



Two Harbors Investment Corp.
Second Quarter 2022 Earnings Call Transcript

August 4, 2022



TWO HARBORS
Investment Corp.

PRESENTERS

Paulina Sims, Head of Investor Relations

Bill Greenberg, President and Chief Executive Officer and Chief Investment Officer

Mary Risky, Chief Financial Officer

Q&A PARTICIPANTS

Doug Harter – Credit Suisse

Arren Cyganovich – Citi

Trevor Cranston – JMP Securities

Bose George – KBW

Rick Shane – J.P. Morgan

PREPARED REMARKS

Operator: Good morning, my name is [operator] and I will be your conference facilitator.

At this time, I would like to welcome everyone to Two Harbors' second quarter 2022 financial results conference call. All participants will be in a listen-only mode. After the speakers' remarks, there will be a question and answer period.

I would now like to turn over the call to Paulina Sims.

Paulina Sims: Good morning everyone and welcome to our call to discuss Two Harbors' second quarter 2022 financial results. With me on the call this morning are Bill Greenberg, our President, Chief Executive Officer, and 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 a reconciliation 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, Paulina. Good morning everyone and welcome to our second quarter earnings call.

Please turn to **slide 3**. At quarter end, book value was \$5.10 per share, representing a negative -4.7% total economic quarterly return. Following the historic bond market re-pricing in the first quarter, elevated market volatility continued through the second quarter. Inflation continued to exceed expectations, leading the Federal Reserve to accelerate the pace of monetary tightening and, in turn, raising the possibility of a recession. The risk-off sentiment across many asset classes - including mortgages - gathered steam during the quarter and, as a result, mortgage performance in the first half of 2022 ranked among the worst in decades. Entering the year, with mortgage spreads standing near record tight levels, we added significantly to our MSR portfolio while reducing RMBS balances and overall leverage to help protect against spread widening. While those actions significantly reduced losses during the last two quarters, we now find ourselves in the exact opposite situation, with mortgages currently standing at historically wide levels. Despite plenty of uncertainty surrounding the economy, the future path of interest rates, and monetary policy, we believe there are significant opportunities in both RMBS and MSR and we have repositioned our portfolio again to take advantage of the market environment by increasing our RMBS exposure and leverage.

We have also positioned ourselves to further capitalize on our MSR asset. We are very excited to announce that we have agreed to acquire RoundPoint Mortgage Servicing Corporation from Freedom Mortgage Corporation. This transaction will mark a strategic shift for us as we transition to an in-house servicing model. With the growth we have experienced in the MSR portfolio, bringing the servicing operations in-house will not only increase efficiencies and returns on our MSR asset but enable us to better manage recapture and portfolio defense strategies, grow a third-party subservicing business, and position us to capitalize on other opportunities within the mortgage finance space.

Please turn to **slide 4** for an overview of the transaction. We will purchase RoundPoint for a preliminary purchase price which is comprised of RoundPoint's tangible net book value plus a premium of \$10.5 million, subject to certain post-closing purchase price adjustments. Not included in the transaction will be an MSR servicing exchange called RPX and a retail origination platform, each of which RoundPoint will divest of prior to closing. Founded in 2007, RoundPoint is led by a veteran team with decades of industry experience. By combining their established practices and experience with the size of the Two Harbors portfolio, we believe we will be able to efficiently make this transition from our subservicing model. Although the transaction is expected to close in 2023, we plan to begin transitioning loans to RoundPoint as a subservicer later this year. As we bring RoundPoint to scale, we expect to achieve incremental annual pre-tax earnings of approximately \$20mm. However, beyond the increased efficiency of servicing MSR, this acquisition will open the door to additional and diversified revenues streams. With RoundPoint being an experienced sub-servicer, we plan to look for opportunities to expand that business to further capitalize on the economies of scale in servicing operations. Beyond that, we believe this will enable us to more closely work with our MSR flow sellers, and develop deeper partnerships within the industry. Overall, we are very excited for the integration of RoundPoint and the enhancement to our MSR strategy.

Please turn to **slide 5**. During the quarter, inflation continued to trend higher. As shown in figure 1, the May and June CPI readings, at 8.6% and 9.1% respectively, marked the strongest annual inflation rates since 1981. As seen in the light gray lines, inflation expectations have consistently underestimated reality, which in turn has caused the Fed to increase the pace of monetary tightening. Indeed, the Fed has raised its benchmark rate by 225 basis points so far this year including two 75 basis point hikes, one in June and one last Wednesday, which were the largest single meeting hikes since 1994. Chairman Powell has expressed his strong commitment to contain inflation, and the market is pricing in 100 basis points in additional increases which would bring the implied fed funds rate close to 3.5% by the end of the year, as seen in Figure 2. Current pricing in the front end of the yield curve implies the end of the hiking cycle later this year, with a cut being possible by mid-2023.

With the aggressive measures being taken to bring price growth under control, many market participants believe that a hard landing for the economy is increasingly possible. The consequent lack of clarity around the path of rates pushed bond market volatility in the second quarter to multi-decade highs. As examples, the 2-year Treasury rate began the quarter at 2.34%, rose 109 basis points to peak at 3.43%, before falling 47 basis points to finish the quarter at 2.96%. Longer term rates were equally volatile and the ten-year Treasury rate followed a similar path. Figure 3 shows the rolling three month realized volatility for current coupon mortgage rates. As you can see, realized volatility continued to accelerate higher in the second quarter as the market adjusted to incoming economic data. In the last twenty years, only the great recession and the pandemic periods have had as much rate volatility as we saw last quarter.

Please turn to **slide 6**. In a quarter marked with so much volatility and uncertainty, mortgage performance unsurprisingly struggled. Figure 1 shows a histogram of quarterly excess returns of the Bloomberg US MBS Index. The index, which is heavily weighted to lower coupons and represents an unlevered hedged portfolio of RMBS, had negative 97 basis points of excess return for the second quarter, which was the fourth worst quarter in the last 20 years. In combination with the first quarter excess returns of negative 74 basis points, the first half of 2022 is the fourth worst six-month period in the last 20 years as well.

Given the underperformance of mortgages over the last 6 months, we now see a lot of upside to owning RMBS at these levels. As you can see in Figure 2, current coupon ZV spreads have moved from around 50 basis points at the start of the year to 125 basis points at the end of June, and as of the end July had tightened somewhat. With ZV spreads approximately 50 basis points over the average of periods when the Fed is not conducting quantitative easing, nominal spreads are very high and have rarely stayed at levels this elevated for long. Much of the reason for wide nominal spreads is due to the market pricing in a continuation of the volatility we have seen in Q2. However, as you can see in the chart, even option adjusted spreads were 14 basis points above average non-QE periods as of the end of June. One way to read this chart is that even if the high interest rate volatility of the second quarter continues, mortgages are still cheap and should still produce above-average positive returns absent further spread widening.

Another important, and interesting, current market feature is that the range of tradable RMBS coupons has expanded greatly, creating significant relative value investing opportunities. With a range of 2 percent to 5.5 percent, there has rarely been such a large number of liquid tradable coupons. In Figure 3, we show OAS and ZV spreads as a function of mortgage duration along the x-axis. One very interesting characteristic that you can see in this chart is that the coupon labels all shifted to the right as we moved from 3/31 to 6/30, as interest rates rose and mortgage durations extended. We think it's more relevant to compare spreads of bonds of similar durations rather than keeping the coupon fixed. It is also worth noting the relative flatness of the OAS curve compared to a steep ZV curve. Low coupons such as Fannie 2's were roughly 300 basis points out of the money and, at 86 dollar price as of 6/30, have very little convexity and therefore very little option cost, meaning that the OAS and ZV spreads are reasonably close to each other. The higher, or current, coupons, have higher convexity, and higher option costs, and so there is larger differences between OAS and ZV. Indeed, at the end of June, the ZV of Fannie 2's were 64 basis points and the OAS was 41 basis points, for a spread of 23 basis points, while Fannie 4.5's, for example, had ZV and OASes of 132 and 35 basis points respectively, for a spread of 97 basis points. The lower coupons, with their lower convexities are easier to hedge though their deep-discount prices make them more exposed to prepayment risk, and their long spread duration makes their prices more sensitive to changes in spreads. The higher coupons have shorter spread duration and par-ish dollar prices making them less sensitive to prepayment speeds and spread changes, but the higher convexity means frequent rebalancing is required to hedge. Importantly, the fact that the OASes were similar to the low coupons, as of the end of June anyway, means that the projected high coupon returns shouldn't be worse EVEN IF volatility stays elevated. And if you happen to think that volatility will eventually decline, like we do, then there is significant upside for the higher coupons to tighten in spread. For some investors, earning a lower return with less convexity is interesting, but we think the higher coupons offer more value in this environment. As low coupons tightened significantly in July, we feel they now offer low spread with limited potential for further spread compression. As a result, we see the relative value offered by higher coupons to be considerable, and similar to what it was in March, in both ZV and OAS terms.

Now I will turn it over to Mary to discuss our financial results in more detail.

Mary Risky: Thank you, Bill and good morning everyone.

Please turn to **slide 7**. For the second quarter, the company reported a comprehensive loss of \$(90.4) million, representing an annualized return on average common equity of (19.1)%. Our book value was \$5.10 per share compared to \$5.53 at March 31st. Including the 17 cent common dividend results in a quarterly economic return of -4.7%. The results primarily reflect the mortgage spread widening Bill discussed earlier and, to a lesser degree, higher hedging costs as a result of the elevated volatility we saw during the quarter.

Moving on to **slide 8**, Earnings Available for Distribution was \$0.22 per share compared to \$0.18 for the first quarter. Interest income increased by \$12.2 million, as we grew

the RMBS portfolio and rotated into higher coupon securities. Interest income also benefited from lower amortization as prepayment speeds declined. Interest expense rose by \$14.8 million to \$37.1 million, due to the combination of growth in MSR borrowing balances as well as an overall rise in rates. TBA dollar roll income increased to \$57.7 million on a higher average notional position and a shift to higher coupon TBA which benefited from roll specialness. As we noted earlier in the year, we expected roll specialness to fade in the second half as supply catches up to demand in the production coupons. Currently we aren't seeing TBA trading persistently special in any coupon. Finally, US Treasury futures income was also lower reflecting a larger short position which was used to hedge lengthening mortgage duration. Turning to MSR, net servicing revenue grew by roughly \$6.7 million to approximately \$76.1 million in conjunction with a larger average MSR portfolio.

Turning to **page 9**. The portfolio yield increased 94 basis points to 4.39%, driven by our investment in higher coupon RMBS and higher yields on a larger average MSR portfolio. Our realized net spread in the quarter was 3.26% compared to 2.75% in the prior quarter, as the higher portfolio yield more than offset an increase in the cost of funds. Net spread as of June 30th is estimated at 3.18%. As noted on the bottom of the slide, beginning with the second quarter, we have incorporated the implied asset yield and financing of TBAs. First quarter comparative data has been updated to reflect the change.

Please turn to **slide 10**. Funding in the repo market remains liquid and well supported. Similar to the first quarter, funding costs for Agency RMBS rose on an absolute basis, however, as shown in the chart in the upper right, the Spread to SOFR remains low, currently right around 10 to 13 basis points for both 3-month and 6-month maturities. We maintained access to diverse funding sources for MSR. Our unfunded and committed MSR asset financing capacity stood at \$218.8 million at quarter end, with additional capacity available on an uncommitted basis.

Please turn to **slide 11**. As I mentioned earlier, we grew our mortgage exposure during the second quarter, deploying capital into RMBS and adding TBA, which brought our portfolio leverage to what we would consider to be a neutral position at 6.4x. Average economic debt-to-equity in the second quarter was 5.6x compared to the first quarter average of 4.8x.

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

Bill Greenberg: Thank you, Mary.

With the large repricing in mortgage spreads since the beginning of the year, we felt that the historically cheap valuations currently available in the mortgage market no longer justified the underweight we had been carrying, even despite continued market uncertainties. Overall, our specified pool and TBA positions both grew by \$1.7 billion respectively, as we increased portfolio leverage. We aggressively moved our position up in coupon where we saw the best value, with ZV spreads in the 125 to 150 basis point area. During the quarter, we increased our total spec pool and TBA position in

4.5s and 5s by over \$7 billion, while decreasing our position in 3 through 4 coupons by over \$4 billion. Furthermore, after the material widening of lower coupons within the quarter, we increased our position in 2.5s by nearly half a billion. With roll specialness largely a thing of the past, we have added specified pools when we find ones that meet our criteria. Within specified pools, we have focused our purchases within higher loan balance 200k to 250k max pools, investor properties, and Florida geographies. We view Florida geography as a particularly compelling story as it trades to a sizeable discount to loan balance collateral but with similar prepayment profile. Overall, we view these stories as providing cheap prepayment options with low absolute payups and trade at spreads that are wider than TBA.

Please turn to **slide 12**. While all mortgages widened during the quarter, lower coupons suffered the most. As ten-year rates rose towards 3.5% and mortgage rates approached 6%, a market-wide rotation from lower coupons to current coupons caused that part of the stack to underperform 30 to 60 ticks. In contrast, the 3.5 through 5 coupons where our portfolio was positioned for the majority of the quarter, fared much better, losing between 5 and 25 ticks. Lastly, prepayment speeds, shown in Figure 3, dropped as expected and commensurate with the rate move. With most mortgage-backed securities now trading at a discount, it is important to remember that faster speeds are actually a cashflows advantage as more principal is returned at par more quickly. In contrast, slower speeds are a cashflow disadvantage for the opposite reason. In furtherance of this fact, prepayment speeds on TBA collateral are now below 5 CPR in most cases as those coupons reflect newly originated loans whose borrowers are just settling in and are very unlikely to prepay. As TBA, those slow paying bonds are the cheapest to deliver. We have constructed our portfolio such that many of our specified pools have seasoning and other borrower characteristics which result in faster speeds than the TBA.

Please turn to **slide 13**. Activity in the MSR market remained very robust with approximately \$144 billion of UPB offered during the second quarter and another \$56 billion coming through in July. As seen in Figure 1, our MSR portfolio declined by \$3 billion UPB to \$229 billion reflecting net portfolio run-off. Our MSR price multiple expanded marginally to 5.4x, the result of higher interest rates and wider mortgage spreads. During the quarter, we entered into agreements to sell roughly \$21 billion UPB in the third quarter and intend to deploy the proceeds into historically attractive RMBS. Our 60-day delinquency rate continued to fall towards pre-COVID levels, ending the quarter at 0.8%.

In Figure 2, we show the trend of our settled UPB for our flow and bulk channels over the last four quarters. Flow volumes continue to decline in conjunction with lower refinancing activity.

In Figure 3, we compare our servicing prepayment speeds versus TBA. Overall, prepay speeds on our MSR portfolio declined by 30%, from 14.2 to 10.0 CPR. A moment ago, I told you about how faster speeds are a benefit for mortgage backed securities and slower speeds are a detriment, but that is only true for principal bearing securities. For interest only instruments like MSR, slower speeds are always better than faster

speeds. Although our MSR prepayment speeds are faster than newly originated "TBA" collateral, that is just a consequence of having acquired our portfolio over time. The slow TBA speeds, as I mentioned, reflect newly originated loans and there just hasn't been enough time at these new rate levels to generate MSR off of those loans in any real size. Over time, as those loans move up the so-called seasoning ramp, those speeds should increase as well. Also over time, we will be able to purchase that newer at-the-money MSR, which will also increase our weighted average coupon. However, we view 10 CPR as already quite slow, and we expect it to move slower still. We project our portfolio speeds to decline another 20+% to 6.9 CPR and expect further slowing throughout the third quarter.

Please turn to **slide 14**. Through a combination of our RMBS activity and the effects of the large selloff in rates on our MSR, our exposure to mortgage spreads has increased significantly from where it stood both last quarter and at the beginning of the year. As seen in the lower right panel, a 25 basis point widening in RMBS spreads would have an impact of negative 7.6%, up in magnitude from negative 2.8% in Q1 and negative 0.8% at the beginning of the year. With note rates on the MSR portfolio being so low - our portfolio coupon is 3.2% while primary mortgage rates are around 5% — any change in mortgage rates has little effect on prepay speeds or current cashflows. Importantly, when RMBS spreads are at normal or tight levels, the offsetting risk of at-the-money MSR is a huge advantage, by reducing volatility with a high yielding asset. In this unique period with RMBS spreads so wide, we see the low sensitivity of the MSR asset as an advantage. We capture the upside if mortgage spreads tighten, while the MSR maintains a steady cashflow with low prepays. Over time, as we add new current coupon MSR, the duration and hedging effects of the MSR will return to normal.

Please turn to **slide 15**, where we show our interest rate and yield curve exposures.

Interest rate sensitivity of the portfolio is little changed from the prior quarter and is very low. With the MSR almost fully extended, it has very little duration, and so the duration gap between our RMBS and repo must be hedged primarily with interest rate products. A 25 basis point parallel shock up would have an effect of +1.1% on book value attributed to the MSR asset as seen in Figure 1. The RMBS position, on the other hand, had its sensitivity increase to -9.5% and so the rate hedge offset of 8.5% brings the total rate exposure in an up 25 basis point parallel move to a net positive 0.1%.

In today's environment, with the Fed in motion, we have been particularly focused on the very front end of the curve and we have been very careful to keep exposure in that part of the yield curve as low as possible. I often like to say that we are mortgage investors and not Fed interest rate guessers. In Figure 3, we show that our sensitivity to changes in short term rates is calculated to be 0.0% impact to book value in an up 25 basis point bear flattening shock.

Finally, I'd like to discuss our outlook for Two Harbors and our return expectations for new investments on **slide 16**. Static return expectations are as interesting as they have been in a very long time. Lower coupon pools and TBA offer high single digit returns with relatively low convexity risk. Projected returns on current coupon pools and TBA

are in the mid-teens, have very wide spreads, and stand to benefit the most if and when rate volatility subsides. The MSR paired strategy also continues to have low to mid-teens returns and lower RMBS spread risk. All of these pairings currently offer very attractive returns with different risk profiles.

Despite the uncertainty and near term drag from volatility seen during the quarter, the longer term outlook for Two Harbors is very positive. Historically wide mortgage spreads present an excellent opportunity for investment while the variety of tradeable coupons within the space allows us to take advantage of relative value opportunities. We expect interest rate volatility to eventually subside, and both the MSR and RMBS should benefit when that occurs. Additionally, we are very excited for the evolution of our MSR strategy with the acquisition of RoundPoint. The increased operational efficiencies and the revenue opportunities it presents will add value for shareholders while deepening our involvement in the industry.

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

Q&A

Operator

Thank you. We will now be conducting a question-and-answer session. If you would like to ask a question, please press star one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star two to remove yourself from the queue. For participant using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment, please, while we pull for your questions. Our first question comes from the line of Doug Harter with Credit Suisse. Please proceed with your question.

Doug Harter

Thanks. Bill, since the Fed meeting, your mortgage spreads have tightening quite nicely. I guess just one, can you talk about what that has done to book value quarter-to-date and, two, how that has impacted returns and whether that changes any of the attractiveness of previous assets today?

Bill Greenberg

Yeah. Thanks for the question, Doug. Good morning. Nice to have you. The interest rate volatility and the spread volatility of mortgages has continued through the Fed meeting. Price performances throughout July has been moving up and down. Mortgage spreads, as you know, have been—they can be a quarter-point, half-a-point wider one day, and the same tighter the next day. So, in terms of performance, our performance has also moved around commensurately with that. I hesitate to give one number because it's been both higher than this and lower than this. But as of the end of July, we were up around 1.5% in book value.

Doug Harter

Great. And then—so, I guess based on that, do you still see the return environment as relatively consistent with kind of what that outlook slide has?

Bill Greenberg

Yeah. Generally, given—within the bounds of the volatility that we see on a daily basis, I do. I still see—well, in certain ways I think the higher coupons are certainly still

consistent with what we show, both on the ZV and the OAS graph earlier in the presentation, as well as the returns that are on page 16. The low coupons have tightened a lot, as you probably noticed, and they look closer to what they did at the end of March, I'd say.

- Doug Harter** Great. That makes sense. Thank you.
- Operator** Thank you. Our next questions come from the line of Arren Cyganovich with Citi. Please proceed with your questions.
- Arren Cyganovich** Thanks. I just wanted to dig into the acquisition a little bit more. Can you talk about the rationale? Is it more of a cost savings or a revenue opportunity that you see there? And maybe dig into some of the benefits of having your own servicer versus using a subservicer.
- Bill Greenberg** Yeah, sure. As I think there are—there's many benefits here, which is one of the reasons why we're so excited about it actually. Over time, as our portfolio has grown, we've really just reached a scale where it makes sense for us to bring it in-house. The cost savings that we can achieve from bringing it in-house and not paying subservicers is significant. It gives us more control over the servicing of the portfolio. And it allows us to enter into the ancillary businesses, as I mentioned, such as subservicing and other ways to partner with our existing seller network and other counterparties in more meaningful ways, as well. So, we think it has lots of benefits across our activities in the servicing and in the mortgage finance space. But really one of—maybe the main issue is the extra revenue and cost savings that we're going to generate.
- Arren Cyganovich** Okay. Got it. And you had mentioned that it was a 10.5 million premium to tangible book. Are you able to provide what the total sale price is, and will you have to raise any equity capital associated with the acquisition?
- Mary Risky** Hi, Arren. This is Mary. So, we can't disclose their book value. They're not a public company. However, we are acquiring their servicing platform, which is a capital light business, so we're not acquiring any MSR, and they're divesting of certain businesses that would have capital. So, we don't expect the book value to be a material number.
- Arren Cyganovich** Okay. Thank you.
- Operator** Thank you. Our next questions come from the line of Trevor Cranston with JMP Securities. Please proceed with your questions.
- Trevor Cranston** Great. Thanks. Good morning. You mentioned the benefit of MSR being less rate-sensitive and spread-sensitive in the prepared remarks in terms of increasing your portfolio's spread exposure. I guess where you stand today, does it make—would it make sense, potentially, to sell more of the MSR portfolio in order to reallocate capital to MBS, or, given the lower sensitivities, that's not going to be as meaningful of a benefit where we are today?

- Bill Greenberg** Yeah, thanks for that question. That's an ongoing relative value decision that we make all the time. RMBS is attractive here, but MSR, having very little spread exposure and interest rate exposure and cash flowing as much as us, is also attractive in a different way with a different risk profile. So, I mentioned, prepayment speeds have fallen quite a bit already, as I said in my prepared remarks. We expect speeds in our servicing portfolio to be around 7 CPR for July. We expect them to go slower still in August. My own view—obviously, everyone can have their own views, but my view is that there's probably more possibility of speeds surprising to the slow side than to the fast side here. So, we like having a bunch of servicing with low coupons and deep discounts and exposed to turnover speeds here. So, it's a combination of—or the analysis is one of relative value and risk profiles. And we may sell more, and we may buy more. It depends on the prices in the market.
- Trevor Cranston** Okay. Got it. And then on leverage, I think the current leverage level was characterized as a neutral position in the opening remarks. Can you talk about how high you'd be willing to take leverage if you were to get more aggressive and maybe be kind of more outright positive on the market?
- Bill Greenberg** Yeah. Thanks. So, when we talk about overall portfolio leverage, it's important to incorporate the amount of MSR that we have in our portfolio at any given time. Right? So, more MSR because the leverage in that asset is lower than the leverage in the MBS asset will generally generate a lower overall portfolio leverage. Right? And we have more MSR today than we've had in the past, if you compare our portfolio to what it was pre-COVID. What I would say, as I said, neutral is right around here, mid-high sixes. I would say full overweight is probably in the high sevens, low eights kind of area. But that would be like max overweight kind of thing, which, that's why I say, if you say that's one and a half to two turns higher, go back one and a half to two turns lower, that's what we were when we thought we were maximum underweight. Right? So, that's why we say we're sort of in the midpoint here.
- Trevor Cranston** Okay. That makes sense. Thank you.
- Bill Greenberg** With today's portfolio, of course.
- Operator** Thank you. Our next questions come from the line of Bose George with KBW. Please proceed with your questions.
- Bose George** Hey, everyone. Good morning. Actually, going back to RoundPoint, now that you'll have a servicer I guess, recapture will be a growing part of the mix, or at least part of the mix, does it—will you potentially look at origination capacity, as well, as another way to sort of obtain MSR?
- Bill Greenberg** Yeah. So, it's not particularly our intention to compete in the origination space with retail participants or wholesale participants. As you point out, we are interested in recapturing other portfolio defense strategies and other ways in which to partner in a complementary way with our existing servicing seller network and other counterparties. And so, we will be doing some things along that line, but we don't

- intend, at this time, to really compete in any meaningful way in the retail or wholesale origination space.
- Bose George** Okay. Great. Thanks. And then, actually just in terms of servicing technology, is there a decision to be made in terms of that? Is RoundPoint, on MSB, is there any sort of cost saves that could be from a servicing technology standpoint?
- Bill Greenberg** That's something we are all is going to be looking at over time as these things unfolds and as it develops.
- Bose George** Okay. Great. Thanks.
- Bill Greenberg** Thank you.
- Operator** Thank you. Our next question is coming from the line of Rick Shane with J.P. Morgan. Please proceed with your questions.
- Rick Shane** Thanks, guys, for taking my questions. So, a couple of things on the acquisition. There was question trying to dimensionalize the size of the acquisition, and it sounds like de minimis book value plus the 10.5 million. Are we—should we assume the consideration here is going to be 100% cash? And then, when we think about things on an EPS basis—you talked about \$20 million of net income accretion. I'm assuming that you see this is EPS accretive, as well.
- Mary Risky** Good morning, Rick. Thanks for joining. So, on an EPS basis we did disclose we expect incremental pre-tax income to be approximately 20 million once our portfolio has fully transferred, which, on per share after-tax basis, would be \$0.04 to \$0.05 accretive. And I'm sorry, what was the first part of your question?
- Rick Shane** Consideration—and again, the EPS accretion makes a lot of sense, and it sounds like the book value de minimis, so it's relatively small acquisition price for \$20 million of pre-tax.
- Mary Risky** Yeah, you can expect that will be cash.
- Rick Shane** Got it. And then, when we think about the P&L on a go-forward basis, a servicing platform certainly brings on some additional operating expenses. So, is there anything we need to consider there in terms of how much of an impact it will have on your OpEx side?
- Mary Risky** So, I actually think we will have—let's see, we will see some integration savings over time. So, we would expect our operating expense ratio to improve as we integrate common functions.
- Rick Shane** Got it. Okay.
- Mary Risky** And obviously servicing expense is what it is, but on the OpEx side we would expect some integration savings.

- Rick Shane** Got it. And then, look, historically the plus and minus of being a servicer is that it is a business that doesn't scale particularly well, but it is a business that, at the same time, has a very predictable stream of revenues. And as a business that has historically relied upon outside servicing, you have been able to bulk up very quickly opportunistically. Do you lose that by taking on the scalability issues of owning your own servicing platform?
- Bill Greenberg** Well, I mean, yes and no. And I would phrase it this way, servicing is an integral core part of our strategy. It's going to continue to be so. And having made that decision, then the best way to extract the most value from the assets and the platform is, we decided, is to have our own servicer. Right? And so, you are not going to see us—and our experience has been—our history has been not that we have moved our capital or moved our MSR balances up and down 50% over any periods of time. It's been steady or growing. We expect that to continue, and as long as that's going to be continuing, then owning your own servicer is going to be more efficient and more able for us to extract the value of the platform of the borrower on all the ancillary opportunities that we see.
- Rick Shane** Got it. And then, last question, and this is for Mary. Is there any reason—so you used fair value accounting for your MSR. Many of the servicers use lower cost or market. Is there any reason, if you internalize your servicing, that you need to change that accounting? I just don't remember all the rules associated with this.
- Mary Risky** No, we will not change our accounting methodology for MSR. It will be continue to be valued at—accounted for at a fair value.
- Rick Shane** Okay. Thank you, guys.
- Bill Greenberg** Thanks, Rick.
- Operator** Thank you. There are no further questions at this time. I would now like to turn the call back over to Bill Greenberg for any closing comments.
- Bill Greenberg** I just want to thank you everyone for joining us again today, and, as always, thanks for your interest in Two Harbors.
- Operator** Thank you. This does conclude today's teleconference. We appreciate your participation. You may disconnect your lines at this time. Enjoy the rest of your day.

CONTACT INFORMATION

Investor Relations
Two Harbors Investment Corp.
612-446-5431
investors@twoharborsinvestment.com