SN VALUATION
SN CAPITAL SN CONSULTING SN ENGLISH

Sung Nam

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Armour Residential REIT (ARR)

Overview 1.54BB market cap. Annual dividend yield at 20.39%. P/B at 0.69.

Recently, the stock has taken a fall $6.50/share in March 2013 to the current $4.12.

The residential REIT invests in mortgage backed securities, and other real estate products. All REITs are 80% of assets invested in real estate products, with a mandatory 90% distribution of earnings, which is yielding 20%. The Co. generates revenues from the interest spread and the gain on the securities. Roughly 2.3% on the interest income side ($540MM/$22,605). Interest expense is 0.5% ($95MM/$19,763MM).

REPO is a big part of the financing. How does a REIT which received $2.8BB in capital from investors purchase $22.6BB in securities, without taking out any debt? Well, although REPOs aren't interest bearing debts, they act like zero coupon bonds, which pays out interest to the lender in the form of a premium paid to the lender when the securities are bought back.

i.e.. Let's assume SN Capital owns $1MM in agency bonds. We can use this as collateral, to borrow more money. So, the bank will lend out an amount with a marginal haircut of 2-15%, if the asset is quality level. So, we can borrow up to $980,000. If the borrowing rate is 6%, and we set a payback date of 60 days, we will in return payback $980,000 x (1+(0.06) x (60/360)), or $989,799, or which $9,800 is interest.

During the 60 day period, we use the $980,000 in borrowed money to buy more securities, which will offset the interest expense as we generate additional interest revenue. Thus, on our books, we will record $1,980,000 in securities and $980,000 in repo agreements.

The net asset/repo for ARR is $2.84 BB, which is equal to the capital received from investors. So, this fund is 8x Leveraged, which is $22.6BB in securities divided by the $2.8BB in capital. Our example above assumed 2x leverage, but it looks like the 8x leverage is achieved by borrowing on the borrowed security. The derivative of derivatives we saw fall apart in 2008 is actually still well and alive in the MREIT market.

Most of finance is a zero sum game. If the fund is winning most of the time with the consistent cash flow, should the securities devalue in price, then the fund will realize loses that may be comparable to the cash received over the long stretch. This will happen if the repo market freezes up. This is very much a tail risk that will occur every credit cycle. We may have come out of a credit freeze recently, but it is only a matter of time before these MBS REITs get knocked out, like a house of cards. Until then, enjoy the MBS, leverage party!*note the sarcasm

MREITs have seen considerable weakness with the tapering concerns, which is based on fundamentals of the fixed income market. If rates increase, the value of the securities will decrease. This means, the payables on the repo exceed the market value of the underlying asset over time. So, the REIT will realize much higher implied interest expense rates, thereby compressing margins, and will realize greater losses on the depreciation of their assets. The book value will shrink, with hits to retained earnings.

Assessment MREITs don't operate a sustainable business model. They might have done well as a unit investment trust, which has a set date to cease all operations. From 2009 to today, MREITs have been profitable under favorable circumstances, aided by the FED. Now that the FED party is about to wrap up in the next couple years, this now pyramid scheme has run its course, and the last one holding the MREIT stocks will prove to be the loser. Sell, sell, sell. Don't let the dividends fool you.

SN Valuation FIG Portfolio

As of 2013-08-19

Buy

Name	Ticker	Market Price*	Entry Price	Date	Gain/(Loss)
Premier Financial	PFBI	12.05	12.61	08/07/2013	-4.44%

Average Total Return -4.44%

Follow

Name	Ticker	Market Price*	Entry Price	Date	Gain/(Loss)

*Intraday Market Price