Two Harbors Investment Corp. (TWO)

Updated February 25th, 2021 by Samuel Smith

Key Metrics

Current Price:	$7.3	**5 Year CAGR Estimate:**	9.3%	**Market Cap:**	$1.9B
Fair Value Price:	$7.2	**5 Year Growth Estimate:**	2.5%	**Ex-Dividend Date:**	4/15/21[1]
% Fair Value:	102%	**5 Year Valuation Multiple Estimate:**	-0.4%	**Dividend Payment Date:**	4/29/21[2]
Dividend Yield:	10.1%	**5 Year Price Target**	$8.1	**Years Of Dividend Growth:**	0
Dividend Risk Score:	F	**Retirement Suitability Score:**	B	**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 Feb (02/09/21), Two Harbors reported financial results for the fourth quarter. Quarterly earnings-per-share came in at $0.30, up from $0.28 per share in Q3. Book value per share increased to $7.63 from $7.37 in Sept 30, 2020. Two Harbors settled a $23.0 billion unpaid principal balance of MSR through its MSR flow-sale program and closed on another $20.4 billion UPN of MSR bulk purchases. The company's total portfolio of $21.8 billion as of December 31 fell from $24.4 billion on Sept 30. Annualized net yield for the aggregate portfolio during the quarter was 1.76% compared with 1.78% in Q3, while Q4 servicing income for the quarter stood at $100.5 million from $99.1 million in Q3. Meanwhile, the company's Q4 common stock dividend increased 21% to $0.17 per share from the prior quarter.

Growth on a Per-Share Basis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
EPS	$2.40	$3.30	$0.92	$2.70	$2.03	$1.81	-$0.53	-$2.45	$1.97	$0.78	***$0.94***	***$0.90***
BVPS	$23.1	$20.7	$22.5	$21.3	$20.0	$20.2	$14.9	$14.8	$14.72	$7.63	***$7.95***	***$9.00***
DPS	$3.42	$2.34	$2.08	$2.08	$1.86	$2.01	$1.88	$1.74	$1.60	$0.56	***$0.74***	***$0.60***
Shares[3]	121	175	183	183	174	188	206	262	262	274	***280***	***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 $6.96 at the present. Since its inception in October 2009, the stock has outperformed the BBG REIT MTG index's total return. 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 trust 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.

[1] Estimate
[2] Estimate
[3] 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.

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Valuation Analysis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Now	2026
Avg. P/B	0.87	1.01	0.91	0.87	0.85	0.89	0.94	0.88	1.02	0.84	***0.92***	***0.90***
Avg. Yld.	17.1%	11.1%	10.1%	11.2%	10.9%	11.2%	13.4%	13.4%	10.6%	9.0%	***10.1%***	***7.4%***

Two Harbors has historically traded at a sizable discount to book value due to its riskier (highly leveraged) business model and the trust's nearly annual dividend cuts. As a result, we assume a fair value P/B estimate of 0.90, meaning that the stock remains slightly overvalued based on its current multiple.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
Payout	143%	70.9%	226%	77.0%	91.6%	111%	NA	NA	95.0%	80.0%	***78.7%***	***66.7%***

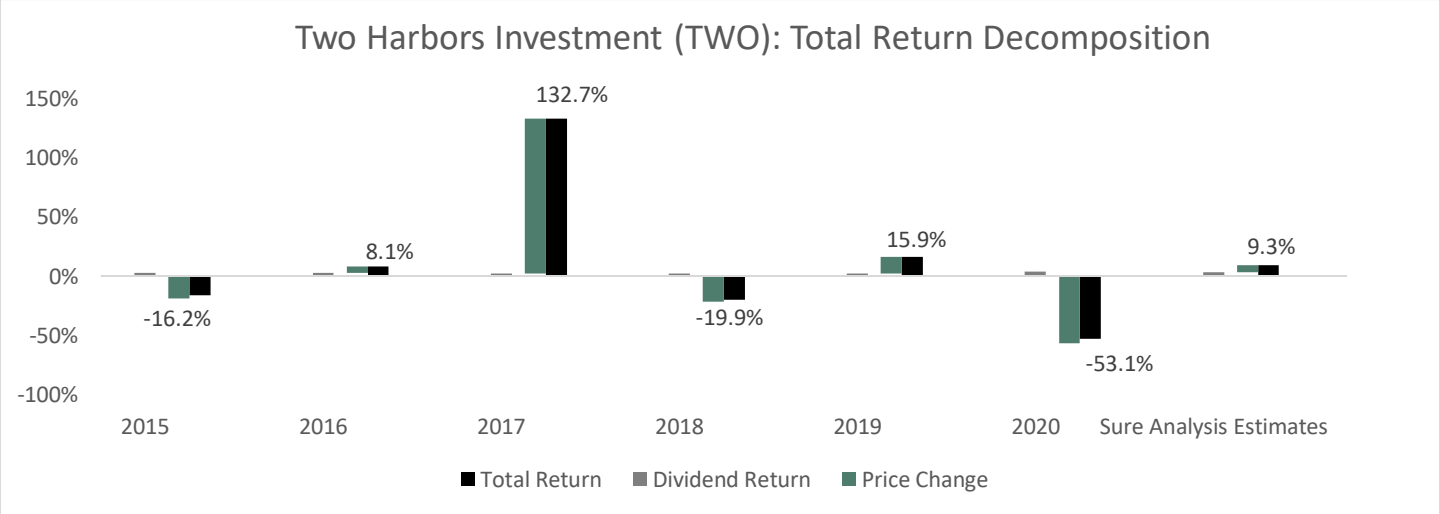
Two Harbors' high dividend yield indicates that the market has some concerns about the safety of its current dividend payment as well as the sustainability of the business model as a whole. In general, the non-recurring nature of the loans within the mortgage REIT business model make Two Harbors somewhat 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 trust lacks any significant competitive advantage other than some economies of scale and significant diversification that add 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 offers an attractive 10.1% dividend yield. However, investors should be cautioned that there is a great deal of risk and uncertainty associated with this yield. Therefore, the expected 9.3% total annualized returns should only be pursued by those with a high-risk tolerance. Investors looking for stable income should steer clear of this stock; we rate it a hold.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	150	296	728	185	612	425	362	183	427	(1,595)
SG&A Exp.	22	33	42	49	49	39	40	30	60	38
D&A Exp.	0	2	2	2	1					
Net Profit	127	292	579	167	492	353	349	(44)	324	(1,630)
Net Margin	84.8%	98.6%	79.5%	90.6%	80.4%	83.1%	96.2%	-24.2%	75.8%	102.2%
Free Cash Flow	152	162	(955)	(727)	-2060	(78)	123	(274)	443	
Income Tax	(1)	(42)	84	(74)	(17)	12	(10)	42	(14)	(36)

Balance Sheet Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Assets	8100	16814	17174	21084	14576	20112	24789	30132	35922	19516
Cash & Equivalents	360	821	1025	1006	738	351	419	410	558	1385
Goodwill & Int. Ass.		-	515	452	494	694	1087	1993	1909	1596
Total Liabilities	6830	13363	13319	17016	10999	16711	21218	25878	30951	16427
Accounts Payable	6	19	20	24	19	29	88	160	150	22
Long-Term Debt	-	-	640	3710	5785	7107	1518	1459	1189	966
Shareholder's Equity	1270	3451	3855	4068	3577	3401	2869	3277	3993	2111
D/E Ratio	-	-	0.17	0.91	1.62	2.09	0.43	0.34	0.24	0.31

Profitability & Per Share Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Return on Assets	2.6%	2.3%	3.4%	0.9%	2.8%	2.0%	1.6%	-0.2%	1.0%	-5.9%
Return on Equity	15.4%	12.4%	15.9%	4.2%	12.9%	10.1%	11.1%	-1.4%	8.9%	-53.4%
ROIC	15.4%	12.4%	14.6%	2.7%	5.7%	3.6%	4.5%	-0.8%	5.5%	-31.9%
Shares Out.	121	175	183	183	174	188	206	262	262	274
Revenue/Share	2.75	2.17	3.91	0.74	3.08	2.22	1.71	0.74	1.37	(5.83)
FCF/Share	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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