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September 12, 2012

### Mortgage Reits

Mortgage reits are posting 30% gains -10% from price appreciation and 20% from dividends. How is this possible? Soberlook mentioned leverage. American Capital Agency (AGNC), Hatteras Financial (HTS), and Annaly Capital (NLY). They get 2-3 months repos, or loans that are collateralized by assets, in this case the mortgages, which are backed by the residential properties. As yield runs dry in vanilla fixed income products, greater demand for yield is coming back to real estate related products, which has driven the MREITS issuance to \$300 BB, past the \$100 BB pre-financial crisis in 2007. I-banks such as Bear and Lehman failed because they couldn't roll the short, overnight repos, but these MREITS have 2-3 months to sell the assets, should financing dry up.

Since REITS can only retain 10% of earnings, they need to issue secondary offerings to grow the asset base. Leverage is worked by purchasing pools of mortgages essentially from repos. Let's assume the spread is about 2%. Then how do REITS pay out double digit dividend yield when Net interest margin (NIM) is 2%? NIM is 2% of the entire capital base, so if equity and no debt, then 2% off a \$100 MM equity would be \$2 MM. However, if we locked \$900 MM for a 9x leverage (borrowed debt/equity), then the entire capital base of \$1BB would be generating 2%, or \$20 MM. The \$20 MM NIM over the \$100 MM equity base is a 20% ROE, which allows the double digit dividend payments.

Since we are financing the repo interest payments with the cash flow from mortgage interest payments, we can continue to roll the credit line every 2-3 months. The concern is when a) interest rate increases, the cost of financing will narrow the NIM, which will most likely cut dividend rates, b) if repo financing dries up, the REIT will have to sell off assets, substantially lowering the NAV of the fund, c) if the mortgagees of the mortgage bonds default on payments, the bond price will sink and interest payments may not be distributed reliably.

A lot of interest has been directed to MREITS after Warren Buffett was in talks of purchasing RESCAP, or affiliated mortgage pools. Also, dividend yields are double digits, which are beating the HY bonds. As long as interest rates are kept low by the FED, repo costs will be minimal. The main concern is probably point c) since many homes are still underwater and borrowers may just drop the ball on their payments.

Let's consider how they generate such gains. They borrow money through repos, which require floor interest rates. With the repo line, they purchase high yielding mortgages, so the REIT will make money from the spread. Banks aren't as concerned about lending via repo since it is backed by the mortgages.

<b>Total Cash</b>	<b>100</b>		<b>Total Cash</b>	<b>100</b>	
Leverage	8.0		Leverage	1.0	
Repo credit line	800.0		Repo credit line	100.0	
<b>Total Capital</b>	<b>900.0</b>		<b>Total Capital</b>	<b>200.0</b>	
	Interest Rate	Cashflow		Interest Rate	Cashflow
Borrowing Cost	5.0%	40	Borrowing Cost	5.0%	5
Interest yield	7.0%	63	Interest yield	7.0%	14
<b>NIM</b>	<b>2.0%</b>	<b>23</b>	<b>NIM</b>	<b>2.0%</b>	<b>9</b>
<b>ROE</b>	<b>23.0%</b>		<b>ROE</b>	<b>9.0%</b>	

**Annaly Capital Management, Inc. (NLY) - Fixed Rate Agency Focused REIT**

- Price to Book Value: 1.0x
- Dividend Yield: 13.2%
- Market Capitalization: \$16.2 billion
- Leverage: 5.2x

**American Capital Agency (AGNC) - Fixed Rate Agency Focused REIT**

- Price to Book Value: 1.1x
- Dividend Yield: 15.4%
- Market Capitalization: \$9.8 billion
- Leverage: 7.7x

**MFA Financial (MFA) - Hybrid REIT (Agency and Non-Agency)**

- Price to Book Value: 1.0x
- Dividend Yield: 12.5%
- Market Capitalization: \$2.7 billion
- Leverage: 3.2x

**Two Harbors (TWO) - Hybrid REIT (Agency and Non-Agency)**

- Price to Book Value: 1.1x
- Dividend Yield: 15.6%
- Market Capitalization: \$2.2 billion
- Leverage: 4.5x

**Hatteras Financial (HTS) - Floating Rate Agency Focused REIT**

- Price to Book Value: 1.0x
- Dividend Yield: 12.6%
- Market Capitalization: \$2.8 billion
- Leverage: 6.7x

Source: <http://seekingalpha.com/article/646421-building-a-mortgage-reit-portfolio>