



Two Harbors Investment Corp. First Quarter 2020 Earnings Call Transcript

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TWO HARBORS
Investment Corp.
A Pine River Capital Managed Company

PREPARED REMARKS

Operator: Good day, and welcome to the Two Harbors Investment Corp. first quarter 2020 financial results conference call.

Today's conference is being recorded.

At this time, I would like to turn the conference over to Miss Margaret Karr. Please go ahead.

Margaret Karr: Thank you and good morning, everyone. Thank you for joining our call to discuss Two Harbors first quarter 2020 financial results. With me on the call this morning are Tom Siering, our president and CEO; Mary Risky, our CFO; and Matt Koeppen and Bill Greenberg, our co-CIOs. On our call today, given potential conflicts of interest, any comments about internalization will be delivered by Mary, Bill, and Matt.

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 our website or on the SEC's website, at sec.gov. In our earnings release and slides, 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 in the Investor Relations section of our website.

I would like to remind you that remarks made by management during this conference call and the supporting slides may include forward-looking statements. Forward-looking statements are based on the current beliefs and expectations of management, and actual results may be materially different because of a variety of risks and other factors. We caution investors not to rely unduly on forward-looking statements. Except as may be required by law, Two Harbors does not update forward-looking statements and expressly disclaims any obligation to do so.

I will now turn the call over to Tom.

Tom Siering: Thank you, Maggie, and good morning, everyone. We hope that you had a chance to review our earnings press release and presentation that we issued last night.

Coming off the heels of a very strong 2019 for the company, we could not have imagined the societal and economic conditions that would result from the global coronavirus pandemic. This has been a challenging time for our nation

and the world, and our thoughts are with those most affected by COVID-19, especially those who have lost loved ones. Additionally, we want to express our gratitude and admiration for the heroes who are on the front lines. We, like everyone else, are hoping for a return to normalcy soon.

First and foremost, we have been concerned about our most valuable asset: our people. We have implemented mandatory work-from-home measures across our three offices and are utilizing technology to stay well connected. We are all adapting to the new reality and we were able to execute our day-to-day business with very minimal disruption.

In the first quarter no one was spared from the volatility of the markets. Unlike the 2008 financial crisis, the speed with which the market dislocation appeared and the large spread moves that occurred on a daily basis were unprecedented. Every asset class was impacted. Spreads, especially on illiquid assets, widened dramatically. Margin calls were swift.

Nonetheless, I am proud of how our team managed the volatility by actively de-risking our portfolio in order to establish and maintain a very strong defensive liquidity position. Throughout this period, we satisfied all margin calls and did not enter into any forbearance arrangements with our lenders.

In the midst of the volatility, we also made the difficult decision to suspend our first quarter and preferred stock dividends in order to ensure we maintain sufficient excess liquidity and preserve stockholder value for the long term.

Our decisive actions allowed us to weather extreme volatility in March and ended the quarter with \$1.2 billion in unrestricted cash. Given the de-risking of our portfolio and the increased confidence in our liquidity position, we announced an interim common stock dividend of \$0.05 per share, as well as full payment of our first quarter preferred stock dividends. Though we are not able to provide guidance on future dividends, together with the board we will be evaluating our quarterly dividends, going forward, based upon the composition of our portfolio and evolving market conditions.

Additionally, post quarter-end we announced that the independent members of our board of directors elected not to renew the company's management agreement with PRCM Advisers. Mary will comment on this in more detail shortly.

We believe that how we are regarded once this crisis passes will depend upon our actions now. We strive to be best in class, and in this time of great uncertainty we are committed to all of our stakeholders: our employees,

stockholders, business partners, and communities. We are weathering this storm together.

While we can't predict how this global pandemic will play out and what its lasting effects will be, we are making every effort to best position our company for events outside of our control. Despite all the uncertainty, we believe that we can withstand future volatility and, ultimately, on the other side of this crisis once again drive long-term stockholder value.

With that, I will now turn the call over to Mary to review our financial results.

Mark Risky:

Thank you, Tom. Turning to Slide 4, let's review our financial results for the first quarter.

Our book value at March 31 was \$6.96 per share, representing a decline of 52% from \$14.54 cents at December 31. On the right-hand side of this slide we have provided a more detailed attribution of our book value decline in the quarter. As expected, the sale of substantially all of our non-agency securities was the largest contributor, resulting in over 70% of the decline. Our rate strategy also contributed to the decline, driven by fair value markdowns on MSR, specified pool underperformance, as well as specified pool sales as a result of delevering our portfolio in March. Matt and Bill will detail this portfolio activity shortly.

Moving to Slide 5, let's discuss our core earnings results. Core earnings were \$0.25 per share in the first quarter, consistent with the previous quarter. Core earnings was favorably driven by higher net interest income due to purchase of higher-coupon agency RMBS early in the quarter and lower amortization. This was offset by increased interest spread cost on swap positions due to LIBOR resets and lower TBA dollar roll income.

Turning to Slide 6, our portfolio yield in the quarter was 3.52% and our net yield decreased to 1.13%, from 1.19%. We saw improvement in repo costs, but this was more than offset by higher swap costs as three-month LIBOR rates declined in the quarter. As funding rates have come down post quarter-end, we expect to continue to see improvement in repo costs.

On Slide 7, we have summarized our financing profile as of March 31. As the turmoil in the markets unfolded in March, our financing and investment teams worked closely together to preserve liquidity and delever the portfolio. As a result, we have made all of our margin calls. Our liquidity position remains strong, and we are confident in our ability to continue to meet margin calls and servicing advance requirements on our MSR.

Our economic debt to equity at quarter-end was 7.0x, compared to 7.5x at December 31, and our quarterly average economic debt to equity was 7.4x. It is

important to note that we sold our lower-levered non-agencies during the quarter. So, while the change was nominal in our quarter-over-quarter debt to equity, the leverage on agency RMBS and MSR decreased meaningfully.

We did not experience any issues with accessing the agency repo market and were active in rolling our repo positions. At March 31, we had 22 active agency repo counterparties, with a weighted average maturity of 52 days. In aggregate, we have been able to roll our agency RMBS positions without much change in haircut. As was true in many markets, repo levels were stressed in March. However, as we have progressed past quarter-end we have seen more clarity and consistency in rates and term markets are developing again. Repo levels for one-month to three-month terms are indicated today in the OIS plus 25 to 35 basis point range.

As of March 31, we had \$252.1 million outstanding across our MSR bilateral facilities and \$400 million outstanding MSR term note. Our total committed capacity across our MSR financing alternatives is \$450 million.

Importantly, we are in advanced discussions with two major banks on servicing advance facilities. This will provide us with additional liquidity to continue to make servicing advances in the event of increased forbearance or defaults. For more information on our financing profile, please see Appendix Slide 28.

Please turn to Slide 8. On April 13, we announced our election to not renew the management agreement with PRCM Advisers. As a result, the agreement will terminate on September 19, 2020, and we will become a self-managed company. The decision was the result of a diligent, thorough, and extensive months long process led by the independent directors of our board, with the advice of independent legal and financial advisers. The board-driven process commenced long before the COVID-19 pandemic, and timing of the announcement was predicated in part on the non-renewal provisions of the management agreement.

We believe that our stockholders will benefit from significant annual cost savings, as well as from further alignment of interests of management and stockholders, enhanced returns on any future capital growth, and the potential for attracting new institutional investors.

Under the terms of the agreement, we are required to pay a one-time cash termination fee, which we estimate will be approximately \$144 million. We expect to realize an annual cost savings of approximately \$42 million, or \$0.15 cents per share, before giving effect to any additional cost savings from the elimination of the management fee on future capital growth. Therefore, the payback period on the termination payment is relatively short, at just over three

years, and the return on investment is approximately 29% per annum, without accounting for future capital growth.

The manner in which the termination payment is calculated, using a 24-month lookback period, is such that when the lower management fees paid in earlier quarters is taken into consideration, the payment of the estimated termination fee results in the most favorable economic benefit to stockholders.

In conclusion, we are confident that this is the right time to make this change given the maturity of our business model, our well-established infrastructure, and the material economic benefits to stockholders. And we believe strongly that the transition to being self-managed is a very positive step for the future of our company.

With that, I will now turn the call over to Bill and Matt for a markets overview and portfolio update.

Bill Greenberg:

Thank you, Mary, and good morning, everyone.

We'd like to start this morning by spending a few minutes discussing the effects of the COVID-19 pandemic on the residential mortgage market. Then, we will discuss our portfolio activity for the quarter. Finally, we will talk about our outlook for servicing advances in our portfolio liquidity.

Please turn to Slide 9. In March, the COVID-19 pandemic had a swift and dramatic effect on valuations, leading to extraordinary spread widening across virtually all asset classes. The left-hand chart shows the 10-year swap rates and the S&P 500 in the first quarter. Although the 10-year swap rate trended lower early in the quarter, it moved sharply in March, finishing the quarter roughly 120 basis points lower. The S&P 500 performance really emphasizes how quickly events unfolded, and the all-time high on the index was realized on February 19, before falling 35% just a month later.

The right-hand chart shows spread widening impacts across various fixed income asset classes: from pre-crisis levels in mid-February, indicated by the low point in each vertical line; through the crisis, indicated by the high point in each vertical line; and then ending mid-April, indicated by the gray circles. No asset class escaped, and this affected us and other mortgage REITs significantly.

Most spreads remain significantly wider than they were in February, with the exception of agency RMBS, which have retraced all of their widening more due to the direct impact of QE4 purchases by the Federal Reserve.

Moving to Slide 10, the left-hand chart compares an MBS-Treasury spread index in 2008 versus March 2020. While the magnitude of the widening is notable and

similar in both cases, the real difference was the speed at which it unfolded. The round trip was completed in three weeks in March, compared to six months in 2008.

The right-hand chart shows the large intraday spread changes in the Fannie 4% coupon during the most volatile week in March. As you can see in this chart, each day is delineated by the vertical lines and starts at zero. It was not uncommon during that week to see 50-basis-point moves, both widening and tightening, sometimes even in the same day. This high level of volatility was further exacerbated by extremely low levels of liquidity in the MBS market. At times, the bid-offer spread in the most actively traded securities were as much as 100 times their normal levels. At the end of April, the agency market had substantially healed and bid-offer spreads were largely back to normal.

Please turn Slide 11. As the stress on the RMBS market grew, the Federal Reserve took a number of actions meant to stabilize the markets. At the outset, the Fed cut interest rates by 50 basis points on March 3 in an attempt to offset increasing liquidity fears. The market was not soothed, and by March 15 it was clear that the system needed additional action. The Fed responded by cutting rates to zero and announcing its commitment to purchase \$500 billion in Treasuries and \$200 billion in RMBS. The market was still underwhelmed, and volatility in the Treasury and the RMBS markets actually worsened. In response, on March 23, the Fed committed to unlimited purchases of both, in what has become known as QE4.

Following the recommendations of various market participants, the Fed also began to buy bonds on a short settled basis instead of waiting until the regular mid-month settlements.

The Fed's RMBS purchases were also expanded to include higher coupons, and not just the lower dollar price production coupons, which was very helpful for many market participants, including mortgage REITs, who generally had large holdings in the higher-coupon bonds.

The left-hand chart shows daily Fed purchases of MBS, which have now exceeded \$500 billion. The right-hand chart shows the pace of QE4 compared to QE1 in 2008 and QE3 in 2012, demonstrating again the speed and size at which events are unfolding today.

With that, I will hand it over to Matt.

Matt Koeppen:

Thank you, Bill, and good morning, everyone.

Please turn to Slide 12. With the foregoing discussion as a backdrop, let's now discuss the actions we took in March in response to the liquidity crisis caused by

the pandemic. As volatility increased and spreads widened on agency RMBS, we delevered, reduced risk to raise excess cash. We liquidated around \$18 billion specified pools and TBAs, representing about 50% of our agency portfolio. When liquidity was poor in March, we initially sold lower coupons where there was some sponsorship, but eventually reduced exposure to higher coupons when the Fed adjusted its program to focus on purchases in that part of the coupon stack.

Timing of most of these portfolio sales, occurring as they did before unlimited QE was announced, were such that we did not fully benefit from the spread tightening driven by outside spread purchases.

With respect to our legacy non-agency portfolio, we had become increasingly concerned about levered portfolio liquidations occurring across the market, acceleration in size and frequency of margin calls arising from widening spreads, increasing haircuts, and the future ability to access ongoing funding in the repo market. As a result, we decided to liquidate substantially all of our non-agency portfolio and to eliminate the aforementioned risks. The charts on the bottom of this slide show our portfolio composition on December 31, where you can see the effect of the portfolio sales we just described.

Please turn to Slide 13. Another large driver of performance during the quarter was the collapse in specified pool payups. The chart on the upper right-hand side of this slide shows 3.5 coupon, high loan balance specified pool payup levels. This chart is indicative of the price action that impacted all specified pools in March. As the month unfolded, with risk appetite and balance sheet capacity low, specified pool payups suffered.

The payups are indicated by the blue bars and measured on the left axis. The gray line shows the ratio of the payup to one measure of its theoretical value and is measured on the right axis. You can see that premiums fell from around four points to around one point at the end of the quarter. There were even trades that took place in the market at negative payups, indicating that the specified pools traded below settlement date-adjusted and cost of funds-adjusted TBA levels.

Specified pools have significantly recovered in April. The lower charts show our specified pool breakdown on December 31 and on March 31. You can see that we liquidated essentially all of our lower payup stories during March to minimize losses while delevering. Specifically, we sold a net of \$13.4 billion pools during the quarter, across 3% to 4.5% coupons, predominantly in high-LTV pools. Today, we are positioned largely in loan balance and geography stories.

Please turn to Slide 14. The graph on the right-hand side of this slide shows coupon performance for the first quarter. Despite the massive volatility, agency RMBS ultimately performed well after the Fed stepped in with support. Coupons in the middle of the stack, including 3's, 3.5's, and 4's, all outperformed by one point or more.

Our effective coupon positioning is shown in the bottom charts. Our implied short positioning from the MSR asset moved to the 2% coupon in March, from 2.5's and 3's at the end of December, as a result of the interest rate rally. Our long holdings include 2.5's through 5's.

Please turn to Slide 15. This slide shows our interest rate and mortgage spread exposure. Although we recognize that these representations of our exposures are too simple to have been accurate descriptions of portfolio performance during the crisis, as volatility subsides and market movements return to normal these kinds of risk measures regain their usefulness.

These exposures remain low, consistent with our historical positioning. In the top-right chart, you can see our exposure to instantaneous changes in mortgage spreads. As of March 31, a 25-basis-point spread widening would decrease book value by 1.4%. The chart on the bottom of the page shows our book value exposure to instantaneous parallel changes in all interest rates. You can see that as of March 31, an instantaneous parallel shift in interest rates upward of 50 basis points would negatively impact book value by only 1.3%.

Bill Greenberg:

Please turn to Slide 16. We'd like to dedicate time today to one of the biggest challenges we are currently facing: increasing mortgage loan forbearances and servicing advances. While the COVID-19 pandemic began as a liquidity crisis, as these things often go, it has transformed into a credit crisis. Shutting down large swaths of the United States has had far-reaching economic impacts. Unemployment has skyrocketed and is expected to continue to climb. With so much of the economy shuttered and people out of work and staying home, the ability of all types of borrowers, renters, and lessees to pay their obligations has been called into question.

At the end March, Congress enacted the CARES Act, which besides including relief checks and other supporting measures has an important impact directly on our industry. One provision of the Act provides for up to 180 days of forbearance relief from mortgage loan payments, with the right to extend up to an additional 180 days for borrowers with federally backed mortgages who have experienced financial hardship related to the pandemic. The Act also prohibits foreclosures for 60 days.

Through one of our subsidiaries, we own the MSR for over 800,000 loans guaranteed by Fannie Mae and Freddie Mac. And as a result, we are responsible for making advances for certain payments in the event they are not made by a borrower. In normal times, this obligation is not burdensome. Pre-COVID, our 60-day delinquency rate was about 30 basis points, and we were able to manage liquidity needs related to this in the ordinary course of our business.

However, with the forbearance programs now in place as a result of the CARES Act the situation is different. During the forbearance period, we are responsible for remitting monthly scheduled principal and interest for loans backed by Fannie and monthly scheduled interest for loans backed by Freddie. Additionally, we are responsible for making intermittent tax and insurance payments to local authorities and insurance companies.

In this slide, we show our MSR portfolio forbearance rates since we started collecting data on March 23. This data is shown by the blue bars at the bottom of the chart, and references the left axis. As of April 28, our experience is that 5.7% of our loans, by count, have entered forbearance. The gray line shows the daily percentage changes in the number of loans entering forbearance and is measured by the right axis. This number has been steady in the low single digits for some time. It's worth pointing out that both the Mortgage Bankers Association and Black Knight, a loan servicing technology company, publish data regularly regarding forbearance rates for GSE loans, and our data has so far been very consistent with both of those sources.

Please turn the page to Slide 17. On this slide, we consider how our servicing obligations intersect with our liquidity position. We have taken a scenario analysis approach and created three scenarios: base case, a moderate stress case, and a severe stress case.

Depending on the speed of the relaxation of social distancing measures and the reopening of the economy, we believe that a 15% rate is a reasonable estimate for a base case. Of course, it is impossible to predict the ultimate take-up rate with any certainty, but as you will see, we believe our liquidity position is strong enough to withstand stresses to this outcome.

The scenarios differ primarily by varying the maximum forbearance take-up rates: the base case assumes 15%; the moderate stress case assumes 20%; the severe stress case assumes 25%. Additionally, moving across these three scenarios we vary prepayments from 25 CPR in the base case, to 20 CPR in the moderate stress case, to 15 CPR in the severe stress case.

The prepayment rate is an important driver in forecasting the advancing obligations since the custodial accounts for principal and interest can be used to

offset advancing obligations, though of course these funds must be paid back the next month.

The next variable is the existence of a servicing advance facility. We are in the process of negotiating documents on such facilities for large Wall Street banks. We expect that any facility would accommodate both Fannie and Freddie advances. Although subject to customary closing conditions and GSE approvals, we have included the existence of such a facility in our scenarios.

The last variable is the valuation of our existing MSR portfolio. We have two outstanding facilities where we borrow against our MSR assets. As distinct from facilities, which are meant to finance the advances, and the borrowing pace depends on the market value of the MSR. Therefore, in each scenario we stress the MSR price to simulate potential margin calls. These price stresses start from our 3/31 valuation and decline from a 3.0 multiple down to a 2.0 multiple in the severe stress scenario. All three scenarios explicitly include payments of the estimated non-renewal fee due in September.

The chart at the bottom-left of this slide shows our projection for our advancing obligations. In all three scenarios, you can see that the servicing obligation peaks right around December 2020. Before this, the curves rise quickly due to the accumulation of P&I and T&I advances and then decline as we are able to recoup T&I advances from interim claims processing.

You can see that in the base case the maximum advancing obligation is around \$100 million, while in the moderate stress and severe stress scenarios the obligation increases to \$250 million and \$450 million, respectively.

To determine whether or not those are big numbers or small, we need to overlay those projections with our liquidity. The chart on the bottom-right of this slide lays out a path of our liquidity over the next 18 months. We start off with a steady-state cash balance of around \$1.2 billion. The reason we are holding such a large cash balance today is precisely in consideration of this future advancing obligation. As you can see, we expect our excess cash balances to decline as we pass through the advances wave and then to return to a more normal level. In all three cases, we maintain an excess liquidity buffer of between \$400 million and \$600 million. For a portfolio of our size and with the risk tolerances we expect to be running, we believe \$400 million is a very comfortable amount.

It's important to us that you have full transparency about what we're seeing around servicing advances and how we are thinking about this in the context of our MSR portfolio. We hope this explanation helps. In summary, based on

information we've been discussing today, we feel quite confident about our liquidity position.

Matt Koeppen:

Please turn to Slide 18. The reality is that this pandemic has reordered everything, and we have a lot of work to do before we are in a position to return to business as usual. The advancing obligation is significant, and while we feel confident in our ability to manage it, it will take time for events to unfold before we anticipate returning to a steady-state business model.

To be sure, there are multiple obstacles that will certainly drag down earnings in the near term. These include: higher-than-normal cash balances; increased servicing costs from our subservicers on delinquent loans; costs to set up and maintain the servicing advance facilities; and uncertainty in MSR pricing.

Having said that, we believe that the opportunity set in our target assets is very attractive today. As we discussed earlier, with Fed support agency TBAs recovered all of the March widening, and then some, so that returns in that part of the market are similar to what they were pre-crisis. Specified pool payups have recovered much of what they lost in March but are still somewhat lower than they were when the crisis began. As a result, we are seeing returns on rate-hedged agency RMBS in the low to mid-teens.

It's in the MSR asset that we're seeing the most interesting opportunities. While it's true that there's much to work through regarding forbearances, advances, and higher costs to service, we still estimate that the forward-looking returns on our existing book of MSR, when paired with MBS, is in the mid-teens based on our Q1 valuation. Earlier, we discussed some potential scenarios about the future path of MSR prices. Should MSR multiples decline to 2.5x on our existing book from 3x, we would estimate that the paired return would be in the very high teens.

The MSR bulk market remains shut down. So, it's not possible at the moment to acquire new assets there.

The MSR flow market has slowly come back to life, and indeed we are buying a trickle of MSR assets in that channel. The multiples in the flow market are usually lower than in the bulk market. And while visibility remains somewhat unclear, today we think that flow product can be acquired below two multiples. On a forward basis, we think that translates to yields north of 25%, when paired with agency RMBS. We don't yet know the amount of assets that can be acquired at those levels, but it is clearly very interesting at those prices.

The barriers to entry in the servicing business are many. Every facet is time-consuming and complex. Only market participants who already have the

infrastructure, processes, and relationships in place will be able to access the kinds of returns just mentioned. We at Two Harbors are uniquely positioned to take advantage of that attractive opportunity on an ongoing basis.

With each day that passes, the outlook gets a little clearer. As Tom said at the outset, we aim to be as transparent as possible. So, we will continue to update you with new developments over time.

With that, I will turn it back to the Operator.

QUESTION & ANSWER

Operator: Ladies and gentlemen, we will now have our question-and-answer session. And if you would like to ask a question today, please press "*", "1" on your telephone keypad now. If you find that your question has been answered, you may remove yourself from the queue by pressing "*", "2." Again, that's "*", "1" to ask a question, and we'll just pause for a moment to allow everyone to signal.

We will take our first question today, which comes from Doug Harter. Please go ahead.

Doug Harter: Thanks. First, thanks for the additional disclosure around the liquidity. Just, Matt, then on your commentary about the attractiveness of new returns, can you just talk about kind of where you are in the flow program? Is that something that you guys are acquiring loans or MSRs through the flow today? Or what it would take from a liquidity position to feel comfortable reacquiring loans through flow?

Bill Greenberg: This is Bill. I'll take that. So, as Matt said, we are acquiring what we call a trickle. During the depths of the liquidity crisis, we, like many other competitors, suspended our acquisitions there. As I said, that market is slowly coming back to life. We are back in the market on a limited basis, really in a way that does not increase our forbearance and advance risk. There's different ways to do that by targeting certain types of collateral, and so forth. Maybe we can talk about it later, if you'd like.

And so, we're doing it in a way that minimizes that liquidity burden, and we're using the opportunity to see how much assets can be acquired at those levels and how much. And obviously, at those levels it's very interesting. And if we're able to do that, we will figure out a way how to make that work.

- Doug Harter: Great. And then if you could just talk about the capital structure after the book value decline in the quarter – the mix of preferreds is obviously much higher now – and kind of how you think about that mix and kind of what would be the plan to kind of get that back in line with the goals you had previously or targets you had previously mentioned.
- Tom Siering: Thank you. Good morning. Obviously, it's something that we're acutely aware of and are reviewing. So, yes, you're right that it's having that effect on our capital structure. And so, it's something that we have under review. So, people might be curious as to whether or not we would raise common equity. And obviously, that would be very dependent upon the opportunity set. But it's something that we're obviously aware of. We have a review and we will attempt to deal with that the best we can.
- Doug Harter: Okay. Thank you, Tom.
- Tom Siering: Thank you.
- Operator: Our next question today comes from Mark DeVries. Please go ahead. Your line is open.
- Mark DeVries: Thanks. I had a question about the liquidity projection chart on Slide 17. Is that liquidity number –? Does that assume –? Is that just based on the cash you have on hand now? Or does it also assume draws on these facilities that you're in the process of negotiating?
- Bill Greenberg: This is Bill. I'll take that. It's a combination of all of that. It's a pretty comprehensive set of assumptions and models that incorporate to the best of our knowledge all of the potential drags and sources that we will have at our disposal, we think, where we can. And we've tried to be fair, but conservative, and try to stress the models, as you see, by the three scenarios. So, it includes all of those things.
- Mark DeVries: Okay. Got it. And just given the high-quality nature of a servicing advance and all the risk around it, are you generally sensing a somewhat unlimited capacity to finance that so if, God forbid, you have a scenario even more stressful than your severe stress you would just be able to expand the financing available to you?
- Bill Greenberg: We are certainly – I think you can see this in the liquidity projections. We are certainly sizing our needs based on stresses to the base case, to the severe stress and even a little bit more than that. You can't see that in the liquidity projection because we only went to this stress. But it would still be true it would hold up for somewhat bigger than that.

Now, it is true if we see forbearance rates increasing a lot higher than 25%, which, frankly, I don't see – I think we're already starting to see – as staggeringly big as the unemployment statistics are that we're seeing in the market, we are starting to see them leveling off a bit. And so, we feel pretty good about the projections, that it won't rise above 20% or 25%. But obviously, if that does, the negotiations that we have with the banks could allow potentially to be renegotiated and upsized, but we're sizing it to be something larger than 25% at the moment.

Mark DeVries: Okay. Great. And could you give us a sense of how your blended returns might be impacted under the different scenarios as they'd be kind of forced to reallocate some capital to funding advances (inaudible)?

Bill Greenberg: Well, that might be a little bit more – I don't know if I have those numbers at my fingertips. I do know what we said was, including the higher forbearances and increased cost of service and reduced cash flow from loans in forbearance on the servicing asset, that in our base case the paired levered return is still in the mid-teens. I'd have to check about the other scenarios. I don't have them handy. We can get back to you.

Mark DeVries: Okay. Got it. That's helpful. Thank you.

Operator: Our next question today comes from Bose George. Please go ahead. Your line is now open.

Bose George: Hey, all. Good morning. I hope everyone is staying safe. Actually, first, can you give us an update on book value since quarter-end?

Tom Siering: Sure. Good morning, Bose. This is Tom. I'll take that.

Bose George: Hey, Tom.

Tom Siering: I'll take that first and then hand it off to Bill and Matt for further comments.

So, firstly, I always have to open up with the caveat that five weeks do not a quarter make. But as Bill and Matt alluded to in their script, in April and May we experienced a notable and favorable repricing on spec pools, which generated a significant amount of P&L.

However, there is a couple of other things to note. As Bill and Matt discussed, there's some uncertainty with respect to the effects that forbearance and extended servicing advances will have on future MSR marks. And then, additionally, we plan to record the internalization fees to Pine River in Q2. So, there's a couple – the big variable, obviously, is the forbearance effect.

Bill, Matt, please?

- Matt Koeppen: I'll take that one. Thanks, Tom. And good morning, Bose. So, to put a little more color around those moving parts, the specified performance has been strong in April and followed on in May. We've seen a multiple-point recovery after the big selloff in March, which basically put things back to closer in line with where we saw them in February. So, that component for Q2 is driving an attribution of around up 14%.
- Tom also mentioned servicing. So, we, like always, are getting our servicing valuations. They are valued by three independent brokers. However, as time passes – and we had this in some of our liquidity projections – you can imagine as forbearance flows through and prepayment speeds possibly pick up, we might see some pressure on multiples. And so, if that sort of pricing were to come through, we could see that sort of in the base case with the 2.5 mult leading to a book value change of about – that could be \$150 million or \$175 million. So, that could be around an 8% or 9% impact.
- And the third thing that Tom noted, the internalization payment, although it is due to be paid in September we are going to record it in Q2. So, that's about another 8% offset.
- So, I'd like to give you a more straightforward answer, but there's a lot of moving parts here and it'll depend on how those things play out.
- Bose George: Okay. Actually, thanks, Matt. That is very helpful. So, actually, just leaving aside the charge for the management fee, the spec poll, up 14%; the MSR, maybe down 8% or 9%. So, like a 5% up for the quarter to date is probably a reasonable ballpark?
- Bill Greenberg: This is Bill. So, the MSR mark that – we're guessing about that. That, we don't know. We have end-of-April marks which don't reflect that kind of movement at the moment. Given what we think is happening with forbearance rates increasing and how we think the world will think about that, that is a possibility of how we think the world might unfold. But that depends on the path of how the MSR asset performs and what the future marks end up being.
- We highlight it and we flag it just to put it out there, that that is a possibility and could happen, but we don't know. We'll have to wait and see.
- Bose George: Okay. That's really helpful. Obviously, that makes sense in terms of conservatism on that estimate. So, thanks very much.
- And then just going back to that stress scenario slide, you note that you assume the reimbursement on the P&I is after the 15 months. There's been some discussion and some chatter that the GSEs might come out with something to

reimburse servicers sooner than that. Do you have any thoughts on how that might play out?

Bill Greenberg: I don't, unfortunately. I'm hearing the same things you are. There's lots of proposals and possibilities in flux. These projections are made with the best information and assumptions that we have at the time. We update them every day as we learn new things and incorporate new information. So, as of the moment that's what these things include, and should we be able to be reimbursed differently or hopefully better, then we'll include those and we can update you guys on those when they happen.

Bose George: Okay. Great. Thanks very much.

Tom Siering: Thanks, Bose.

Operator: Thank you. Our next question comes from Trevor Cranston. Please go ahead.

Trevor Cranston: Great. Thanks. One more question on the liquidity projection and the forbearance scenarios. I guess, first, I just wanted to clarify that that does include the buyout of the management contract. And then, two, I was curious if there was any assumption in that projection around the dividend level changing from what was paid for the first quarter. Thanks.

Bill Greenberg: Sure. Hi, Trevor. Thanks for the question. So, the answer to the first question is, yes, it explicitly includes that payment. I'll also point out, by the way, what's not included in here is any liquidity or cash-raising from any portfolio adjustments that we could make, if necessary. This is all keeping the portfolio constant at what it is.

It does not include any dividend payments – well, it does and it doesn't, in a way. But the idea here is that the portfolio is going to earn what it's going to earn and that's going to be paid out. So, we're not building into these liquidity projections a growth in the liquidity from not paying the dividend. It's assumed to all be paid out. So, included or not included, I'm not sure, but we're not taking that money and hoarding it to make the liquidity look better. It's assumed to be paid out to the dividend.

Trevor Cranston: Okay. Gotcha.

Tom Siering: So, is that clear, Trevor?

Trevor Cranston: Yes. Thank you for that.

And then, on the scenarios you were discussing for MSR valuations, I was curious if there's any way for you to provide some context around kind of what you think the rough approximate sort of multiple on the MSR book would be in

the scenario with, like, your stress case in terms of forbearance combined with, like, a significant compression in the primary/secondary mortgage rate spread?

Bill Greenberg:

Look, it's very – thanks for the question. That's a very hard question. It's very hard to know. You're asking about what I think the future prices of something might be as the world unfolds.

That said – and we talked about this a little bit earlier in the quarter – the MSR market is hard to value, especially today because there's not very many trades taking place and so, the brokers are in a situation where they say, "Well, how do I put numbers on something when I don't see any observable trades in an illiquid and stressed market without willing buyers and willing sellers?" and so, in the absence of that the brokers have taken the approach that, "Let's keep for the moment risk premiums constant to what they were." We don't know whether that's true or not. The speed with which the markets have been evolving and moving has been astonishing. As Matt just told you, specified pool payups, as you saw in the chart in the presentation, they went from four points; down to one point, or below, in some cases; back up to four points. They're all back to where they were.

Now, there will be increased costs from servicing delinquent assets from the forbearances. There will be reduced cash flows, as the non-paying borrowers won't pay their service fee. So, there is what I would call a technical cash flow effect from the servicing cash flows. But depending on the curing scenario that you think might exist in the world, whether it's a deferral option or something, how long that persists for is unknown. Maybe, it's even short. Maybe, after one year people start paying their mortgages again if some of these deferral options come to fruition and there's not that much of an interruption.

So, it's hard to know. I think we do think, generally, that below-2 multiple is very hard to achieve on any long-term basis for these assets, with willing buyers and willing sellers, just the nature of the cash flows and the timing and what they're worth and the interest rate and convexity characteristics, and so forth. As I said in a previous comment, I think it could go to 2.5 depending on some of these things, depending on lots of factors. I don't see it going much below that, below 2. I guess if you had some very high stress scenario, 25%, that no one is expecting, including us, yes, I guess. It's very hard to know.

As things normalize, as trades start to occur, the market starts to heal, we'll get more visibility and we'll be able to speak with more clarity on what we think those scenarios are.

Trevor Cranston:

Okay. That's really helpful.

- Matt Koeppen: Trevor, I would add, in our liquidity projections we did and have – like Bill said, there's all kinds of uncertainty, but we did and do include scenarios that do take us down to a 2 mult even though we think maybe that's severe. We'll have to see what happens, but we do include those numbers in our projections.
- Trevor Cranston: Okay. Gotcha. That's helpful.
- Then, on the advance facilities, you guys are working on – I know they're not closed yet, but are you able to say anything about kind of what the costs of those facilities are likely to be when they're utilized and assuming they do close?
- Bill Greenberg: Not really, I'd say. We're still working on them and they're not closed and we're still negotiating.
- Bill Greenberg: They're very market terms, I would say.
- Trevor Cranston: Okay. That's fair.
- Tom Siering: We're not prepared to discuss that today.
- Trevor Cranston: Okay. Thank you, guys.
- Tom Siering: Thanks, Trevor.
- Operator: Our next question today comes from Rick Shane. Please go ahead.
- Rick Shane: Hey, guys. Thanks for taking my questions this morning, and I hope everybody is doing well.
- I want to touch on servicing advance facilities briefly. Historically – and I think Mark pointed this out – servicing advances are AAA-type assets and get very favorable financing. I am curious in this environment if pricing remains as attractive as it has historically and does access to servicing advance borrowing represent another barrier to entry in terms of that business.
- Bill Greenberg: Sure. Thanks for the question. So, servicing advancing as an asset class does typically enjoy financing advancing and so forth. That would be an asset, though, that – I think what you're thinking of is if we were to create the advancing securities and then sell them to the marketplace what it would look like. That would be a AAA security for the investor that would buy those notes. That's on the end user side to what we're making here.
- So, we may do that...
- Rick Shane: Actually, I misspoke and you're overcomplicating my question. I apologize. I just meant from a collateral perspective, the servicing advance is considered to be AAA collateral, that it gets – that it is – because of where it stands in the

waterfall, you typically get very favorable borrowing costs and very high advance rates.

Bill Greenberg: Yes, that's true. Because the counterparty risk is generally considered to be GSE risk instead of the servicer risk, yes, the advance rates are typically – and I can tell you market advance rates on advance facilities, depending on T&I and P&I, corporate advances, typically range in the 85% to 95% range. Those are just market terms for those kinds of things. Reflective of what you just said.

Rick Shane: Yes. And are you seeing any change in pricing, given the current market conditions related to those facilities?

Bill Greenberg: Yes, I'd say it's probably a little bit wider than what it was and what it would have been in February. But it's still very low – I consider it's still very low compared to other things in the world at the moment.

Rick Shane: Got it. Okay. You made the classic mistake of assuming my question was smarter than it really was. I wanted to do it on a very simple level to make sure I understood that.

Second thing. Look, you've exited the non-agency business. We understand given market conditions why you did that. I am curious if you think that that is a permanent exit? Or that will be a business and an opportunity that you'll revisit when markets normalize?

Tom Siering: Well, obviously – good morning, Rick. It's Tom. Obviously, it's something that we have deep expertise in, but we'll just have to see how things unfold.

Rick Shane: Okay. Great. Thanks, Tom.

Tom Siering: You bet.

Operator: Our next question today comes from Stephen Laws.

Stephen Laws: Hi, good morning. Effectively, no credit risk now. So, I want to focus one question on prepayments and two on servicing, if I can.

First, on repayments and refinance activity, really more at the higher level, how do you see the recent environment impacting processing times and repayment speeds? A lot of, in forming applications, borrowers that would have maybe been a clean rate-driven refi will now have an employment gap. Unemployment, possibly other things that I would have to think will slow that approval pipeline. But how did you guys see that impacting refinance activity? I know the mortgage bankers are pretty optimistic that the mortgage-to-Treasury spread tightened pretty quickly back to pre-COVID levels. But would love to get your thoughts.

And then, how to think about that from a lag on the refi index. Is it going to extend where that, instead of six weeks, it's more of eight or 10 or 12 or more? So, comments around that would be great.

Matt Koeppen:

Sure. I'll start with that one. Stephen, that's a great and interesting question these days. There's definitely a lot of uncertainty and speculation going on out there. I think one interesting thing that we've observed very recently – just yesterday, actually – speeds were released for the April period. And broadly, I think they surprised most of the market on the high side. So, the April closings would have reflected the very high MBA refi rate and the rate environment sort of back in the end of February and in early March before we really came under any stress. And I think most market participants would have thought that there would have been a very big impact on the ability of people to sort of go through with closings, just with social distancing and the country being as shut down as it was.

I think the feeds that came through in April showed that there probably was a pretty high pull-through rate. They actually increased by about 25%, which I think is what people might have thought they would have increased in typical times, in normal times, given the prevailing interest rates and conditions.

So, I think that was – it's only one month, and it was a bit surprising, and we'll have to see. This is unlike anything anyone's ever really observed. So, we're monitoring that and we're obviously going to watch the data as it comes in and see where that goes.

Bill Greenberg:

I'll just add a few words to that. I think there are forces on both sides. Obviously, rates are at low levels. So, that in ordinary times should be creating very high refinancing volumes. Forty-seven states now permit some sort of remote notarization. By our count or things that we've read, two-thirds of recording offices allow electronic filings today. Verification of employment requirements have been relaxed across the country, and so forth. So, the world has made adjustments to allow for the refinancing machine to continue, and I think this month's speed has been a reflection of that, which was a surprise to many people.

That said, I think various Wall Street analysts are projecting speeds to slow down, as much as 15%, or maybe even more, next month. We're seeing some signs of that in the refi index, and so forth. But I think it's slowing down from a high level. And so, I think that speeds will probably remain more elevated than people might think, given a more naive thought about what the pandemic is doing and the social distancing measures.

- Stephen Laws: Great. Appreciate the comments. And I guess before asking you to predict the future again, I'll ask about the servicing portfolio and just how the advance obligations are structured. But can you provide any kind of mix of your obligations, how much of it is scheduled versus actual for both interest and principal. I know it's different across Fannie and Freddie. And certainly, Ginnie, I believe is scheduled-scheduled, but I don't think you guys have any exposure there. Can you give us any breakdown there and maybe even quantify the difference? How much of an average payment is principal? And so, if it's actual principal advances instead of scheduled, how much is that a savings on the total advance obligation to you guys? 5%? Or 15%? Or what is that number on a delinquent payment?
- Bill Greenberg: Okay. So, the short answer to your last question is, I don't know. I don't have those numbers handy.
- On the breakdown of the portfolio, 20% of our portfolio is Fannie Mae actual-actual. I want to say around 30% is Freddie Mac and, therefore, scheduled-actual.
- Stephen Laws: Right.
- Bill Greenberg: And the balance is Fannie Mae, schedule-schedule.
- Even the actual-actual, though, which has no principal and interest advancing obligation, does have T&I advancing obligations.
- Tom Siering: Yes.
- Stephen Laws: So, you still have the T&I?
- Bill Greenberg: Yes. And in most ways, the way the modeling works – and not only the model, the way that the world works – is that's the bigger part of the obligation, anyway.
- Stephen Laws: Okay. But still, if I've heard correctly, 20% is actual-actual, which means you're not advancing any scheduled and unreceived interest or principal in that 20%.
- Bill Greenberg: That's correct.
- Stephen Laws: Great. I appreciate you clarifying that. I've been digging for that information.
- Back to predicting the future. A "W" recovery or a "W" event outlook, certainly concerned people are talking about. One aspect of the 120-day rule is if you get one good payment and they go into forbearance again the clock resets. So, I don't want to ask you to run a scenario for every possible situation, but in that event where you're maybe forced to cover seven of the next 10 mortgage

payments, how does that look from a liquidity standpoint? I would imagine the government would have to step in, in that type of situation, with some facility, because it's certainly not a Two Harbors-specific problem. It would be everyone. But do you have any thoughts around that with the clock resetting, if you get one payment in?

Bill Greenberg: Not very deep ones. I would say that the advance facilities are built to cover that. So, I think these things, they would be scalable in order to accommodate that, that the sizes are large enough. As you know, especially with the P&I advancing, the principal and interest custodial accounts can be used to offset that. And so, while low rates and fast repayments for a premium mortgage portfolio are generally not great, in this instance it would go a long way towards covering those sorts of obligations. As I said, the P&I part of the advancing is generally we look at it as being the easier to accommodate because of that. And so, I think all those thoughts would be true if that were to take place.

Stephen Laws: Great. Well, I appreciate the...

Matt Koeppen: And like we said earlier – I would add, too, like we said earlier, if a scenario like that were to happen, we of course will then have time. We don't have an unlimited amount of time, but as time passes that allows us to sort of be reactive and work on either additional facilities or upsizing of facilities, which I think we would be able to do if we needed to in that scenario.

Stephen Laws: That's a great point because it's not a margin call one-day issue. It's something you'll see playing out over months, and you'll see the "W" as you follow your delinquency numbers. So, I appreciate the comments today. And thank you very much.

Bill Greenberg: Thank you.

Tom Siering: Thanks, Stephen.

Operator: Our next question comes from Kenneth Lee. Please go ahead.

Kenneth Lee: Hi. Thanks for taking my question. Just wondering, on a broader level, how would you characterize your current appetite for making investments over the near term, just given the potentially attractive opportunities you see weighed against the uncertainty that's around the environment? Thanks.

Matt Koeppen: I'm sorry. Could you repeat that question? I don't think I caught it.

Kenneth Lee: Yes, certainly. Just on a broader level, just wondering how would you characterize your current appetite for making investments in the near term, given the potentially attractive investment opportunities you're seeing weighed

against the uncertainty you're seeing around environment? And relatedly, how leverage in the portfolio could evolve over the near term?

Matt Koeppen: I'll start. This is Matt. In one word, we're quite cautious here. I think we have to get a little bit of time passage and a little bit more visibility into what our advancing obligations are going to be and see how forbearance unfolds and sort of look at its impact on all mortgage assets. And we're looking forward to doing that. I think we're not quite there. We do need some passage of time.

But like I said earlier, there's indications that there's interesting opportunity out there once we feel like we're in a comfortable position to take advantage of things, but we're still pretty cautious today.

Bill Greenberg: I would add, one thing that I think is sort of self-evident, in a way, like, one signal for that would be when the forbearance uptake rates start turning over, just like we've seen in other contexts. Once you see that, then you can sort of project really what the future is going to look like, and so forth. And so, I think that's one of the main things that we're looking for.

Kenneth Lee: Okay. Very helpful. Thanks again, and hope everyone stays safe.

Bill Greenberg: Likewise, thank you very much.

Tom Siering: Thanks, Kenneth.

Operator: Our final question comes from Matthew Howlett. Please go ahead.

Matthew Howlett: Hey, guys. Thanks for taking my questions. Just a few quick ones. First, how are you monitoring sort of counterparty risk with the non-bank servicers or the guys you're buying from flow? Just curious on what's it like out there.

Bill Greenberg: I'm sorry. From people who we're buying from? I'm not sure what you're referring to.

Matthew Howlett: Well, kind of both. (inaudible) with some of the capital rules coming out or could come out, or liquidity, obviously, issues. How is that just sort of being monitored? I guess the question is, do you feel like there's going to be a need to Treasury servicing at some point?

Bill Greenberg: Right. So, the answer is, no. We have three subservicers, as you know And we've been public about who they are. It's Flagstar Bank, which is a bank. There's Dovenmuehle, which is a pure subservicer. They don't own any servicing. They don't have particularly any capital stress here. And then we have Mr. Cooper. And we have ongoing diligence reviews with them, and we check in with them about these sorts of things regularly and periodically. So, we don't have concerns at the moment about that.

- Matthew Howlett: Okay. There's no reason to go back up servicing or anything of that nature if any one of them run into liquidity issues.
- Bill Greenberg: I'm sorry. Can you say that one more time. I'm sorry.
- Matthew Howlett: I'm just saying backup servicing, things like that. There's no – is there anything in place to move servicing if you have to?
- Bill Greenberg: We do not have, like, a hot backup in place. No, we don't have that. One of the advantages I think of our model is its diversified nature of the thing, that we have it spread out among different subservicers. So, as you know, our portfolio is roughly split 40/30/30. To the extent that we would be able to potentially see through our regular reviews any stress or maybe on a forward-looking basis try to anticipate such things, we can of course enter into the process to move servicing from one to the other. We do that, not regularly, but we do it. We're very experienced in that. That could be accommodated in some amount of time. Obviously, it requires coordination and approval from the GSEs. So, we could do that, but we do not have a hot backup in place.
- Matthew Howlett: Okay. Thanks for answering that. And then, on just a modeling question, that sort of net interest spread that you guys get, that 113. There's been a lot of moving parts, obviously, with the sale of the non-agency book and repo costs coming down. How do we think about trending, how that's going to trend? How should we think about modeling that, going forward?
- Mary Risky: So, I can take that question. This is Mary. So, I think we expect on the asset side the yields to be in the low to mid-3s in the near term. I would note that as we delevered the portfolio, we correspondingly needed to reduce our net swap book at a time when three-month LIBOR was extremely elevated and stressed and long-term rates were low. So, we do expect that this will impact yields in Q2. But as swap and repos reset, we expect the net yield to return to more recently observed levels.
- Matthew Howlett: Got it. There will be an impact on lower yields because the higher-yielding non-agency book is out.
- Mark Risky: Yes, that will have a slight impact.
- Matthew Howlett: Got it. Great. Thank you.
- Tom Siering: Thanks a lot.
- Operator: Ladies and gentlemen, that concludes today's question-and-answer session. I'd like to turn the call back over to Margaret Karr for any additional or closing remarks.

Margaret Karr: Thank you, Claire. And thank you all for joining our conference call today. We look forward to speaking with you again soon. Have a wonderful day.

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