Fourth Quarter 2017 Letter to Stockholders

NYSE: TWO

February 23, 2018

Dear Fellow Stockholders,

2017 was a transformative year for Two Harbors, as we implemented our plan to maximize stockholder returns through running a more efficient and focused business model. The execution of our plan resulted in annual Core Earnings[1] growth and three dividend increases, reflecting our stronger earnings power. Importantly, these results were achieved while maintaining an acute focus on book value protection and risk management.

As you will recall, we completed a thorough analysis of our business in 2016, and as a result, made the decision to discontinue our mortgage loan conduit business. Subsequently, in mid-2017, we formed Granite Point Mortgage Trust (NYSE: GPMT) (Granite Point), a commercial real estate REIT to continue and expand the commercial real estate business that we had started at Two Harbors. In the fourth quarter we completed the distribution of the 33.1 million shares of Granite Point common stock that we had acquired in connection with the contribution of our commercial real estate assets to Granite Point. Concurrently, we also effected a one-for-two reverse stock split. We believe that these actions will allow us to reduce our operating complexity and costs, and most important to make more money for our stockholders. Additionally, we took advantage of opportunities to enhance our balance sheet and capital structure, completing a convertible debt offering and three preferred stock offerings, which resulted in a lower cost of capital that we believe will be accretive to our common stockholders in 2018 and beyond. Our stock price reacted favorably to these developments and we are pleased to have delivered a total stockholder return in 2017 of 26%[2].

There are three key factors that differentiate Two Harbors from our competitive cohort. Firstly, our strategy of pairing mortgage servicing rights (MSR) with Agency residential mortgage-backed securities (RMBS) helps protect our portfolio from changes in mortgage spreads and generates strong returns. Secondly, we use a suite of instruments to more effectively hedge our interest rate exposure, including swaps, swaptions, mortgage options and MSR. Finally, our unique portfolio of deeply discounted legacy non-Agency RMBS is one that can't be easily replicated. This portfolio has benefitted from, and we believe will continue to benefit from, strong residential housing tailwinds and falling loan-to-value (LTV), which positively affect both default probabilities and prepayment speeds. In addition, positive changes in the MSR and non-Agency financing spaces create the potential for greater returns in both our Rates[3] and Credit[4] strategies.

Turning to our results in the fourth quarter, we generated Comprehensive Income of $65.7 million and Core Earnings of $81.3 million, or $0.47 per share. Our book value at December 31st was $16.31 per share. These results were consistent with our expectations when we declared our fourth quarter dividend of $0.47. As we announced in December, we anticipate this dividend to be sustainable into 2018, subject to market conditions and the approval of our Board of Directors. For the year, we generated Comprehensive Income of $459.0 million, representing a return on average common equity of 13.6%. We also grew our Core Earnings return on average common equity to 11.3%[5] from 10.0% a year ago[1].

In our Rates[3] strategy, our objective is to provide strong returns through a variety of rate environments, and MSR is a key component of this. We believe that the combination of Agency RMBS and MSR has the potential to drive a higher return with less basis risk as compared to Agencies hedged only with swaps. With the Federal Reserve reducing its RMBS reinvestments, it is estimated that over $400 billion of net supply of Agency RMBS will need to be absorbed by the market in 2018. This will likely cause mortgage spreads to widen. However, in this scenario, MSR is a significant benefit to our portfolio because it increases in value when mortgage spreads widen. Pairing MSR with Agencies therefore positions us to protect book value in a spread-widening environment.

In the fourth quarter we grew our MSR portfolio through both flow-sale arrangements and a bulk purchase of $9 billion in unpaid principal balance. Additionally, after several months of discussions, we closed a $300 million financing facility for MSR in the fourth quarter, with attractive terms and a spread to LIBOR of 225 basis points. We believe that this will allow us to continue to grow our portfolio of MSR going forward and further benefit our Rates(3) strategy.

Our Credit(4) strategy continues to realize benefits from fundamental improvement in the housing market and the overall economy. Our unique portfolio of deeply discounted legacy non-Agency RMBS is a distinguishing feature of our strategy because of the total return opportunities that exist. 2017 was an excellent example of this as yields were strong and bond prices improved. Residential credit assets benefitted from increasing home prices supported by affordability, low housing supply and strong demand. As a result of this, our non-Agency portfolio contributed nicely to our book value and overall strong performance for the year.

In addition to the strong returns we've already realized, we believe our legacy non-Agency holdings have the potential for even greater price improvement and total returns. While many credit assets today trade at or near par, our portfolio - with a weighted average market price of approximately $76 - has a tremendous amount of upside price potential over the coming years. Residential credit tailwinds remain strong and continued re-equification by borrowers can result in increased prepayments. Additionally, lower LTVs benefits delinquencies, defaults and severities. Taken together, we believe these factors can positively impact our Credit(3) strategy, driving bond prices higher, and generating strong total returns, which should benefit our book value going forward.

Heading into 2018, our streamlined business model is focused on executing on our residential Rates(3) and Credit(4) strategies, which are rooted in our core competencies of understanding and managing interest rate, mortgage prepayment and credit risks. As the Federal Reserve reduces its reinvestments in RMBS, we believe there could be a tremendous opportunity to add Agencies at attractive spreads. We also expect to continue to grow our MSR portfolio through both flow-sale and bulk purchases. In our Credit(4) strategy, we believe that returns in our legacy non-Agency portfolio will continue to positively benefit book value. Additionally, the recently passed tax reform legislation, which includes a 20% deduction benefit on ordinary REIT dividends, may increase the after-tax attractiveness of investing in REITs for certain types of investors. All said, we believe that we have the ability to generate strong earnings in 2018, while maintaining book value stability through a variety of interest rate environments.

Thank you for your interest in and support of Two Harbors.

Sincerely,

Thomas Siering
President and Chief Executive Officer

Note: On November 1, 2017, the company distributed to its common stockholders the 33,071,000 shares of Granite Point common stock it had acquired in connection with the contribution of its commercial real estate portfolio to Granite Point. Due to the company's controlling ownership interest in Granite Point through November 1, 2017, Granite Point's results of operations and financial condition through such date are included in the company's financial statements in accordance with U.S. generally accepted accounting principles (GAAP). Because the company no longer has a controlling interest in Granite Point, it has reclassified all of Granite Point's current and prior period results of operations to discontinued operations. On November 1, 2017, the company also completed its previously announced one-for-two reverse stock split of its outstanding shares of common stock. In accordance with U.S. generally accepted accounting principles, all common share and per common share amounts presented herein have been adjusted on a retroactive basis to reflect the reverse stock split.

(1) Core Earnings is a non-U.S. GAAP measure that we define as comprehensive income (loss) attributable to common stockholders, excluding "realized and unrealized gains and losses" (impairment losses, realized and unrealized gains or losses on the aggregate portfolio, reserve expense for representation and warranty obligations on MSR, certain upfront costs related to securitization transactions, non-cash compensation expense related to restricted common stock, restructuring charges and transaction costs related to the contribution of TH Commercial Holdings LLC to Granite Point). As defined, Core Earnings includes interest income or expense and premium income or loss on derivative instruments and servicing income, net of estimated amortization on MSR. We believe the presentation of Core Earnings provides investors greater transparency into our period-over-period financial performance and facilitates comparisons to peer REITs.
(2) Two Harbors' total stockholder return is calculated for the period December 31, 2016 through December 31 2017. Total stockholder return is defined as stock price appreciation including dividends. Source: Bloomberg.
(3) Assets in "Rates" include Agency RMBS, Agency Derivatives, MSR and Ginnie Mae buyout residential mortgage loans.
(4) Assets in "Credit" include non-Agency securities, prime jumbo residential mortgage loans and credit sensitive residential mortgage loans.
(5) Core Earnings return on average common equity for the quarter ended December 31, 2017 excludes the company's controlling interest in Granite Point equity.