

THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

TWO - Q4 2016 Two Harbors Investment Corp Earnings Call

EVENT DATE/TIME: FEBRUARY 07, 2017 / 2:00PM GMT



CORPORATE PARTICIPANTS

Tim Perrott *Two Harbors Investment Corp. - Senior Director of IR*

Tom Siering *Two Harbors Investment Corp. - President and CEO*

Brad Farrell *Two Harbors Investment Corp. - CFO and Treasurer*

Bill Roth *Two Harbors Investment Corp. - Chief Investment Officer*

CONFERENCE CALL PARTICIPANTS

Doug Harter *Credit Suisse - Analyst*

Bose George *Keefe, Bruyette & Woods, Inc. - Analyst*

Trevor Cranston *JMP Securities - Analyst*

Mark DeVries *Barclays Capital - Analyst*

Stephen Laws *Deutsche Bank - Analyst*

Joel Houck *Wells Fargo Securities, LLC - Analyst*

Brock Vandervliet *Nomura Securities Intl (America) - Analyst*

Rick Shane *JPMorgan - Analyst*

Tim Hayes *FBR Capital Markets & Co. - Analyst*

Jim Young *West Family Investments - Analyst*

Fred Small *Compass Point Research & Trading - Analyst*

PRESENTATION

Operator

Good morning. My name is Andrew and I will be your conference facilitator today. At this time, I would like to welcome everyone to Two Harbors' fourth-quarter 2016 financial results conference call. (Operator Instructions)

I would now like to turn the call over to Tim Perrott, Senior Director of Investor Relations for Two Harbors.

Tim Perrott - *Two Harbors Investment Corp. - Senior Director of IR*

Thank you and good morning, everyone. Thank you for joining our call to discuss Two Harbors' fourth-quarter 2016 financial results. With me on the call this morning are Tom Siering, our President and CEO; Brad Farrell, our CFO; and Bill Roth, our CIO.

After my introductory comments, Tom will provide a brief recap of our quarterly results and accomplishments for the year. Brad will highlight key items from our financials, and Bill will review our portfolio performance. The press release and financial tables associated with today's call were filed yesterday with the SEC. If you do not have a copy, you may find them on our website or the SEC's website at sec.gov.

In our earnings release and slides, which are now posted in the investor relations section of our website, we have provided a reconciliation of GAAP to non-GAAP financial measures. We urge you to review this information in conjunction with today's call. I would also like to mention that this call is being webcast and may be accessed on our website in the same location.



Before I turn the call over to Tom, I would like to remind everyone that remarks made by management during this conference call and supporting slides may include forward-looking statements. Forward-looking statements reflect our views regarding future events and are typically associated with words such as anticipate, expect, estimate, and believe or other such words.

We caution investors not to rely unduly on forward-looking statements. They imply risks and uncertainties, and actual results may differ materially from expectations. We urge you to carefully consider the risks described in our filings with the SEC, which may be obtained on the SEC website at sec.gov. We do not undertake any obligation to update or correct any forward-looking statements if later events prove them to be inaccurate.

I will now turn the call over to Tom.

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Thank you, Tim. And good morning, everyone. We hope that you had a chance to review our earnings press release that we issued last night. As you can see, we delivered a quarter of solid results and did so in the midst of one of the most volatile interest rate environments in recent history. Our performance this quarter is a true testament to our disciplined approach to risk management and our ability to drive stable results through just about any rate environment.

Looking at the highlights of our financial results as reflected on slide 3, despite the historic move in interest rates in the quarter, we delivered a positive total return on book value and generated comprehensive income of \$2.2 million. Fourth-quarter GAAP net income was \$0.98 per weighted average share and core earnings were \$0.24 per weighted average share.

For the year, I am proud to report that we delivered a 20% total return for our shareholders. We also delivered comprehensive income of \$193.4 million and core earnings of \$0.90 per weighted average share. Superior asset selection across our strategies and a prudent approach to risk management drove these results.

I would like to spend a few moments discussing our strategic accomplishments in 2016 and remind you of our areas of focus for the coming year, as highlighted on slide 4. Our overall approach is to employ a flexible model and manage risk in a manner that provides for more stable book value and income generation. Throughout the year, we made significant progress on streamlining and simplifying our business, redeploying capital, and improving efficiencies with a goal of maximizing return for shareholders.

One significant development was our decision to discontinue our mortgage loan conduit business. We have completed the closure of this business, consistent with our previously stated timeline and expense expectations. We have redeployed the capital to other areas of our business that we believe will generate higher returns, namely MSR and commercial real estate lending.

Additionally, we expect to realize the cost benefits related to this wind-down and believe this will help our overall efficiencies in the years ahead. Taken together, we believe this will benefit our earnings power by approximately \$20 million or about \$0.06 per share in 2017.

Turning to our risk management approach, throughout the year, we continued to utilize smart hedging strategies, including adding to our portfolio of high-quality, new production MSR. MSR is a cost-effective hedge to our agency position, helping to protect against interest rate and spread risks. I would also note that our MSR assets performed well throughout the volatility of this past quarter, helping to provide stability in our results.

In terms of further diversifying our financing profile, we added multiple cost-effective sources of funding aimed at MSR and commercial real estate lending. As a component of these efforts, subsequent to quarter end, we successfully placed a convertible debt security, providing us additional flexibility in our financing to help us pursue opportunities in areas of our business generating the highest returns. Demand was strong for this security, as demonstrated by the exercise of the overallotment option by the underwriters.

Regarding our mindset for 2017, we will continue to allocate capital in a manner to maximize shareholder returns over the long term. Our focus on risk management will remain at the center of all we do, protecting shareholder capital while focusing on building greater earnings power in



the year ahead. We will continue to manage the portfolio in a manner to remain largely insulated from changes in rates, not only in terms of book value, but also in terms of income and earnings.

More specifically, the four components in support of our strategy that I have outlined on our previous earnings call are the following. First, we will continue to thoughtfully manage the agency portfolio and continue to build out our MSR position by adding conventional MSR at attractive yields. Second, we anticipate further capitalizing on the fundamental and technical factors that support our non-Agency position.

Third, we plan to increase capital allocated to our commercial strategy and grow our portfolio of high-quality loans with attractive rates and structures, providing compelling return opportunities. Fourth and finally, we expect to reap the benefits of a more streamlined and simple business model with capital redeployed in a manner to maximize returns.

Overall, we delivered strong results in 2016, and we are off to a terrific start in the new year, remaining focused on driving our earnings potential and maximizing value for shareholders.

I will now turn it over to Brad for a review of our financial results.

Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

Thank you, Tom. Let's turn to slide 5. Our book value at December 31 was \$9.78 per share compared to \$10.01 at September 30 and \$10.11 at the beginning of 2016. We delivered comprehensive income of \$2.2 million or \$0.01 per share in the fourth quarter and \$193.4 million or \$0.56 per share for the full year. Bill will expand on this overall portfolio performance shortly.

Please turn to slide 6. Core earnings were \$0.24 per share in the fourth quarter, consistent with the prior quarter and our fourth-quarter dividend. Core earnings principally benefited from higher average leverage and favorable yields on recently acquired agency RMBS.

Additionally, slower prepayment expectations on our agency IO positions contributed to our core results. This is an excellent example of the merits of our portfolio construction and holding IO during periods of interest rate volatility. Core earnings also increased as a result of the growth in our net interest income from CRE assets.

Our debt to equity decreased slightly in the quarter, from 4.2 times to 3.9 times. However, our average debt to equity increased from 4.1 times to 4.2 times quarter over quarter. We continue to increase our investments in MSR and CRE, which will likely decrease our debt-to-equity ratio over time.

I would also note that our other operating expenses were \$16.2 million compared to \$14.8 million in the third quarter of this year or an expense ratio increase from 1.7% to 1.9%. This increase was primarily driven by an increase in transactional expenses associated with portfolio growth. I would also note that long-term incentive compensation expenses are included in our expense ratio, with no impact on our book value.

Turning to slide 7, I'd like to discuss our taxable income, dividend distributions, and the 1099 treatment of those distributions. In 2016, the REIT generated taxable income of \$316 million. After factoring in the \$28.8 million of undistributed taxable income from the prior year, our 2016 dividend declarations of \$320.5 million or approximately \$0.93 per share resulted in a distribution percentage of 92.3%.

\$24.3 million or approximately \$0.07 per share will be carried into 2017 for future distribution. As a result, the 2016 dividends distributed by Two Harbors will be characterized as ordinary income to our shareholders.

All of these metrics align with our financial projections and tax-funding efforts throughout 2016. For additional information regarding the distributions and a tax treatment, please reference the dividend information found in the investor relations section of our website.



Please turn to slide 8. We continue to maintain a diversified financing profile, utilizing traditional repurchase agreements, direct lending, the FHLB, and revolving credit facilities. We had \$9.3 billion of outstanding repurchase agreements at December 31 with 23 counterparties. We have not observed any disruptions in the repo markets and they continue to function efficiently for us.

We continue to thoughtfully manage our FHLB capacity. Our FHLB advances totaled \$4 billion at December 31 with a weighted average borrowing rate of 85 basis points. We increased our financing for MSR, adding a second facility in the fourth quarter. These two facilities, totaling \$70 million, have initial favorable terms with advance rates of approximately 60% to 65% at a spread of 365 basis points to 375 basis points over LIBOR.

We have three facilities in place for financing commercial real estate, including a new facility that we added in the fourth quarter which serves as bridge financing for CRE assets prior to their placement with the FHLB. As discussed in the past, it may take several weeks to operationally onboard an asset at the FHLB. This bridge facility avoids cash funding the asset and enhances our overall return.

As Tom highlighted, post quarter end, we further diversified our financing profile by completing an offering of convertible unsecured senior notes. The offering was met with strong demand and provides us five-year term financing at attractive rates.

We intend to use the majority of the proceeds to help fund our MSR position, which previously has largely been funded with cash. We have provided some additional details on our borrowings on appendix slide 25.

I will now turn the call over to Bill for a portfolio update.

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Thank you, Brad. Our results this quarter serve as an endorsement of our disciplined approach to managing risk. Our superior asset selection and hedging strategies drove strong earnings while protecting book value, particularly during a volatile interest rate environment, and places us in an excellent position for 2017.

Looking at slide 9, you will see both our portfolio composition at December 31 and our capital allocation year over year. Over the course of 2016, consistent with our expectations, we increased capital allocated to our commercial strategy from 8% to 15%, and to MSR, which is embedded in our rate strategy. Capital allocated to credit declined to 27%, largely due to the wind-down of our mortgage loan conduit.

Moving to slide 10, let's cover a few of the drivers of our portfolio performance in the fourth quarter. Interest rates were volatile, and while agency spreads widened, mortgage credit spreads tightened somewhat, which positively benefited our credit strategy and overall performance. Yields were generally consistent with last quarter.

Increased agency prepay speeds early in the quarter were driven by low rates during the summer, although speeds slowed late in the quarter with the subsequent rise in rates. We would expect this trend to continue through the winter months, which could be beneficial to yields for our rate strategy.

Residential credit performed well due to strong underlying fundamentals, with our legacy non-Agency holdings delivering an attractive 9.1% yield, which was consistent with the third quarter. Commercial real estate also continued to demonstrate strong performance, delivering a 6.1% yield.

Please turn to slide 11 as we discuss our rate strategy and portfolio activity in the quarter. Consistent with our philosophy of sustaining an overall conservative risk profile, we maintained very low exposure to interest rates, protecting our book value and our income-generating ability.

We utilized a combination of hedging tools, including holding high-quality interest-rate-sensitive MSR, to accomplish this goal. MSR was a key component in our ability to protect against the increase in rates and wider mortgage spreads experienced in the quarter.

As a result of the rate moves, servicing valuations increased substantially. With the relatively higher rate environment, we expect that the trend for slowing prepayment speeds could continue throughout the year, benefiting our MSR holdings.

In terms of portfolio activity during the quarter in our rate strategy, we repositioned our agency RMBS holdings to better align with the current interest rate environment. This better coupon positioning also served to reset our agency pool yields higher by about 20 basis points.

We remained focused on adding MSR to pair with agency pools, adding approximately \$10.6 billion UPB of new-issue conventional MSR, largely from flow sale arrangements. This brings our total portfolio to \$62.8 billion of UPB. It is our expectation that near-term flow sale MSR volumes will run between \$2 billion to \$3 billion per month.

Let's move to slide 12 as we discuss our credit strategy. Our portfolio of legacy non-Agency securities continues to perform very well, delivering a yield of 9.1%. This strategy has benefited from the strong tailwinds for residential credit.

In 2016, we continued to experience favorable prepayment speeds relative to our modeled expectations. Given this strong performance, we again released credit reserves during the fourth quarter. We anticipate maintaining these attractive yields for our legacy non-Agencies; and with an average market price of about \$74.50, we believe that there remains future upside to better underlying loan performance.

Consistent with our expectations, we completed the wind-down of the mortgage loan conduit business, including the sale of our remaining prime jumbo portfolio and pipeline. As of December 31, we retained approximately \$234 million of subs and IO, representing roughly 2% of capital. We have also redeployed the capital previously committed to the conduit to both MSR and CRE, which we expect will be additive to earnings in 2017.

Please turn to slide 13 as we discuss our commercial strategy. Our portfolio grew to \$1.4 billion in the fourth quarter with an average stabilized LTV of 62.4% and an average spread over LIBOR of 474 basis points. As a reminder, this is a lending strategy whereby we originate, source, underwrite, document, close, and monitor primarily first-mortgage LIBOR floating-rate loans.

We believe the opportunity today for non-bank CRE lenders is even stronger than it was a few years ago. We expect this to continue due to the regulatory environment for banks and the implementation of CMBS risk retention rules. We remain focused on growing this portfolio of high-quality loans.

As we look forward in 2017, we remain committed to deploying capital to areas of our business with the highest returns and driving our earnings power while also maintaining a disciplined approach to risk management and protecting book value.

I will now turn the call back over to Andrew for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Doug Harter, Credit Suisse.

Doug Harter - Credit Suisse - Analyst

Just wanted to be clear. So is all of the conduit capital redeployed at this point? And then where do you stand on taking the conduit cost out of -- or how much was in the fourth quarter, or how much of a benefit could we see going into the first quarter?

Tom Siering - Two Harbors Investment Corp. - President and CEO

So in respect to the capital deployment, I'll give that to Bill. And then Brad can update you on the expense kind of question that you had.



Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Yes, so the capital from the sale of the loans and the pipeline has been deployed by the end of the fourth quarter, primarily into the asset classes we talked about: MSR and CRE.

And then I'll turn it over to Brad for second half of the question.

Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

Yes. So as you would expect, we had a lot of activity in the fourth quarter: completing our pipeline, exiting through a sales of the loans. So the majority of our personnel were onboard through a large part of the quarter as well as our operational and support of loans.

Another way to answer it, too, is going back to what we originally said is after we expect the conduit wind-down to occur, we generally expect our expense ratio to largely jump between 160 basis points to 180 basis points. Now, there will be variances there as we support transactions, but that's where we expect it to land once we move into the new year.

Doug Harter - *Credit Suisse - Analyst*

Great, thank you.

Operator

Bose George, KBW.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

First, just in terms of the incremental yield, can you just talk about where you find the best opportunities? And also with that repositioning of the agency portfolio, what did that do to the incremental yield?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

As we talked before, we are very excited about all three of our strategies. In the rate strategy, MSR plus pools are in the low- to mid-double-digit expected ROEs.

On the credit strategy, when we are able to find assets that we like there, they are typically high-single to low-double digits, although we like bonds that have upside, which has served us really well in the past. And the tailwinds we are seeing there, we think, will continue.

And then on CRE, consistent with prior quarters, we continue to see low- to mid-double-digit ROEs on a floating-rate basis. So I hope that -- that's where we are seeing right now.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, great. That's helpful. And then actually, just in terms of the capital allocation to the MSR, the fact that you used to fund it with cash, now you are using the capital you guys raised. Does that change how you view how much capital you will allocate to that asset? Or anything changed over there?



Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Well, it just gives us the ability to continue to grow the MSR effort. That's an integral part of our ability to drive returns and stabilize our results in challenging environments like we had in the fourth quarter. Obviously, MSR was a huge contributor to our stability, given the big rate move and spread widening. So historically that was entirely funded with cash. So now we are able to add a little bit of leverage to it.

In terms of going forward, we said we are doing about \$2 billion to \$3 billion a month in the flow programs, which we happen to like a lot. It's stable, it's current coupon, we are able to pick characteristics that we like. So we continue to expect to grow that program. But yes, it will help benefit the ability for us to grow it there.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, thanks. And then actually, earlier when you just talked about the leverage yields or returns on the MSR, that was assuming a little bit of leverage from you using the new debt?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

You are talking about the MSR plus pools?

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Yes, yes.

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Talked about -- yes, in low- to mid-double digits. Yes, that assumes a modest amount of leverage. Obviously, we raised \$287 million. We do have some in the convertible bond. We do have some facilities in addition.

But if you look at our disclosures, our market value is about \$700 million. So clearly, there's not a high degree of leverage on that, either, currently. And we wouldn't expect to see that -- that to change dramatically going forward.

Bose George - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay, great. Thanks.

Operator

Trevor Cranston, JMP Securities.

Trevor Cranston - *JMP Securities - Analyst*

One more question on the MSRs. Given the move up in rates that we saw during the fourth quarter, can you guys talk about what you are seeing in the market in terms of supply coming out? And if you think the move up in rates might create the ability to add some additional flow partners this year?



Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Yes, sure. Well, what we've seen is we've seen continued interest in originators who would like takeouts such as ourselves to help them with managing their capital. We have roughly 20 flow sellers currently.

I think with the move up, you are going to see -- rates are still historically fairly low. You can certainly get a 30-year mortgage somewhere in the low 4s today, somewhere between 4 and 4 1/2, which on an historic basis is still low. For us, it's still a very good hedge, as we've discussed in the past and also discussed on our webinar.

So I would expect that you will continue to see not only small and midsized originators who want to participate in flow programs. But also I would expect that you'll see bulk transactions like we've seen in the past several years at similar rate levels as well as somewhat lower and somewhat higher rate levels.

Trevor Cranston - *JMP Securities - Analyst*

Got it. Okay, that makes sense. And then just a question on the convertible debt that you guys raised in the first quarter here. Can you say in the very near term since you raised that capital, is the target for deploying it likely to be into agencies?

And so should we think about maybe the agency portfolio having the potential to grow a little bit in the first quarter? Or are you guys really thinking that you will put that into the flow MSR and CRE loans as you bring those on?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

That's a great question, and you kind of answered it almost exactly yourself. So well done. If you look at our leverage, fourth quarter dropped slightly, and that was due to a combination of MSR going up, which has obviously got very little leverage, and pools going down slightly.

In the first quarter, we have moved pools up somewhat slightly. We've seen some opportunities there, more in line with what we were running for the past several quarters. But over the first half of the year, you can definitely expect the capital from the convertible bond to be more focused on MSR, which we see as just -- it's currently hedging somewhere in the 10% to 15% of our pool holdings. So we definitely have room for that to move higher. And so that was the primary focus.

Trevor Cranston - *JMP Securities - Analyst*

Got it. Okay, thank you.

Operator

Mark DeVries, Barclays.

Mark DeVries - *Barclays Capital - Analyst*

Was hoping you could provide a little bit more color on what you mean by capitalizing on tailwinds supporting non-Agencies. I think it sounds like you are saying you want to just hold what you have in general, and let the positive real estate trends continue to play out in terms of valuations versus sales. Is that an appropriate read of those comments?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Yes. If you think about it, right, the average dollar price of what we own is in the mid-70s. So there's 25-point discount to par. The other thing that's important to think about from what is in those deals is these loans are generally 10 years old to as much as 13-14 years old. So you have a lot of opportunity for people who are re-equifying, if that's the word, or who would like to move.

And so if you look at the prepayment speeds that we've realized in the last year as well as the trend, the trend is that you are seeing more borrowers who are performing. You are seeing delinquencies come down. You are seeing pre-pays go up.

So we think that that -- as loans age and as time passes, we just think that the opportunity for positive surprises continues there. So the stuff that we've sold historically are securities where they got much, much higher in dollar price, closer to par, and there really wasn't that much upside. So we've tried to maintain our portfolio at a big discount so that we can reap the benefits of those trends.

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

So it's Tom, Mark. Good morning. Even if you look at recent prepayment data within the subprime space, which is largely, as you know, what we hold, that continues to uptick. And if you think about it, right, the consideration attached to that borrower is probably far greater than any localized move in mortgage rates. In other words, the move from 3.5% to 4% or 4 1/4% probably isn't going to unduly influence that homeowner's desire to refinance their mortgage.

And so if you look at it, given that and given what's going on with HPA throughout the country, credit performance has been very strong and continues to be strong in the new year. So recent performance has been quite good, and it's for very strong fundamental reasons.

Mark DeVries - *Barclays Capital - Analyst*

Okay. That's helpful. When you think about the fact that the legacy non-Agency market is effectively going away, how do you guys balance the temptation to hold onto those securities and hope that the valuations catch up to the fundamentals? Versus the risk that as you do that, liquidity could dry up and create some difficult technicals for you?

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Well, we have shown an absolute willingness to solve anything and everything within the portfolio when we think it achieves fair value. Liquidity, obviously, in the non-Agency space isn't what it is in the agency space. But we still believe that there's value there, and liquidity is certainly sufficient for our holdings.

And so obviously, we always keep an eye on the considerations that you mentioned. But right now, we think there continues to be upside in the space.

Mark DeVries - *Barclays Capital - Analyst*

Okay, great. And sorry if I missed this, did you provide any updated thoughts on how much capital you think you can end up allocating to the commercial real estate opportunity this year?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Yes. We've talked in the past, and given the opportunity we are still seeing there, it's sort of running between 50 basis points and 100 basis points a month of capital. So assuming that the opportunity continues to be attractive, I think you can expect that pace to continue.



Mark DeVries - *Barclays Capital - Analyst*

Okay, great. Thank you.

Operator

Stephen Laws, Deutsche Bank.

Stephen Laws - *Deutsche Bank - Analyst*

I wanted to follow up on book value comments from the call. You've got a slide that talks about the MSRs being instrumental in providing book value stability. Can you maybe quantify the mark on agencies, the agency MBS portfolio this past quarter versus the offset on the positive mark on MSRs?

Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

Yes. I guess we would point to what's out there in the financial statements. You can see -- I guess I'd point at two things: one, the fair value of the MSR runs through our income statement. And obviously that was a sizable number this quarter. I'm trying to find numbers to be very clear. But it's approximately kind of about \$150 million, I seem to recall, in round numbers.

Obviously, the pool has deteriorated in value, relatively a little bit higher number than that. I'd say it was somewhat -- it's a complicated portfolio that you have. Reminder that MSR is only hedging a portion of the duration of the pools.

So you have swaps, swaptions, IOs, and other instruments that are going to neutralize your pool movement. And you can't look at one or two pieces of the puzzle and mathematically calculate.

Generally speaking, through our interest rate sensitivity disclosures in the past, we had projected that a movement of 100 basis points would be down in book value of like, say, 3.5%. We outperformed that this quarter, largely because of the strength of the MSR value. And you have to add those up, and that's how the math comes out. I'm not quite sure if I can answer your question more specific than that.

Stephen Laws - *Deutsche Bank - Analyst*

That's kind of where I was headed. And so looking at the \$2 billion to \$3 billion in EP per month, it looks like near-term flow expectations. So are you guys focused on maybe making MSRs larger as a total piece of your total portfolio just to help improve that? Or how should we think about the size of the MSR portfolio versus the size of the agency portfolio shifting over the course of this year?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Yes, given the MSR, how much of the agency book is hedging currently, there is obviously room for that to grow. As I mentioned earlier, we are seeing really tremendous opportunity to grow MSR to combine with pools. That was one of the reasons we did the convertible bond offering because that becomes accretive to the earnings power of the Company.

So you can definitely expect that we're going to continue, at least in the near term, assuming current opportunities stay the way they are, to continue to grow the MSR at the pace that we are growing it. And obviously as that grows, that would increase the amount that is hedging the agency pools.



Stephen Laws - *Deutsche Bank - Analyst*

Great. And shifting gears a little bit to the political landscape: big change, obviously, in administrations moving from the Obama administration to the Trump administration. Can you talk about how the regulatory environment or world has or may change.

Just I don't know if it's FHLB membership and that views there changing and maybe making that something that's part of the go-forward business instead of being a sunset provision. Maybe it's the Dodd-Frank stuff in the last week or so that has been in the news, although I haven't seen a lot of specifics there. But can you take a second to talk about the new administration and how that may impact your business for better or for worse?

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Well, that's a darn good question and I wish I had a darn good answer for you. Unfortunately, I don't. I would say, obviously, this: that I think on the margin, there's going to be pressure from the Trump administration for less regulation and perhaps less regulatory scrutiny. But it's difficult to say.

That being said, the things that really impact us the most don't seem to be an acute focus of the Trump administration at this point. So it's really difficult to say. Obviously, it's something that we will keep an eye on.

But what happens at the various regulators obviously could impact our business. And so it's something that we will keep our finger on the pulse. But I would say right now it is not a source of undue concern for us. As I said, I don't think it seems to be a focus of the Trump administration right now.

Stephen Laws - *Deutsche Bank - Analyst*

Great. Okay, well, I appreciate the comments today and look forward to talking to you soon.

Operator

Joel Houck, Wells Fargo.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

So you mentioned earlier that the average leverage was higher in the quarter. That points to perhaps being opportunistic maybe on the agency side post-election. I'm wondering if you can talk about if that was the case, maybe what you took advantage of. And then obviously, leverage came down [in] the quarter.

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

I guess the best way to think about it is if you look at the way that we've approached the market historically, as Tom mentioned, we tend to try and be as opportunistic as we can when it makes sense to move capital into different sectors or to increase or decrease leverage. So there are times that have occurred not only in the fourth quarter, but if you recall, earlier in 2016, where we made a fairly dramatic change.

But yes, we have seen opportunities not only in the fourth quarter, but as I mentioned on one of the questions earlier, more recently a little bit in the first quarter to grow our pool somewhat. So I don't think you should expect to see dramatic swings going forward in our leverage. But certainly with respect to the fourth quarter and then again in the first quarter, we are not afraid to move our holdings when we see opportunity one way or the other.

Joel Houck - Wells Fargo Securities, LLC - Analyst

Okay. But it sounds like if you just look at the math that you pointed out, the average leverage went up, and then the end of quarter was lower. So that seems to imply that you took down some of the -- or maybe perhaps shrunk the pools a little bit and then maybe it got back in in Q1. I'm not trying to put words in your mouth, just trying to --

Bill Roth - Two Harbors Investment Corp. - Chief Investment Officer

No, no. That's fine. Yes, I mean, look, during the selloff, right? So mortgages -- it was obviously a very volatile time, and there were definitely times when it made sense, where mortgages didn't look so good to us. So we did cut them back modestly during the quarter, which affects -- depending on when the settlement date, that will affect the leverage. And then coming into first quarter, conversely, there's been opportunity to grow the assets up somewhat.

Joel Houck - Wells Fargo Securities, LLC - Analyst

Okay, that's helpful. Then just kind of switching gears on the income statement, there's -- the servicing income actually went -- last quarter it was 5.4; this quarter it was negative 0.4. So that's a little surprising, given what went on. Is that because prepay speeds picked up earlier in the quarter and we just haven't seen it flesh through? Or is there something else in that line item that we need to be aware of?

Brad Farrell - Two Harbors Investment Corp. - CFO and Treasurer

Yes. You've again hit spot on to the main driver. There's two fundamental things. One, we did sell our Ginnie Mae portfolio at the end of September, so the redeployment of that MSR took a bit of time. So it was a small decrease in gross servicing income, if you will.

But the big driver you hit spot on is that the realization of CPR speeds really hasn't taken effect toward the latter half of the fourth quarter into Q1. You also multiply that from an accounting perspective -- and there's economics in accounting -- is that there's always a one-month delay on CPR speeds impacting amortization.

So if you think about it, higher speeds September, October, November; declining speeds later in the quarter. Those really won't play out -- we didn't see them really play out in quarter four versus where we see them playing out more in quarter one.

Joel Houck - Wells Fargo Securities, LLC - Analyst

Got you. Okay, great. And then just lastly -- this is more kind of a big-picture question. Anybody who wants to tackle it, that's fine. What's unusual in the capital markets today is the volatility in fixed income and foreign exchange is significantly higher than what we are seeing in the equity side.

There's lots of theories about that, but I'm just wondering if anybody in management has any comments or more germane to how you look at your business. Obviously, your hedging strategy with the MSR buildup is doing very well -- at least, I would say that's the case. But I'm just wondering how you think about particularly fixed income volatility going forward and if it changes any of the thought process in terms of the hedging strategy.

Bill Roth - Two Harbors Investment Corp. - Chief Investment Officer

I don't think we're going to try and tackle the equity volatility question right here. But in terms of fixed income volatility, we've been in business for about 7 1/2 years. We've seen a tremendous swing in rates over that time period. We've seen big moves in spreads, both tightening and widening.

And I think, if you look at our performance, particularly in periods of stress, so I would say if you look at 2013, if you look at fourth quarter of last year, we are always focused on managing for particularly volatile periods.



And so I would not say that our approach or our thoughts about how to do that have changed. We have been very consistent in protecting book value, particularly against violent moves. And so fixed income volatility will probably be here for as long as we are all around. I don't expect that to change. It might be less volatile or more volatile, but the biggest thing is to make sure that we protect our shareholders against the times when it's extremely volatile.

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

If you look at what happened in the fourth quarter, it was really a Six Sigma event with respect to rate movement. And so what we're really focused on just acutely is to continue to run a risk management set of protocols that will stand up to whatever volatility the market can throw us.

Now, obviously, anything is going to be imperfect. But I think our results for the quarter, given the move in rates, is a pretty good testimony that we are really watching the kitchen quite closely. And so that's going to be our strategy going forward. I mean, we run a lot of different scenarios: what if this happens, what if that happens. And we try to build a portfolio that will stand up to whatever the what-ifs are.

But we are quite proud of last quarter. And I think that for many months or many years, people didn't particularly care about our hedging strategy because rates pretty relentlessly just fell.

But to the extent that there is interest rate volatility, and I would presume there will be in the coming year, we think the model we have built stands up well to those tests.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

All right, very good. Thank you very much, guys.

Operator

Brock Vandervliet, Nomura.

Brock Vandervliet - *Nomura Securities Intl (America) - Analyst*

Thanks for taking my question. You mentioned a couple of ROE numbers with respect to the MSR strategy. I guess on a levered basis, that's the way you are running it. On the flow MSR that you are now taking on, the ROE profile is low- to mid double-digit, to confirm?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Yes. When paired with the pools, that's correct.

Brock Vandervliet - *Nomura Securities Intl (America) - Analyst*

Okay. And has financing for MSR improved? My understanding was that was a pretty limited mix of counterparties that were willing to lend against that.

Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

Yes. And I'm sorry; I was giving a second component to the question. But you kind of fed into the financing side of it. So that range is somewhat dictated by the amount of cut given in the market. So the small facilities we have added is roughly around a 35% to 40% haircut, so 60% to 65% advance rate.

That's a basic premise of some of the ROE midpoints that we're looking at. Obviously, if you apply that to and allocate a relatively sizable proportion of the convertible debt issuance to MSR, but you also still then have a portion of our portfolio that is unfinanced.

So those are all three attributes when you are obviously modeling those returns. But when we are talking about a 10% to 15% opportunity in the space, it was applying really more kind of the market haircut is around 40%.

To the next question about is the availability of MSR out there in the market, the answer is it is relatively limited. We have found two what I would say is smaller opportunities that we feel are very appealing terms and partners that we can potentially grow that over time.

But it was also very appealing of why the convertible debt issuance made sense for us. We felt that issuance could be accretive to the MSR strategy into 2017, and it kind of made up for somewhat of a market that hasn't fully come back yet. So hopefully I answered the first and second question you had.

Brock Vandervliet - *Nomura Securities Intl (America) - Analyst*

Yes, that's great. And you briefly mentioned risk retention. With respect to that change, which I guess on the CMBS side kicked in around Christmas Day, as that market has come back, restarted again after the turn of the year, does that regulation help push some borrowers toward alternative lenders like yourselves? Or has that really not had that kind of an effect?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Yes. The combination -- look, we think it's a great time to be a non-bank lender. We have talked about that probably more than you guys care to hear about it. But it's really a combination of the regulatory environment for banks as well as the changes in risk retention and CMBS. So I would say that the combination of those two are what's driving -- are key drivers to the opportunity.

Brock Vandervliet - *Nomura Securities Intl (America) - Analyst*

Got it. Okay, thank you.

Operator

Rick Shane, JPMorgan.

Rick Shane - *JPMorgan - Analyst*

Thanks for taking my questions. I will comment that the MSR strategy worked very well this quarter, and good to see that in the results.

The Fed just released new stress test parameters for banks. And one of the things that changed this year was that they did highlight greater potential risk in CRE, and in particular, CRE related to multifamily home. It doesn't look like your exposure there is disproportionate versus any of your peers; it kind of is middle-of-the-road.

But I am curious what is going on in that sector or segment of the portfolio, if you could provide any comments? And just give some framework on how you are going to approach this going forward.

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

I guess I would make some higher-level comments just generally how we are thinking about it, the whole approach to this space. We are seeing, frankly, great opportunity to make what we consider to be conservative loans at attractive spreads. If you look at our -- our average spread is around 4.75 or so, and our stabilized LTVs are in the low 60s.

So what we are focused on are, whether it's multifamily or anything else, loans where the sponsors got 30 points or more of equity in the project. And once again, to reiterate what we said in the past, we are focused on loans where there's decent current cash flows in place as opposed to spec lending or construction lending. And we are focusing on undervalued opportunities in a broad range of markets with this profile.

So with respect to multifamily specifically, look, there's great opportunities in certain markets to lend against multifamily. And like anything else, you just have to be careful with your underwriting and with the sponsor and with the project. And so that's how we are approaching it.

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

So our portfolio is still of a size that whatever risk exists within the portfolio is largely idiosyncratic and not unduly influenced by beta across -- in the multifamily sector or any other sector. So the key in multifamily or any other of our loans are to make good loans with good properties and good sponsors and good cash flows. But obviously, we do look at our overall exposure within a sector, within any market, etc.

Rick Shane - *JPMorgan - Analyst*

And with perceived froth on the coasts, is there any -- how comfortable are you with multifamily in New York, San Francisco, LA, etc.?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

One of the things I just mentioned was that we are playing in a lot of second-tier markets and in some cases third-tier markets. We're frankly not -- we don't compete with high-profile, high-priced properties in these highly competitive markets.

If you look at our average loan size, it's in the \$35 million to \$40 million. So you can imagine that if you are talking about some of the things you are talking about, those ticket sizes are going to be substantially higher. And that's not a sector that we are really focused on at this point.

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Yes. Obviously, in multifamily, affordability is something that's key. Never say never, but avoiding frothy markets is clearly one of the primary considerations. Because if affordability isn't there, then the viability of the project obviously is imperiled.

Rick Shane - *JPMorgan - Analyst*

Got it. Okay, guys, thank you very much.



Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

This is Brad, real quick. I just wanted to comment on one thing. There were a lot of questions on MSR. And Brock, I'm not sure if we fully addressed your ROE question.

The one thing that we are noting is that we published an MSR webinar last quarter. We actually took -- the webinar was really focused on the sophisticated nature of MSR and how it hedged our pools.

In that webinar, there's actually an ROE calculation that goes into depth on that ROE. I think it came out to be about 13%. That math will be very supportive and take you through the different components of how we estimate that market rate.

Obviously, that's a little stale, but it will give you a little bit more better color than I did previously about that number. I just wanted to comment on that.

Operator

Jessica Levi-Ribner, FBR.

Tim Hayes - *FBR Capital Markets & Co. - Analyst*

This is Tim for Jessica. Just piggybacking off of Rick's questions, are there any geographies or property types that you are really liking right now?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Given the size of our effort, the loans that we are looking at, we can effectively be extremely selective at what we look at and what we decide to actually make a loan on. So given the pace of the capital that we are putting out, it's, call it, roughly \$100 million of loans per month, the first mortgage loans.

Now, that number could be higher or lower, depending on the month. But we are not really talking about a massive operation here where we need to put out billions of dollars.

So I'd say that without going into what we -- if we like -- like we might like a hotel in Kansas City, but we might like a different hotel in Atlanta. And it may be totally unrelated to the sector as opposed to the particular opportunity. So it's really more property- and sponsor-specific as well as the details of the loan and the opportunity as opposed to making macro bets on sectors or locations.

Tim Hayes - *FBR Capital Markets & Co. - Analyst*

Got it. And then I'm going to touch on something you just said. Should we think about the pace of new loan originations -- you said about \$100 million, give or take any quarter going forward. Is that how we should think about the pace of growth over 2017? Is there any color you can give us around just portfolio size or capital allocated to that segment? Do you guys have any objectives there?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Yes. Thanks, Tim. So what I mentioned is that the pace has been between 0.5% and 1% of capital per month, so that's probably somewhere between \$60 million or \$70 million and \$120 million of loans.



And we are certainly comfortable with that pace, and if you extrapolate that throughout the year, that will take commercial real estate up into the 20% or into the somewhat higher by the end of the year. Obviously, that depends on us seeing loans that we like and the opportunity -- the ROE opportunities being the same as we are seeing today.

Tim Hayes - *FBR Capital Markets & Co. - Analyst*

Got it. Thanks for taking my questions.

Operator

Jim Young, West Family.

Jim Young - *West Family Investments - Analyst*

Bill, you had mentioned that credit spreads tightened during the quarter, which helped the book. And what I was wondering is that, what are your general thoughts about where credit spreads are today? And what is your outlook for credit spreads in this environment?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Yes, so credit spreads in the fourth quarter, I think we reacted to -- frankly, to the election results and the anticipation that the economy will be stronger. Obviously, the stock market had a good run. And so if it's good for business and good for growth, that was reflected in credit, both corporate as well as residential and mortgage credit.

Going forward, I don't think we have a big view on high-yield and corporate bonds, which have also -- and investment-grade, which have done well. Obviously, those will perform based on how the economy does.

But with regards to residential and commercial credit, I think we've talked a little bit ad nauseam about our excitement about the residential, particularly what -- the bonds and the loans that are underlying those that we have. Because those are extremely seasoned, well insulated, with opportunity for upside. We've also talked about our credit approach to commercial real estate, which we think is highly conservative.

So I think broader credit moves will obviously be driven by the economy. With respect to our own positioning, we are very excited about what we have, primarily based on the way we have positioned the portfolio.

Jim Young - *West Family Investments - Analyst*

Okay, great. And the follow-up there -- you had mentioned that you continued to release credit reserves this quarter. Can you quantify how much you did release and what the outlook is for the first quarter?

Brad Farrell - *Two Harbors Investment Corp. - CFO and Treasurer*

Yes. It was a relatively small release this quarter. I think the rough number was around \$4 million. So it's not going to have a significant impact on forward-looking yields. Last quarter, it was a little bit more sizable, and it did have an impact.

But again, these are not going to have big, huge swings in our yields. But these are just -- the main point that Bill was obviously trying to comment on was that quarter over quarter, they are driving higher yields. And we feel the fundamentals are just on a good trend for further releases.

Jim Young - *West Family Investments - Analyst*

Okay, thank you.

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Just to add it up for the year, I think it was around \$75 million for the year, for last year, if that helps you.

Operator

Fred Small, Compass Point.

Fred Small - *Compass Point Research & Trading - Analyst*

A quick follow up on the non-Agency portfolio. From the increase you said you are seeing in voluntary prepayments or the voluntary prepayments overall, what percentage of those loans have been modified?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

Actually, don't -- I guess the true answer is neither of which are going to exactly answer your question. First of all, don't have that information at our fingertips. I also don't believe that that's a disclosure that we make or have made historically.

What I would say, though, is that in terms of if you just think about big picture, the fact that these loans are between 10 and 13-14 years old, whether a loan has been modified or not, a lot of these people are looking to either move or refinance a loan into something where their payment goes down.

So I think the combination of the housing market having gone up and better employment has caused the prepayment speeds generally to be better than we expected. So I would say whether a loan has been modified or not is not necessarily the driver there. Thanks for joining us.

Fred Small - *Compass Point Research & Trading - Analyst*

Okay, got it. Thanks. And then just one follow-up to that -- so the overall CPR, the three-month weighted-average CPR for the non-Agency strategy, was down quarter over quarter. And I was just wondering how much you've actually seen involuntary prepayments increase. And if you can say it roughly, what the mix is between voluntary and involuntary prepayments within that CPR?

Bill Roth - *Two Harbors Investment Corp. - Chief Investment Officer*

I really apologize. That's also something we don't happen to have at our fingertips. I'd say the best thing to do would be to point you to maybe aggregate subprime statistics. Our portfolio is quite large, and it's likely that if you looked at the aggregate numbers that are published that that might give you some direction. But once again, that's not something we've disclosed in the past.

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Yes. So if you look at -- depending upon what it is in the nonprime sector, it has been trending slightly upward more or less continuously. And the numbers are anywhere from the low-single digits to around 10%, depending upon what subsector you are talking about.



But the point being that essentially, back when we constructed the portfolio, you were getting prepayments from nothing. They continued to be relatively modest, but continued to uptick. And to the extent that you get anything in a portfolio comprised of \$75 price bonds, that's meaningful.

Fred Small - *Compass Point Research & Trading - Analyst*

Great, thanks a lot.

Operator

Thank you. That's all the time that we have for questions for today. So I'd like to turn the call back over to Tom Siering for closing comments.

Tom Siering - *Two Harbors Investment Corp. - President and CEO*

Great, thank you. Thanks to everyone for joining our fourth-quarter conference call today. We will be hosting an analyst and investor day at the New York Stock Exchange on March 16. Please contact investor relations for more information. We look forward to speaking with you soon. Have a great day.

Operator

Ladies and gentlemen, thank you again for your participation in today's conference. This now concludes the program and you may all disconnect at this time. Everyone have a great day.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2017, Thomson Reuters. All Rights Reserved.