Two Harbors Investment Corp. (TWO)

Updated March 23rd, 2020 by Samuel Smith

Key Metrics

Current Price:	$5.60	**5 Year CAGR Estimate:**	15.2%	**Market Cap:**	$1.5B
Fair Value Price:	$7.80	**5 Year Growth Estimate:**	0.0%	**Ex-Dividend Date:**	3/30/20[1]
% Fair Value:	72%	**5 Year Valuation Multiple Estimate:**	6.7%	**Dividend Payment Date:**	4/24/20[2]
Dividend Yield:	7.1%	**5 Year Price Target**	$7.80	**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 February (2/5/20), Two Harbors reported financial results for the fourth quarter. Quarterly earnings-per-share came in at $0.25, up from $0.24 per share sequentially. They also added $22.3 billion in unpaid principal balance of mortgage servicing rights due to bulk acquisitions and monthly flow-sale arrangements that brought their total holdings to $175.9 billion. Book value per share declined sequentially to $14.54 from $14.72 as their return on book value declined sequentially to 1.5% from 6.7%.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	$2.58	$2.40	$3.30	$0.92	$2.70	$2.03	$1.81	-$0.53	-$2.45	$1.97	***$0.50***	***$1.25***
BVPS	$18.6	$23.1	$20.7	$22.5	$21.3	$20.0	$20.2	$14.9	$14.8	$14.72	***$12.00***	***$12.00***
DPS	$3.20	$3.42	$2.34	$2.08	$2.08	$1.86	$2.01	$1.88	$1.74	$1.60	***$0.40***	***$1.00***
Shares[3]	49	121	175	183	183	174	188	206	262	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. Most of all, the disruption caused by the coronavirus outbreak will harm earnings as mortgage defaults surge, resulting in considerable book value write downs and earnings declines.

Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/B	0.97	0.87	1.01	0.91	0.87	0.85	0.89	0.94	0.88	1.02	***0.47***	***0.65***
Avg. Yld.	17.8%	17.1%	11.1%	10.1%	11.2%	10.9%	11.2%	13.4%	13.4%	10.6%	***7.1%***	***12.8%***

[1] Estimate
[2] Estimate
[3] In millions

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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. With the coronavirus pandemic poised to ravage its industry and leave a very uncertain future outlook, we are reducing our fair value multiple estimate even further to 0.65 times book value.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout[4]	124%	143%	70.9%	226%	77.0%	91.6%	111%	NA	NA	95.0%	***80.0%***	***80.0%***

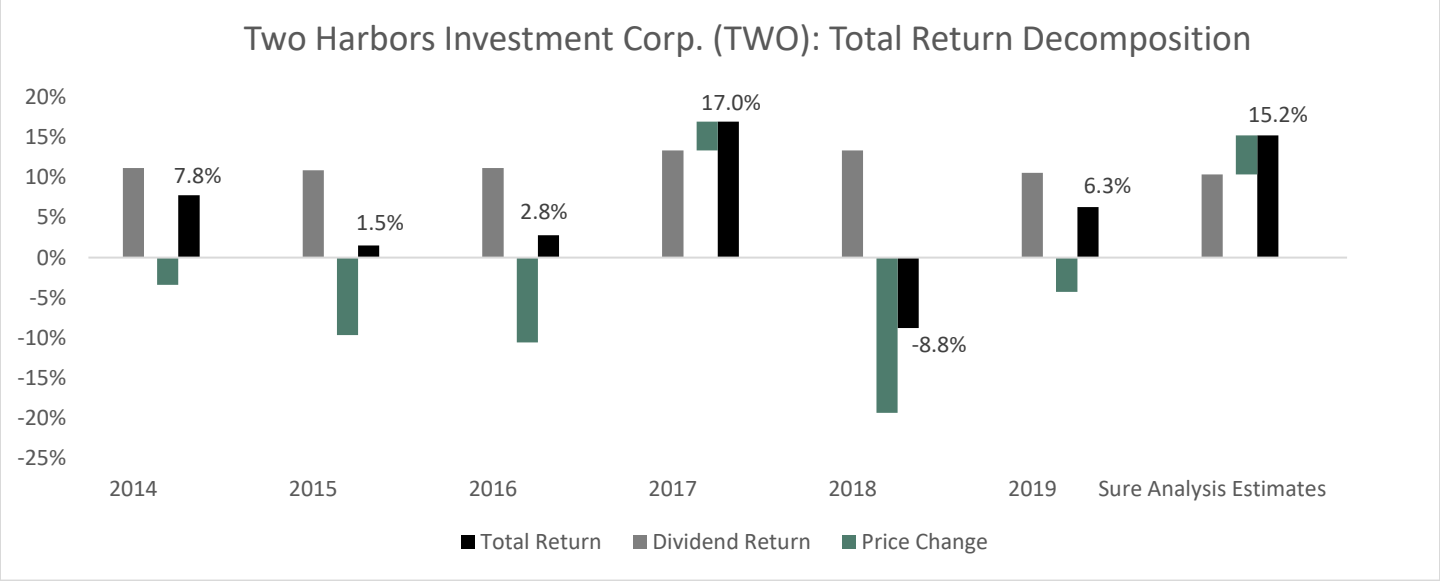
Two Harbors' high dividend yield indicates that the market has some concerns about the safety of its current dividend payment as well as the sustainability of the business model as a whole. In general, the non-recurring nature of the loans within the mortgage REIT business model make Two Harbors somewhat 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 has sold off heavily with the coronavirus outbreak, and for good reason. We expect significant book value destruction and are forecasting a massive dividend cut as well. While the stock has gotten beaten down so much that it offers a 15.2% annualized total return outlook over the next half decade, investors should be cautioned that there is a great deal of risk and uncertainty associated with this forecast. If the economy enters a depression, there is a good chance that Two Harbors will fail to survive. We therefore advise conservative investors to steer clear, and rate it a sell.

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	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	43	150	296	728	185	612	425	362	183	427
SG&A Exp.	6	22	33	42	49	49	39	40	30	60
D&A Exp.	-	0	2	2	2	1				
Net Profit	36	127	292	579	167	492	353	349	(44)	324
Net Margin	83.9%	84.8%	98.6%	79.5%	90.6%	80.4%	83.1%	96.2%	-24.2%	75.8%
Free Cash Flow	33	152	162	(955)	(727)	-2060	(78)	123	(274)	443
Income Tax	(1)	(1)	(42)	84	(74)	(17)	12	(10)	42	(14)

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	1,797	8,100	16,814	17,174	21,084	14,576	20,112	24,789	30,132	35,922
Cash & Equivalents	164	360	821	1,025	1,006	738	351	419	410	558
Goodwill & Int. Ass.		23	43	50	66	50	59	68	87	93
Total Liabilities			-	515	452	494	694	1,087	1,993	1,909
Accounts Payable	1,415	6,830	13,363	13,319	17,016	10,999	16,711	21,218	25,878	30,951
Long-Term Debt		6	19	20	24	19	29	88	160	150
Shareholder's Equity	-	-	-	640	3,710	5,785	7,107	1,518	1,459	1,189
D/E Ratio	382	1,270	3,451	3,855	4,068	3,577	3,401	2,869	3,277	3,993

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	3.1%	2.6%	2.3%	3.4%	0.9%	2.8%	2.0%	1.6%	-0.2%	1.0%
Return on Equity	14.2%	15.4%	12.4%	15.9%	4.2%	12.9%	10.1%	11.1%	-1.4%	8.9%
ROIC	14.2%	15.4%	12.4%	14.6%	2.7%	5.7%	3.6%	4.5%	-0.8%	5.5%
Shares Out.	49	121	175	183	183	174	188	206	262	262
Revenue/Share	3.81	3.04	2.44	4.15	1.01	3.35	2.44	1.93	0.89	1.60
FCF/Share	2.96	3.07	1.34	(5.44)	(3.97)	(11.28)	(0.45)	0.65	(1.33)	1.65

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

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