Two Harbors Investment Corp. (TWO)

Updated January 17th, 2020 by Samuel Smith

Key Metrics

Current Price:	$15.05	**5 Year CAGR Estimate:**	6.3%	**Market Cap:**	$4.1B
Fair Value Price:	$14.72	**5 Year Growth Estimate:**	-2.5%	**Ex-Dividend Date:**	3/30/20[1]
% Fair Value:	102%	**5 Year Valuation Multiple Estimate:**	-0.4%	**Dividend Payment Date:**	4/24/20[2]
Dividend Yield:	10.6%	**5 Year Price Target**	$13	**Years Of Dividend Growth:**	0
Dividend Risk Score:	F	**Retirement Suitability Score:**	C	**Last Dividend Increase:**	NA

Overview & Current Events

Two Harbors Investment Corp. is a residential mortgage real estate investment trust (mREIT). As such, it focuses on residential mortgage-backed securities (RMBS). residential mortgage loans, mortgage servicing rights, and commercial real estate. The trust derives nearly all of its revenue in the form of interest through available-for-sale securities.

In early November (11/5/19), Two Harbors reported financial results for the third quarter. Core earnings-per-share came in at $0.24, down by $0.15 year-over-year. Aggregate third quarter core earnings – Including dollar roll income of $65 million – fell from $106 million in the second quarter. Return on book value during the quarter was 6.7%, signaling a sizable increase in profitability from the previous quarter, where return on book value was just 5.4%. Book value stood at $14.72 at quarter end and total portfolio value stood at $39.9 billion. The annualized interest rate spread for the aggregate portfolio stood at 1.16%, down significantly from the second quarter's annualized interest rate spread of 1.38%. The trust also added $5.8 billion in unpaid principal balance of MSR through flow sale arrangements.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$3.20	$2.58	$2.40	$3.30	$0.92	$2.70	$2.03	$1.81	-$0.53	-$2.45	***$1.97***	***$1.74***
BVPS	$18.9	$18.6	$23.1	$20.7	$22.5	$21.3	$20.0	$20.2	$14.9	$14.8	***$14.72***	***$13.00***
DPS	$2.96	$3.20	$3.42	$2.34	$2.08	$2.08	$1.86	$2.01	$1.88	$1.74	***$1.60***	***$1.40***
Shares[3]	11	49	121	175	183	183	174	188	206	262	***262***	***300***

Two Harbors has a history of generating strong total returns for investors. Despite book value per share declining significantly from $18.9 in 2010 to $14.72 at the present. Since its inception in October 2009, the stock has generated total returns of 211%, outperforming the BBG REIT MTG index's total return of 158% during that span. The three main reasons for this are that it pairs its MSR assets with Agency RMBS, utilizes a variety of instruments to hedge interest rate exposure, and utilizes a unique portfolio of legacy non-Agency securities.

Currently the company faces a few headwinds to growth, including higher prepayment speeds due to low interest rates driving an increase in mortgage refinancing, higher yielding non-Agency securities rolling off the balance sheet and being replaced with lower rate assets, and lower TBA dollar roll income from higher implied financing costs. However, there are a few positive market fundamentals as well. First, interest rate spreads have begun to improve, with current coupon spreads rising 8 basis points in Q2 and 27 basis points in Q3. Second, low mortgage rates have offset steadily increasing HPA, keeping affordability within recent context and allowing for increased mobility, higher prepayments, and better overall expected returns. Declining losses over time have provided an important tailwind to performance.

All that being said, we believe that TWO's book value and therefore earnings-per-share will continue to decline at a steady pace (-2.5% annually) over the next half decade as low interest rates and a slowing global economy will likely lead to higher risk taking, and eventually a rise in defaults.

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[1] Estimate

[2] Estimate

[3] In millions

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Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/B	0.90	0.97	0.87	1.01	0.91	0.87	0.85	0.89	0.94	0.88	***1.02***	***1.00***
Avg. Yld.	17.4%	17.8%	17.1%	11.1%	10.1%	11.2%	10.9%	11.2%	13.4%	13.4%	***10.6%***	***10.8%***

Two Harbors has historically traded at a sizable discount to book value due to its riskier (highly leveraged) business model and the company's nearly annual dividend cuts. However, given that the company has significantly outperformed its index over the long term, it warrants at least trading at book value. As a result, we view it as trading near fair value at present, especially considering the low interest rate environment we are currently operating in.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout[4]	92.5%	124%	142.5%	70.9%	226.1%	77.0%	91.6%	111%	NA	NA	***95.0%***	***95.0%***

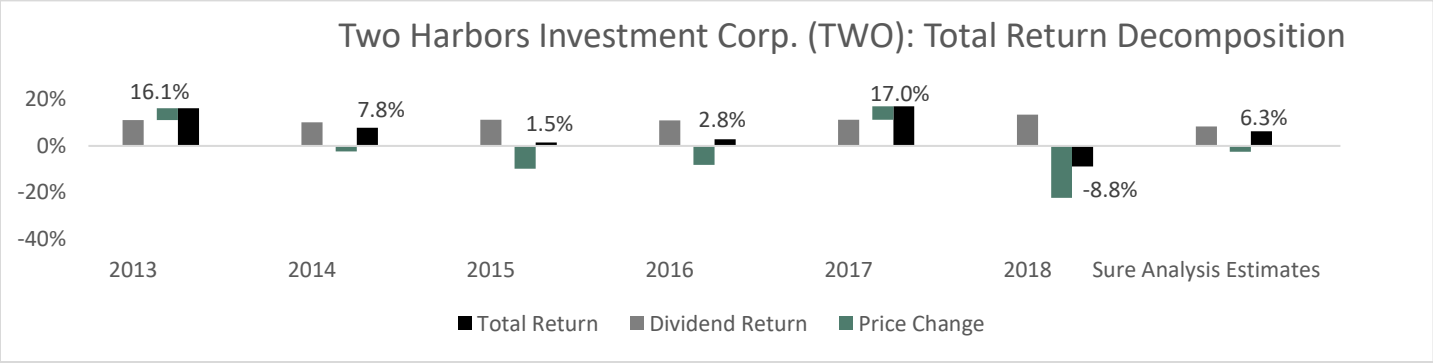
Two Harbors' high dividend yield indicates that the market has some concerns about the safety of its current dividend payment as well as the sustainability of the business model as a whole. In general, the non-recurring nature of the loans within the mortgage REIT business model make Two Harbors somewhat less of a sleep-well-at-night stock than some of its peers in the equity REIT universe. We have serious questions about its dividend safety through all economic environments, particularly in light of its very high current payout ratio. While the REIT was founded in the wake of the last recession, we believe that – due to its leverage ratio of over 7x – it will struggle in the next economic downturn.

The company lacks any significant competitive advantage other than some economies of scale and significant diversification that adds some stability to performance. However, we see nothing that will lead to outsized returns in the future – all conditions being constant. We believe past outperformance was largely due to a strategy that aligned with market forces, though some of it was due to a shareholder friendly dividend policy and solid management performance.

Final Thoughts & Recommendation

Two Harbors' high dividend yield will immediately make it attractive to income-oriented investors. With that said, some conservative assumptions reveal that the company is likely to deliver mediocre annualized total returns (6.3%) moving forward and has a moderate risk profile. Accordingly, Arbor Realty earns a hold recommendation from Sure Dividend. Investors who are not extremely risk tolerant will want to look elsewhere, as the risk of further dividend reductions and business declines is high at Two Harbors.

Total Return Breakdown by Year



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[4] *Note: This payout ratio using AFFO in the denominator.*

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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	3	43	150	296	728	185	612	425	362	183
SG&A Exp.	2	6	22	33	42	49	49	39	40	30
D&A Exp.		-	0	2	2	2	1			
Net Profit	-9	36	127	292	579	167	492	353	349	-44
Net Margin	-319.7%	83.9%	84.8%	98.6%	79.5%	90.6%	80.4%	83.1%	96.2%	-24.2%
Free Cash Flow	-11	33	152	162	-955	-727	-2,060	-78	123	-274
Income Tax	0	-1	-1	-42	84	-74	-17	12	-10	42

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	538	1,797	8,100	16,814	17,174	21,084	14,576	20,112	24,789	30,132
Cash & Equivalents	26	164	360	821	1,025	1,006	738	351	419	410
Goodwill & Int. Ass.				-	515	452	494	694	1,087	1,993
Total Liabilities	417	1,415	6,830	13,363	13,319	17,016	10,999	16,711	21,218	25,878
Accounts Payable			6	19	20	24	19	29	88	160
Long-Term Debt	-	-	-	-	640	3,710	5,785	7,107	1,518	1,459
Shareholder's Equity	122	382	1,270	3,451	3,855	4,068	3,577	3,401	2,869	3,277
D/E Ratio	-	-	-	-	0.17	0.91	1.62	2.09	0.43	0.34

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	-2.2%	3.1%	2.6%	2.3%	3.4%	0.9%	2.8%	2.0%	1.6%	-0.2%
Return on Equity	-5.7%	14.2%	15.4%	12.4%	15.9%	4.2%	12.9%	10.1%	11.1%	-1.4%
ROIC	-5.7%	14.2%	15.4%	12.4%	14.6%	2.7%	5.7%	3.6%	4.5%	-0.8%
Shares Out.	11	49	121	175	183	183	174	188	206	262
Revenue/Share	0.24	3.81	3.04	2.44	4.15	1.01	3.35	2.44	1.93	0.89
FCF/Share	-0.99	2.96	3.07	1.34	-5.44	-3.97	-11.28	-0.45	0.65	-1.33

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

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