Two Harbors Investment Corp. (TWO)

Updated February 15th, 2024 by Samuel Smith

Key Metrics

Current Price:	$12.9	**5 Year CAGR Estimate:**	10.8%	**Market Cap:**	$1.3B
Fair Value Price:	$13.5	**5 Year Growth Estimate:**	0.0%	**Ex-Dividend Date:**	4/11/24[1]
% Fair Value:	95%	**5 Year Valuation Multiple Estimate:**	0.9%	**Dividend Payment Date:**	4/29/24[2]
Dividend Yield:	14.0%	**5 Year Price Target**	$14	**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 its financial results for the fourth quarter of 2023 on January 29, 2024. The period was marked by volatility in the mortgage market, with mortgage spreads and implied volatility remaining positively correlated to interest rates. The company reported a comprehensive income of $38.9 million, equating to $0.40 per weighted average share. This performance reflected a significant reversal from the previous quarter's comprehensive loss of $56.8 million, or $0.61 per weighted average share.

The book value per share stood at $15.21 at the end of December 2023, slightly down from $15.36 at the end of the previous quarter, indicating a modest economic return on book value of 2.0% for the quarter. This was an improvement over the -3.5% economic return on book value recorded in the third quarter of 2023. The company's operating expenses, excluding non-cash long-term incentive plan amortization and certain operating expenses, totaled $40.2 million for the fourth quarter, reflecting an increase from $12.6 million in the third quarter.

The portfolio of Two Harbors as of December 31, 2023, consisted of $11.4 billion in Agency Residential Mortgage-Backed Securities (RMBS), Mortgage Servicing Rights (MSR), and other investment securities, in addition to their associated notional debt hedges. Additionally, the company held a net long to-be-announced securities (TBAs) bond equivalent value of $3.2 billion.

Two Harbors' investment strategy and portfolio adjustments during the quarter reflected a cautious approach to leverage exposure given the current market conditions. Despite the decline in mortgage rates over the quarter, the weighted average coupon rate of the MSR portfolio remained low at 3.45%, with less than 1% of its balances having a significant rate incentive to refinance.

Growth on a Per-Share Basis

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029
EPS	$10.8	$8.12	$7.24	-$2.12	-$9.80	$7.88	$3.12	$3.28	$2.50	-$0.07	***$1.85***	***$1.50***
BVPS	$85.2	$80.0	$80.8	$59.6	$59.2	$58.88	$30.52	$28.16	$17.72	$15.21	***$15.02***	***$15.00***
DPS	$8.32	$7.44	$8.04	$7.52	$6.96	$6.40	$2.24	$2.72	$0.68	$1.80	***$1.80***	***$1.50***
Shares[3]	45.8	43.5	43.6	43.9	62.8	68.4	68.4	86.0	96.6	103.2	***103.2***	***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

[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.

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	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Now	2029
Avg. P/B	0.91	0.87	0.85	0.89	0.94	0.88	1.02	0.84	0.88	0.78	***0.86***	***0.90***
Avg. Yld.	10.1%	11.2%	10.9%	11.2%	13.4%	13.4%	10.6%	9.0%	11.0%	15.0%	***14.0%***	***11.1%***

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	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029
Payout	77%	92%	111%	NA	NA	81%	72%	83%	27%	NA	***97%***	***100%***

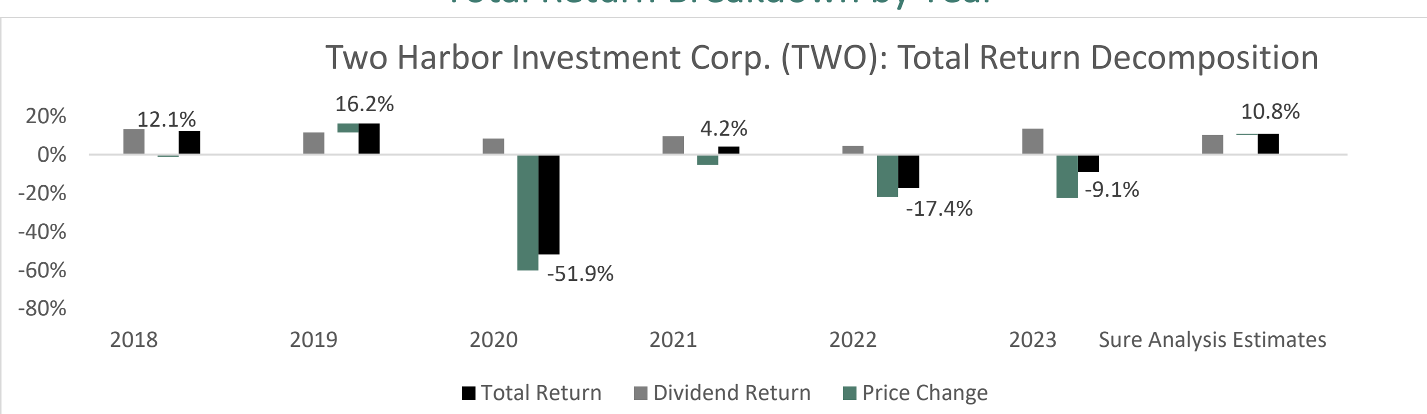
Two Harbors' high dividend yield indicates that the market has some concerns about the safety of its current dividend payment as well as the sustainability of the business model as a whole. In general, the non-recurring nature of the loans within the mortgage REIT business model make Two Harbors somewhat 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 14% dividend yield. However, investors should be cautioned that a great deal of risk and uncertainty is associated with this yield. Therefore, the expected 10.8% 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	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Revenue	203	590	435	392	186	428	(1,562)	255	407	32
SG&A Exp.					36	33	38	35	41	53
D&A Exp.	2	1								
Net Profit	167	492	353	349	(44)	324	(1,630)	187	220	(106)
Net Margin	82.3%	83.4%	81.2%	88.8%	-23.8%	75.8%	104.4%	73.4%	54.1%	-335%
Free Cash Flow	(727)	(2,060)	(78)	123	(274)	443	9	(319)	(6)	
Income Tax	(74)	(17)	12	(10)	42	(14)	(36)	4	104	23

Balance Sheet Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Total Assets	21,084	14,576	20,112	24,789	30,132	35,922	19,516	12,114	13,466	13,139
Cash & Equivalents	1,006	738	351	419	410	558	1,385	1,154	683	730
Goodwill & Int. Ass.	452	494	694	1,087	1,993	1,909	1,596	2,192	2,985	3,052
Total Liabilities	17,016	10,999	16,711	21,218	25,878	30,951	16,427	9,370	11,283	10,935
Accounts Payable	24	19	29	88	160	150	22	18	94	142
Long-Term Debt	3,710	5,785	7,107	1,518	1,459	1,189	966	1,242	1,799	1,893
Shareholder's Equity	4,068	3,577	3,401	2,869	3,277	3,993	2,111	2,041	1,553	1,590
LTD/E Ratio	0.91	1.62	2.09	0.43	0.34	0.24	0.31	0.45	0.82	0.86

Profitability & Per Share Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Return on Assets	0.9%	2.8%	2.0%	1.6%	-0.2%	1.0%	-5.9%	1.2%	1.7%	-0.8%
Return on Equity	4.2%	12.9%	10.1%	11.1%	-1.4%	8.9%	-53.4%	9.0%	12.3%	-6.8%
ROIC	2.7%	5.7%	3.6%	4.5%	-0.8%	5.5%	-31.9%	4.7%	5.5%	-2.6%
Shares Out.	45.8	43.5	43.6	43.9	62.8	68.4	68.4	86.0	96.6	103.2
Revenue/Share	4.44	12.93	10.00	8.34	3.61	6.39	(22.84)	3.43	4.24	0.33
FCF/Share	(15.89)	(45.13)	(1.79)	2.61	(5.31)	6.62	0.13	(4.28)	(0.07)	

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

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