Second Quarter 2016 Letter to Stockholders

NYSE: TWO

August 18, 2016

Dear Fellow Stockholders,

We had a solid second quarter, delivering a total return on book value of 3.7%[1] and comprehensive income of $122 million. These results were achieved despite a volatile interest rate environment, with all signs pointing to rates being lower for longer due to global economic weakness. Our Rates[2], Credit[3] and Commercial[4] strategies all contributed to this success.

Within our Rates strategy, we added to our Agency residential mortgage-backed securities (RMBS) holdings as spreads widened in the quarter and increased overall debt-to-equity to 4.0x at June 30, 2016 from 3.0x at March 31, 2016[5]. With respect to mortgage servicing rights (MSR), we added three new flow-sale arrangements, bringing our total flow-sale partners to thirteen. We expect near-term flow-sale acquisitions of around $2 billion per month. MSR represents an excellent fit within our portfolio and complements Agency RMBS, providing a natural hedge. Agency RMBS and MSR have offsetting risk profiles and we believe that when combined, Agency and MSR generate better returns with less book value volatility than a strategy of hedging with interest rate swaps only.

U.S. economic growth albeit modest, low inflation, housing price improvement and low interest rates provide favorable tailwinds for our legacy non-Agency RMBS and overall Credit strategy. When we began purchasing non-Agency RMBS in 2009, we expected that we could benefit from upside driven by faster than expected prepayments, improving home price appreciation, better borrower performance, and potentially positive legal proceedings. We have benefitted from all of these over the past several years. Additionally, both credit performance and prepayments have been better than our initial expectations, contributing to the continued attractive yields on our legacy non-Agency holdings. As a result of this strong performance, we have again this quarter released credit reserves against this portfolio.

In commercial real estate, we continue to grow our portfolio as we added four assets in the second quarter, bringing the total carrying value to $926 million at June 30. These assets had a weighted average stabilized loan-to-value (LTV) of 65.5% and a weighted average spread of LIBOR plus 486 basis points. Our investment approach allows us to be selective in crafting a diversified portfolio. We believe that the environment continues to be favorable for non-bank lenders, such as Two Harbors. Rents and occupancies are improving, new construction remains muted and our loans benefit from the healthy cushion provided by borrower equity. At June 30, we had deployed about $430 million of equity capital to the Commercial strategy. As we have previously stated, due to the attractiveness of this opportunity, we intend to continue deploying capital past our initial $500 million equity commitment.

From a financing perspective, we had $9.7 billion of outstanding repurchase agreements at June 30, up from $6.2 billion at March 31 due to the additional borrowings on Agency RMBS. The repurchase market continues to function efficiently, and importantly, we have observed improved advance rates and spreads on financing non-Agencies. In the quarter we introduced direct lending with one counterparty. This relationship affords us further diversification of our financing profile and lowers our overall repo costs. Our Federal Home Loan Bank (FHLB) advances totaled $4.0 billion at June 30, with a weighted average borrowing rate of 63 basis points. These advances were collateralized by $3.4 billion of Agency RMBS, $0.6 billion of prime jumbo loans and retained interests, over $0.4 billion of senior commercial real estate loans. Additionally, we had two facilities in place for financing commercial real estate assets and expanded the usage of these in the second quarter.

Subsequent to quarter-end we announced the discontinuation of our mortgage loan conduit business. Over the past few months, we spent a significant amount of time analyzing the fundamentals of our entire business, reviewing the performance and growth potential of each area. The current environment in the prime jumbo mortgage market has made it difficult for us to grow our conduit business to a level where we can achieve economies of scale. We do not expect that these market conditions will change in the foreseeable future. Therefore, despite the best efforts of our team, we made the decision to discontinue the conduit business. While this was a difficult decision, it was made in the best interests of our stockholders. It will allow us to reduce the operating complexity and costs, as position us to redeploy capital to areas of the business that will generate stronger risk-adjusted returns for stockholders over the long-term. The wind-down process is expected to be substantially complete by the end of 2016.

We have an extraordinary opportunity ahead. The second quarter was strong across the board, and we are excited about the available opportunities in all of our strategies. We will continue to take a disciplined approach and allocate capital and resources to areas of our business to position us to drive strong, long-term returns for our stockholders. Thank you for your interest in and support of Two Harbors. As always, we welcome any questions you may have.

Sincerely,

Thomas Siering
President and Chief Executive Officer

(1) Return on book value for the quarter ended June 30, 2016 is defined as the increase in book value from March 31, 2016 to June 30, 2016 of $0.13, plus the dividend declared of $0.23 per share, divided by March 31, 2016 book value of $9.70 per share.
(2) Assets in "Rates" include Agency RMBS, Agency Derivatives, MSR and Ginnie Mae buyout residential mortgage loans.
(3) Assets in "Credit" include non-Agency RMBS, prime jumbo residential mortgage loans, net economic interest in securitization trusts and credit sensitive residential mortgage loans.
(4) Commercial consists of senior and mezzanine commercial real estate debt and related instruments.
(5) Defined as total borrowings to fund RMBS, residential mortgage loans held-for-sale, commercial real estate assets and Agency Derivatives, divided by total equity.