Dynex Capital Inc. (DX)

Updated April 17th, 2020 by Samuel Smith

Key Metrics

Current Price:	$14	**5 Year CAGR Estimate:**	4.4%	**Market Cap:**	$303M
Fair Value Price:	$8	**5 Year Growth Estimate:**	8.5%	**Ex-Dividend Date:**	6/20/20[1]
% Fair Value:	175%	**5 Year Valuation Multiple Estimate:**	-10.6%	**Dividend Payment Date:**	7/1/20[2]
Dividend Yield:	6.4%	**5 Year Price Target**	$12	**Years of Dividend Growth:**	0
Dividend Risk Score:	F	**Retirement Suitability Score:**	C	**Last Dividend Increase:**	NA

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 trust is structured to have internal management, which is good because it can reduce conflicts of interest and often leads to lower management expenses.

The trust reported fourth quarter results on December 6th. Core earnings-per-share came in at $0.66, up significantly from $0.48 sequentially thanks to an increase in net interest income. The growth in net interest income came as a result of lower financing costs due to lower short-term interest rates. Adjusted net interest spread increased significantly sequentially to 1.53%, up from 1.14% in Q3. Book value per common share stood at $18.01 at quarter end, down slightly sequentially from $18.07 at the end of Q3. The decline was primarily driven by a net unrealized loss on MBS resulting from interest rates increasing in the long end of the yield curve. During the quarter, the economic return to common shareholders came in at 2.2% based on dividends declared of $0.45 per share less the decline in book value per common of $0.06.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	$4.23	$3.09	$4.05	$3.30	$1.02	$0.42	$2.07	$1.38	-$0.24	$2.16	***$1.00***	***$1.50***
DPS	$2.94	$3.27	$3.45	$3.36	$3.00	$2.88	$2.52	$2.16	$2.16	$1.80	***$0.90***	***$1.20***
Shares[3]	7	13	18	18	18	18	16	17	19	25	***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 it to continue growing.

First, an aging population in a low-yield world should foster a growing demand for the cash flow that the 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.

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[1] Estimate

[2] Estimate

[3] Share count in millions

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.

Taking into account these headwinds and tailwinds along with the trust's high payout ratio and the current headwinds from the coronavirus outbreak, we expect a steep earnings and dividend decline this year followed by a gradual recovery.

Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	7.0	7.5	9.0	7.25	12.0	40.0	9.5	15.0	NA	7.8	***14.0***	***8.0***
Avg. Yld.	9.9%	14.1%	9.0%	14.0%	24.5%	17.1%	12.8%	10.4%	11.4%	10.7%	***6.4%***	***10.0%***

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 was recently 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 headwind to annual total returns.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	69.5%	106%	85.2%	102%	294%	686%	122%	157%	N/A	83%	***90%***	***80%***

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

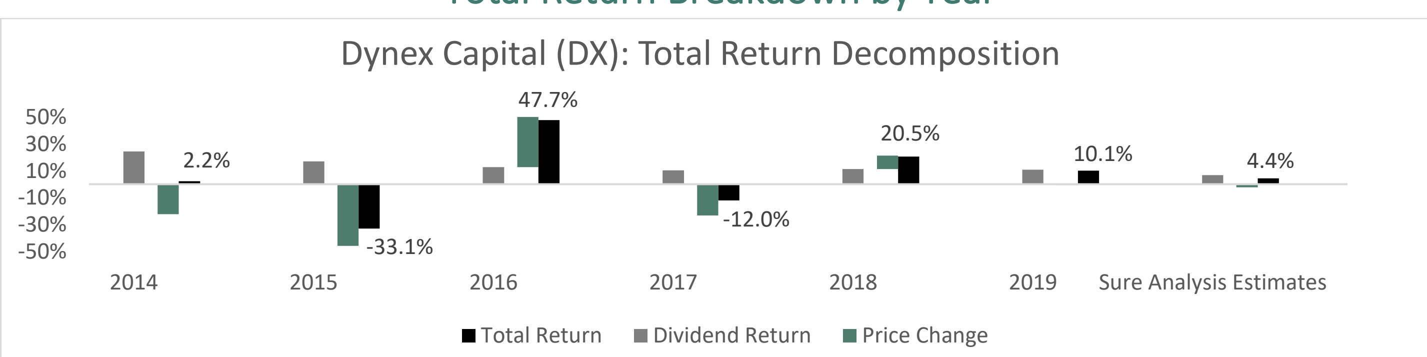
One of the biggest challenges is the shrinking spread between 3-month LIBOR and short-term repo rates, as repo rates remain elevated due to the Fed's pause on the Fed Funds rate. Another risk is that prepayment speeds could rise due to seasonal factors. Additionally, the fall in mortgage rates could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

The trust'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 so high, combined with highly volatile earnings-per-share.

Final Thoughts & Recommendation

Looking ahead to the next half decade, we expect total annualized returns of 4.4%. Given the current headwinds facing the sector, we feel that these meager total returns – which assume a recovery – are even less attractive on a risk-adjusted return basis. Therefore, we rate it as a sell despite its very attractive dividend yield.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	40	51	87	81	44	34	57	50	24	(137)
SG&A Exp.	9	10	13	13	16	18	15	16	15	16
D&A Exp.	6	33	91	8	9	5	2	1	1	2
Net Profit	29	40	74	68	28	17	43	34	7	(153)
Net Margin	74.3%	78.6%	85.1%	83.9%	63.5%	49.2%	75.7%	67.9%	29.6%	112%
Free Cash Flow	30	71	149	209	214	217	211	204	181	175

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	1650	2582	4280	4217	3688	3670	3398	3306	3886	5,371
Cash & Equivalents	19	49	56	69	44	34	74	41	35	63
Acc. Receivable	6	13	23	22	21	23	20	20	21	26
Total Liabilities	1357	2211	3664	3631	3081	3178	2931	2749	3359	4,788
Accounts Payable	1	2	3	3	2	2	3	4	10	16
Long-Term Debt	107	0	31	13	11	528	0	0	0	3
Total Equity	292	371	561	476	498	382	357	416	384	420
D/E Ratio	0.37	0.00	0.05	0.02	0.02	1.07	0.00	0.00	0.00	0.00

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	2.3%	1.9%	2.2%	1.6%	0.7%	0.4%	1.2%	1.0%	0.2%	-3.3%
Return on Equity	14.1%	12.0%	15.9%	13.1%	5.7%	3.8%	11.7%	8.8%	1.8%	-38.0%
ROIC	8.3%	10.3%	14.5%	10.9%	4.6%	2.0%	5.8%	6.6%	1.3%	-27.4%
Shares Out.	7	13	18	18	18	18	16	17	19	25
Revenue/Share	5.69	3.94	4.91	4.45	2.40	1.91	3.48	2.97	1.23	(5.79)
FCF/Share	4.31	5.49	8.43	11.46	11.76	12.32	12.86	12.17	9.39	7.42

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