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TWO - Q1 2017 Two Harbors Investment Corp Earnings Call

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PRESENTATION

Operator

Good morning, my name is Kaley and I will be your conference facilitator. At this time, I would like to welcome everyone to Two Harbors First Quarter 2017 Financial Results Conference Call. (Operator Instructions) I would now like to turn the call over to Tim Perrott, Senior Director of Investor Relations for Two Harbors.

Timothy J. Perrott - *Two Harbors Investment Corp. - Senior Director of IR*

Thank you, Kaley, and good morning to everyone. Thank you for joining our call to discuss Two Harbors' first quarter 2017 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 a brief recap 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 may find them on the website or the SEC's website at sec.gov. In our earnings release and slides, 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'd like to remind you that remarks made by management during this conference call and supporting slides, may include forward-looking statements. Forward-looking statements reflect our views regarding future events and 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. They imply risks and uncertainties, and actual results may differ materially from expectations. We urge you to carefully consider the risks described in our filings with the SEC, which may be obtained on the SEC's website at sec.gov. We do not undertake any obligation to update or correct any forward-looking statements if later events prove them to be inaccurate. I will now turn the call over to Tom.

Thomas Siering - *Two Harbors Investment Corp. - CEO, President and Director*

Thank you, Tim, and good morning everyone. We hope that you had a chance to review our earnings press release that we issued last night. As you can see, we are off to a terrific start to the year as our team continues to execute in accordance with our previously articulated plan for 2017.

In the quarter, we drove solid increases in book value, core earnings and comprehensive income, and are on track to deliver strong earnings this year. In support of this, we are intent on running a leaner business model focused on allocation of capital to the most attractive market opportunities and by cost containment. Through our attention to risk management and asset selection, our performance this quarter again demonstrates our ability to deliver stable and strong returns for shareholders through a variety of rate environments.

Looking at the highlights of our financial results, as reflected on Slide 3, we delivered a total return on book value of 3.9% and generated comprehensive income of $146 million or $0.42 per weighted average share. First quarter GAAP net income was $0.21 per weighted average share and core earnings were $0.27 per weighted average share, consistent with our plan. Our rates, credit and commercial strategies all contribute to our solid performance during the quarter. We opportunistically added agency pools as we raised capital. I would also highlight that our MSR position continues to grow and is performing well, helping to provide book value stability.

The environment for credit continues to improve with economic growth, strong employment and increasing housing prices all enhancing the long runway for our valuable credit portfolio. The opportunities for high-quality commercial lending are abundant and our loan portfolio continues to expand.

Additionally, we continued to manage our balance sheet and capital structure to benefit stockholders. Specifically, we recently executed convertible debt and preferred stock offerings that we believe will be accretive to earnings in 2017 and beyond.

Please turn to Slide 4. Overall, we are off to a great start and are very encouraged about the opportunities ahead in 2017. Moving forward, we will continue to execute upon the plan we outlined during our recent Investor Day, and look for additional ways to optimize our business in order to maximize value for our shareholders.

We continue to see attractive investment opportunities in all of our business strategies, which we will pursue while not losing focus on our disciplined and refined approach to risk management. Because our approach leaves us largely insulated to changes in rates, we believe that we are well-positioned to deliver strong value for shareholders in this environment.

I will now turn it over to Brad for a review of our financial results.

Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

Thank you, Tom. Let's turn to Slide 5. Our book value at March 31, was $9.91 per share compared to $9.78 at December 31, and we declared a $0.25 dividend per share. We delivered comprehensive income of $145.7 million or $0.42 per share in the first quarter.

Please turn to Slide 6. Beginning this quarter, we are revising our methodology for calculating core earnings, a non-GAAP measure, to exclude amortization of our unvested restricted stock.

Because of the fair value volatility associated with restricted stock amortization, and the non-cash nature of the expense, we believe this change creates a more meaningful definition of core earnings that better reflects recurring cash earnings. As such, excluding the restricted stock amortization, core earnings were $0.27 per share in the first quarter. Without this change to the definition, our core earnings for the first quarter would have been $0.26 per share. For the fourth quarter of 2016, revised and unrevised core earnings would have been $0.25 and $0.24, respectively.

Please see Appendix Slide 17 in the earnings presentation for historical data on revised and unrevised core earnings.

In the quarter, core earnings principally benefited from a $3.3 million increase in net carry from purchases of RMBS at higher yields, growth of our commercial real estate portfolio and higher average leverage during the quarter. Additionally, we realized a $13.6 million increase in servicing revenue net of estimated amortization, driven primarily by portfolio growth, and importantly, lower prepayments in the quarter.

We'd also like to highlight that core earnings, attributable to common shares this quarter, was not reduced by any preferred stock dividends given the timing of our issuance. Beginning next quarter, any preferred stock dividends will be reflected in our results. I would note that our second quarter results will likely include an additional $1.4 million of preferred dividends as it will cover an extended period from March 14 to July 27. As a reminder, both common stock and preferred stock dividends are subject to the approval of the Board of Directors.

In the quarter, our debt-to-equity increased to 4.9x from 3.9x and our average debt-to-equity increased to 4.4x from 4.2x in the fourth quarter. The increase in our debt-to-equity, quarter-over-quarter, is largely a product of our increased Agency RMBS position.

Our other operating expense ratio decreased to 1.8% down from 1.9% in the fourth quarter, despite significant business activity. As we have said on past earnings calls, we believe that our expense ratio will stabilize in the 1.6% to 1.8% range as we continue to support our strategies.

Please turn to Slide 7. We are focused on constructing a dynamic and diversified financing profile, including traditional repurchase agreements, the FHLB, revolving credit facilities and convertible senior notes. We had $13.6 billion of outstanding repurchase agreements at March 31, with 24 counterparties.

The repo markets continue to function efficiently for us and we have not observed any disruptions. We continue to thoughtfully manage our FHLB capacity. Our FHLB advances totaled $3.6 billion at March 31, with a weighted average borrowing rate of 1.04%. MSR is being financed through both revolving credit facilities and the convertible debt issuance. At quarter-end, we had $15 million of short-term borrowings under revolving credit facilities, with additional available capacity of $55 million. Subsequent to quarter-end, we added an additional $20 million of capacity under one of our facilities.

Additionally, as we mentioned on our prior earnings call, this quarter we completed an offering of convertible unsecured senior notes. This is a great example of expanding our toolbox to improve our financing profile. While there are some larger MSR financing facilities in the market recently, the spreads range between 500 to 550. We were able to add the convertible debt issuance at a fixed rate of 6.25%, which we felt was a much better rate due to the 5-year term.

We now have 4 facilities in place for financing commercial real estate and expanded one of our facilities from $250 million to $400 million in the first quarter. We expect to add more counterparties in the next several months as there are a significant number of counterparties in the market that have both the knowledge and the balance sheet to support our CRE portfolio as it grows. We have provided some additional details on our borrowings on Appendix Slide 25.

I will now turn the call over to Bill for a portfolio update.

William Roth - *Two Harbors Investment Corp. - CIO and Director*

Thank you, Brad, and good morning, everyone. We had a strong quarter across all of our strategies, particularly our credit strategy. With a focus on asset selection and maintaining low exposure to interest rates, we opportunistically added Agency and non-Agency RMBS and continued to grow our MSR and CRE portfolios.

Looking at Slide 8, you will see both our portfolio composition at March 31 and our capital allocation quarter-over-quarter and year-over-year. Capital allocated across our 3 strategies remained consistent with the prior quarter.

Moving to Slide 9, I'd like to go over a few of the drivers of our portfolio performance in the first quarter. Interest rates were less volatile, with the curve flattening modestly. Agency RMBS prices were relatively flat, while non-Agency spreads tightened, positively benefiting our credit strategy and overall performance.

Our annualized portfolio yield was 3.99% up from 3.54% in the fourth quarter. This increase was largely driven by higher yields in our rate strategy, including seasonally lower prepayment speeds typically experienced in the first quarter of the year that particularly benefited our MSR position. Our non-Agencies performed well, as there was increased demand for assets with exposure to residential credit risk.

Commercial real estate also performed very well in the quarter delivering a 6.2% yield.

Please turn to Slide 10, as we discuss our rate strategy. As we have mentioned in the past, our approach to risk management is designed to provide book value stability, through different rate environments. We believe that we can drive strong returns by getting better spreads with lower risk and without taking outsized interest rate exposure.

MSR is an important component of our rate strategy as the combination of agency pools and MSR drives a higher return with less basis risk than agencies hedged with swaps. We think that this is particularly important given the potential spread widening that could occur if the Fed reduces their MBS holdings later this year and into 2018. Furthermore, as we mentioned in our Investor Day presentation, with the issuance of the convertible debt financing, we have been able to add a modest amount of leverage to our MSR and increase our expected returns.

In terms of portfolio activity, during the quarter in our rates strategy, we sold some pools at lower yields while buying additional pools at higher yields. You will note that our balance of agency pools, including TBAs, went from $9.3 billion at December 31 to $13.6 billion at March 31. The primary driver of this increase was due to initially deploying proceeds from the capital raises in the first quarter into highly liquid agency pools in order to maximize returns, with a plan to redeploy that capital into MSR and commercial real estate assets.

We expect that as this happens, our agency pools balance and overall leverage will drop back down. To highlight this, subsequent to the quarter-end, we entered into an agreement to purchase approximately $12 billion UPB of new issue conventional MSR for about $130 million. As usual, this is subject to GSE transfer approval. Additionally, during the quarter, we added approximately $7 billion UPB of new issue conventional MSR from flow sale arrangements. It is our expectation that near-term flow sale MSR volume will run between $2 billion to $2.5 billion UPB per month. We expect to continue to grow MSR as a component of our rates strategy of 2017.

Let's move to Slide 11 to discuss our credit strategy. Residential credit performed very well in the first quarter as spreads tightened and as asset class continues to experience fundamental improvement and positive market technicals. Home prices have outperformed expectations, up 7% on a rolling 12-month basis, boosted by affordability, low housing supply and strong demand. Additionally, prepayments are higher year-over-year as exemplified by our 3-month CPR increasing to 6.7% from 5.3% a year ago. We believe that future upside for residential credit, and therefore our non-Agency holdings, will be driven by increasing prepays, lower delinquencies, defaults and severities.

We opportunistically bought about $340 million of legacy non-Agency securities in the quarter as we saw bonds with upside potential trading at attractive levels. We anticipate that this strategy will continue to perform well and with our portfolio having an average market price of about $75, we believe we have the ability to realize future upside.

Please turn to Slide 12 as we discuss our commercial strategy. Our portfolio grew to $1.5 billion in the first quarter, with an average stabilized LTV of 64% and an average spread over LIBOR of 478 basis points. While the first quarter of the year is seasonally slow for commercial real estate, recently, we have seen a tremendous amount of loans come into our purview. Subsequent to quarter-end, we have about $300 million of loans in our pipeline that are either closed or under contract. As a reminder, we are focused on leveraged first mortgage loans in the top 25 and up to top 50 MSAs in the United States. We believe these markets provide ample supply of high credit quality properties to lend against, sufficient number of owners and sponsors with institutional attributes and adequate market liquidity. We remain focused on growing this portfolio of high-quality loans.

Our performance this quarter is a testament to our focus on asset selection, while maintaining a sophisticated and sensible approach to risk management. Looking forward into 2017, we see attractive investment opportunities in our target assets and aim to execute on our plan to drive increased earnings this year.

With that, I will turn the call back over to Kaley for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Bose George with KBW.

Eric Hagen - *Keefe, Bruyette, & Woods, Inc., Research Division - Analyst*

It's Eric on for Bose. Bill, I'm hoping you can expand on the last couple of sentences of your opening remarks. Can you talk about where you're finding the best incremental opportunities for new investments, including some of the gross ROEs that you expect to hit on those?

William Roth - *Two Harbors Investment Corp. - CIO and Director*

Yes, Eric, this is Bill. Yes, I mean, I think what we're seeing today is fairly consistent with what we've talked about in the last several quarters. The best opportunities that we're seeing continue to be MSR, combined with pools which we see expected gross returns in the low to mid-double digits. We've talked about the CRE opportunity where returns are also in the low to mid-double digits for levered first mortgage loans. And then, additionally, I commented on the call about non-Agencies with the upside potential we see there. So I'd say that consistent with what we said before, we're really focused on primarily the MSR and CRE for capital deployment as we move through the rest of the year.

Eric Hagen - *Keefe, Bruyette, & Woods, Inc., Research Division - Analyst*

Right. Has your target leverage changed at all in those segments prior to where it was maybe a few quarters ago? Or last quarter?

William Roth - *Two Harbors Investment Corp. - CIO and Director*

Yes. Not really. I mean, what I would say about leverage, and I did mention this on the call, we had a convertible bond and preferred stock issuances which we deployed primarily into agencies as a placeholder -- opportunistically during the quarter. But you should expect to see our overall leverage move lower as we redeploy those proceeds into MSR and CRE. One thing that is worth noting is that by having the MSR in our portfolio, it allows us to own more agency pools relative to our size without taking on the additional basis risk. On the margin, we can run slightly higher leverage because of that fact. But we're not looking at changing leverage away from that.

Thomas Siering - *Two Harbors Investment Corp. - CEO, President and Director*

Yes, Eric, it's Tom. When you raise capital to minimize the drag from the additional capital, the quickest way to put it to work, obviously, is within the Agency space. So our leverage ticked up as a result of that but then as we reallocate to other areas you should expect it to tick down. So the short answer to your question is no, our target leverage hasn't changed significantly.

Eric Hagen - *Keefe, Bruyette, & Woods, Inc., Research Division - Analyst*

Got it. No, that definitely makes sense. Just one from me, if you don't mind. I mean, following up on that comment about basis risk, I think we've become accustomed to seeing a core position of options in the portfolio, including things like puts and calls on TBAs. Should we expect the size of that to change at all with respect to the size of the Agency portfolio? Or are you generally comfortable with the amount of convexity protection that you're getting from the MSR portfolio as well?

William Roth - *Two Harbors Investment Corp. - CIO and Director*

Well -- this is Bill, again. The amount of optional protection that we carry at any given time is really a function of a couple of things. First of all, obviously, how much we have in agencies. So the bigger it is, you can expect us to have more protection, and then the relative pricing attractiveness of that versus other potential choices. More recently, we've seen -- since the fourth quarter, we had a big move in rates. Rates have been fairly muted. If you look at the first quarter, it bounced around, but generally, volatility was very low. So when volatility is low and you can buy options cheaply, we would typically have more and vice versa. When it's expensive, we would have less. But I think the big driver will be the amount of pools that we have. I mean, to be clear, our thinking on the use of those has not changed.

Operator

Our next question comes on the line of Trevor Cranston with JMP Securities.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

Another couple of questions on the MSR portfolio. First, you guys added the $12 billion pools subsequent to quarter-end and, obviously, talked about the expectation for flow volume. Can you comment on what you're seeing in the sort of MSR availability for sale outside of the flow agreements and if there has been much change in terms of market competition for those assets, since interest rates have moved higher over the last few months?

William Roth - *Two Harbors Investment Corp. - CIO and Director*

Yes, so we have seen some bulk pools out for bid, nothing extraordinarily out of the norm. I think you saw some pools come up for bid in the first quarter because the rate moved higher and some folks maybe wanted to take advantage of that, that had been sitting on some when the evaluations of what they had increased. But our approach, frankly, is really geared towards the flow. Opportunity -- we have about 16 sellers currently that we work with, and I talked about the pace. Our interest in taking advantage of bulk pool really just would be opportunistic. We saw an opportunity to buy a pool that really the characteristics were good, the price is good, et cetera, and so we would take advantage of that. But I would not say that the landscape has changed dramatically one way or another vis-a-vis overall transaction volume or supply or, frankly, the level, the price level. Valuations are roughly consistent to where they've been for the last 6 months to 18 months.

Thomas Siering - *Two Harbors Investment Corp. - CEO, President and Director*

Yes, and keep in mind, too -- it's Tom. We have a very bespoke interest in MSR. In other words, current coupon, high-quality, more or less new productions. And so that doesn't really lend itself broadly to bulk purchases but, as Bill said, opportunistically we'll certainly play there.

Trevor John Cranston - *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

Right. That makes sense. Okay. And then on the financing side for the MSRs. Obviously, you guys have some capacity in place currently. Could you just give us an update on sort of what you're seeing in terms of availability? And if you expect that to just continue growing incrementally as MSR continues to be added to the portfolio?

Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

Trevor, this is Brad. I'd say long-term we're optimistic that participants are coming back to this space. What we're seeing right now is more focused on -- or at least the deals that were out, were more focused on Ginnie Mae collateral. And they were starting to become a better size, but the pricing was still a little off. So I think, if we wait patiently, I think we'll start seeing some opportunities in the market. We are looking at that quite in-depth and we think -- there's -- in the next 12 months, we think there is some opportunity to start adding some more secured MSR financing net rates that we find appealing. The good thing is we're seeing a lot of participants really start designing structures that are both appealing to our REIT and as well as, just obviously, economically appealing. For now, the 2 facilities we have, we're happy with, as well as offering that convertible debt -- in the near-term, was a nice way to apply some leverage to the MSR. It'll take a bit of time, but we do think the market will come back. I think it first came back with a little bit more focus on Ginnie Mae, but we will see opportunities for other conventional collateral as well.

Operator

Our next question comes from the line of Samuel Choe with Credit Suisse.

Samuel Choe

This is Sam, filling in for Doug. I mean, you guys have been pretty consistent in saying that you guys like the MSR and the commercial space. I was just wondering if you provide any guidance on how these assets might comprise of the entire investment portfolio by year-end?

William Roth - *Two Harbors Investment Corp. - CIO and Director*

This is Bill. Thanks for joining us. I think, consistent with what we said on our Investor Day back in March, we continue to expect to deploy capital of somewhere between 0.5% and 1% to 1.5% combined to those 2 on a monthly basis throughout the remainder of the year, assuming the opportunity in each was still attractive. I think given that we still do view both of those opportunities as quite attractive, I think that pace is -- we would not change our view on that kind of pace of deployment for the remainder of the year.

Samuel Choe

Got it. Okay. And my second question was, after the capital raises, I was wondering how much leverageable capital you guys have on hand? I'm not sure if you guys disclose that number.

Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

Just want to make sure we understand your question.

Samuel Choe

More like excess capital, yes, just excess capital.

Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

Generally speaking, we're fully deployed on at this time. Obviously, we carry unencumbered cash for both -- from a risk and a managing of margin protection. But from a deployment perspective, we feel we're deployed from the preferred and convertible debt offering.

Operator

Our next question comes off the line of George Bahamondes with Deutsche Bank.

George Bahamondes - *Deutsche Bank AG, Research Division - Research Associate*

Pretty much my questions on MSR were answered earlier, but just one more on my end was, I noticed that the servicing expense decreased a bit. Was wondering if you could clarify what some of the drivers were there?

Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

Yes, I'll take that question. So you're going to have to dig into a little bit of the details there, but one of the reasons it jumped down a little bit is we released some rep and warrant reserves in the quarter, so some of that is just more driven by our accounting around reserves versus necessarily the run rate on underlying expenses. Our underlying kind of cost to subservice has remained consistent quarter-over-quarter.

Operator

And our next question comes on the line of Joel Houck with Wells Fargo.

Joel Jerome Houck - *Wells Fargo Securities, LLC, Research Division - MD and Senior Analyst*

First one is just about the $340 million purchase of legacy non-Agency RMBS. I guess, maybe you could provide a little bit color on what was unique about that particular purchase, given that your overall theme has been one that kind of let that portfolio wind down and in some cases you've been very clear about selling down exposure. So, I guess, that's the first question.

William Roth - *Two Harbors Investment Corp. - CIO and Director*

Joel, thanks for joining us today. This is Bill. I mean, I think, let me answer that. You had a few questions in there. So the first thing, in terms of the selling down, what we said in the past and what we focused on doing is selling bonds that basically had run out of room and from a price standpoint. In other words, if we bought something at 50 and it's now trade -- and it had all this upside, and it's now trading at 95. There's just not much upside to capitalize there. So I'd say that the bonds that we've sold historically over time have typically been very high dollar price where there was really not much more upside available. In terms of sort of why we added the portfolio, there were some opportunities that we saw to buy deeply discounted bonds, and if you think back to what we talked about on Investor Day, the supply/demand equation for housing is very favorable in terms of potential future price appreciation. Affordability is still very, very favorable and the tailwinds that we see to this strategy are also extremely favorable. So we believe that -- and the fact -- to give you an idea, we talked about the most recent increase year-over-year in housing prices. One investment bank just increased their forecast for 2017 by several percentage points. I mean, the gist of it is that what we bought it is our deeply discounted bonds where we think there's a lot of upside and that's what we're focused on capitalizing on. So I think the way you should think about our approach to that is, when bonds have run out of room, it's not unfair to assume we might sell them. But where there is opportunities for bonds that have decent initial expected ROEs with a lot of price appreciation capability, those are the kind of bonds that we really like.

Thomas Siering - *Two Harbors Investment Corp. - CEO, President and Director*

So Joel, not surprisingly, we keep very close track of housing data. I mean, obviously, it's an obsession of ours. And if you look at the data around things like household formation versus new construction, you look at affordability, it's pretty easy to stay -- continue to be bullish on HPA and the reason that our prepayments have upticked as they have in the non-Agency space, is just because people are coming into the money primarily and are able to refinance. And so we see those trends continuing throughout the year. So I think Bill said it right -- that opportunistically we saw some bonds that really fit our profile and while it was admittedly somewhat unexpected, it was serendipitous.

Joel Jerome Houck - *Wells Fargo Securities, LLC, Research Division - MD and Senior Analyst*

Yes, I mean, you guys have been good recyclers of capital in this particular subsector, I guess, we were thinking perhaps there weren't that many opportunities out there to buy deeply discounted bonds, but obviously, there still are. On the second point, you brought up, Tom, that the home price appreciation in CoreLogic up 7% in the last 12 months. That's now accelerating. And you hit on some of the points of why that may be the case. I'm wondering kind of is the outlook here any type of abatement of home prices just given the strength we've seen recently or is this the situation where there's -- could be a lot more upside in terms of home prices given the factors that you cited a few minutes ago.

Thomas Siering - *Two Harbors Investment Corp. - CEO, President and Director*

Well, yes, I mean, if you look at most experts, their recent changes to HPA have been going up and it's for the factors that I talked about. If you look at relatively simple data, like household formation versus new construction, it's pretty easy to continue to be bullish on HPA. There are more households being formed than there are homes being built. If that continues, simple math say prices have to go up.

Joel Jerome Houck - *Wells Fargo Securities, LLC, Research Division - MD and Senior Analyst*

Yes, no. I absolutely agree. Also, at the same time, rents are fairly higher as well because for people that can afford a home, that's -- they are going to continue to shape, particularly the new entrant market, but you also see strength in the multifamily market as well. And I'm just kind of wondering is there, in your view, is there enough depth of homebuyers that the affordability doesn't become an issue, more so on the purchase of homes as opposed to rental, because that's obviously where your legacy non-Agency exposure is at?

William Roth - *Two Harbors Investment Corp. - CIO and Director*

Joel, I mean, those are good points. Let me just -- this is consistent with some data that we had on our Investor Day back in March. End of last year, the median sales price in the U.S. was around $235,000, whereas the cap -- the maximum affordable price was over $300,000. So as you can tell, there's a pretty big gap there, and we've had a deficit of homes, the net supply of homes versus the net demand of homes. Since 2009, it has been running in excess of 200,000 units per year. So if you think about that, it makes total sense that rents would be going up, but if rents are going up and multifamily values are going up, by definition, housing prices are going up in concert with that. You add to that the fact that rates are still really very -- quite low and you can certainly get a mortgage for 4% area or potentially lower, depending on what kind of product you choose, and the economy has been good. So between the supply/demand imbalance, the affordability and whether it's demand for rental housing or demand for housing, in general, we're very optimistic on future price path for housing.

Thomas Siering - *Two Harbors Investment Corp. - CEO, President and Director*

To be clear, this strategy is not predicated on wild HPA assumptions whatsoever. That's simply the gravy. But I like gravy, so.

Operator

And our next question comes from the line of Jessica Levi-Ribner with FBR.

Timothy Paul Hayes - *FBR Capital Markets & Co., Research Division - Associate*

This is Tim for Jessica. Just to focus on the CRE loan portfolio, saw that the weighted average yield was up during the quarter. Does that reflect the origination activity this quarter being put on at higher yields in the portfolio average? Or is it more a function of higher rates flowing through the floating rate portfolio? And then kind of what does the competitive environment look like today? Are you seeing the spreads come in all?

William Roth - *Two Harbors Investment Corp. - CIO and Director*

Yes, Tim. Thanks for joining us. Yes, so I think to your first question, our weighted average LIBOR spread is roughly the same as it was last quarter, a few basis points higher I think. The yield would've -- the yield change would've been driven by LIBOR moves more as opposed to big spread changes. In terms of the opportunity, basically, the opportunity remains very, very strong. It's north of $3 trillion market. There's about $1.5 trillion that are rolling in the next several years. The fundamentals in this sector are very strong. There's good NOI growth, vacancies have improved, cap rates versus treasuries are in line with historical averages, and there's, frankly, a continuous lack of supply. Consistent with what we commented on residential side, there's under abundance of supply (inaudible) to prices. In terms of our specific focus, we really have a fundamental approach. We take a bottoms-up approach. We're not focused on any particular property type or market, and we're generally looking into top 25 to top 50 markets for loans that have very attractive attributes. From our standpoint, we're seeing a continuous, attractive loan quality and volumes, as we mentioned, our pipeline was $300 million or so, and -- that you can expect would hopefully flow through this quarter.

Timothy Paul Hayes - *FBR Capital Markets & Co., Research Division - Associate*

Okay. And I guess to that end, I believe on your last conference call you mentioned that the pace of the origination run rate was about 0.5% to 1% of capital per quarter, but your comments seem pretty bullish on lending and the pipeline is obviously very strong. So would you expect the pace of loan originations going forward more to mirror the pipeline now or that historical 0.5% to 1% range you had mentioned?

William Roth - *Two Harbors Investment Corp. - CIO and Director*

Tim, just to make sure we're on the same page, so the 0.5% to 1% was on a monthly basis, as opposed to a quarterly basis. So if you want to just, from a putting a pencil on paper, let's just say it's roughly $30 million a month in capital. That gets you somewhere around $100 million or so of senior loans per month. So I think (inaudible) the difference might be the per quarter versus the per month. We're comfortable with that way of thinking at this point.

Operator

And our next question comes from the line of Rick Shane with JPMorgan.

Richard Barry Shane - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

You guys had, over the years, pursued -- I would describe a myriad of different strategies and right now it really feels, and especially in terms of results, like you're firing on -- if not all cylinders, most of the cylinders. And a lot of the investments and strategies that you pursued are coming to fruition. I'm curious, given where we are right now, what concerns you. What's the tail risk that keeps you guys up at night?

Thomas Siering - *Two Harbors Investment Corp. - CEO, President and Director*

Yes, I don't know. I mean, obviously -- probably the biggest risk that we have to the business, obviously, is financing risk, debting-levered business model, that's the biggest risk. I think Brad and his team have done an amazing job. I think he said, his words were "expanding our toolbox" and I think that's probably -- was pretty apt. I mean, we, I think, have the most varied financing options of anyone in the industry. We're very religious about liquidity management and I think we've done a really good job of that, balancing the need to deploy capital but having ample liquidity at all times. That's certainly a risk to the business, but something that, as I said, we're quite religious about managing. Obviously, too, we're still exposed to housing credit and so if there were a significant downturn in housing credit, that would not be good for our book. But again, something that we monitor obsessively and we feel very good about the housing market, and particularly about our portfolio and how that's able to withstand, if there is a hiccup within the credit space. So, thank you for your comments about firing off on all cylinders. We feel that way ourselves. We articulated the plan, we're executing on that plan and we're quite optimistic about the rest of the 2017 and beyond.

Richard Barry Shane - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

In that -- and I like the description maybe not of strategies, but of the toolbox. I think that's probably a good analogy. One of the things that we've struggled with over the years is that we've liked the different tools that you've thrown into that -- into the box, but at different points, the investment of buying those tools has caused a pattern of $0.01 or $0.02 like, here and there. And it feels like over the last several quarters, you've been able to emerge from that. Is it just that you've reached a size and scale that those investments, in the new tools, no longer have the sort of $0.01 or $0.02 impact you did as you were building up?

Thomas Siering - *Two Harbors Investment Corp. - CEO, President and Director*

Rick, I'm not quite sure that we understand your question. Could you rephrase it perhaps for us? I apologize.

Richard Barry Shane - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

Sure. Surprisingly, I get that a lot from folks. What I was saying is that, look, we've followed you guys for a long time. And when we think back about the history is you have been expanding that toolbox. There has always -- there was a pattern, particularly as you were building it up, of earnings a $0.01 or $0.02 below what the street might be looking for, and generally speaking, it was -- and we were in this category as well -- something that we categorized as related to those investments, that there was always a build to that toolbox. And in the last 6 months to 12 months, that really hasn't been the case. Is that just a function of you achieving the scale that you can continue to invest in new tools and expand the platform, but because of the size of the platform, it's no longer having that earnings drag?

Thomas Siering - *Two Harbors Investment Corp. - CEO, President and Director*

Yes. Now I understand your question. Thanks, Rick, for rephrasing it. I think this -- that we have a very dedicated approach to what our game plan is, and it's quite simple. It's 3 things that I've laid out. It's allocation to the most attractive investment areas. It's cost containment -- obviously, our costs have come down as a result of the closing of the conduit and other factors. And then it's opportunistically using our balance sheet to benefit shareholders. So it's a combination of all those things. And we have a very defined business strategy. We're executing upon that strategy and it shows in our better results.

Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

Yes, this is Brad and let me just complement those comments as well from Tom. If you think about MSR, we have achieved scale. We're having very efficient deployment through our co-issue program and through both some of our smaller secured financing, but then with the convertible debt, we're able to apply some leverage to the balance sheet, which obviously does drive returns. If you think about CRE, again, the development of that business, the pipeline that Bill mentioned, and also with now a myriad of financing tools which we've also now put in place, that also has achieved what we feel is a good scale. And then feeding off of Tom's comments, we're always willing to pay some cost of financing. So diversification and laddered maturities do have a cost, but just like derivatives and hedging, that cost is worth it to protect book value to us and liquidity. And so that's always something that we're going to continue on. And then finally, the prime jumbo offered some efficiencies in both financing and deployment, so with that decision in 2016, we've been able to also drive returns there. So I would just kind of complement Tom's points there.

Operator

Our next question comes from the line of Mark DeVries with Barclays.

Mark C. DeVries - *Barclays PLC, Research Division - Director and Senior Research Analyst*

And sorry if I missed this, but I think Bill you alluded to the fact that, after you guys raised the recent capital, you quickly ramped up into agencies and expect to run that off a little bit as you're able to redeploy into MSRs and to commercial mortgages. Could you give us a little better sense of the pace at which that would happen and how much we should expect to see the agencies to shrink and the others to grow?

William Roth - *Two Harbors Investment Corp. - CIO and Director*

Mark, thanks for joining us. Yes, we had a side question, that wasn't quite as pointed as yours, so hopefully, this will help. As I mentioned, if you figure the CRE to run at 0.5% to 1% of capital a month and same with MSR, so it's, call it $30 million, net $40 million a month between the 2 of them. So you can certainly do the math on the preferred, given the size of the preferred that it wouldn't take us very long. And in fact, as an example, this $12 billion of MSR that we contracted to purchase sends about $130 million and that's subject to DSC approval, but that's a second quarter event. I think you should assume that the timeframe to redeploy is short. And in terms of the second part of your question, which is how much should you expect to pools to come down. That's a really good question, because as we have more MSR, we're comfortable having more pools to go with that.

So I'd say you should expect it to come down, probably not to the full amount of what it was at the end of last quarter but somewhere in between. And the amount -- what that size is, will really relate to what the opportunity is in the Agency space. And I did mention, and you might have missed this, that we are comfortable holding more pools as we have more MSR because of -- the MSR provides basis risk protection. We can basically run more pools than someone comparable to our size that doesn't have MSR. But I'd say the short answer is somewhere between 12/31 and March 31, depending on the market environment.

Mark C. DeVries - *Barclays PLC, Research Division - Director and Senior Research Analyst*

My next question is related with mortgage revaluations recovering back closer to 1x book. Common equity raises are starting to be back on the table. If you were to do a common raise, I think, at that point you probably have deployable capital that would exacerbate that challenge of being able to invest in MSR, in particular, and commercial at the same pace as you raise capital. How should we think about in a scenario like that your investment mix shifting, if at all?

Thomas Siering - *Two Harbors Investment Corp. - CEO, President and Director*

You're saying our investment mix predicated on an equity capital raise? Is that your question?

Mark C. DeVries - *Barclays PLC, Research Division - Director and Senior Research Analyst*

Yes, exactly. So if you were to raise equity capital, I think, clearly, given your market cap now, I think the size is clearly a fair amount more than your preferred. And now I think your ability to, given like the -- I guess -- the $2 billion to $2.5 billion of flow UPB and MSR it would be much harder to deploy that at anywhere near the same pace at which you could buy pools. So just wondering how that might impact the shift? And how you allocate?

Thomas Siering - *Two Harbors Investment Corp. - CEO, President and Director*

Firstly, I certainly don't want to put the cart before the horse here. This is predicated on us raising capital through a common stock offering and that's a very big presumption. The way we feel about this is that -- never say never, but we would be really, really reluctant to do a common stock offering that would be dilutive for shareholders. Our history in this has been very clear that it's premised on 2 things, is it a good deal for our existing shareholders? And secondly, do we have something smart to do with the money? And so it would be very presumptuous to assume that we're going to raise equity capital in here. But to be abundantly clear, the capital that we did raise through the convertible debt offering went primarily to financing MSR and with respect to the preferred issuance, that capital was used initially -- was allocated to Agency securities as a placeholder and then over time it would be -- will be reallocated to MSR and to commercial real estate.

Operator

And I'm showing no further questions at this time. I'd like to turn the call back to Mr. Siering for closing remarks.

Thomas Siering - *Two Harbors Investment Corp. - CEO, President and Director*

Thank you, Kaley. Thank you for joining our first quarter conference call today. We hope to see you at our annual meeting in May. Please call Investor Relations to RSVP. Have a wonderful day.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone have a wonderful day.
