



ARMOUR Residential REIT, Inc. (ARR)

Updated October 29th, 2018 by Josh Arnold

Key Metrics

Current Price:	\$21	5 Year CAGR Estimate:	7.2%	Volatility Percentile:	38.3%
Fair Value Price:	\$20	5 Year Growth Estimate:	-2.0%	Momentum Percentile:	34.8%
% Fair Value:	107%	5 Year Valuation Multiple Estimate:	-1.4%	Growth Percentile:	1.3%
Dividend Yield:	10.6%	5 Year Price Target	\$18	Valuation Percentile:	34.5%
Dividend Risk Score:	C	Retirement Suitability Score:	A	Total Return Percentile:	29.2%

Overview & Current Events

ARMOUR Residential is a mortgage REIT that was formed in 2008. The trust invests primarily in residential mortgage-backed securities that are guaranteed or issued by a United State government entity including Fannie Mae, Freddie Mac and Ginnie Mae. ARMOUR has a \$900 million market capitalization and produces about \$140 million in annual revenue.

ARMOUR reported Q3 earnings on 10/25/18 and results were roughly in line with expectations. Cash flow per share came in at 64 cents, exceeding the dividend payment for the ninth quarter consecutively. Average yield on assets was steady at 3.5%, as was net interest margin at 1.6%. The trust also maintained leverage at 5.9, which is right near the average for other mREITs like ARMOUR. In total, Q3 largely met expectations and as a result, we've maintained our estimates for this year and beyond. The trust continues to be able to amply cover its all-important dividend and the outlook is mostly favorable.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
CF/Share	\$0.36	-\$1.02	\$12.52	\$15.38	\$12.26	\$8.14	\$7.06	\$5.57	-\$5.54	\$2.78	\$2.50	\$2.25
DPS	--	\$0.13	\$12.16	\$11.28	\$9.60	\$6.48	\$4.80	\$3.89	\$3.02	\$2.28	\$2.28	\$2.28
Shares	3	3	1	8	28	45	45	43	37	40	42	40

ARMOUR's cash flow has been volatile since its inception in 2008, but this is to be expected with all mREITs. Of late, a shrinking balance sheet and declining spreads have crimped the company's ability to produce cash flow, but as stated, it is still more than able to cover its coveted dividend payment.

With short-term rates still rising and long-term rates rising less quickly, spreads for mREITs like ARMOUR are shrinking. In addition, ARMOUR continues to see a slight decline in its balance sheet size, which impacts its earning asset base. Given this, we are projecting -2% cash flow growth for the foreseeable future. However, we will regularly monitor market conditions as spreads can widen and narrow rapidly for mREITs given how rates move relative to each other. While we do not expect ARMOUR to meaningfully boost its balance sheet size anytime soon, that is another variable that could change our outlook. However, even though these significant variables exist to the outlook, we believe the trust will be able to earn enough to continue to cover the current \$2.28 annual dividend payment for the foreseeable future. The dividend has declined enormously over time as the trust has earned less cash through the years. But the current 19 cent monthly dividend appears to be comfortable for the trust and is also highly rewarding to shareholders at the current stock price. We do not foresee another dividend cut at this point; Q3 results support this position.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/CF	--	--	5.0	3.7	4.2	3.9	4.2	3.9	--	9.3	8.6	8.0
Avg. Yld.	0.0%	0.2%	19.5%	20.0%	18.5%	20.2%	16.3%	17.9%	13.9%	8.9%	10.6%	12.7%

As one would expect, ARMOUR's valuation has moved around a lot in recent years. With cash flow declining of late, the valuation has moved significantly higher. However, we have set fair value at 8 times cash flow given that the yield is

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well-supported by cash flow and we believe investors will purchase the yield rather than the cash flow multiple. Thus, we see a modest 1.4% headwind to total returns from the valuation moving forward.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	11%	10%	67%	90%	84%	83%	86%	84%	73%	63%	60%	65%
Debt/A	33%	83%	91%	90%	89%	88%	89%	91%	86%	85%	85%	85%
Int. Cov.	--	33.2	10.1	9.9	6.4	6.0	6.9	6.2	3.6	2.7	2.0	3.0
Payout	--	--	97%	73%	78%	80%	68%	70%	--	82%	91%	101%
Std. Dev.	8%	19%	37%	15%	14%	26%	13%	17%	25%	17%	20%	19%

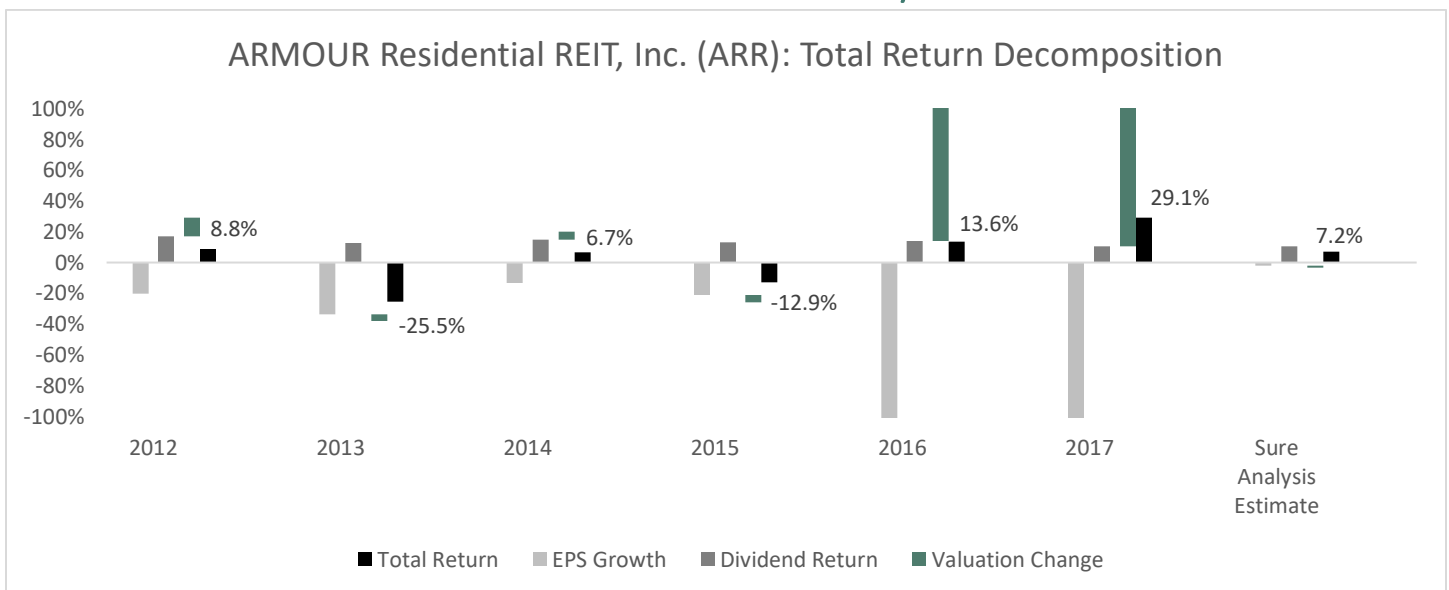
ARMOUR's quality metrics have been volatile given the performance of the trust as rates have moved around over the years. Gross margins have moved down since short-term rates began to rise meaningfully a couple of years ago, although it appears most of that damage has been done. Balance sheet leverage has moved down slightly but we do not forecast significant movement in either direction from this point. Interest coverage has declined with spreads but also appears to have stabilized, so we are somewhat optimistic moving forward, while keeping in mind the significant potential for volatility. The dividend is covered by cash flow and we foresee that continuing indefinitely.

ARMOUR is not beholden to recessions so much as it is rates. However, long-term rates tend to move down in a recession, which would make it less attractive for mREITs to purchase more securities. That, in turn, would crimp balance sheet growth and thus, the outlook for cash flow growth.

Final Thoughts & Recommendation

In total, we see 7.2% annual returns for shareholders in the coming years. We forecast a 2% headwind from cash flow declines, a 1.4% headwind from the valuation and a 10.6% return from the dividend. ARMOUR has endured some tough times in the past but with prudent leverage and a management team that does not chase unprofitable growth, it appears the 10%+ yield is going to be safe for the foreseeable future. We rate the stock a buy for those seeking high levels of income, but investors looking for growth or value should look elsewhere.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	5	0	9	118	389	505	451	365	264	254
Gross Profit	5	0	8	106	328	421	386	306	191	160
Gross Margin	100%	97.2%	87.0%	89.9%	84.3%	83.3%	85.6%	83.8%	72.3%	62.8%
SG&A Exp.	2	0	1	9	24	35	35	33	35	34
Operating Profit	3	0	7	97	304	386	351	273	156	126
Operating Margin	57.4%	13.4%	73.0%	82.3%	78.2%	76.3%	77.8%	74.6%	59.2%	49.4%
Net Profit	1	-1	7	-9	222	-187	-179	-31	-46	181
Net Margin	19.8%	-231%	70.5%	-8.0%	57.1%	-37.0%	-39.7%	-8.5%	-17.2%	71.2%
Free Cash Flow	1	-3	9	118	344	369	315	238	-203	110

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	250	127	1209	6208	20879	15733	16286	13055	7978	8929
Cash & Equivalents	0	7	35	252	771	496	495	290	272	265
Accounts Receivable	N/A	0	3	395	684	0	261	0	N/A	N/A
Total Liabilities	84	105	1101	5581	18571	13831	14537	11830	6886	7603
Accounts Payable	1	59	126	121	4	183	462	19	7	3
Shareholder's Equity	166	21	109	627	2308	1901	1749	1225	1092	1326

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	N/A	-0.6%	1.0%	-0.3%	1.6%	-1.0%	-1.1%	-0.2%	-0.4%	2.1%
Return on Equity	0.6%	-1.2%	10.0%	-2.6%	15.2%	-8.9%	-9.8%	-2.1%	-3.9%	15.0%
ROIC	N/A	-1.2%	10.0%	-2.6%	15.2%	-8.9%	-9.8%	-2.1%	-3.9%	15.0%
Shares Out.	3	3	1	8	28	45	45	43	37	40
Revenue/Share	1.83	0.19	12.67	15.32	13.88	11.14	10.10	8.54	7.19	6.42
FCF/Share	0.36	-1.02	12.52	15.38	12.26	8.14	7.06	5.57	-5.54	2.78

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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