



Orchid Island Capital, Inc. (ORC)

Updated October 23rd, 2018 by Bob Ciura

Key Metrics

Current Price:	\$6.86	5 Year CAGR Estimate:	11.0%	Volatility Percentile:	62.0%
Fair Value Price:	\$7.37	5 Year Growth Estimate:	-5.0%	Momentum Percentile:	10.6%
% Fair Value:	93%	5 Year Valuation Multiple Estimate:	2.6%	Growth Percentile:	0.6%
Dividend Yield:	14.0%	5 Year Price Target	\$6.07	Valuation Percentile:	64.5%
Dividend Risk Score:	F	Retirement Suitability Score:	C	Total Return Percentile:	63.1%

Overview & Current Events

Orchid Island Capital, Inc. is a Real Estate Investment Trust, or REIT, operating in the mortgage industry. Mortgage REITs differ from most other REITs. For example, traditional REITs typically own a portfolio of physical real estates, which they lease to tenants to collect rental income. Mortgage REITs are purely financial entities, and Orchid Island does not own any physical properties. Instead, it is an externally managed REIT that invests in residential mortgage-backed securities, either pass-through or structured agency RMBSs, which are financial instruments that collect cash flow based on residential loans such as mortgages, including subprime, and home-equity loans.

On 7/26/18 the company reported poor second-quarter results. Revenue of \$22.01 million declined by 14.8% from the same quarter a year ago. Book value per share declined to \$7.86 for the second quarter, down from \$8.71 at the end of 2017. Earnings-per-share were just \$0.03, as net interest income of \$0.42 per share was nearly offset by total expenses of \$0.05 per share and net realized and unrealized losses of \$0.34 per share on RMBS and derivative instruments. Company management stated that continued flattening of the yield curve is likely to keep pressuring returns for RMBSs.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
BPS	-	-	-	-	-	\$13.40	\$13.06	\$11.64	\$10.10	\$8.71	\$7.84	\$6.07
EPS	-	-	-	-	-	-\$0.23	\$2.48	\$0.05	\$0.08	\$0.05	\$0.06	\$0.01
DPS	-	-	-	-	-	\$1.395	\$2.16	\$1.92	\$1.68	\$1.68	\$1.07	\$0.63
Shares	-	-	-	-	-	3,012	9,890	20,267	24,100	41,062	53,000	65,000

Orchid Island has reported extreme earnings volatility over the past several years, with a net loss in 2013 and multiple years in which it barely generated a profit. As a result, we are using book value per share as an alternate metric to earnings-per-share. The growth outlook for mortgage REITs is challenged. Mortgage REITs make money by borrowing at short-term rates, and lending at longer-term rates, then pocketing the difference. This is referred to as the spread, which is how Orchid Capital generates its own cash flow. When the spread between short-term rates and long-term rates compresses, profitability erodes at a rapid pace. This is why mortgage REITs can be dangerous if the yield curve flattens. The company has also sold huge amounts of stock in recent years, which will further erode shareholder value. We estimate book value will decline by 10% in 2018 and by 5% per year through 2023.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/B	-	-	-	-	-	0.93	1.01	0.98	1.02	1.17	0.88	1.0
Avg. Yld.	-	-	-	-	-	11.2%	16.3%	16.9%	16.3%	16.5%	14.0%	10.4%

Since we are using book value instead of earnings-per-share, we will also use the price-to-book ratio for valuation, instead of the price-to-earnings ratio. Orchid Island stock has a price-to-book ratio of 0.97, compared with our fair value estimate of 1.0. This means the stock could generate annual returns of 2.6% per year from expansion of the stock valuation. Investors will also note the extremely high dividend yield for the stock, which we expect to make up the vast majority of its future returns. However, Orchid Island has reduced the dividend twice in recent years.

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.



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Safety, Quality, Competitive Advantage, & Recession Resiliency

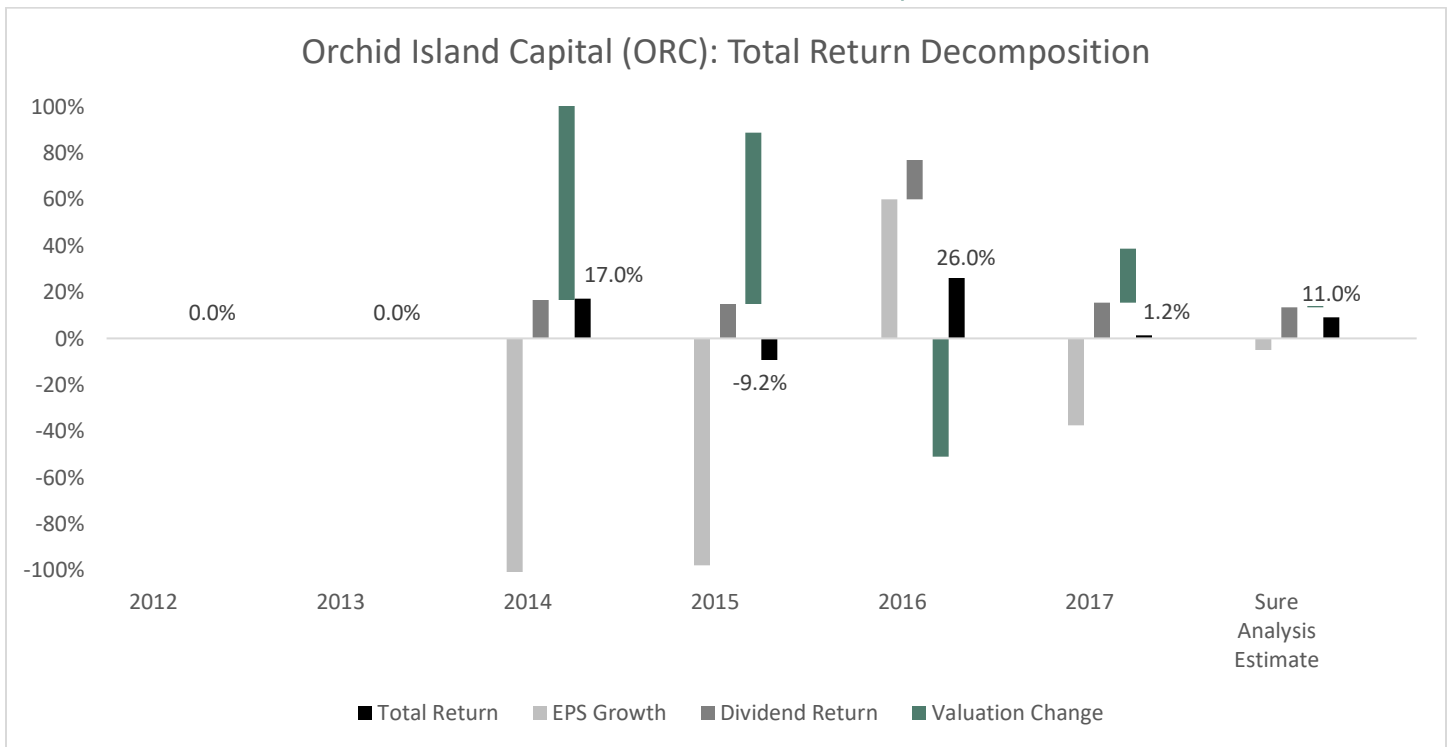
Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	-	-	-	688%	1074%	267%	1750%	400%	353%	327%	300%	300%
Debt/A	-	-	-	76.4%	87.6%	87.7%	86.8%	88.7%	89.4%	88.5%	88.5%	88.5%
Int. Cov.	-	-	-	18.4	9.7	8.2	10.5	9.5	5.6	3.5	3.0	3.0
Payout	-	-	-	-	-	N/A	87.1%	3840%	2100%	3360%	1783%	6300%
Std. Dev.	-	-	-	-	-	23.3%	16.4%	37.0%	20.1%	25.2%	25.0%	25.0%

Orchid Island is not a safe stock. It has a very high payout ratio, due to low earnings. Mortgage REITs are exposed to a number of risks, including interest rate risk, as well as credit risk. These risks pertain to the direction of interest rates, as well as the ability of borrowers to repay the mortgage loans. Moreover, mortgage REITs do not hold many competitive advantages. Since mortgage REITs do not provide differentiated products and services, traditional competitive advantages such as brand power or manufacturing efficiencies do not apply. In addition, Orchid Island is not a recession-resistant company. A recession would likely lead to higher mortgage defaults.

Final Thoughts & Recommendation

Orchid Island is a highly risky stock. Its business model is volatile, and the environment for mortgage REITs is becoming more difficult with interest rates on the rise. Continued interest rate hikes by the Federal Reserve will likely erode in Orchid Island's fundamentals. The stock has a fairly high expected rate of return of 11%, which would normally result in a buy recommendation. However, returns are reliant on the 14% dividend yield, and future dividends are likely to be cut. Orchid Island is only a buy for investors with a very high tolerance for risk.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	N/A	N/A	0.01	0.40	1.27	0.97	29.01	8.97	11.07	13.17
SG&A Exp.	N/A	N/A	0.02	0.48	0.56	1.25	3.90	7.19	8.22	10.46
Net Profit	N/A	N/A	-0.03	-1.19	0.53	-0.70	24.52	1.07	1.98	2.01
Net Margin	N/A	N/A	N/A	N/A	42.1%	-72.0%	84.5%	11.9%	17.9%	15.2%
Free Cash Flow	N/A	N/A	-0.04	-0.11	1.88	10.10	11.65	30.71	47.05	85.01

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	N/A	N/A	27.13	58.37	118.86	363.58	1658	2242	3139	4023
Cash & Equivalents	N/A	N/A	1.20	1.89	2.54	8.17	93.14	57.23	73.48	214.36
Accounts Receivable	N/A	N/A	0.09	0.37	0.44	1.56	6.21	8.49	11.51	14.44
Total Liabilities	N/A	N/A	22.76	44.59	104.14	318.81	14340	1989	2806	3561
Accounts Payable	N/A	N/A	0.00	0.01	0.05	0.09	0.63	0.86	1.83	6.52
Long-Term Debt	N/A	N/A	0.00	0.00	0.00	0.00	0.00	187.50	0.00	0.00
Shareholder's Equity	N/A	N/A	4.37	13.78	14.72	44.77	218.08	253.26	332.78	462.21
D/E Ratio	N/A	N/A	0.00	0.00	0.00	0.00	0.00	0.74	0.00	0.00

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	N/A	N/A	N/A	-2.8%	0.6%	-0.3%	2.4%	0.1%	0.1%	0.1%
Return on Equity	N/A	N/A	N/A	-13.1%	3.7%	-2.3%	18.7%	0.5%	0.7%	0.5%
ROIC	N/A	N/A	N/A	-13.1%	3.7%	-2.3%	18.7%	0.3%	0.5%	0.5%
Shares Out.	N/A	N/A	N/A	N/A	N/A	3,012	9,890	20,267	24,100	41,062
Revenue/Share	N/A	N/A	0.01	0.41	1.29	0.32	2.93	0.44	0.46	0.32
FCF/Share	N/A	N/A	-0.04	-0.11	1.91	3.35	1.18	1.52	1.95	2.07

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

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