floating rates.

We finance our MSR across five lenders with \$1.6 billion of outstanding borrowings under bilateral facilities and \$296 million of outstanding five-year term notes. We ended the quarter with a total of \$591 million unused MSR financing capacity and \$168 million unused capacity for servicing advances. I will now turn the call over to Nick.

Nick Letica

Thank you, Mary.

Please turn to Slide 10. As Bill discussed, there was no lack of volatility in the fourth quarter. Following the rise in interest rates in October, mortgage spreads underperformed, widening by about 20 basis points. Rates reversed course in November, and spreads tightened back by about 35 basis points. This tightening trend continued in December with the Fed strongly signaling that the period of rate hikes was over. Ultimately, current coupon mortgage spreads, on a nominal basis finished the quarter at 118 basis points, tighter by 33 basis points. This is at the tighter end of the 2023 range of 100 to 167 basis points. You can see this in Figure 1. Though the spread is still much wider than the longer-term non-QE average of 80 basis points, it reflects an environment of high realized rate volatility and tepid demand from depository institutions. Being at the tighter end of the range is likely the result of the market's expectations of more than five Fed rate cuts priced in for 2024, a steeper forward curve and lower forward implied volatility. Putting all that together, while we are positioned to benefit from spread tightening, we still see enough risk to, as Bill said, not go out on a limb.

As anticipated, reported prepayment rates broadly declined by 16% in the fourth quarter. This decline reflected weaker seasonals and effective mortgage rates of over 7%, the highest in 20 years. Despite 30-year mortgage rates falling by 70 basis points over the quarter to 6.4%, 96% of mortgages remained outside the refinance window.

One thing I'd like to detail today is how decreasing rates and increasing prepayments could affect our portfolio of MSR. Let's look at this in more detail in Figure 2, which shows projected prepayment rates for our MSR versus a typical current coupon MBS in varying interest rate scenarios. Being about 300 basis points out of the money, prepayment speeds on our MSR remain very insensitive to falling rates. In fact, less than 1% of our balances have 50 basis points or more of rate incentive to refinance. The green line in this chart represents our portfolio of MSR. As you can see, even with an instantaneous 200 basis point decline in rates, speeds are projected to only increase to 10 CPR. Compare that to the current coupon, whose speeds could top 60 CPR. I'm sure some of you are thinking that although 10 CPR is still absolutely slow, it's a big increase from what we are experiencing now. That's true, but those expectations are also built into how we actively hedge our MSR.

Turning to the MSR marketplace, as is typical, the pace of sales slowed in the fourth quarter with \$53 billion offered in the bulk market. This brings the total MSR offered for the year to just under \$500 billion. 2023 finished as the second most active year in the MSR market, falling just behind 2022's total of \$525 billion. Lower supply in the

fourth quarter did little to affect the traded spreads of MSR. Bids remained well supported, as evidenced by sellers typically receiving a high single digit number of bids.

Now let's turn to Slide 11 and discuss our portfolio positioning and activity in the fourth quarter. At December 31st, our portfolio was \$14.6 billion, including \$11 billion of settled positions. On the top right of this slide, you will see a few bullets about our risk positioning and leverage. As spreads widened in October and our book value declined, we responded by selling some MBS, actively lowering our leverage to protect against further losses. Our average leverage for the quarter reflects this, decreasing to 5.8x from 6.3x at third quarter-end. Following optimistic signs from the Fed in November, we strategically increased our risk and added leverage to the portfolio. This decision proved to be effective and captured most of the retightening of spreads through year-end. Our quarter-end economic debt-to-equity was 6x. For similar reasons that we have outlined in prior calls, we continue to think it is prudent to maintain a neutral leverage position. We don't believe that we need to add more leverage to generate strong returns, as you will see in a few slides when we detail our return outlook.

Please turn to Slide 12 to review our Agency portfolio. Figure 1 shows the composition of specified pool holdings by coupon and story, and on Figure 2, you can see the performance of TBAs and the specified pools we owned throughout this quarter. We migrated the portfolio down in coupon by replacing approximately \$2.5 billion 4.5% and 6.5% TBAs with an equal amount of 2.5% to 4% TBAs in order to take advantage of the sharp cheapening of lower coupons that occurred in October. Additionally, we enhanced liquidity by rotating approximately one billion 4% to 4.5% specified pools into same coupon TBAs. At quarter-end, about 70% of our MBS holdings were in specified pools that, we believe, offered better relative value than TBAs. Figure 3 on the bottom right shows our specified pool prepayment speeds decreasing to 5.4 CPR in the fourth quarter from 6.7 CPR in the third quarter. As you can see from the chart, on aggregate, speeds for these predominantly discount pools were materially faster than TBAs, hence providing more return.

Please turn to Slide 13. Our MSR portfolio was \$3 billion in market value at December 31st, which includes the addition of \$829 million UPB through flow purchases in the quarter. As rates declined in the quarter, the price multiple of our MSR declined from 5.8 to 5.6 times. The prepayment speed of our MSR dropped by 22% to an historically low 3.8 CPR, and our expectation is that prepayment rates for deeply out-of-the-money mortgages will continue to remain at historically low levels through 2024, providing a tailwind for this strategy. Post quarter-end, we signed two term sheets, one to purchase \$3 billion UPB of MSR to settle in the first quarter, and another to sell \$1.5 billion UPB on a servicing retained basis. At current spread levels, we prefer investing capital in hedged MSR, rather than hedged securities.

Finally, please turn to Slide 14, our Return Potential and Outlook slide. The top half of this table is meant to show what returns we believe are available in the market. We estimate that about 62% of our capital is allocated to hedged MSR with a market static return projection of 12% to 16%. The remaining capital is allocated to hedged RMBS with a market static return estimate of 10 to 11%. The lower section of this slide is

specific to our portfolio with a focus on common equity and estimated returns per common share. With our portfolio allocation shown in the top half of the table and after expenses, the static return estimate for our portfolio is between 8.9% to 11.5%, before applying any capital structure leverage to the portfolio. After giving effect to our outstanding convertible notes and preferred stock, we believe that the potential static return on common equity falls in the range of 9.9% to 14.0%, or a prospective quarterly static return per share of \$0.38 to \$0.53.

Thank you very much for joining us today, and now we will be happy to take any questions you might have.

Q&A

- Operator** Thank you. Our first question is from Doug Harter from UBS. Your line is now live.
- Doug Harter** Thanks. Can you talk about what were the factors that are leading you to see the lower returns in the Agency MBS hedged with rates, other participants are still seeing kind of teens returns, and hoping you could offer your opinion as to why you're seeing 10% to 11%?
- Nick Letica** Hey Doug, this is Nick. Thank you for the question. Yeah, over the quarter, well, spreads did tighten over the quarter, as you know. For us specifically, we--and again, this is through the lens of our spreads and how we construct our portfolio on that page and capital structure of the portfolio, which can cause differences from person to person or institution to institution. But in addition to all those things we did, as you can see from our other slides, we did materially go down in coupon over the quarter, and these are nominal spreads. And when you go down in coupon in mortgages you do lose spreads. So, a lot of this spread potential is driven by the coupon selection for mortgages. And it is also just to remind everyone that it is a moment in time. It is just a snapshot of the portfolio at the end of the quarter. And it so happened that last quarter, from relative value reasons, we did think that it made sense to go down in coupon as we went through the quarter, and that does negatively impact the return potential of that segment of the portfolio. But it is by no means something that we think is long-term in nature in the sense that, as you well know, we do move our coupon exposure around quite a bit from quarter-to-quarter and in fact, over this quarter, we have gone back up in coupon. And if we were to rerun this projection today, you would see materially higher return projection out of that segment of the portfolio. So, it really is just a snapshot at the end of last quarter, reflects predominantly a down-in-coupon bias.
- Bill Greenberg** And I might just add, Doug--good morning, by the way--is that the down in coupon movement in the portfolio that Nick mentioned, we did that from a relative value perspective, because we thought the total return potential of those mortgages would be better than some of the up in coupon ones as we moved a portion of the portfolio

there. So, the lower return potential is an artifact, if you will, even though we thought the total return was going to be better by making that move.

Doug Harter Got it. And just on that total return comment, how do you think about the time frame for capturing that total return, and how do you think about the tradeoffs there between current and total return and time to recognize that?

Bill Greenberg Yeah, that's a good question. It's one that we talk about frequently when we're making these decisions. I'd say generically, we're thinking about months in terms of seeing the relative value opportunity play out over time, but it's certainly not days. We're thinking about longer timescales than that, and we generally expect them to occur less than a year. So, I'd say the timescale is generally a few months.

Nick Letica The other thing I just want to mention about the return potential calculation, as I'm sure as you guys know, there's a lot of technicalities in our market and how people look at things. We tend to look at things, our spreads, we look at them versus the entire curve, rather than just looking at things versus a blend of, for example, the 510 part of the curve. The curve is inverted. So, if you do run mortgages against the whole curve, you tend to get tighter spreads than you do if you just look at something versus the longer end of the curve. And I think that also is a factor that plays into how we look at things versus others. And of course, it just depends on the leverage people assume, also. That's a big factor as to how those numbers got determined. But it's really, as I said, a moment in time and it is something that will move around, as you know.

Bill Greenberg Well, I think there's a lot of opportunity there. There's lots of servicing that is for sale. There's lots of servicers that are moving around from sub-servicers from one to another. And I think that that our positioning in the market and what we are, which is a large owner of servicing, and a sub-servicer, is not that many of those guys in the market where people can put their loans next to someone who is--as I wrote, as I said in my prepared remarks, is eating their own cooking, right.

And I think we're able to provide sub-servicing clients a lot of what they're looking for that is underserved in the marketplace. So, I think we're really excited about that.

Doug Harter Thanks.

Bill Greenberg Thank you.

Operator Thank you. Our next question is from Trevor Cranston from JMP Securities. Your line is now live.

Trevor Cranston Another question on the Return Potential slide. You guys have been earning a pretty decent amount of float income on the MSR portfolio. When we look at the forward return projections on Slide 14, does that incorporate the impact of lower forward Fed funds on the float income component of the MSR, and also funding expenses? And I guess, generally, if you guys could just comment on how you think about the impact of lower Fed funds being on the portfolio as a whole. Thanks.

- Bill Greenberg** Yeah, good morning. Thanks for the question. So, yes, the downward sloping curve is incorporated into the float earnings of the MSR asset. And of course, the entire subject of floats is one that we actively hedge the interest rate risk of, so I wouldn't say that we experienced a windfall when rates rose, and we won't experience a large decline in book value when and if rates fall, because we're hedging that exposure. And so, that is also the answer to the question of what happens to our portfolio if the Fed cuts and if funding rates or short-term rates fall, is that because our portfolio is hedged across the curve, and as a result, our portfolio returns and how that slide of the return potential was really constructed depends on the spread between the asset and the, I'll say, longer-term rates, but notwithstanding what Nick just said about not being one point on the curve. That is true of every point that we hedge on the curve. But that's a complexity. It's the spread of the asset relative to the risk-free curve that matters and not the funding rate, itself. And so, I'd say to zero order, that's hedged. And if you want to talk about it more completely, I think it actually--the returns would go down slightly because of the risk-free rate that's earned on the equity.
- Nick Letica** But to your base question, those calculations all assume that the forward curve is realized. So those are all embedded in the calculations.
- Trevor Cranston** Right. Okay. That makes a lot of sense. And then, Bill, you talked about some of the opportunities for growth in the subservicing business, in particular. I was wondering if you could expand a little bit on that and talk about sort of how you see the magnitude of potential growth on the subservicing side of things, specifically over the next couple of years? Thanks.
- Bill Greenberg** Yeah, sure. Well, as I said in my remarks, the interesting thing that's happened in the servicing market over the last year or two is that rates have risen so much, and the mortgage universe as has been well described by us and others, has an average dollar price of 80 and is more than 300 basis points out of the money. And so, the risk characteristics of the asset is something that hasn't really been seen before. You see it a little bit on the chart that Nick talked about in his presentation where we showed the relative S curves of the portfolio on page, what page is that there? Whatever, where we showed that if rates fall 200 basis points, Page 10, that the prepayments on our portfolio aren't expected to increase very much. It has very low prepayment sensitivity. It has very low convexity. And so, it's just a risk profile that's not been seen before. And as a result, we're seeing lots of interest from market participants who are not the usual cast of characters that are buying MSRs. And there's been lots of structures that have been created in the marketplace in order to help those nontraditional market participants invest in the MSR market. And I think there's lots of reasons why we are the best subservicing partner for those new investors, chief among them being that we have \$200 billion of our own servicing that is at RoundPoint, and we will be subject to the exact same results of the subservicing platform, RoundPoint, as any third-party clients that we bring in, too. I like to say that we are managing subservicing for MSR investors by MSR investors, meaning that we know exactly what MSR investors like to see in trying to extract the value from the cash flows and so forth. There are other reasons, as well. We're a well-capitalized institution, which provides the wherewithal to invest in infrastructure and deal with any market uncertainties that occur then, too. So, I think for all those reasons, this is

one area that we're going to focus on as being able to grow our subservicing business from that perspective.

Trevor Cranston Got it. Okay, that's helpful. Thank you.

Bill Greenberg Thank you.

Operator Thank you. Our next question comes from Eric Hagen from BTIG. Your line is now live.

Eric Hagen Hey, thanks. Good morning, guys. Hey. So, how do you feel like you control for recapture in the MSR without an origination platform, and how secure do you feel like that is? And do you have an estimate for how much MSR you might need to buy if mortgage rates were like 50 basis points or 75 basis points lower than they are, today?

Bill Greenberg Not sure I understood the second question, but the first question is, but the answer to the first question is that we have, as we said in our prepared remarks, we have hired an experienced professional to begin the build out of a recapture or portfolio defense strategy, in order to provide that not only to our own portfolio, but also to any third-party clients that we have. That process is ongoing. We're hiring people, we're filling roles. And as we said in the prepared remarks, we expect to be able to be making loans in Q2. Again, looking at Page 10 and looking at how far out of the money our servicing portfolio is, we feel like we have time. There's no particular urgency to this, although we are certainly acting with due haste in order to build it as quickly but as prudently as we can. And again, the main point here is, we're not going to be a retail originator. We're not going to be someone who's going to compete with the largest guys out there in the world. The point of this thing is really to protect our servicing portfolio, to defend our portfolio, to perform recapture on our portfolio. And we're really excited about the opportunity and the ability to be able to build this thing from scratch.

Nick Letica Eric, if I could build on, this is Nick. I just want to build on what Bill said. And I think to your second question, which I also didn't fully understand, but as that slide shows that Bill refers to on Page 10, our MSR is very far in the money and speeds, even with a reasonable rally, are going to stay slow. So, we're not as though we're going to--it would be very, very surprising if we were to see a rapid amortization on our MSR, as it is. So we are, as we also said in our prepared comments, we really like the paired strategy. As you know, we like it right now; I think looks great on a return potential. So, our intention is new capital as we have to keep adding to it, but we don't really see the paydown being a big issue for the near future.

Eric Hagen Okay. Yeah, thanks for fleshing that out. You guys talked about a neutral leverage position, but if you do see growth opportunities in the MSR, I mean, is there room for that to change and what are the parameters for it to change? And especially if the Fed cuts rates, I mean, do you feel like you would still run with this level of leverage, and how much flexibility do you feel like you have there if the Fed cuts?

Nick Letica In terms of leverage, yes, definitely, we are running in what we think is a neutral territory. As we said again, in our prepared remarks, spreads are at the tighter end of

recent ranges, and we think they price in a lot of what the market expects the Fed to do, perhaps too much. But there's still volatile events ahead of us, and we think spreads are kind of two-sided, right now. So look, lots of things can change this year. We have a year coming up with a big election coming up that can have a lot of ramifications and geopolitical tensions and other things. So, we're going to just see where the market takes us and what makes the most sense, but for the near future, we kind of see ourselves as being in this kind of leverage posture.

- Eric Hagen** Got it. All right, thank you, guys.
- Bill Greenberg** Thanks, Eric.
- Operator** Thank you. Our next question comes from Ken Lee from RBC Capital Markets. Your line is now live.
- Ken Lee** Hey, good morning. Thanks for taking my question. In terms of the IXM that you report in the quarter, wonder if you could just further expand upon the portfolio activity that you mentioned in the prepared remarks that, potentially, impacted IXM in the quarter. Thanks.
- Nick Letica** Sure. So as discussed, we did go down in coupon, which was a factor that took our IXM down for the quarter, as well as--as we mentioned, we did sell some mortgages when things widened out in October, which we felt was prudent just given the environment at the time. And as you'll know from our prior calls, we've been talking about the fact that going into last quarter, the market was different than it was the prior year. We did feel like there was money managers had already expressed a pretty big overweight in the market and there were still vol events ahead of us. So, we decided in that time slice to reduce our exposures to mortgages and that, as mentioned, comments that Mary made, we did have reduced balances in the portfolio for a period of time and a little lower leverage. All of those things did impact our IXM for the quarter. But as discussed, we did buy back some mortgages, bring back our leverage up, and we have also gone back up in coupon, since the end of the quarter. So, all of those things for this quarter, we think will have a positive effect in the right direction.
- Bill Greenberg** I might just add a couple more thoughts if I can, which is even without portfolio activity, there is natural variation in the backward looking IXM that occurs just from timing of cash flow. As you know, MSR is not a bond. It doesn't pay a fixed coupon, every month. Some people pay their mortgage payment and, therefore, they're servicing on the 31st of the month and, therefore, they don't have to pay any for the next month. Or sometimes, they pay it on the first and then the 30th. So, there's two, in one month versus another. There are all kinds of interesting timings of cash flows on the MSR asset that occur, right. And also, of course, we know that the IXM, the backward looking IXM, also reflects actual prepayment speeds. So, prepayment speeds come in slower than we thought or slower than projected, that will be a benefit. If they come in faster than expected, that would be a disadvantage and so forth. So even without any portfolio activity, there's natural variation. At the quarter-end, we think all of that being considered, taking into consideration the forward-looking projection on Slide 15

there is a good estimate of what we think the portfolio will learn. And as Nick said earlier, that snapshot at the end of the quarter is actually lower than it would be if we rent today by a couple of hundred basis points probably. And so, given all that and how that corresponds to dividend, we feel pretty good.

Ken Lee Got you--got you. Very helpful there. And just one follow-up on the potential expansion on the RoundPoint, the DTC channel. Wondering how should we think about potential need for investments or spending along with those efforts? Thanks.

Bill Greenberg Yeah, we think the capital investment for that activity will be pretty low. The intent is not for us to originate these loans and necessarily hold them all. We will do what is normally done in these sorts of things, which we'll originate the loans and sell them directly into the Agencies. And we'll keep the servicing for ourselves, of course. And the idea is that this is just going to replace the servicing that, otherwise, would have run-off and would have disappeared. And the benefit of having it in-house and having the recapture thing is that we can keep the servicing. We can keep the loans on the RoundPoint platform, rather than having them refinance away. So, that's the whole idea of what we're trying to do with this direct-to-consumer channel.

Ken Lee Got you. Very helpful there. Thanks again.

Bill Greenberg Yeah, thank you.

Operator Thank you. Next question is coming from Bose George from KBW. Your line is now live.

Bose George Hey, guys. Good morning. Actually, could we get an update on your book value, quarter-to-date?

Bill Greenberg Yeah, as of the close of Friday, we think that book value is up between 1% and 1.5%.

Bose George Okay, great, thanks. And then the range in your target of IXM, what takes you to the high end versus a low end? Is it a lot of prepayment expectations, or just curious what kind of drives that range?

Nick Letica Hey, Bose. Nick, thank you for the question. We have various factors that go into that range. Among them would be our prepayment assumptions, as well as some of our funding assumptions. And those are things that are primary drivers of that range.

Bose George Okay, thanks. And then just in terms of where that number is intra-quarter, Bill, did you say it's going to back up a couple of hundred basis points? Is that what you said?

Bill Greenberg Yeah, again, as Nick and I both said, it moves around with the portfolio and so forth. But I'd say given our current coupon distribution and so forth, yeah, that's about the right magnitude. On the security side of the portfolio, not on the combined thing. If you look at the RMBS part, which is 10 to 11, that's probably 200 basis points higher given our portfolio right now, but not in the overall.

- Bose George** Okay, great. Thanks.
- Operator** Thank you. Next question is coming from Rick Shane from JPMorgan. Your line is now live.
- Rick Shane** Thanks guys, for taking my questions, this morning. I just wanted to talk a little bit about the use of the ATM, during the quarter. Curious if this is going to be something we should expect going forward, more aggressively. When we do the math, it looks like you did the offering a little bit below \$14 per share and even on a sort of mark-to-market basis. If we go back to your comments last quarter at this time about where book value was intra-quarter, it looks like the offerings were dilutive to book, modestly. Can you talk about the rationale for that, please?
- Bill Greenberg** Yeah, sure. Thanks, Rick. I think that's correct. We also saw them as modestly dilutive to book. The rationale is the same as what we said when we raised capital in February of 2023. We think that at its most sort of mechanical level, that even at a slight discount to book, the dilution of the expenses means that the return on the investment of that dilution is still quite high, certainly higher than our cost of capital. It's in the, I'd say, mid-double-digits. By that I mean 30%, 40%, somewhere in those sorts of numbers. And also, as we always say, we have to have something that's good to do with the money, and we think we do, which is to buy more MSR with that money. In February, of course we did that right away. Today, we're looking for pools to buy that fit our criteria. But with the RoundPoint acquisition, the earnings that we make on new MSR purchases are greater than the existing MSR that we have in our portfolio because the marginal cost of service goes down with the more loans that we have on the platform. And so, it's a really very powerful set of math in order to take that money and invest in new MSR, where we are the servicer and we get the benefits of the economies of scale that we thought that paying a slight dilution, today, was well worth it for those reasons.
- Rick Shane** Got it. Thank you. And then there was some repurchase of the prefs as well. Is that just an arbitrage when you see the implied yield on the prefs, approaching the yield on the common, you'll step in, or how should we think about that? What drove it? Because it seemed like it was across all three of the prefs.
- Nick Letica** Hey, yeah. So, as you know, for a long time, we've been managing our capital structure, and we do consistently, constantly evaluate where our preps are trading relative to our assets and where the arbitrage lies. And I think, and as you guys know from prior times, we have been seeking, all else being equal, to reduce our share of prefs as a percentage of our total shareholder equity. So, those things, last quarter, they did align the prefs. So, we did buy back a little over 200,000 shares of prefs, which is activity we'll continue to do, should they trade at an attractive level, as you said, relative to where our investments are.
- Rick Shane** Got it. Okay, that's it for me. Got it. Thank you.
- Bill Greenberg** Thanks, Rick.

- Operator** Thank you. Next question is coming from Arren Cyganovich from Citi. Your line is now live.
- Arren Cyganovich** Thanks. The question I have is more on the spread tightening that happened in the fourth quarter. I believe that you typically have your portfolio to benefit from spread tightening. Why did the book value not benefit from the spread tightening that happened in November and December?
- Nick Letica** Arren, well, I mean it did. If you look at the progression of our TER for the quarter, in our last quarterly call, which I think was right at the end of October, beginning of November, we reported an approximate book value decline, about 6% at that time and yet, we ended up the quarter at up two. So, there was a material reversal, and there were things in the quarter, such as our ATM issuance and other things that did impact our TER, and it would have been higher, for example, if we hadn't done that. But we did, as mentioned in the comments, we did decide, I think prudently at the time, to sell some mortgages in October, as the book value was declining. And then we did immediately in November, when there was a sentiment change to start buying them back. But when you engage in that kind of activity, it does tend to impact your book value. Now mind you, if you look at our risks, at the end of last quarter, we had something like average return of mortgages, something like 6% positive book value for 25 basis point tightening in mortgages, and which is not the same as some of our peers that are just more purely an Agency spread play. As we've discussed, our capital structure, where we have 38% of our capital in mortgages and the majority of it in hedged MSR is going to not give us the same amount of volatility and exposure to mortgage spreads in both directions, right. In the third quarter of last year, we vastly outperformed our peers when mortgage spreads widened, and then this prior quarter was the opposite. And that's by construction. And it is why you're not going to see the same kind of numbers out of us, generally speaking, compared to some of our other peers when you have mortgage spreads as they move around.
- Bill Greenberg** Yeah, I just had a couple of comments. I think Nick said the salient point, which is that our capital structure, our asset allocation, rather, only has 38% of our assets allocated to RMBS. So, if a pure agency strategy is going to return 10% in a quarter like this, we only have 38% of that. So, it's going to be high 3% sort of number. And then there's other things on top of that in terms of how people hedge or various other things that go into impacting that. But the point is that our portfolio is by choice, meant to emphasize, maybe overemphasize, the MSR part of the portfolio, 62% of our capital structure. And we think the RoundPoint acquisition is going to be able to add even more revenue to that part of the strategy. And then the RMBS, which is 38%, serves to hedge the interest rate risk and the mortgage risk of the MSR portfolio, and also to provide a store of liquidity for rainy days, and so forth. But the result of that is that we just have less exposure to mortgage spreads than portfolios without Agency MSR, and we like that. And that's the strategy that we're pursuing, and we think it's really good.
- Arren Cyganovich** Okay, yeah. And then on the direct-to-consumer build out, sounds like you're doing that organically versus going out to acquire something? What's the benefit of doing that versus going to buy something that's existing? And then would you be, in addition

to protecting the MSR, would you be marketing outside of your existing servicing mortgages, or would it be kind of just more specifically targeted at your own book?

Bill Greenberg Yeah. The benefits of building versus buying are the same as any kind of decision like that. Same as about remodeling your house, rather than buying an existing one. You get the thing that you want. And with this environment and lots of other structures out there, or companies out there that are upside down on costs or are built for a different environment, or have legacy risks of some kind, we don't want to be involved in any of that. We're going to build the platform that we want that's perfectly suited for our needs. And I don't feel like we are stressed for time here because of where the gross WAC is of our portfolio and the current outlook of rates. We're just miles and miles away from being able to refinance and so, we have the time. It's not going to take forever to build this thing, as I said. It's going to be just measured in months, right, not years. And so, we have the time. We're going to build exactly what we want. We're going to have no legacy issues or risks, and we're going to focus on recapture on our portfolio. That's the main thing of what we're doing here. You ask whether we're going to go out and try to market to the whole world, and so forth. That's really a very different business model than what we have in mind. We're really focused on portfolio defense and recapture of our portfolio.

Arren Cyganovich Okay. Got it. That sounds better, since the alternative would be pretty expensive, I'd imagine. All right. Thank you.

Bill Greenberg Yes, exactly. Thanks very much, Arren.

Operator Thank you. We have reached end of our question-and-answer session. I'd like to turn the floor back over for any further or closing comments.

Bill Greenberg Just want to thank everyone for joining us today. And thank you, as always, for your interest in Two Harbors.

Operator Thank you. That does conclude today's teleconference webcast. You may disconnect your lines at this time and have a wonderful day. We thank you for your participation today.

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