



Dynex Capital Inc. (DX)

Updated June 25th, 2019 by Samuel Smith

Key Metrics

Current Price:	\$17	5 Year CAGR Estimate:	13.4%	Volatility Percentile:	6.6%
Fair Value Price:	\$17	5 Year Growth Estimate:	0.0%	Momentum Percentile:	38.0%
% Fair Value:	98%	5 Year Valuation Multiple Estimate:	0.5%	Growth Percentile:	2.1%
Dividend Yield:	12.9%	5 Year Price Target	\$17	Valuation Percentile:	60.1%
Dividend Risk Score:	D	Retirement Suitability Score:	B	Total Return Percentile:	81.5%

Overview & Current Events

Dynex Capital, Inc. was founded in 1987 and is headquartered in Glen Allen, Virginia. As an mREIT, Dynex Capital invests in mortgage-backed securities (MBS) on a leveraged basis in the United States. It invests in agency and non-agency MBS consisting of residential MBS, commercial MBS (CMBS), and CMBS interest-only securities. Agency MBS have a guaranty of principal payment by an agency of the U.S. government or a U.S. government-sponsored entity, such as Fannie Mae and Freddie Mac. Non-Agency MBS have no such guaranty of payment. The company is structured to have internal management, which is good because it can reduce conflicts of interest and often leads to lower management expenses.

The company reported first quarter results on May 1st. Core net operating income came in at \$0.18 per common share while book value per common share increased \$0.22 per share, or 3.7%, to \$6.24. Meanwhile, the net interest spread and adjusted net interest spread of 0.84% and 1.19%, respectively, declined compared to 0.93% and 1.24%, respectively, for the fourth quarter of 2018 primarily due to lower TBA dollar roll income and the tighter spread between 3-month LIBOR and repo rates. This poses a challenge for growth moving forward and requires management to further leverage positions (i.e., take on more risk) in order to sustain income levels. This was evidenced by the fact that leverage positions increased by half a turn sequentially in the first quarter to 8.5x shareholders' equity.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	\$3.06	\$4.23	\$3.09	\$4.05	\$3.30	\$1.02	\$0.42	\$2.07	\$1.38	-\$0.24	\$2.16	\$2.16
DPS	\$2.76	\$2.94	\$3.27	\$3.45	\$3.36	\$3.00	\$2.88	\$2.52	\$2.16	\$2.16	\$2.16	\$2.16
Shares	6	7	13	18	18	18	18	16	17	19	25	30

Given that interest rates are expected to remain in a narrower and lower range for a longer period than ever seen in recent history, growth will likely suffer substantially. This is because the global economy will continue to be weighed down by large pools of negative yielding debt, forcing central banks to remain accommodative in their monetary policy. That being said, such a low yield environment creates an opportunity in high quality real asset backed loans. However, Dynex still benefits from several long-term factors that could enable them to continue growing. First, an aging population in a low yield world should foster a growing demand for the cash flow that their business can generate, thereby boosting valuations and making attracting capital easier for mortgage REITs. Second, as the Federal Reserve attempts to reduce its investment in Agency RMBS and GSE reform opens new investment opportunities, demand for private capital in the US housing finance system should grow. Third, the shortage of affordable housing means that there is a need for additional investment into the sector. Taking into account these headwinds and tailwinds along with the company's 100% payout ratio, we do not expect any earnings per share or dividend per share growth over the next half decade.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	8.0	7.0	7.5	9.0	7.25	12.0	40.0	9.5	15.0	NA	7.8	8.0
Avg. Yld.	11.3%	9.9%	14.1%	9.0%	14.0%	24.5%	17.1%	12.8%	10.4%	11.4%	12.9%	12.5%

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Due to lumpiness in earnings, it is difficult to establish an accurate price to earnings ratio from the past decade. Excluding the outliers in 2014 and 2018, we get an average earnings multiple of 10.4. However, we see that most years it has been between 7.0 and 9.0. Given that the current dividend is at risk of being cut and growth prospects are poor, we do not believe that the multiple should be much higher than this. As a result, we believe that a multiple of around 8 times earnings is appropriate. If achieved over the next half decade, it would provide a minimal 0.5% tailwind to annual total returns.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	90.2%	69.5%	106%	85.2%	102%	294%	686%	122%	157%	N/A	100%	100%

Dynex brings to the table some competitive advantages which should enable it to generate strong returns for investors throughout business cycles. These include the company's experienced management team with expertise in managing securitized real estate assets through multiple economic cycles as well as their emphasis on maintaining a diversified pool of highly liquid mortgage investments with minimal credit risk.

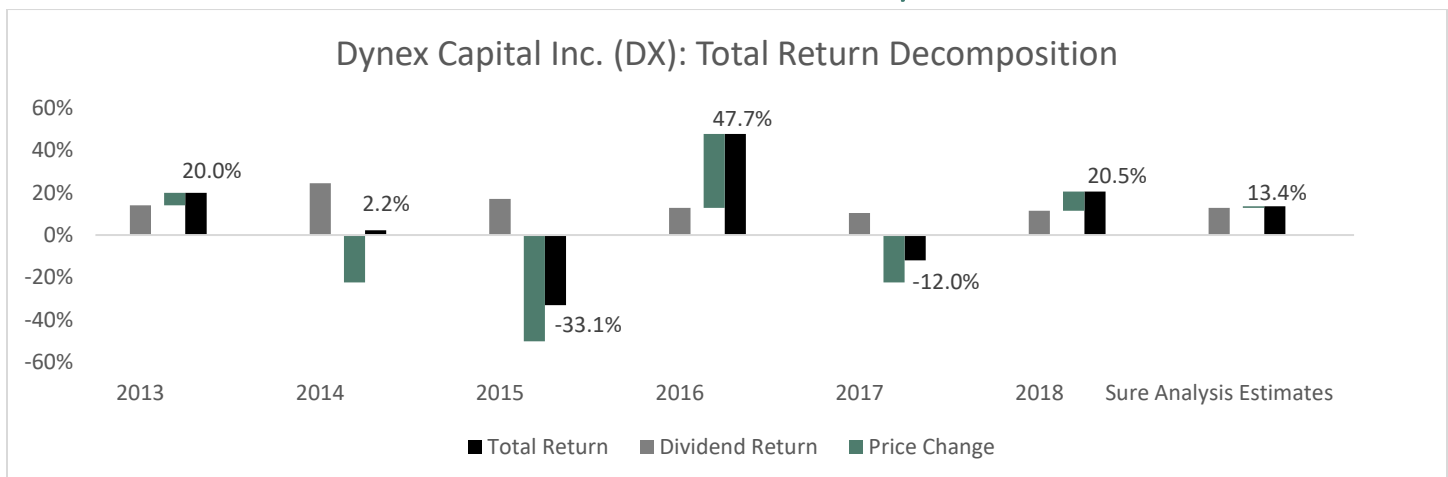
One of the biggest challenges is the shrinking spread between 3-month LIBOR and short-term repo rates as repo rates remain elevated due to the Fed's pause at 2.5% on the Fed Funds rate. Another risk is that prepayment speeds that could rise due to seasonal factors. Additionally, the drop in mortgage rates could increase refinancing activity, further cutting into profits.

The company's normalized diluted earnings per share were actually quite stable through the last recession, though shares still sold off very heavily, losing about 40% of their market value. All in all, there's little margin of safety here due largely to the payout ratio being at 100%, combined with highly variable earnings-per-share.

Final Thoughts & Recommendation

Looking ahead to the next half decade, we expect total annualized returns of 13.4%, in large part due to the 12.9% dividend yield and a small (0.5%) tailwind from slight multiple expansion. However, the 100% payout ratio and the significant headwinds to growth posed by the shrinking lending spreads could force a dividend cut, which would likely lead to significant multiple contraction rather than expansion. We view the stock as too risky. Therefore, we rate it as a sell for most investors, and a hold only for speculative investors who don't rely on the company's dividend.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	25	40	51	87	81	44	34	57	50	24
SG&A Exp.	7	9	10	13	13	16	18	15	16	15
D&A Exp.	2	6	33	91	8	9	5	2	1	1
Net Profit	18	29	40	74	68	28	17	43	34	7
Net Margin	70.5%	74.3%	78.6%	85.1%	83.9%	63.5%	49.2%	75.7%	67.9%	29.6%
Free Cash Flow	20	30	71	149	209	214	217	211	204	181

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	958	1650	2582	4280	4217	3688	3670	3398	3306	3886
Cash & Equivalents	30	19	49	56	69	44	34	74	41	35
Acc. Receivable	5	6	13	23	22	21	23	20	20	21
Total Liabilities	789	1357	2211	3664	3631	3081	3178	2931	2749	3359
Accounts Payable	1	1	2	3	3	2	2	3	4	10
Long-Term Debt	143	107	0	31	13	11	528	0	0	0
Total Equity	127	292	371	561	476	498	382	357	416	384
D/E Ratio	0.85	0.37	0.00	0.05	0.02	0.02	1.07	0.00	0.00	0.00

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	2.2%	2.3%	1.9%	2.2%	1.6%	0.7%	0.4%	1.2%	1.0%	0.2%
Return on Equity	15.6%	14.1%	12.0%	15.9%	13.1%	5.7%	3.8%	11.7%	8.8%	1.8%
ROIC	5.5%	8.3%	10.3%	14.5%	10.9%	4.6%	2.0%	5.8%	6.6%	1.3%
Shares Out.	6	7	13	18	18	18	18	16	17	19
Revenue/Share	4.32	5.69	3.94	4.91	4.45	2.40	1.91	3.48	2.97	1.23
FCF/Share	3.40	4.31	5.49	8.43	11.46	11.76	12.32	12.86	12.17	9.39

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

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