



Two Harbors Investment Corp. Second Quarter 2020 Earnings Call Transcript

August 6, 2020



TWO HARBORS
Investment Corp.

A Pine River Capital Managed Company

PREPARED REMARKS

Operator: Good day, and welcome to the Two Harbors Investment Corp. Second Quarter 2020 Financial Results Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Margaret Karr with Investor Relations. Please go ahead.

Margaret Karr: Thank you, and good morning, everyone. Thank you for joining our call to discuss Two Harbors Second Quarter 2020 Financial Results. With me on the call this morning are Bill Greenberg, our President and CEO; Mary Risky, our CFO; and Matt Koeppen, our CIO.

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 Bill.

Bill Greenberg: Thank you, Maggie, and good morning, everyone. I'd like to welcome you all to our Second Quarter 2020 Earnings Call.

First and foremost, we hope each of you and your families are safe and healthy. We also want to express our heartfelt sympathies if you or any of your loved ones have been affected by the virus. Lastly, we want to convey our tremendous gratitude to the heroes who are on the front lines of COVID-19, especially our fearless healthcare workers.

Please turn to slide 3 where you can view a summary of our results.

Our book value at June 30th was \$6.70 per share, compared to \$6.96 per share on March 31st. Excluding the previously anticipated one-time cost associated with the termination of the management agreement of \$0.54 per share, our book value would have been \$7.24 per share. After including both the interim

and regular second quarter dividends amounting to \$0.19 per share, this represents a 6.8% return on book value.

Please turn to slide 4. In the past few weeks, we have been asked what modifications in strategy might be expected given the recent management changes. The answer to that question is none. Matt and I, together, have been instrumental in developing and executing on our paired RMBS/ MSR strategy since we began investing in MSR in 2013. Today, as our portfolio consists almost entirely of Agency RMBS and Agency MSR, it is fair for you to think of us as an Agency-only REIT going forward.

We believe that our strategy of pairing Agency RMBS with MSR is a better portfolio construction than an Agency portfolio without MSR. The addition of MSR in a portfolio results in lower mortgage spread risk for a given amount of nominal portfolio leverage, which we believe will result in more attractive and higher quality risk-adjusted returns over the long term. We are as confident as ever that this is the right strategy going forward.

Next, I'd like to say a few words about our expected transition to self-management. As you are aware, on July 21st the Two Harbors Board of Directors announced that it had terminated the management agreement with Pine River for cause with an effective date of August 14. Under this provision of the management agreement, no termination payment is due. In response Pine River has amended its original complaint against Two Harbors. The Board believes this complaint is without merit and intends to vigorously defend its rights.

Unfortunately, we cannot say much more than that under the circumstances. We can say, however, that we stand ready and able to become self-managed on August 15, and this will be an important milestone for our company.

On behalf of the entire team at Two Harbors, I want to express our sincere gratitude to Tom Siering, our previous CEO, for his 11 years of service to the company. Going forward, I am humbled and honored to be given the opportunity to lead Two Harbors into its next chapter.

In summary, we are very optimistic about the future for Two Harbors and our unique portfolio construction. Our second quarter results were strong, our liquidity is excellent, and there are attractive opportunities in front of us. Now, I'll turn the call over to Mary to discuss the details of our financial results.

Mary Risky:

Thank you, Bill. Turning to slide 5, let's review our financial results for the second quarter.

Our book value at June 30th was \$6.70, compared to \$6.96 per share on March 31st. Excluding the previously anticipated one-time cost associated with the termination of the management agreement of \$0.54 per share, book value would have been \$7.24 per share, representing a 6.8% return on book value.

Quarterly book value growth was driven by positive performance from our RMBS portfolio as specified pool payups recovered and was offset by lower MSR pricing from fast speeds and increased forbearance. Our liquidity position remains strong with \$1.6 billion in unrestricted cash at June 30th.

Moving to slide 6, let's spend a few minutes discussing our swap position. Coming into the market volatility in March, a significant portion of our payer swap position was transacted some time ago and in a higher rate environment. As rates fell during the quarter, these payer positions declined in value as you would expect so that by the end of Q1 the mark-to-market value of these positions was an unrealized loss of approximately \$700 million.

As we de-levered in March by selling pools, we replaced that duration by entering the swap positions with offsetting terms to some of our existing payer swaps. However, at that time, three-month LIBOR, which was the pay leg of the new swaps happened to be at elevated rates relative to where it was earlier in the month, and this created a core earnings drag for Q2.

Although economically we are indifferent to swaps with positive or negative mark-to-market values, our position in Q2 with large negative swap values and correspondingly large costs materially impacted net interest margin, core earnings and taxable income.

Importantly, at the end of the second quarter, we restruck our entire swap portfolio at current market rates, compressing offsetting positions and reducing overall gross notionals. As you can see on this slide, we went from a gross notional of \$57 billion down to \$4 billion and reduced our net swap cost from an annual cost of \$344 million to something projected to be near zero.

Our remaining swap position is \$1 million per basis point in total. However, the position has fixed paying swaps in the front part of the yield curve, and fixed receiving swaps in the longer part of the curve, in order to hedge the residual duration of our RMBS and MSR portfolio.

Additionally, during this repositioning, we took the opportunity to convert the entire position to OIS swaps instead of LIBOR swaps. We expect these actions will increase net interest margin and core earnings in the latter half of 2020 and future years.

Moving to slide 7, let's discuss our core earnings results. Core earnings were negative \$0.05 per share in the second quarter. Core earnings were primarily impacted by elevated swap costs, as we just discussed, and lower net interest income due to the sale of legacy non-Agencies and higher coupon Agencies in the first quarter. Though we have not typically provided core earnings guidance and don't expect to do so going forward, given the extraordinary difference in core earnings this quarter and current market conditions, we anticipate core earnings to be in the range of \$0.22 to \$0.26 in the third quarter, assuming no change in portfolio composition.

This quarter again highlights what we have been messaging for many years: core earnings is not necessarily indicative of the ongoing earnings power of our portfolio nor is it necessarily a good measure to compare to our dividend level. In fact, as a result of our actions in re-striking our swap portfolio, we expect that in Q3 and beyond we will have the opposite situation to prior quarters where core earnings will be in excess of our portfolio earnings power and dividend.

Turning to slide 8, our portfolio yield in the quarter was 2.84% and our net yield decreased to 0.23% from 1.13%, driven primarily by portfolio sales in Q1 and elevated swap costs. As you can see on this slide, our estimated net yield of 2.24% on the portfolio held as of June 30th, is dramatically higher due to swap re-striking and continued repo rolls at favorable terms. As we just discussed, since our swap position is now very small, and our RMBS position still reflects accounting yields in the higher rate environment in which most of them were purchased, both core earnings and portfolio yields are anticipated to exceed our expected returns in coming quarters.

As we continue to rotate our asset portfolio and sell some of our older holdings and move into newer, low coupon pools, we expect our asset yields to decline to market rates, and the net portfolio yield should start to converge to market levels that are more consistent with our return expectations.

On slide 9, we have summarized our financing portfolio as of June 30th. Our economic debt-to-equity at quarter end was 7.4x compared to 7.0x at March 31, and our quarter average economic debt to equity was 6.8x.

As we will discuss shortly, we plan to increase our leverage in the second half of 2020 with a target in the 8-9x range.

The repo markets have been stable and term markets have redeveloped. At June 30th, we had 20 active Agency repo counterparties with the weighted average maturity of 47 days. However, I would note that as term markets have developed further since quarter end, our weighted average maturity has extended to 65 days as of the end of July.

Across our MSR facilities, we had \$267.2 million outstanding in bilateral structures and \$400 million outstanding MSR term notes. As of June 30th, our total committed capacity across our MSR financing alternatives was \$750 million.

Post-quarter end we closed an additional \$100 million MSR financing facility. We are also in the final stages of closing a servicing advance-only facility and are working sequentially on another facility that finances both MSR assets and servicing advances. These facilities will provide us with additional liquidity in the event of increased forbearance or defaults and support future MSR portfolio growth. For more information on our financing profile, please see appendix slide 27.

Turning to slide 10, we'd like to address some dividend and taxable income considerations for 2020. As a result of the events of the first quarter, the REIT is anticipated to generate a net operating loss for 2020 and distributions to common stockholders are likely to be characterized as return of capital for tax purposes. Return of capital is a tax concept, not an economic concept, and says little about whether distributions are supported by earnings or economic returns due to differences in income recognition rules.

Return of capital can be constructive to a stockholder in that the distribution is not subject to current tax but rather reduces the tax basis in the stock. Any potential tax from such distribution is deferred until a future sale is realized by the stockholder, which may also benefit from reduced long-term capital gains tax rates versus ordinary tax rates.

As we have messaged consistently, our dividend level is a function of several factors including earnings power of the portfolio and we expect Q3 and Q4 dividends will be sustainable at the current level, before giving effect to the expense savings we anticipate in Q4 from our transition to self-management, subject to the discretion and approval of our Board of Directors and market conditions.

Lastly, let me say a few words about the non-renewal payment. When the Board of Directors announced its plan to not renew the management contract with Pine River on April 13th, the non-renewal payment as well as associated legal and advisory costs were required to be recorded in Q2. The non-renewal payment was initially estimated at \$144 million and subsequently calculated at \$139.8 million based on June 30th results.

As announced on July 21st, the Board of Directors subsequently terminated the management agreement for cause which carries with it no associated termination payment.

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

Matt Koeppen:

Thank you, Mary, and good morning, everyone. Turning to slide 11, let's review our quarterly portfolio activity and composition.

As Mary noted, the quarter-to-date performance on book value was 6.8% excluding the recorded charge for the non-renewal. As we've noted, the primary contribution to our positive performance was due to reflation in specified pools following the extreme stress of March. Net of TBA spread widening in the 3% through 4.5% coupons, the gross return from pool and TBA performance was approximately 13%.

As expected, we did see some pressure on the pricing of the servicing portfolio which was a negative offset of around 4%, reflecting in part the reality of higher

servicing costs and the impacts of borrowers in forbearance and their ultimate resolution. We did add modestly to our RMBS portfolio on net during the quarter, deploying risk as we became more confident in our liquidity position which we will discuss shortly.

Our TBA balances increased by \$1.5 billion, as we added in the current coupon. Additionally we purchased approximately \$2.1 billion of low coupon specified pools and sold approximately \$1.4 billion of high coupon specified pools. We have begun rotating down in coupon, where due to the Fed's large-scale purchase activity, we expect rule specialness to persist in the near future.

Our high coupon positions, while experiencing faster speeds, should benefit not only from their inherent call protection but also from burnout at some point.

Please turn to slide 12, as we discuss our specified pool positioning and prepayments. You can see in the lower left-hand chart the performance of TBA coupons in grey and also specified pools in blue. The underperformance in the 3% through 4.5% TBA coupons occurred as spreads widened after the Fed ceased purchasing those assets. At the same time, the specified pool performance overwhelmed the underlying TBA widening.

The drivers of this were the Fed's large intervention in the RMBS market; the recovery of the repo market; and general improvement in price stability following March. Today we remain positioned largely in loan balance and geography stories.

In the lower right-hand chart, we show a comparison of generic speeds to our specified portfolio speeds by coupon. The slower prepayment speeds of the specified compared to generic highlights the reason that specified pools command a significant price premium over TBA.

We expect that while prepayments will increase in specifieds, those increases should be modest compared to generic collateral.

With that, I will turn it back over to Bill.

Bill Greenberg:

Thank you, Matt. Please turn to slide 13. We added \$4.1 billion of UPB of new MSR in the quarter, after resuming our flow sale program with all of our sellers. The lower left-hand chart shows our flow volumes and pricing going back three years. You can see that we had high flow volume in March as originations are high and increasing just as the liquidity events occurred.

In April we moved our pricing to zero and lock volume dropped off to almost nothing. After resuming our program at adjusted levels, we have started to generate flow volume again, locking in more than \$2 billion in June and increasing to approximately \$4.5 billion of flow commitments in July, which brings us back to record highs. Also, we have seen activity in the bulk market increase, with multiple sellers engaging with brokers and buyers.

We continue to expect higher volumes transacting in the coming quarters as origination volumes remain robust. There is still price discovery taking place in the bulk markets, and we find valuations to be situational with some packages trading at pre-crisis yields while some are clearing at wider spreads. Additionally, it's worth noting that our existing portfolio is marked roughly in line with the current bulk trade levels.

In the lower right-hand chart, we have another prepayment comparison, this one showing our servicing prepayment speeds in blue versus generic collateral in grey. Although speeds have increased recently, a majority of the underlying loans in our servicing portfolio have some form of seasoning or prepayment protection which is why our speeds are so much slower. Nevertheless, we do have expectations for speeds to remain elevated going forward. Low interest rates have given rise to all-time low mortgage rates, even with the spread between primary and secondary rates at very wide levels. The longer that interest rates stay low, the greater our expectation that primary rates will come in further.

In addition, the refinancing machinery in the market seems to be operating with no degradation from the social distancing measures in place across the country. Prepayment speeds have generally been faster than most market participants expected.

This quarter, we have once again put together our forbearance and liquidity projections, as shown on slide 14. Our data remains similar to other publicly published sources, and we are seeing more borrowers exiting forbearance than entering. From a high on June 1st of 7.2% of borrowers by loan count, we are down to approximately 5.8% at the end of July with approximately 32.2% of borrowers having made the July payment as of July 28th. Said another way, the number of loans that are both in forbearance and not paying their mortgage is just under 4%.

You will recall from prior presentations our scenario analysis includes peak forbearance uptake rates of 8%, 12% and 16%. Our resultant liquidity profile is updated based on those scenarios and is displayed in the lower chart.

You can see that we retain significant amounts of liquidity even in the 16% scenario. Given that our delinquent forbearant loans are only running at 4%, these projections show that we are well-protected even at levels that are four times our current experience.

I would point out that this liquidity forecast includes the impact of the use of our anticipated funding facilities, excludes expected future capital deployments, and assumes no payment for the termination of the management contract.

We do expect that we will be deploying additional capital in the coming quarters, and that would reduce the liquidity projection shown here by

approximately \$200 million to \$300 million. Finally, given our confidence in the outlook for forbearance in our liquidity, we don't anticipate including this slide in future presentations.

Matt Koeppen:

If you'll turn to slide 15, I'd like to make a few comments about the repo markets in addition to what Mary discussed earlier. The left-hand chart shows a time series of the Fed's outstanding balances in overnight and term repo operations going back to September, which was the outset of the Fed's program to normalize market functioning. It's notable that recently the balances have fallen to zero.

On the right-hand chart you can see our estimate of mortgage repo rates since March. After spiking during March, rates have settled in at much lower levels. Combined, this data presents a picture of a much healthier funding environment and, importantly, a free-standing market without the support for the Federal Reserve.

On the next two slides, we discuss our effective coupon positioning and risk profile. On slide 16, you can see that as of June 30th, our effective coupon positioning was short the 1.5% and 2% coupons through our position in MSR and long 2.5% through 5%. The current coupon today includes the 1.5% coupon, as the 2% coupon was trading around a \$102 price at the end of June.

Although there isn't any significant volume trading in the 1.5% yet and there is no regular TBA quoted, we have observed a small amount of 1.5% coupons pooled recently. Additionally, subsequent to quarter-end, we have continued to rotate down in coupon and have outright added 2%'s to our position.

Moving to slide 17, our exposure to both rates and spreads remains low and in line with our historical positioning. The left-hand chart shows that for a 25-basis-point parallel shift up in rates, we would expect book value to increase by 0.6%.

Interestingly, our MSR position has more negative duration than our RMBS position. As shown in the right-hand chart for a 25-basis-point spread widening, we expect book value to lose 1.4%. Again, our MSR position provides significant hedging benefits and reduces the overall exposure by 70%. I would like to remind you that these exposures are expressed as changes to book value of common shares, not changes to book value of total stockholders' equity.

The capitalization changes during the events of the first quarter resulted in the amount of preferred shares increasing from roughly 20% of total stockholders' equity to around 35%. This increase in preferred share percentage acts just like additional leverage to the common shares, which should be considered in conjunction with the overall portfolio leverage. While we are respectful of the overall nominal leverage and the preferred share percentage, we manage our portfolio to drawdown risks to common which include all these effects and we

are very comfortable with the drawdown risk exposure of 1.4% shown on this slide.

In conclusion, before turning it back to the operator, let's take a look at our outlook for Two Harbors and our return expectations on slide 18.

We see gross returns for RMBS hedged as swaps to be in the range of high-single to low-double digits, depending on coupon, story, and roll financing. On the MSR side, we are seeing larger-than-usual divergence between flow and bulk acquisitions with flow MSR paired with RMBS having an expected return in the low-to-mid double digits while bulk transactions can be 250 to 500 basis points tighter.

Although last quarter we indicated that returns on paired MSR could be in the high teens to mid-20s, these returns turned out to be unachievable at scale as regular sellers have been retaining their production and MSR prices in general have increased off the lows very rapidly, like most asset classes.

As we look forward, our liquidity profile has become not only stable but strong and the risk of price declines on MSR due to increased forbearance and delinquencies have receded. As a result, we are increasingly comfortable with prudently deploying additional capital in the second half of the year. This will result in ultimately raising our economic debt-to-equity from our June 30th level of 7.4x up to 8x to 9x, and also increasing our drawdown risk from 1.4% to a range of 2% to 3%.

We expect that this will increase our portfolio returns from high single digits to low-to-mid double-digit gross returns.

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

QUESTION & ANSWER

- Operator: Thank you, sir. If you would like to ask a question, please signal by pressing star-one on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star-one to ask a question. We will now take our first question from Bose George. Please go ahead. Your line is open.
- Bose George: Hi, everyone. Good morning. Can you just talk about your economic return expectations this quarter? You noted the core earnings expectations and the difference between that and the economic return. So just curious how that would be, and especially keeping in mind that your cash is still a little bit higher than it will be when it's normalized.
- Bill Greenberg: Good morning, Bose. Thanks for the question. So I would say this, that the expected economic return for the portfolio is as Matt describes on page 18 for

the various different combinations of RMBS and MSR. The fact that we have more cash than maybe you're used to seeing from us is a little bit of a side show that really we're managing our portfolio with respect to risk, right, and what we call drawdown risk. And given the changes in our portfolio since Q1 and really only having agency assets, that is the lever that is most constraining to us. And as Matt said, we intend to increase our leverage to 8 to 9 times because that's a level of risk that we feel comfortable with. And given the composition of the portfolio that will necessarily come with higher cash balances than you're used to seeing.

Bose George: Okay. Yeah. So that makes sense. So the cadence of the returns will just improve over the course of the year, I guess, as the leverage gets to that level? And is that sort of the year-end target, or when do you get to the higher level of leverage?

Matt Koeppen: Yeah. Good morning, Bose. This is Matt. I do think that we intending to be prudent about it. The cadence of the increase we'll have to see, it'll be dictated a little bit by what's going on in the market. But I do think certainly by year-end we'll be able to get to those levels, and hopefully sooner than that.

Bose George: Okay. Great. Thanks very much.

Operator: We will now take our next question from Doug Carter. Please go ahead.

Doug Carter: Thanks. Matt, on your comment about increasing that drawdown risk or exposure, is that something that you know, I guess we get there through the higher leverage? Or though the kind of change in the swap portfolio?

Matt Koeppen: Hey. Good morning, Doug. No. It's more from the -- well, the higher leverage will in turn increase mortgage spread risk which is what -- which is what would lead to sort of higher shock. So that's a pretty low number, right, as you know just in absolute terms and relative to our peers, I think we'd still be quite comfortable with a portfolio that had a 2% to 3% drawdown in a 25-basis-point mortgage shock. So --

Doug Carter: And then --

Bill Greenberg: And some of that range out at one thing, Doug.

Doug Carter: Sure.

Bill Greenberg: Some of the variation in that range will depend on the -- as we deploy additional capital, but it will depend on the mix of MSR amounts that we will be able to add in that process as well. Obviously the more MSR that we add, the smaller that increase will be.

Doug Carter: So I guess along that point, Matt, as you mentioned kind of the -- your negative duration from the MSRs, kind of that exposure greater than it is on the agency

MBS, I guess how do you think about balancing those -- those two numbers, what kind of how and when you're looking to add leverage and how does that kind of fit into kind of what you're looking to do over the coming months?

Matt Koeppen: Yep. That's a good question. Maybe we'll -- oh, go ahead, Bill.

Bill Greenberg: I was just going to say, right, but then Matt, please jump in -- that the fact that the MSR interest rate duration and the RMBS interest rate duration happened to be very close to one another although the MSR is slightly higher, is an accident of just where we happen to be in rate level and in notional amounts of each of those components. And so there's no target for that, and to the extent that we add additional assets, we will hedge the interest rate duration as we always do to something close to zero. Matt, would you add anything to that?

Matt Koeppen: I was just going to say, it's going to be a function of a little bit in what sort of servicing we are able to procure. You know. We've had good luck as we said recently, restarting our flow program. Those volumes have been increasing nicely at attractive levels. We've started to see more bulk transactions being discussed, especially more recently in the last month. And so you know, the size of our servicing portfolio would be a function of what we were able to execute on and we certainly have room to grow it from here.

Doug Carter: Great. Thank you, Bill.

Operator: We will now take our next question from Trevor Cranston. Please go ahead.

Trevor Cranston: Great. Thanks. Question about how you're thinking about the agency market as you're looking to sort of re-deploy some of the excess capital. You mentioned that you're rotating down in coupon. Can you comment on how you see the relative value between investing in TBAs versus pools given the rule specialness that we're seeing in the TBA market? Thanks.

Bill Greenberg: Yeah. I'll start. Hey, good morning, Trevor. Thanks for the question. Obviously the amount of specialness that we're seeing in 2%, 2.5% and 3% is significant as Matt indicated during his remarks. We have, especially post-quarter-end, begun adding exposure to those coupons. It seems like the forces that have driven the roll specialness to be what it is, seem to be in place for a little while. Obviously, these things never last forever. But they seem to be in place for the foreseeable future. And so I think that's made those coupons very attractive from a -- from a total return perspective.

Obviously, prepaid speeds are fast. It's obviously one of the reasons why roll specialness is what it is. But this is also the exact environment where the prepayment protection of those specified characteristics really become manifest and show why those pay-ups are what they are.

So we continue to find attractive opportunities in value in both of those things, but as Matt said, we are -- the bulk of our additional exposure has been in the current coupons.

Trevor Cranston: Got it. Okay. Thanks. And then one more follow-up on the hedging strategy. You talked about the duration of the MSR versus the agency portfolio today. And obviously the resetting of the swap book. Can you talk about how you're thinking about options working into your hedging strategy, you know, in light of the convexity and you having a larger MSR hedge versus the agency portfolio?

Matt Koeppen: Sure. I'll start with that. Typically the times that we are more active in option strategies is when our portfolio is more negatively convex. And given the low level of rates and the low durations in both servicing and in mortgages, we are less negatively convex than usual and that then requires less use of options in the portfolio. At the moment, at this level of rates, that's where we find ourselves.

Trevor Cranston: Okay. That makes sense. And then the last question, on the internalization. Can you guys comment on sort of where you expect the quarterly expense level to come out, you know, on a run rate after the internalization is completed?

Mary Risky: Sure. This is Mary. So, our management fee is currently 1.5% of equity, and our other operating expenses is running around the same. We just expect a small increase in the expense ratio for the things that were covered under the management agreement. I would expect we would be in the 2% to 2.5% range.

Trevor Thompson: Okay. That's helpful. Thank you.

Operator: We will now take our next question from Rick Shane. Please go ahead.

Rick Shane: Hey, guys. Thanks so much for taking my questions. Most have been asked and answered, but first, just from a housekeeping perspective on the termination of the management agreement, I'm assuming that we will see a reversal of that in the third quarter, that this is a timing issue. Is there anything from a legal or GAAP perspective that puts that at risk? Is there any certainty that needs to be achieved there that we need to be aware of?

Mary Risky: So the -- you know, as I noted on the call or in my prepared remarks, that the non-renewal termination payment was required to be recorded under GAAP. The termination for cause was announced in Q3, and as stated, has no termination payment under the contract.

As you know, there is pending litigation so we will just be evaluating that as we go through the quarter and see how all of that unfolds.

Rick Shane: Okay. So it's not 100% certain that that will be reversed, so to the extent you're providing book value ex- the termination fee, that's something that is subjective at this point?

Mary Risky: Well, I --

Bill Greenberg: I'd just say we can't say more than we -- we just said, right, unfortunately given the situation. I hope you understand. When we mention the results of a book value of what the book value would have been of \$7.24, had that termination payment not been recorded, that was to give you a sense of what the economic return would have been just based on the earning assets. These other one-time charges will be accounted for and unfold as they will in the course of the events.

Rick Shane: Got it. And I do want to be respectful of the sensitivity of the topic and so I'll move on. Thanks. Thanks you guys, for that.

Just to explore a little bit further some of the comments that have been made on the call, one on there is the intention and the opportunity to increase leverage, expand the portfolios through the remainder of the year. The second is that the flow program has been turned back on, but you guys made the comment that there are lenders who are retaining servicing and pricing ends up being higher. Two questions there. Does that suggest that the marks to the MSR portfolio based on current pricing should be positive if we were to take them today, and also does that change your strategy related to hedging vis-à-vis MSR versus swap, particularly in light of the fact that rates are going to be likely low for so long?

Bill Greenberg: So I'll start. There was a lot there, and so please forgive me if I -- if I miss some of the questions, and you can remind me to answer some of them. So firstly as Matt said, in his remarks, we believe based on the trade color that we're seeing in the bulk market, situational as it may be, seems supportive of the level that we are currently marking our MSR at, where the brokers are marking the MSR at. Unlike in the first quarter when we felt like values would likely drift lower, but they hadn't yet because brokers hadn't any observations on which to base that. We now feel like all that is in sync and the MSR portfolio is marked where trade levels are current.

On the flow side, as Matt said, we are able to acquire servicing through that channel at a significantly cheaper level than where we see bulk deals clearing, to the tune of 250 to 500 basis points cheaper. You know, while we made record levels in July of around \$4.5 billion. We're currently running in the days since then, I could say we're currently running at around a \$5 billion per month rate at the moment. And we're continuing to add new sellers and relationships. And so I think we would expect that number to go higher rather than lower over the balance of the year, maybe to \$6 billion or so depending on lots of factors. But that's where we see it headed over the balance of the year, hopefully.

And then I think you had a question about leverage potentially. Matt, you want to jump in there?

- Matt Koeppen: I think Rick, I think the last part of your question was maybe about how we're thinking about hedging and swaps. I think we are not thinking differently about how we structure and hedge our portfolio. Because of the presence of MSR, our swap hedges are quite small, right. We're net payers in the front end and net receivers in the longer end. So it's really just to hedge out our curve exposure. But as I think you observed and mentioned, you know, a very large percentage of our spread and long-end duration is hedged in the portfolio construct with servicing.
- Rick Shane: Great. Bill and Matt, thank you. You got all those questions. I appreciate it very much. Have a great day, guys.
- Bill Greenberg: Thank you, Rick. You too.
- Matt Koeppen: Thanks, Rick.
- Operator: We will now take our next question from Stephen Laws. Please go ahead.
- Stephen Laws: Hi, good morning. So like with Rick, a lot of my stuff has been covered but do have a couple of smaller things. I guess we'll continue for leverage for a second. Just so I understand, the 8 to 9, is that comparable to the economic leverage of 7.4 or do we need to build 8 to 9 versus some other leverage metric that you're referencing?
- Bill Greenberg: No. That's comparable to the 7.4. Good morning, Steve. Thank you for the call.
- Stephen Laws: Yeah. Morning. You know, follow-up on that, obviously you can increase leverage by buying back common stock, trading at about a 20% discount to book, almost 30 if you add back the restructuring charge. Is that something you're considering as a way to increase leverage that might have better returns than the double digit, you know, portfolio returns on new investments? Or does something with the lawsuit put you in a blackout period until that's resolved and prevent you from repurchasing common stock?
- Bill Greenberg: Yeah. So repurchasing stock is obviously something that we look at frequently and obviously we talked about, but doing such a thing -- earlier in the period, in the crisis, when the discount to book was very significant, in March and April we were obviously very concerned about our liquidity when capital was precious. And so we chose not to do anything at that time. At current levels, when we look at that, we are always weighing what does a 20% to 30% one-time gain -- how does that compare with earning low -- low mid-double digits for many years, all right. So if you're talking about sort of a two-year sort of equivalence, we think it's a better use of capital to keep it in-house and to invest in our target assets rather than to buy back shares.
- But depending on the opportunities in front of us and the level of the discount, that may change. But that's certainly one tool in our box that we look at as ways to increase shareholder value.

Stephen Laws: But it is a tool at your disposal, you're not blacked out at this point? I mean, other than the -- the 48 hours I guess around earnings?

Bill Greenberg: I can't answer that question. I'm sorry.

Stephen Laws: Okay. Moving on, then. Servicing expenses, up some, not as much as I expected. I believe you guys have tiered subservicing costs with your contractors. Can you maybe talk about those tiers, and I guess to relate it to your deck, I appreciate all the disclosure and the work you guys have put into this, expanding over the last couple of quarters. But the MSR looks at really an 8%, 12% and 16% forbearance rate. Can you talk about what the impact would be on your subservicing expense rate at those different levels?

Bill Greenberg: Sure. So, a good question. So as you know the cost to service a loan is call it \$6 to \$7 per loan, right. The cost to service a delinquent loan is I don't know, 10 times that number. Everyone's different and our subservicers is a different mix, right.

Given the situation that we have with the CARES act and people entering forbearance and so forth, it obviously costs more to service those loans than it does a current loan but not as much to service a loan in forbearance than it does to service a delinquent loan where people aren't paying and you're trying to get them paying again. This is you set it, and you forget it in a way until they come off it in six months or a year or whatever. And so we have renegotiated our subservicing costs for all loans that are delinquent and in forbearance to be something between those two levels, call it something in the \$30 per loan area. Okay.

So I don't have those numbers handy in terms of 8%, 12% and 16%. I think with the math that I gave you, you can probably calculate that more quickly than I can while I'm on the call here. But that's what it would be. But as I said, we are seeing more loans exit forbearance than enter. We said we were at 5.8% at the end of July. That's continued to have gone down in the days since even more. Obviously we're concerned and we're watching about potential second waves or expiration of PPP, and -- that cause those rates to go up. So we're aware of that but as of right now the trend is still clearly for those numbers to go down.

Interestingly, I can also tell you that of the people who are leaving forbearance, around 80% of those guys were the guys that were current, right. So when we said today at the end of July our current rate was 5.8% and 32% have made their July payments, that compares in previous months when the number who were current was higher. Most of the people exiting forbearance have been people who have been current. That's part of the reason why that ratio has been dropping. But around 20% of those guys have been actually prepaying, and have been curing in one other way or another.

So the trends could reverse. But right now you see the chart. It's a pretty -- pretty significant trend declining, that we expect that to continue for some time.

Stephen Laws: Great. And my last question is a follow-up on servicing. I believe your advance obligations include real estate taxes, and correct me if I'm wrong. But you know, what kind of risks do you think there is, that you know, different municipalities try to address their budget issues for higher real estate taxes that maybe makes this liquidity -- I don't know. If taxes are part of what you have to advance, are those assumed flat in these liquidity projections? And how do you view the risk around higher real estate taxes as far as what that would do to your advance obligations?

Bill Greenberg: Yeah. So the short answer is, who the heck knows. The longer answer is, in our projections we do assume real estate taxes increase at around 3% a year. That's just some relative inflation rate. You know, the frequency of the remittances to the local taxing authorities is typically infrequent. It's on average one to two times a year. Sometimes there are some -- some municipalities that collect them quarterly. And so those numbers have so far been small, right, because the biggest months are February and August-September. So those are just starting here. But the current rates are still low, as we said, 4%. So I guess if that number goes up, it could go up. But my sense is that will take a long time for -- for people to try to change those things in some way that can affect these things, and who knows how long the time scale of this thing will happen?

And then I'll point out also that the liquidity projections show that we are very comfortable, at least up to 4 times our current levels of what they are. So if you'd map a higher real estate tax amount into a gross higher forbearance take-up rate, you can see there's lots of room there that we would be comfortable with. And so that's not something that we're worried about really at all.

Stephen Laws: Okay. I appreciate the color and the time this morning. Thank you.

Operator: We will now take our next question from Kenneth Lee. Please go ahead.

Kenneth Lee: Hi. Thanks for taking my question. Just one follow-up on the prepared remarks. You mention that you're probably earning excess net investment spreads, currently, but you expect asset yields to gravitate towards you know, a little bit lower. Wondering if you could just give us a sense of where the net investment spread could ultimately settle down at? Thanks.

Mary Risky: I think we're expecting over time it would be in the 125 to 150 range. Matt, I don't know if you have anything to add to that.

Matt Koeppen: Yeah. That sounds right. Good morning, Ken. I mean, you can look in the market and see the current yield environment. Obviously we're low here, and so if you know, if asset yields on RMBS are 100 or to 125 basis points or 150 basis points, as we stay low, right, you would expect that as prepayments speeds work their way through our portfolio and we're reinvesting into current

market rates, in addition any portfolio turnover that we have or we're selling existing assets and buying new assets at new market yields, you could see with enough time passing you would expect our net interest spread and our -- and yield of our portfolio to reflect something that looks more like a market rate. But that would be measured over the course of -- that will take time, right. Even if we stay at low rates, that's going to be measured in years. You know, that's one to three years before we fully realize lower net investment spreads. So --

Kenneth Lee: Got you. Very helpful. And just one follow-up if I may. Just in terms of the current discussions on the servicing advanced facilities, realize that you guys are close to the final stages but wonder if you can just give us any additional color on the discussions and then perhaps time frames in terms of what -- when you could potentially close them. Thanks.

Bill Greenberg: Yeah. You know, as Mary said in her remarks, you know, we're very close on one. Some of these timelines have a life of their own in terms of the approvals that need to be acquired and so forth. And so we expect that one to be up and running shortly, I'd say. And then the second one again, as Mary said, we're working on that sequentially so that will be a little bit longer. But there's the -- there's no roadblocks or hurdles. It's all just -- just what I would say, regular way people getting approvals in this environment.

Kenneth Lee: Great. Very helpful. Thank you very much.

Bill Greenberg: Thank you.

Operator: We will now take a follow-up question from Bose George. Please go ahead.

Bose George: Hey, thanks for taking the follow-up. I just had a question on the dividend. You note in the slides that the common dividend is going to be treated as a return of capital for tax purposes. Was curious whether that benefit goes for the preferred as well.

Mary Risky: That is to be determined. I think you could assume that all the dividends would be, would have the potential to be return of capital, but it'll depend on how the year plays out.

Bose George: Okay. And actually just thinking prospectively, given the level of taxable losses, is a portion of a dividend likely to be return of capital for a while? Is there -- how should we sort of think about that as well?

Mary Risky: I think there's a potential that a portion of the dividend in future years could be return of capital.

Bose George: Okay. Great. Thank you.

Operator: There are no further questions. I'll now turn the call back to Maggie Kerr for any additional or closing remarks.

Margaret Kerr: Thank you, Tracy, and thank you for joining our conference call today. We look forward to speaking with all of you again soon. Have a wonderful day.

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