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TWO - Q2 2016 Two Harbors Investment Corp Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the second-quarter 2016 financial results. (Operator Instructions) As a reminder, this conference is being recorded.

I would like to introduce your host for today's conference, Tim Perrott, Senior Director Investor Relations. Sir, you may begin.

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

Thank you, Terrence, and good morning to everyone. Thank you for joining our call to discuss Two Harbors' second-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 recap of our quarterly results, 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 on the SEC's website at sec.gov.

Also, 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 you that remarks made by management during this conference call and the supporting slides may include forward-looking statements. Forward-looking statements reflect our views regarding future events and are typically associated with the words such as anticipate, target, expect, estimate, believe, assume, project, or should or other similar words.



They imply risks and uncertainties and actual results may differ materially from expectations. So we caution investors not to rely unduly on forward-looking statements. We urge you to carefully consider the risks described in our filings with the SEC, which may be obtained on our 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.

With that, now I'll turn the call over to Tom. Tom?

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

Thank you, Tim and good morning everyone. I would like to take a moment to welcome Tim Perrott, our Senior Director of Investor Relations, to the team. Tim has an extensive background in investor relations and we are excited to have him on board.

We hope you have had a chance to review our earnings press release that we issued last night. As you can see in our results, we delivered a solid quarter in a volatile interest rate environment, highlighted by healthy increases in book value and comprehensive income. Our Rates, Credit, and Commercial strategies all contributed to this success as our team took advantage of attractive market opportunities to drive strong performance and return for shareholders.

As reflected on Slide 3, in the quarter, we had a total return on book value of 3.7% and Comprehensive Income of \$122 million or \$0.35 per share. We incurred a GAAP net loss of \$0.05 per weighted average share and Core Earnings of \$0.22 per weighted average share.

We accomplished these results despite a volatile market following the Brexit vote, where during the quarter, the ten-year dropped by 30 basis points to 147, with all signs pointing to rates being lower for longer.

Turning to Slide 4, let's review some highlights from the Rates, Credit, and Commercial strategies in the second quarter. Within the Rate strategy, we added to our agency RMBS holdings and thusly increased overall leverage.

We started taking locks from three new MSR float sale arrangements and remain focused on adding more of these relationships. MSR represents an excellent fit within our portfolio and complements our agency RMBS holdings, providing positive yields, negative duration, and hedging mortgage basis risk. In our Credit strategy, our legacy non-Agency RMBS continued to perform well due to strong underlying fundamentals.

On the commercial real estate side, we continued to add assets to our portfolio. 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. Rents and occupancies are improving, new construction remains muted, and our loans benefit from the healthy cushion provided by borrower equity.

Before I turn the call over to Brad, I would like to discuss our decision to discontinue the mortgage loan conduit and securitization business as we announced last week. Over the past few months, we have 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 market has made it difficult for us to grow our conduit business to a level where we can achieve economies with scale. We do not expect these market conditions to change anytime soon.

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 shareholders. It will allow us to reduce our operating complexity and costs and position us to redeploy our capital to areas in the business that will generate stronger risk-adjusted return for stockholders over the long term. The wind-down process is expected to be substantially complete by the end of 2016.

I will now turn the call over to Brad to discuss 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 June 30 was \$9.83 per share, which represents an increase from March 31 book value of \$9.70 per share. Comprehensive income of \$122.3 million this quarter was primarily driven by fair value gains on both agency and non-agency RMBS as well as a meaningful increase in net interest income due to growth in our agency RMBS and commercial real estate portfolios. This was offset by fair value losses on our hedges, both derivatives and mortgage servicing rights.

Please turn to Slide 6. Core earnings were \$0.22 per share in the second quarter, representing a \$0.01 per-share increase over the prior quarter. Core earnings principally benefited from purchases of Agency securities and overall higher debt- to- equity, which increased to 4 times from 3 times at March 31.

This was offset by increased overall financing costs due to the associated borrowings on Agency RMBS and a sale of previously retained Agate Bay senior AAA bonds, which resulted in higher collateralized borrowing costs.

In addition, we realized a lower yield on MSR investments. The decrease in the MSR yield is consistent with our expectations of increased prepayment speeds due to the lower interest rate environment.

Our other operating expenses were \$17.6 million compared to \$14.9 million in the first quarter of this year. The primary driver of the increase was higher amortization of previously issued restricted stock awards due to the strong performance of our shares, up nearly 8% during the quarter.

We continue to focus on expense efficiency across our business and evaluate our expenses based on the additional returns that they support. For example, while there are expenses associated with our MSR and CRE businesses, we believe that they drive higher returns in our portfolio.

That said, it is important to note that we expect that the discontinuation of the conduit business will ultimately allow us to reduce ongoing operating expenses by over \$10 million on an annual basis. When combined with the restricted stock amortization, void of valuation adjustments, we believe that our other operating expense ratio this quarter will decrease by more than 40 basis points in 2017.

Please turn to Slide 7 for an overview of our financing profile. We had \$9.7 billion of outstanding repurchase agreements at June 30, up from \$6.2 billion at March 31 due to purchases of Agency RMBS. The repo markets continue to function efficiently, and importantly, we have observed improved advance rates and spreads on financing of non-agencies.

As we announced on our first-quarter earnings call, we introduced direct lending with one counterparty. We had about \$418 million outstanding at quarter end. This relationship afforded us further diversification of our financing profile and lowers our overall repo costs. Our FHLB advances totaled \$4 billion at June 30, with a weighted average borrowing rate of 63 basis points.

At quarter end, our advances were collateralized by \$3.4 billion of Agency RMBS, \$0.6 billion of prime jumbo loans and retained interests, and \$0.4 billion of senior commercial real estate loans.

Additionally, we have two facilities in place for financing commercial real estate assets and we expanded the usage of these in the second quarter. As a reminder, from time to time, we cash fund certain of these senior commercial loans prior to being financed by the FHLB and therefore fully levered. We have provided some additional details in 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. Let's turn to Slide 8. In the second quarter, we had strong performance across the board in our Rates, Credit, and Commercial strategy. As of June 30, our portfolio was \$16.1 billion, with 56% of capital allocated to our Rate strategy, 31% to Credit, and 13% to Commercial.

Our allocation was relatively stable quarter over quarter, with Commercial increasing from 11% to 13% as we continued to commit capital to this strategy.

Moving to Slide 9, let's cover a few of the drivers of our portfolio performance and yields. Our strong return for the quarter was positively impacted by higher leverage on our agency holdings, offset by a lower net interest margin of 2.59%. As expected, the addition of approximately \$4 billion of agency pools at lower yields than our existing Agency holdings contributed to this lower margin. Additionally, faster realized prepays drove a lower MSR yield of 3.3%.

As Brad mentioned, our debt to equity increased quarter over quarter. We had solid performance across our residential mortgage credit assets as well as our growing commercial real estate portfolio. Both of these strategies had realized yields largely consistent with the first quarter.

Please turn to Slide 10 to discuss our rates strategy in the second quarter. As you can see on the bottom left of this slide, our total Agency holdings, including TBAs, increased about \$2 billion. Agency pools, however, increased by about \$4 billion as we converted our long TBA positions into generic pools during the quarter.

Late in the quarter, we also began converting some generic pools into specified pools, thus seeking better prepayment protection in the lower rate environment. As of July 31, approximately 60% of our agency pools had some form of prepayment protection. We also had roughly \$4 billion of generic Fannie Mae 3.0 pools, which we expect to exhibit slow prepayment characteristics.

With respect to MSR, we added about \$5.7 billion UPB from flow sales arrangements during the quarter. As of June 30, we had 13 total flow-sale partners and we anticipate average MSR flow-sale acquisitions of around \$2 billion per month in the near term.

As we have noted in the past, we look at MSR paired with fixed rate Agency RMBS pools, not in isolation, as they have offsetting risk profiles. When combined, we believe that Agency and MSR generate better returns with less book value volatility than a strategy of hedging with interest rate swaps only.

We have continued to maintain low interest rate and duration exposure this quarter. That said, given the uncertainty from low and negative global interest rates and the potential fallout from Brexit, along with economic growth in the U.S., we increased our use of optional hedge protection, increasing our swaptions and mortgage options positions by \$3.5 billion on a net notional basis. This provides protection against higher rates, but also allows us to benefit should rates fall further.

Let's move to our Credit strategy highlighted on Slide 11. U.S. economic growth, housing price improvement, and low interest rates provide favorable tailwinds for our legacy non-Agency RMBS portfolio. When we began purchasing non-Agency bonds in 2009, we expected that we could benefit from upside resulting from faster than expected prepayments, improving housing price appreciation, better borrower performance, and potentially positive legal proceedings. We have benefited from all of these over the past several years. And most recently this quarter, we benefited substantially from the Countrywide settlement. Both credit performance and prepayments have been better than our initial expectations, contributing to the continued attractive yields on our legacy holdings. As a result of this strong performance, we have again this quarter released credit reserves against this portfolio.

Consistent with the discontinuation of the conduit business, we recently ceased taking locks, although we do have approximately \$1.2 billion of loans either closed or in the pipeline as of July 31. We anticipate disposing of these loans by completing one or more securitizations or by selling them through whole loan sales.

Roughly half of the capital allocated to the conduit is invested in subordinate and IO bonds, which we view as attractive assets and intend to keep. The other half of the capital is dedicated to the mortgage loans that we aggregate for securitization and our loan pipeline.

As we dispose of these loans over the remainder of the year, we intend to redeploy that capital into our other target assets. In addition to the cost savings of \$10 million that Brad mentioned, we also expect the incremental investment income on that redeployed capital to be about \$10 million in 2017.



Turning to Slide 12. Our commercial real estate portfolio grew as we added four assets, bringing the total carrying value of our portfolio to \$926 million at June 30. These assets had an average stabilized LTV of 65.5% and an average spread of LIBOR plus 486 basis points.

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 to this strategy past our initial \$500 million equity commitment.

The second quarter was strong across the board. We are excited about the opportunities ahead and believe that we can deploy capital to drive strong returns for our shareholders.

I will now turn the call back over to Terrence.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Douglas Harter, Credit Suisse.

Douglas Harter - Credit Suisse - Analyst

Thanks. Bill, I was hoping you could just clarify that last comment you made about that freed-up capital from the locks generating \$10 million. Does that capital generate any income today? So is that incremental \$10 million?

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

Thanks for joining us. Yes, so the capital that I referred to there that supports loans that we've aggregated for securitization or loans that we need to have capital for that are in the pipeline, typically that's a relatively low return because you are basically hedging these out until you sell the AAAs into the market. So we're really in this for the returns on the credit and the IO.

And so the capital that's currently going against that is generally earning a fairly low return. So as we free that up, the \$10 million is what we expect to be incremental income once that gets deployed to much higher returning -- the other asset classes we're targeting.

Douglas Harter - Credit Suisse - Analyst

Great. And then sort of on the conduit, one of the other benefits you had talked about was relationships and adding flow agreements and possibly adding non-Agency or expanded credit products. Are those things that are impacted by the decision as well?

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

So, with respect to our discontinuation of the business -- and firstly, I want to say that we're very proud of the team and platform and the securitization brand that the business built.

But as we evaluated the business, the economics of this decision were fairly clear. It was a difficult decision in respect of it affected some folks' jobs around here. So definitely difficult in that regard.



But as we looked forward, the environment just was not one that was conducive to the continuation of the business. The market hasn't materialized in the way that we expected when we started in 2011. We couldn't conceive of a way that we could achieve the scale necessary to be truly economic and frankly, competing ROEs and things like MSR and commercial were certainly a consideration.

But with regard to your question, with respect to the nonprime business, that has been very, very slow to rebuild itself in the last couple years. And with respect to these relationships, that is an important thing because there is commonality between people that were doing origination business for us and MSR sellers.

And obviously, we took that under consideration when we made this decision, but we expect to be great counterparties in respect of purchasing MSR and we think we can manage through that process.

Douglas Harter - *Credit Suisse - Analyst*

And then are there other ways to use the Agate Bay shelf? I know other mortgage rates have bought pools of existing legacy loans and have been able to securitize those. Do you see those as opportunities for you guys as well since you have the Agate Bay shelf?

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

I would say probably we would not do that. Agate Bay -- the one thing that it's got a great reputation in the market for being a pristine -- sort of focused on pristine collateral. All the deals we've done, people -- they know what they are getting.

To the extent that we were going to look at doing sort of re-securitizations, you can easily use a dealer shelf or you can come up with another shelf that would be whatever different name or different brand. We are certainly aware that some others have done that. We haven't gone down that path. We've basically bought and held the securities and used Street leverage as opposed to during re-securitizations.

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

Doug -- Tom again. Yes, I really wouldn't expect that out of us. We want to be laser focused on our other businesses.

Douglas Harter - *Credit Suisse - Analyst*

Okay. Thank you.

Operator

Trevor Cranston, JMP Securities.

Trevor Cranston - *JMP Securities - Analyst*

Thanks, good morning. A follow-up on the closing of the conduit. Can you remind us what the FHLB financing that you guys are using for the loans? And I guess some of the investment-grade securities, if you had the ability to transfer other types of collateral onto those lines? And maybe just comment generally how you intend to use the FHLB financing going forward? Thanks.

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

Trevor, thanks for joining us and thanks for getting up so early on the West Coast. I'll hand the home loan question over to Brad.

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

So, the appealing thing -- or the many appealing things about the FHLB advances -- but one of them is that you can replace collateral to support the advances. So with that, the loans that we have on our balance sheet as well as any of the senior AAA retain interest, which we really don't hold much anymore.

When those wind down, we would just really replace it with either agency RMBS, which we find appealing with our advanced rates and cost, as well as some senior commercial real estate assets. Those would be what would be replaced and are eligible for the FHLB. So, no impact to the collateral support for those advances and a multitude of things we can do with those advances that align with our portfolio.

Trevor Cranston - *JMP Securities - Analyst*

Got it. Okay. And one more on the financing side, I guess we've seen a decent increase in three-month LIBOR in the last few weeks, I guess. Have you guys seen any change in repo financing connected with that?

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

Hi, Trevor. It's Bill. I'll take that one. You know, it's interesting. What we have seen -- the full LIBOR thing's related to the -- some of the new rules that are coming in in October.

So while LIBOR has gone up, agency repo levels have basically stayed the same. So on a spread to LIBOR, agency repos actually improved. So I guess the shorter answer is that the rate that you pay on agencies is really unchanged, despite the fact that LIBOR has gone up.

Trevor Cranston - *JMP Securities - Analyst*

Got it. Okay. And then last question. Looks like you guys added like \$1 billion of bulk MSR acquisitions in the quarter. Could you talk about where you are seeing valuations on bulk MSRs and if you think there's opportunity to add more of those over the next couple of quarters?

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

I think basically, our additions were all in flow. But to answer your question about opportunities in bulk, I think as we've said before, we're really focused on new issue GSE prepay-oriented servicing. So, to the extent that bulk comes out of that, we could obviously look at it.

Yields on sort of the flow or bulk of that type are sort of in the 8% area. That's sort of the market yield for that. In terms of other bulk transactions that might have taken place, if they were away from that type -- in other words, either distressed servicing or delinquent servicing or other -- that's not an area that we are playing in. So I would say that we're not probably the best guys to ask on that.

Trevor Cranston - *JMP Securities - Analyst*

Okay. Appreciate the comments. Thank you.

Operator

Bose George, KBW.

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

Going back to the conduit, now that you guys won't be investing in newly created credit risk through the conduit, are you going to look more meaningfully at doing it in other ways? Like maybe through CRT or through the securitizations run by JPMorgan and potentially by others in the future?

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

Hi, Bose. Good morning. It's Bill. You know, look, we obviously have a big credit book. We have a great expertise there. Our credit -- the performance our credit strategy has delivered over the years has just been tremendous. So, there should be no misunderstanding about our commitment to that.

The only difference is when we got into this, we thought that geez, we would be able to make our own credit and make it in good size. So while we did make credit, we wouldn't be able to make it in any real size to justify it.

That does not mean, though, that we won't be looking at other ways to invest. So it's absolutely the case that -- we've looked at CRT; we've been involved not in any big way, but as that looks attractive, we could take part in it. We can take part in any of these other transactions, whether it's the bank is doing it or the GSEs or what have you.

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

One thing to note about CRT -- while we have participated in that market in the past, it's not a good REIT asset as it's constituted today. So we don't expect any time soon for that to be a substantial part of our portfolio.

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

Okay. Great. That makes sense. And then switching to the comment you'd made earlier about direct repo, how big a piece do you think that could be of your funding over time? And then can you also just talk a little bit about the mechanics of that: who values the securities, who issues margin calls, things like that?

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

Great question. So first the market. I think over the long term, I think that is a -- could be a large opportunity, but I think that time period is going to be fairly lengthy. I think right now, the participants who are starting to have the most interest -- one, are largely focused on rated players. And second, they're establishing their mechanics and the processes that they haven't really had historically. So it's going to be relatively slow going.

We've been fortunate to find a counterparty and then finding a handful of others that are starting to work with us. So the mechanics themselves, they are going to be with your standard -- they are going to be clearing margin. And that's why it is going to take some time for them to build those mechanics.

But it could be quite large down the road, but I think that's going to take quite a bit of time and for us in the near term, it's not going to be that meaningful to our portfolio. Standard clearing repo -- any time in the near future is where most of our financing will be from.

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

Okay. Great. That's helpful. Thanks. And actually, just one more on the prepayments. Your prepays actually went down this quarter. Can you just comment on sort of what's going on with that. Is it just the payment protected collateral performing very well? And then just where you see prepayments over the next few quarters?

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

The prepayments dropping is largely a function of -- well, first, our prepay protected pool's performing well. But additionally, we added a substantial amount of pools, and generally, those were either new or prepay protected, so those we are going to pay extremely slowly. That's more a function of their newness. So I wouldn't read a huge amount into just one quarter's numbers.

In terms of going forward, I mean, it's going to be driven by rate. I would expect and if you look at the projections that most mortgage research groups have, for generic collateral, given the level of rates, speeds will be in the 20s or 30s for a good part of the rest of the year.

Prepay protected collateral typically is much slower and that's been our experience and so we would be -- expect our speeds to be relatively tame compared to that. But then as you might expect, it will depend what rates do in terms of what happens from there.

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

Okay. Great. That's helpful. Thanks.

Operator

Joel Houck, Wells Fargo.

Joel Houck - Wells Fargo Securities, LLC - Analyst

The second quarter in a row you increased the agency exposure. This quarter -- or I should say second quarter, it looks like it actually accelerated. Can you talk about the relative attractiveness of agency RMBS versus what you currently own or other opportunities with non-Agency?

And then the second part of the question is how does the kind of cheap optional protection weigh into that decision? Obviously, you noted that you added \$3.5 billion in net notional in option protection.

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

Sure. Good morning, Joel. So I mean, the agency -- so just to be -- I sort of remind just as a little bit of a follow from last quarter. When we saw the dislocation that occurred in the market in sort of the late first quarter and into the second quarter, we saw agency spread as really being very attractive. We also saw there are sectors that were attractive. It was just very easy to add agency pools in good size. So we added pools and TBAs.

And then this quarter, we largely -- if you look at the numbers, we generally converted a lot of those TBAs into pools and then we saw some other opportunities to add. So I would say that spreads since then have tightened up somewhat and so we're pretty happy with what we have. They are sort of in the hold zone.

Given current spreads, I don't think you should expect to see agencies move in any large size one way or the other. So we're pretty happy with what we have.

In terms of other opportunities vis-a-vis agency, today -- and I think you probably have gotten this from our comments -- MSR continues to be attractive when paired with pools. MSR and pools is sort of in the 12% to 13% ROE area.

And so we are going to be putting based on about \$2 billion a month. That's \$20 million or more per month into MSR. And then commercial is sort of in the low to mid-teens and those are floating rate, so we don't have any rate risk there. And that run rate is more in the \$30 million to \$40 million a month. So I would say that those are the areas that you are most likely to see growth in vis-a-vis others.

And then to your second part of your question on the cheap optional protection, I mean, basically after we sort of saw all this volatility, the cost of buying protection came down quite a bit, partly as I think as a result of all the Fed and other central banks' comments or actions.

And if you look at it, there's always uncertainty in the market. But given where rates are, you could see a 50 basis points move one way or the other and have a good explanation for either outcome. And so we just saw it as a chance to improve our convexity by basically buying a bunch of put options.

So that if the market rallies, we do benefit because those are sort of more for protection against a big increase in rate. So we would benefit from a rally, but be protected somewhat in a sell-off.

Joel Houck - Wells Fargo Securities, LLC - Analyst

So that's not necessarily driving the agencies, it's just more of a side benefit of owning a larger agency portfolio, as you can get in your view cheaper protection for a outsized rate move either direction?

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

I think that's fair. They go together, really. I mean, if we had no agencies, obviously we wouldn't need the hedges that we have. But given our agency position, we use a combination of the MSR, some swaps, and we just converted a bunch of the swaps into swaptions and puts, which is a similar form. It just improves our convexity.

Joel Houck - Wells Fargo Securities, LLC - Analyst

Okay. Great. Thanks, Bill.

Operator

Jessica Levi-Ribner, FBR.

Ted Eachly - FBR Capital Markets & Co. - Analyst

Ted Eachly here for Jessica. Just one question today. How are you guys thinking about the MSR investments, given the historically low rates?

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

Good morning. This is Bill. So actually, if you think about it, the best time to be adding MSR is when rates are low. I mean, I'm not saying -- or projecting that they won't go lower. But if you think about it, people who are taking mortgages today that have, say, 3.75% coupon, the odds are extremely high that those are going to be around for a long time.



So, we are actually really quite excited that we've got our flow sellers in place, the volumes that we are expecting to see. If you figure \$20 million a month, that's \$240 million over the course of a year going forward. That's pretty exciting, given where rates are and given what we expect the yields to be on those new acquisitions.

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

And I was going to add, kind of circling act to Trevor's question earlier and making sure we're clear, that the nearly \$60 million of fair value of MSR we added this quarter was flow. That represents roughly about nearly \$6 billion of UPB.

And it kind of correlates to what Bill has commented on is that we're -- through our flow network, we are up in the low teens now with relationships and able to really generate this new production at rates that are very appealing, given prepayment behaviors going forward and replacing some of the valuation of our MSR currently on the hedge.

And earlier, while we've terminated our prime jumbo and expanded credit programs, this was an opportunity for us to kind of reaffirm and even strengthen our commitment to our relationships there to continue to buy that product on an ongoing basis. So, we're very happy with that flow program and it fits really well with the benefits of that asset in a low rate environment.

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

Let me -- I just want to add one more comment to emphasize that. We continue to work to add other flow sellers. And we expect that we would be in the 15 to 20 flow sellers as we get to be end of the year, which would drive those monthly volumes up somewhat as we move into 2017. So, it's definitely an area of high focus for us, especially given the low level of rates.

Ted Eachly - *FBR Capital Markets & Co. - Analyst*

Okay. Sounds good. Thanks, guys.

Operator

Brock Vandervliet, Nomura.

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

Good morning. Thanks for taking the question. I think everything has been asked and answered, with the exception of the commercial real estate initiative. I see the slide on page 12 in terms of the breakdown.

As you think about the portfolio by property type, what are you most focused on? Are you trying to keep the relative weightings the same at this point? And how are you sourcing these credits?

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

Hi, Brock, this is Bill. Good morning. So looking at slide 12, as the portfolio grows, the percentages will move less than they have when you start with a small portfolio.

Our whole intent is to have a diversity, not just in property type, but also in geography, also in sponsor. In other words, you might really like a sponsor; you don't want to make every loan to the same borrower.



So as a result, you see hotel is currently very low, as you can see. We don't have a problem with that number being higher, but you shouldn't expect that to be substantially higher.

Multifamily is a great asset class. It's typically done very well; there's huge cash flows there. But we like the diversity that we have, and we'll keep you posted if we think that there will be any significant changes.

The thing that we are finding is that given that there's been relatively low levels of construction and building relative to the growth in the economy. And you've seen huge amounts -- you can see our borrower equity is substantial. We're focused mostly on properties that have cash flow that can cover the debt service today. So that as the borrowers move forward, if their plans don't quite work out the way they anticipate, we're still in very good shape, not only on a cash flow coverage, but also on an equity basis.

So we're just very excited about the opportunities we are seeing. There's a huge amount of refinancings taking place. There's lots of transaction volume, so it's a perfect opportunity for a balance sheet lender like ourselves.

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

It's Tom. If I could add something to that. And the commercial business is much more idiosyncratic than our other businesses. So what's really our focus is to make sure that we have good deals with good cash flow, good LTV, and good sponsors. And that's our primary obsession, rather than targeting and saying we want X percent of hotels, X percent of commercial, etc. So that's our true focus.

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

The second part of your question is about how do we get these things? So you know, the group that we have on board has been doing this for decades. They have very deep relationships not only directly with borrowers, but with also in the broker community. Commercial real estate lending is a highly brokered business.

So our pipeline of deals that we actually see, either directly or through the brokers, is extremely large. It just doesn't always ferret down to if you see 20 deals, you might only do one or two of them. So, it's a direct lending relationship, so we are originating the loans directly, underwriting them, and closing them.

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

Great. Thank you very much.

Operator

Rick Shane, JPMorgan.

Rick Shane - *JPMorgan - Analyst*

Thanks for taking my questions. Last quarter when you talked about the portfolio growth on the agency side, you attributed it to wider spreads. Obviously this quarter, we saw the timing would matter a great deal because we saw rates decline throughout the quarter and we saw spreads tighten up a little bit.

Love to get a sense of when during the quarter you added the agency assets. And also get a sense with rates now as low as they are, what the duration on that portfolio is. And I apologize if I missed that; we've got a lot of companies on the tape today.



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

Well, it's an early morning for you as well, Rick, so good morning. So, the first part of your question about timing. You know, the timing was early in the quarter. I mean, as we said I think on our last call that late first quarter/ early second quarter was really a great time for adding, which we did.

The difference is in this particular case, we had close to \$2 billion of TBAs, which is the same risk profile. It's just not in pool form. So, a lot of the growth -- half the growth roughly was pools that we took on early in the quarter and the other half roughly was converting TBAs to pools during the quarter. So, I hope that answers your timing question.

Rick Shane - *JPMorgan - Analyst*

It does. And presumably the reason you let the TBAs convert as spreads tighten, there's value being created there?

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

Yes. I mean, look, as I think the second part was about low rates. And the bulk of what we added was in 3s and 3.5s. New 3s we're not particularly worried about because these are people who literally just took out a loan at the market rate.

3.5s, you'll see that we have a lot of prepay protection there just because if you have a 4.25% coupon and the rates are 3.75%, we feel more comfortable with protection on that either in today's rate environment or potentially lower rate.

And then in terms of your question on duration, I think probably the best thing to point you to is the little table that we and others produce about changes in book value for changes in rates. And once again, you'll see the Q will be out later today.

Our up 100 is once again a very low number. And our up 50 is obviously even much less. So, without necessarily -- unless -- without necessarily getting the duration of any particular asset, we look at the whole portfolio with its hedges on a combined basis.

Rick Shane - *JPMorgan - Analyst*

Got it. So one other question and one other comment. The question is basically that interest rate sensitivity, despite the significant ads, because of the swap and swaptions that you added isn't considered a material change?

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

It's a combination of the MSR, which has negative duration, the swaps, and the swaption. So when you take the duration impact of all of the assets and the duration impact of all of the hedges, that's where you are going to get the overall sensitivity.

Rick Shane - *JPMorgan - Analyst*

Got it. And then the comment is would you have ever imagined discussing needing prepayment protection on 3.5s?

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

Well, you know, I started in 1981 when the long treasury bond yielded almost 15%. So I think it's fair to say, no, I would not have ever imagined that.

Rick Shane - *JPMorgan - Analyst*

Guys, thank you very much.

Operator

Jim Young, West Family Investment.

Jim Young - *West Family Investments - Analyst*

You mentioned the commercial real estate area that you had a \$500 million equity commitment, but that's going to be expanded. Could you give us a sense as to how large you expect that to grow to and over what time frame?

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

Hi, Jim. This is Bill, good morning. Thanks for joining us. Well, as I mentioned a few minutes ago, our capital commitment run rate is in the \$30 million to \$40 million a month. So, if you think about the back half of the year, that's going to be call it roughly \$200 million.

So we could certainly see that adding to what we have now, getting up close to that 20% of capital around the end of the year, plus or minus. Certainly it is going to depend on the opportunity, but based on what we are seeing today, we are going to continue at that pace. And then we'll see how things unfold as we get late in the year and into next year.

But as Tom mentioned and some of the comments I had, with high sponsor equity and good cash flow coverage and the kind of ROEs we're seeing and also the fact that it doesn't have rate exposure, fully underwritten commercial loans is definitely something that we intend to keep adding throughout the remainder of the year.

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

Jim, you've been in the market a long time and you know that market conditions are temporal. But right now, the runway for commercial looks quite good for us. Obviously we can't make any super-strong comment with respect to allocation because market conditions could change. But that's our expectation for the remainder of the year.

Jim Young - *West Family Investments - Analyst*

Okay. So if I'm hearing it, it will be effectively about 20% of capital by year end 2016 as you move into 2017. Would a target range be 25% or would you be even willing to take your equity commitment to the commercial real estate business even higher?

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

It's just going to depend upon market conditions and other opportunities that exist within our universe. So we are reluctant, as I said, to get pinned down on precise allocation metrics. But that is -- as Bill said, that is our expectation for the remainder of 2016. It will be just based upon market conditions in commercial and other market conditions for our competing assets.

Jim Young - *West Family Investments - Analyst*

Okay. Thank you.

Operator

And at this time, I am showing no further questions. I would like to turn the call over to Tom Siering for any closing remarks.

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

Thank you, Terrence. Thank you for joining our second-quarter conference call today. We will be participating in the Barclays and JMP conference in September in New York. We hope to see you there. Thanks again for joining us. Have a wonderful day.

Operator

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

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