SN VALUATION
SN CAPITAL SN CONSULTING SN ENGLISH

Sung Nam

August 6, 2013

Invesco Mortgage Capital (IVR)

Overview

1.9BB market cap. Dividend yield at 17%. P/B at 0.72. Launched in 2009. MREIT.

The Co's share price dropped from $21 to $15 in the past 2 months, beginning in April 2013, with the great Tapering fear, which would imply higher interest rates. The mortgages would fall in value, and the cost of borrowing would increase, thereby narrowing the net interest margin. A double whammy to asset value and cash flow.

The Co., which is essentially a fund, is managed by Invesco (IVZ), which is affiliated with the venerable WL Ross & Co. Invesco is a large asset management firm which manages $600 BB in assets The Co. invests in RMBS and CMBS, commercial loans and finances the investments through repos, or repurchase agreements. Repos are like non-interest bearing bonds, or a zero coupon bond, which essentially tops off the initial borrowed amount with a premium, which acts like the interest. This is worrisome as the Co. was established after the credit crisis. We have not seen how the Co. overcomes such obstacles, so there is a risk should financing dry up in the next credit crunch, the Co. may not react quick enough to stave off the ensuing tail risks. The lenders have the right to evaluate the value of the collateral posted for the repos and could initiate a margin call. Also, the Co. issued redeemable preferred stock in July 2012 for $135MM in proceeds.

The Co. is exempt from the 1940 Act, since the investments are mainly in real estate related investments, so it is under the RE Investment Trust umbrella. Mortgage banking business was exempt from the Act for 50 years. MREITs only has to comply to investing 75% of assets into real estate related investments and cash, and paying out 90% of earnings as dividend. However, in August 2011, the SEC announced they would be reviewing whether Mortgage REITs should be exempt from the 1940 Act, and if it was to include MREITs, the Co. would not be able to leverage their investments. In concert with the announcement, IVR's share price dropped from $15 to near $11/share. MREITs generate double digit returns off 2-3% spreads by Repos.

The Co. has $18.5BB in MBS, financed primarily by $15.7BB in repos. $566MM in interest income, or 3% in interest income, and $237MM in interest expense, or 1.5%, so a net interest margin of 1.50%, or $330 MM. The ROE is 17%. The ROE outperformance is possible due to the 8x Debt to Equity leverage, which is inherent in the business model. SG&A is only $40MM, so there is a sizable cushion, where management could later decide to deleverage operations if the market condition worsens.

50% of portfolio is in 30 year fixed rate mortgages. The interest income has come down annually from 5.1%, 4.1% in 2011 and 2012, respectively. With $4BB in additional repo agreements in 2012, we believe management chased yield and purchased the mortgages in the high price range, which resulted in lower yields. $2.3BB is in additional paid in capital, $135MM in preferred stock.

The crucial factor in the business model is the leverage. We understand the repo uses collateral to lend, so intuitively, the D/E should increase to a maximum of 2x. I.E. Receive $2.5BB in equity, buy $2.5BB in MBS, and borrow $2.5BB in repo to purchase another $2.5BB in MBS, making the total MBS $5BB, off the initial $2.5BB. But to get a higher D/E, above 2.0x means the new mortgages can be repo'd, somewhat a derivative of the derivative. This house of cards will collapse under its own weight should the value of the underlying mortgages fall in value. This is a classic example of a tail risk implosion waiting to happen. We are surprised that such an industry existed, and now not taken back by SEC's actions to curtail the investment activity under the 1940 ACT umbrella.

Assessment

Dividends are spectacular and we anticipate double digit dividend yields for the near future. However, the leveraged nature of MREITs is not entirely ensuring, note the sarcasm. Sure, the experts are running the show and have approval from the SEC. But, this business doesn't sit right with me. We will stay away from MREITs until we become more familiar with the space. A novel trade idea, but risky business.