Two Harbors Investment Corp. (TWO)

Updated May 8th, 2022 by Samuel Smith

Key Metrics

Current Price:	$5.3	**5 Year CAGR Estimate:**	12.8%	**Market Cap:**	$1.8B
Fair Value Price:	$5.1	**5 Year Growth Estimate:**	4.2%	**Ex-Dividend Date:**	07/01/22[1]
% Fair Value:	105%	**5 Year Valuation Multiple Estimate:**	-0.9%	**Dividend Payment Date:**	07/29/22[2]
Dividend Yield:	12.8%	**5 Year Price Target**	$6.2	**Years Of Dividend Growth:**	1
Dividend Risk Score:	F	**Retirement Suitability Score:**	C	**Rating:**	Buy

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 May (05/04/22), Two Harbors reported financial results for the first quarter. Q1 earnings available for distribution decreased to $0.18 from $0.22 sequentially. The company's total portfolio of $14.8 billion grew from $13.6 billion quarter-over-quarter. Book value per share stood at $5.53, representing a (2.9%) quarterly return on book value. Furthermore, servicing income for the quarter increased to $136.6 million from $107.1 million in the year-ago period. Net interest income stood at $22.5 million, up from $12.8 million sequentially and down from $33.4 million in the year-ago period. Total interest income stood at $44.8 million, up from $33.0 million sequentially while down from $56.1 million in the year-ago period. Meanwhile, the company reported growth in MSR portfolio with the acquisition of $37.2 billion unpaid principal balance through the bulk channel and $7.9 billion UPB through the follow channel.

Growth on a Per-Share Basis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
EPS	$3.30	$0.92	$2.70	$2.03	$1.81	-$0.53	-$2.45	$1.97	$0.78	$0.82	***$0.78***	***$1.00***
BVPS	$20.7	$22.5	$21.3	$20.0	$20.2	$14.9	$14.8	$14.72	$7.63	$7.04	***$5.63***	***$6.90***
DPS	$2.34	$2.08	$2.08	$1.86	$2.01	$1.88	$1.74	$1.60	$0.56	$0.68	***$0.68***	***$0.70***
Shares[3]	149.4	183.0	183.3	173.8	174.5	175.4	251.1	273.6	273.7	343.9	***344.1***	***350.0***

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 $6.21 at present. Analysts do expect book value per share to recover to $6.90 per share over the next half decade, however. 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. As a result, we are forecasting low to mid-single-digit growth over the next half decade.

Valuation Analysis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Now	2027
Avg. P/B	1.01	0.91	0.87	0.85	0.89	0.94	0.88	1.02	0.84	0.88	***0.94***	***0.90***
Avg. Yld.	11.1%	10.1%	11.2%	10.9%	11.2%	13.4%	13.4%	10.6%	9.0%	11.0%	***12.8%***	***11.3%***

[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 trust's nearly annual dividend cuts. As a result, we assume a fair value P/B estimate of 0.90, meaning that the stock is slightly overvalued based on its current multiple.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
Payout	70.9%	226%	77.0%	91.6%	111%	NA	NA	95.0%	71.8%	90.7%	***87.2%***	***70.0%***

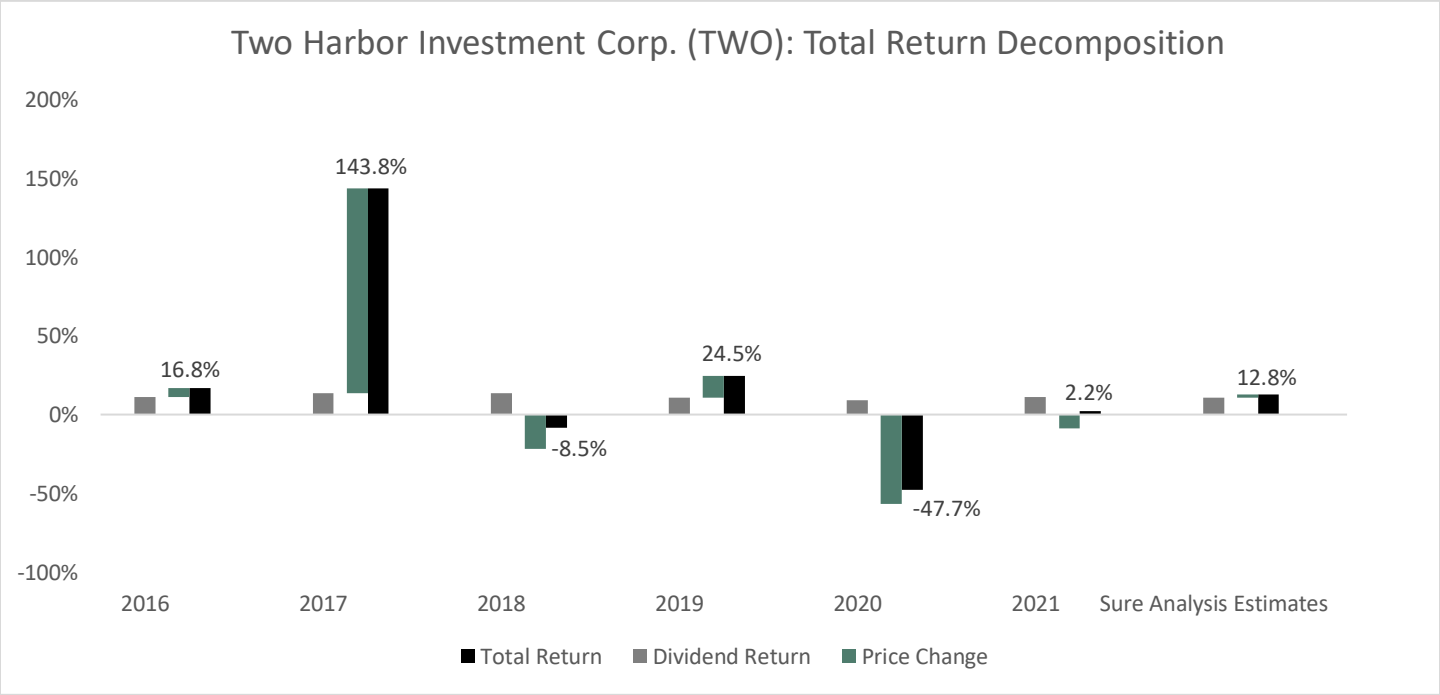
Two Harbors' high dividend yield indicates that the market has some concerns about the safety of its current dividend payment as well as the sustainability of the business model as a whole. In general, the non-recurring nature of the loans within the mortgage REIT business model make Two Harbors somewhat 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 high leverage ratio – 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 12.8% dividend yield. However, investors should be cautioned that there is a great deal of risk and uncertainty associated with this yield. Therefore, the expected 12.8% annualized total returns should only be pursued by those with a high risk tolerance. Conservative investors looking for stable income should steer clear of this stock, and we rate it a speculative Buy accordingly.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue	296	729	331	690	519	483	255	1,125	(626)	370
SG&A Exp.							36	33	38	35
D&A Exp.	2	2	2	1						
Net Profit	292	579	167	492	353	349	(44)	324	(1,630)	187
Net Margin	98.6%	79.5%	50.4%	71.3%	68.1%	72.1%	-17.4%	28.8%	260.3%	50.6%
Free Cash Flow	162	(955)	(727)	(2,060)	(78)	123	(274)	443	9	(319)
Income Tax	(42)	84	(74)	(17)	12	(10)	42	(14)	(36)	4

Balance Sheet Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Total Assets	16,814	17,174	21,084	14,576	20,112	24,789	30,132	35,922	19,516	12,114
Cash & Equivalents	821	1,025	1,006	738	351	419	410	558	1,385	1,154
Goodwill & Int. Ass.	43	50	66	50	59	68	87	93	47	26
Total Liabilities	-	515	452	494	694	1,087	1,993	1,909	1,596	2,192
Accounts Payable	13,363	13,319	17,016	10,999	16,711	21,218	25,878	30,951	16,427	9,370
Long-Term Debt	19	20	24	19	29	88	160	150	22	18
Shareholder's Equity	-	640	3,710	5,785	7,107	1,518	1,459	1,189	966	1,242
LTD/E Ratio	-	0.17	0.91	1.62	2.09	0.43	0.34	0.24	0.31	0.45

Profitability & Per Share Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Return on Assets	2.3%	3.4%	0.9%	2.8%	2.0%	1.6%	-0.2%	1.0%	-5.9%	1.2%
Return on Equity	12.4%	15.9%	4.2%	12.9%	10.1%	11.1%	-1.4%	8.9%	-53.4%	9.0%
ROIC	12.4%	14.6%	2.7%	5.7%	3.6%	4.5%	-0.8%	5.5%	-31.9%	4.7%
Shares Out.	149.4	183.0	183.3	173.8	174.5	175.4	251.1	273.6	273.7	343.9
Revenue/Share	2.44	4.15	1.81	3.78	2.98	2.57	1.24	4.20	(2.29)	1.24
FCF/Share	1.34	(5.44)	(3.97)	(11.28)	(0.45)	0.65	(1.33)	1.65	0.03	(1.07)

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

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