



Orchid Island Capital, Inc. (ORC)

Updated November 21st, 2019 by Samuel Smith

Key Metrics

Current Price:	\$5.65	5 Year CAGR Estimate:	9.5%	Volatility Percentile:	55.8%
Fair Value Price:	\$6.25	5 Year Growth Estimate:	-4.9%	Momentum Percentile:	23.1%
% Fair Value:	91%	5 Year Valuation Multiple Estimate:	2.1%	Growth Percentile:	0.9%
Dividend Yield:	17.0%	5 Year Price Target	\$4.84	Valuation Percentile:	84.4%
Dividend Risk Score:	F	Retirement Suitability Score:	C	Total Return Percentile:	77.5%

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 estate, 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 (by Bimini Advisors LLC) that invests in residential mortgage-backed securities (RMBS), 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. The \$356 million market capitalization trust is based in Vero Beach, FL.

On October 24th, 2019 Orchid Island Capital reported Q3 results. For the quarter, the trust reported net interest income of \$13.6M and a quarterly net loss of \$8.5M, or 14 cents per share. The loss came as a result of both realized and unrealized losses on RMBS and derivative instruments. As of September 30th, book value per share stood at \$6.22 after investors suffered a negative 2.6% total return on equity during the quarter. Looking ahead, the company is positioning itself to deal with an elevated amount of prepayment activity.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
BPS	---	---	---	---	\$13.40	\$13.06	\$11.64	\$10.10	\$8.71	\$6.84	\$6.22	\$4.84
EPS	---	---	---	---	-\$0.23	\$2.48	\$0.05	\$0.08	\$0.05	-\$0.85	\$0.00	\$0.00
DPS	---	---	---	---	\$1.395	\$2.16	\$1.92	\$1.68	\$1.68	\$1.07	\$0.96	\$0.72
Shares¹	---	---	---	---	3,012	9,890	20,267	24,100	41,062	52,198	54,000	60,000

Orchid Island has reported extreme earnings volatility over the past several years, with a net loss in 2013 and 2018, along with multiple years in which the trust 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 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.

To give you an idea of what has occurred lately, since the end of 2017 to 2018 Orchid's average yield on RMBS has gone from 4.18% to 4.53%, but the trust's average cost of funds has gone from 1.50% to 2.49%. As a result, Orchid's average interest rate spread has dropped from 2.68% to 2.04%.

In addition, while the dividend yield is sky high, the payout record has been uninspiring. After bumping the dividend to \$0.18 per month in late 2013, Orchid Island paid this dividend rate for 19 months before dropping it to \$0.14 per month in 2015 (paid for 30 months), then down to \$0.11 in 2018 (paid two months), down to \$0.09 (paid 5 months) and the

¹ In thousands

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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current mark sits at \$0.08. Furthermore, this large dividend payout combined with minimal earnings will continue to erode the trust's book value.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/B	---	---	---	---	0.93	1.01	0.98	1.02	1.17	0.93	0.91	1.00
Avg. Yld.	---	---	---	---	11.2%	16.3%	16.9%	16.3%	16.5%	16.7%	17.0%	15.5%

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. The stock presently has a price-to-book ratio of 0.91, compared with our fair value estimate of 1.0. In turn, investors could experience a sizable annualized valuation tailwind over the next five years.

Some investors may be enticed by the extremely high dividend yield for the stock, which drives the investment thesis. However, we offer two cautionary notes. First, the dividend has already been cut on four separate occasions since 2015. Second, and just as important, is that despite an exceptionally high starting yield, total returns can be dampened significantly by the erosion in the share price as time goes on. This idea is underscored by the 2% to 3% total returns since the security's inception, despite carrying a double-digit dividend yield throughout this period.

Safety, Quality, Competitive Advantage, & Recession Resiliency

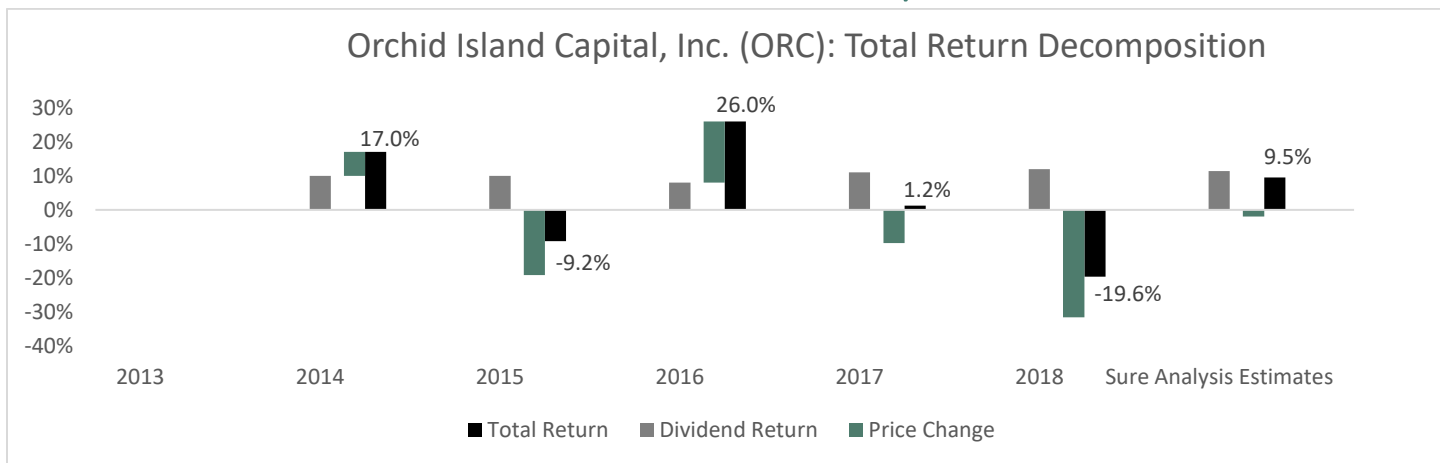
Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	---	---	---	---	---	87%	3,740%	2,000%	3,260%	---	---	---

Orchid Island is not a safe stock. The above payout ratios are extreme due to low or non-existent 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 possess 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 trust. A recession would likely lead to higher mortgage defaults.

Final Thoughts & Recommendation

We believe that the dividend will likely be cut again and that the book value will continue to decline. Therefore, despite an attractive annualized total return outlook of 9.5% and enormous 17% dividend yield, we rate the stock a sell due to these risks.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	N/A	N/A	N/A	N/A	1	29	5	7	7	-39
SG&A Exp.	N/A	N/A	N/A	N/A	1	4	3	3	3	3
Net Profit	N/A	N/A	N/A	N/A	-1	25	1	2	2	-44
Net Margin	N/A	N/A	N/A	N/A	-72.0%	84.5%	21.5%	28.7%	27.4%	115%
Free Cash Flow	N/A	N/A	N/A	N/A	10	12	31	47	85	94

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	N/A	N/A	N/A	N/A	364	1658	2242	3139	4023	3396
Cash & Equivalents	N/A	N/A	N/A	N/A	8	93	57	73	214	108
Accounts Receivable	N/A	N/A	N/A	N/A	2	6	8	12	14	13
Total Liabilities	N/A	N/A	N/A	N/A	319	1440	1989	2806	3561	3060
Accounts Payable	N/A	N/A	N/A	N/A	0	1	1	2	7	6
Long-Term Debt	N/A	N/A	N/A	N/A	0	0	188	0	0	0
Shareholder's Equity	N/A	N/A	N/A	N/A	45	218	253	333	462	336

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	N/A	N/A	N/A	N/A	-0.3%	2.4%	0.1%	0.1%	0.1%	-1.2%
Return on Equity	N/A	N/A	N/A	N/A	-2.3%	18.7%	0.5%	0.7%	0.5%	-11.1%
ROIC	N/A	N/A	N/A	N/A	-2.3%	18.7%	0.3%	0.5%	0.5%	-11.1%
Shares Out.	N/A	N/A	N/A	N/A	3,012	9,890	20,267	24,100	41,062	52,198
Revenue/Share	N/A	N/A	N/A	N/A	0.32	2.93	0.25	0.29	0.18	-0.74
FCF/Share	N/A	N/A	N/A	N/A	3.35	1.18	1.52	1.95	2.07	1.80

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

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