Two Harbors Investment Corp. (TWO)

Updated November 1st, 2023 by Samuel Smith

Key Metrics

Current Price:	$12.0	**5 Year CAGR Estimate:**	12.5%	**Market Cap:**	$1.1B
Fair Value Price:	$13.8	**5 Year Growth Estimate:**	-0.5%	**Ex-Dividend Date:**	1/04/24[1]
% Fair Value:	87%	**5 Year Valuation Multiple Estimate:**	2.9%	**Dividend Payment Date:**	1/27/24[2]
Dividend Yield:	15.0%	**5 Year Price Target**	$13	**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.

Two Harbors Investment Corp. released their third-quarter financial results for 2023 on October 30, 2023. The company reported a book value of $15.36 per common share and a declared dividend of $0.45 per share, which translates to a quarterly economic return on book value of negative 3.5%. However, Two Harbors experienced a comprehensive loss of $56.8 million, or $0.61 per weighted average basic common share. On a positive note, the company generated Income Excluding Market-Driven Value Changes (IXM) of $0.51 per share.

A significant event was the closure of the RoundPoint Mortgage Servicing LLC acquisition, which is forecasted to contribute $25-30 million to pre-tax earnings in 2024. This quarter also saw the settlement of $472.2 million in unpaid principal balance of mortgage servicing rights (MSR) through flow-sale acquisitions. Two Harbors' management highlighted the completion of the RoundPoint acquisition as a key strategic move and expressed confidence in the performance of their MSR portfolio and Agency RMBS exposure management amidst market volatility.

Growth on a Per-Share Basis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
EPS	$3.68	$10.8	$8.12	$7.24	-$2.12	-$9.80	$7.88	$3.12	$3.28	$2.50	***$1.45***	***$1.50***
BVPS	$90.0	$85.2	$80.0	$80.8	$59.6	$59.2	$58.88	$30.52	$28.16	$17.72	***$15.36***	***$15.00***
DPS	$8.32	$8.32	$7.44	$8.04	$7.52	$6.96	$6.40	$2.24	$2.72	$0.68	***$1.80***	***$1.50***
Shares[3]	45.8	45.8	43.5	43.6	43.9	62.8	68.4	68.4	86.0	96.6	***96.2***	***95.0***

Two Harbors has a history of generating strong total returns for investors, despite book value per share declining significantly over the years. As a result, TWO recently had to complete a 4 for 1 reverse stock split to prop up the share price and encourage more fund inclusion. 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. Given economic and industry headwinds as well as the high payout ratio, we are forecasting book value per share to slightly decrease over the next half-decade.

Valuation Analysis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Now	2028
Avg. P/B	1.01	0.91	0.87	0.85	0.89	0.94	0.88	1.02	0.84	0.88	***0.78***	***0.90***
Avg. Yld.	11.1%	10.1%	11.2%	10.9%	11.2%	13.4%	13.4%	10.6%	9.0%	11.0%	***15.0%***	***11.1%***

[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 undervalued based on its current multiple.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
Payout	226%	77%	92%	111%	-355%	-71%	81%	72%	83%	27%	***124%***	***100%***

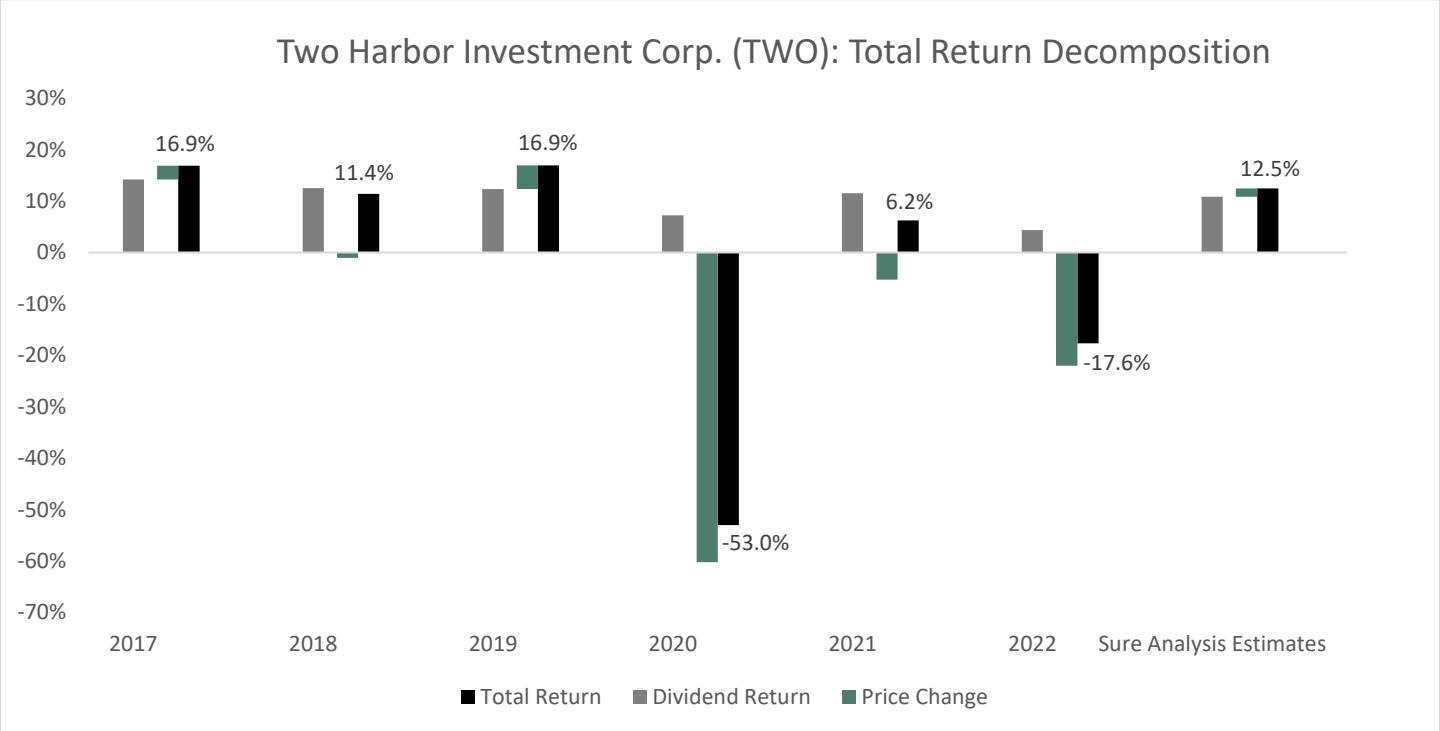
Two Harbors' high dividend yield indicates that the market has some concerns about the safety of its current dividend payment as well as the sustainability of the business model as a whole. In general, the non-recurring nature of the loans within the mortgage REIT business model make Two Harbors somewhat 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 15% dividend yield. However, investors should be cautioned that a great deal of risk and uncertainty is associated with this yield. Therefore, the expected 12.5% 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	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Revenue	729	331	690	519	483	255	1,125	(626)	370	407
SG&A Exp.						36	33	38	35	41
D&A Exp.	2	2	1							
Net Profit	579	167	492	353	349	(44)	324	(1,630)	187	220
Net Margin	79.5%	50.4%	71.3%	68.1%	72.1%	-17.4%	28.8%	260.3%	50.6%	54.1%
Free Cash Flow	(955)	(727)	(2,060)	(78)	123	(274)	443	9	(319)	(6)
Income Tax	84	(74)	(17)	12	(10)	42	(14)	(36)	4	104

Balance Sheet Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Total Assets	17,174	21,084	14,576	20,112	24,789	30,132	35,922	19,516	12,114	13,466
Cash & Equivalents	1,025	1,006	738	351	419	410	558	1,385	1,154	683
Goodwill & Int. Ass.	50	66	50	59	68	87	93	47	26	2,985
Total Liabilities	515	452	494	694	1,087	1,993	1,909	1,596	2,192	11,283
Accounts Payable	13,319	17,016	10,999	16,711	21,218	25,878	30,951	16,427	9,370	94
Long-Term Debt	20	24	19	29	88	160	150	22	18	1,799
Shareholder's Equity	640	3,710	5,785	7,107	1,518	1,459	1,189	966	1,242	1,553
LTD/E Ratio	0.17	0.91	1.62	2.09	0.43	0.34	0.24	0.31	0.45	0.82

Profitability & Per Share Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Return on Assets	3.4%	0.9%	2.8%	2.0%	1.6%	-0.2%	1.0%	-5.9%	1.2%	1.7%
Return on Equity	15.9%	4.2%	12.9%	10.1%	11.1%	-1.4%	8.9%	-53.4%	9.0%	12.3%
ROIC	14.6%	2.7%	5.7%	3.6%	4.5%	-0.8%	5.5%	-31.9%	4.7%	5.5%
Shares Out.	45.8	45.8	43.5	43.6	43.9	62.8	68.4	68.4	86.0	96.6
Revenue/Share	4.15	1.81	3.78	2.98	2.57	1.24	4.20	(2.29)	1.24	4.24
FCF/Share	(5.44)	(3.97)	(11.28)	(0.45)	0.65	(1.33)	1.65	0.03	(1.07)	(0.07)

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

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