ARMOUR Residential REIT, Inc. (ARR)

Updated July 28th, 2019 by Samuel Smith

Key Metrics

Current Price:	$18	**5 Year CAGR Estimate:**	11.9%	**Volatility Percentile:**	18.0%
Fair Value Price:	$20	**5 Year Growth Estimate:**	-2.0%	**Momentum Percentile:**	20.4%
% Fair Value:	88%	**5 Year Valuation Multiple Estimate:**	2.5%	**Growth Percentile:**	1.0%
Dividend Yield:	11.4%	**5 Year Price Target**	$18	**Valuation Percentile:**	73.7%
Dividend Risk Score:	D	**Retirement Suitability Score:**	A	**Total Return Percentile:**	68.8%

Overview & Current Events

ARMOUR Residential (ARR) 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 States government entity including Fannie Mae, Freddie Mac and Ginnie Mae. ARMOUR has a $1.1 billion market capitalization and produces about $165 million in annual revenue.

ARMOUR reported Q2 earnings on 7/24/19. Core income per share came in at 63 cents, well ahead of analyst average estimates of 58 cents. Shareholders experienced a -1% economic return during the quarter as stockholder equity declined more than the dividend payments. However, since the end of the quarter, book value per share had rebounded by 1% to $20.71 per share.

At quarter end, ARMOUR had $14.4 billion of securities, including $595.4 million in cash and unpledged securities, $7.6 billion in interest rate swaps, $0.8 billion in Credit Risk and Non-Agency securities. The trust also fully covered its dividend with core income for the twelfth straight quarter, and repurchased 625,000 common shares to capitalize on the discount to book value. To help fund the buyback, management issued almost 2.2 million Series A 8.25% cumulative redeemable preferred shares and 338,152 shares of Series B 7.875% cumulative redeemable shares. Assets averaged a 3.7% yield and 1.4% net interest margin with a 7.2% annualized average principal repayment rate.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
CF/Share	-$1.02	$12.52	$15.38	$12.26	$8.14	$7.06	$5.57	-$5.54	$2.78	$2.59	***$2.54***	***$2.30***
DPS	$0.13	$12.16	$11.28	$9.60	$6.48	$4.80	$3.89	$3.02	$2.28	$2.28	***$2.04***	***$2.04***
Shares	3	1	8	28	45	45	43	37	40	44	***50***	***70***

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 trust'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 $2.04 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 17-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; Q2 results support this position.

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Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/CF	---	5.0	3.7	4.2	3.9	4.2	3.9	---	9.3	8.6	***7.1***	***8.0***
Avg. Yld.	0.2%	19.5%	20.0%	18.5%	20.2%	16.3%	17.9%	13.9%	8.9%	10.6%	***11.4%***	***11.1%***

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 well-supported by cash flow, and we believe investors will purchase the yield rather than the cash flow multiple. Thus, we see a modest 2.5% tailwind to total returns from the valuation moving forward.

Safety, Quality, Competitive Advantage, & Recession Resiliency

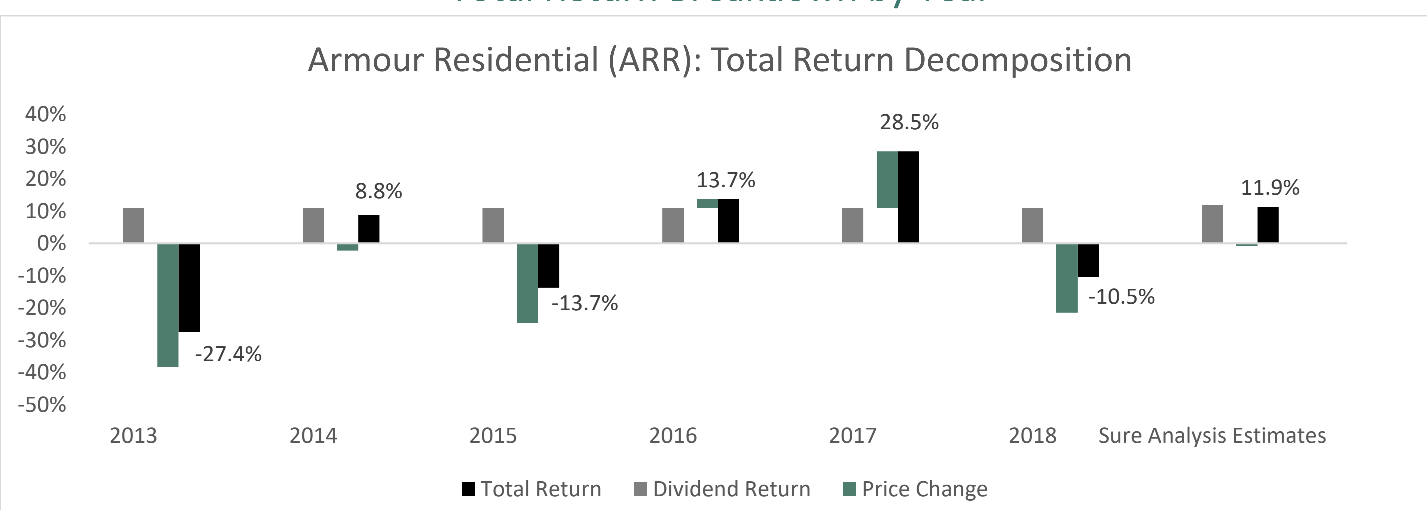
Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Payout	---	97%	73%	78%	80%	68%	70%	---	82%	88%	***80%***	***89%***

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 had been moving down slightly but it saw an uptick again this past quarter. However, 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 11.9% annual returns for shareholders in the coming years. We forecast a 2% headwind from cash flow declines, a 2.5% tailwind from the valuation and a 11.4% 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 11%+ yield is going to be safe for the foreseeable future. Additionally, the stock trades slightly below book value. We therefore rate it a buy for those seeking high income, but not for growth or deep value investors.

Total Return Breakdown by Year



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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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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	0	9	118	389	505	451	365	264	254	283
Gross Profit	0	8	106	328	421	386	306	191	160	129
Gross Margin	97.2%	87.0%	89.9%	84.3%	83.3%	85.6%	83.8%	72.3%	62.8%	45.5%
SG&A Exp.	0	1	9	24	35	35	33	38	36	37
Operating Profit	0	7	97	304	386	351	273	153	124	92
Op. Margin	13.4%	73.0%	82.3%	78.2%	76.3%	77.8%	74.6%	58.1%	48.8%	32.5%
Net Profit	-1	7	-9	222	-187	-179	-31	-46	181	-106
Net Margin	N/A	70.5%	-8.0%	57.1%	-37.0%	-39.7%	-8.5%	-17.2%	71.2%	-37.4%
Free Cash Flow	-3	9	118	344	369	315	238	-203	110	75

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	127	1209	6208	20879	15733	16286	13055	7978	8929	8465
Cash & Equivalents	7	35	252	771	496	495	290	272	265	222
Acc. Receivable	0	3	395	684	0	261	0	N/A	N/A	N/A
Total Liabilities	105	1101	5581	18571	13831	14537	11830	6886	7603	7339
Accounts Payable	59	126	121	4	183	462	19	7	3	4
Long-Term Debt	0	0	0	0	0	0	0	0	0	0
Total Equity	21	109	627	2308	1901	1749	1225	1092	1326	1125

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	-0.6%	1.0%	-0.3%	1.6%	-1.0%	-1.1%	-0.2%	-0.4%	2.1%	-1.2%
Return on Equity	-1.2%	10.0%	-2.6%	15.2%	-8.9%	-9.8%	-2.1%	-3.9%	15.0%	-8.6%
ROIC	-1.2%	10.0%	-2.6%	15.2%	-8.9%	-9.8%	-2.1%	-3.9%	15.0%	-8.6%
Shares Out.	3	1	8	28	45	45	43	37	40	44
Revenue/Share	0.19	12.67	15.32	13.88	11.14	10.10	8.54	7.19	6.42	6.72
FCF/Share	-1.02	12.52	15.38	12.26	8.14	7.06	5.57	-5.54	2.78	1.79

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