Annaly Preferred Shares: Big Yields, Discounted Prices, a Few Things to Consider

Annaly Capital is a mortgage REIT (the company basically borrows money against its book value to buy mortgage related assets, mainly agency RMBS), and it often captures the eye of income-focused investors because it offers a high yield. Mortgage REITs have been through a lot this year as liquidity challenges caused heightened volatility. However, not all mortgage REITs are created equally. In this article we review Annaly Capital, with a particular focus on the preferred shares. The preferreds offer compelling high yields, price appreciation potential and they are safer than the common. We consider Annaly's current balance sheet and liquidity, credit spreads, share price action, valuation and the big risks. We conclude with our opinion on investing.

Key Takeaways:

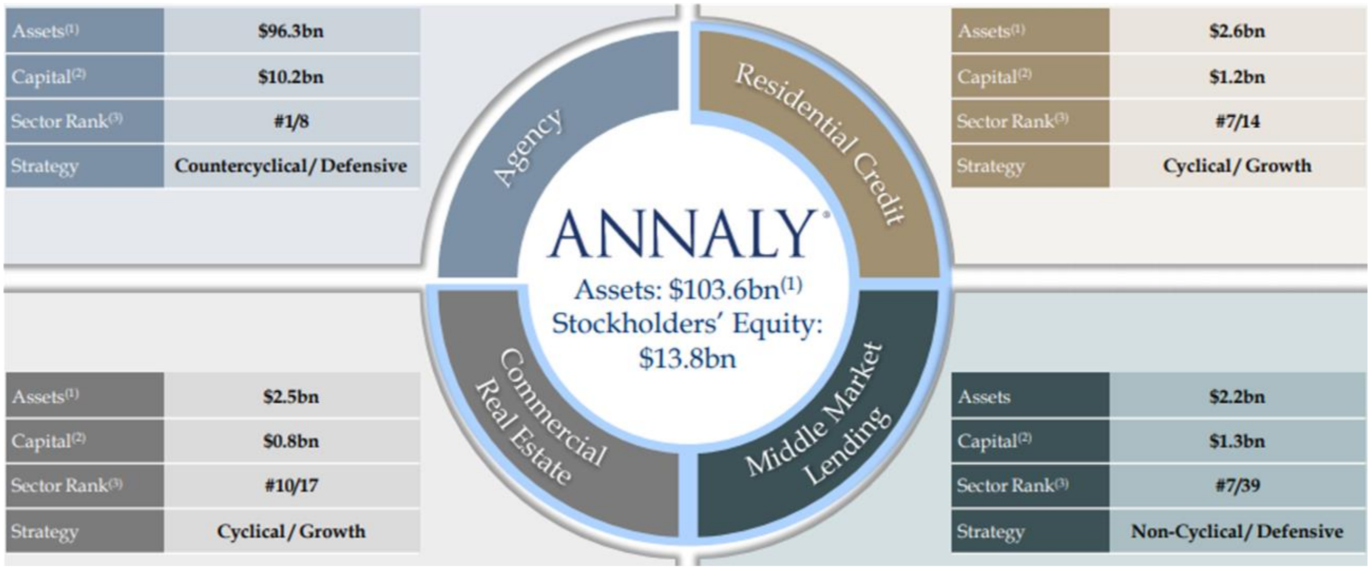
- mREIT share prices have not recovered from this year's liquidity challenges.
- Annaly's book consists mostly of Agency-backed securities.
- Preferred shares offer high yield and capital appreciation potential.
- Know the risks.

Overview

Annaly Capital Management (NLY) is one of the largest mortgage real estate investment trusts (mREIT). It invests in and finances residential and commercial real estate assets. As of 30 June 2020, NLY had $103.6 billion invested in various assets, and the company operates through four segments:

- **Agency** *(93% of total invested assets)*: invests in GSE backed RMBS that are created out of a pool of similar types of mortgages from banks (through the process of securitization).
- **Residential Credit** *(2.5% of total invested assets)*: invests in non-agency residential mortgage assets through securitized products and the whole loan market.
- **Commercial Real Estate** *(2.4% of total invested assets)*: originates and invests in commercial mortgage loans, securities, and other commercial real estate debt and equity assets.
- **Middle Market Lending** *(2.1% of the total invested assets)*: provides financing to private equity backed middle market businesses.

Summary of NLY's Asset Portfolio Across its Investment Groups

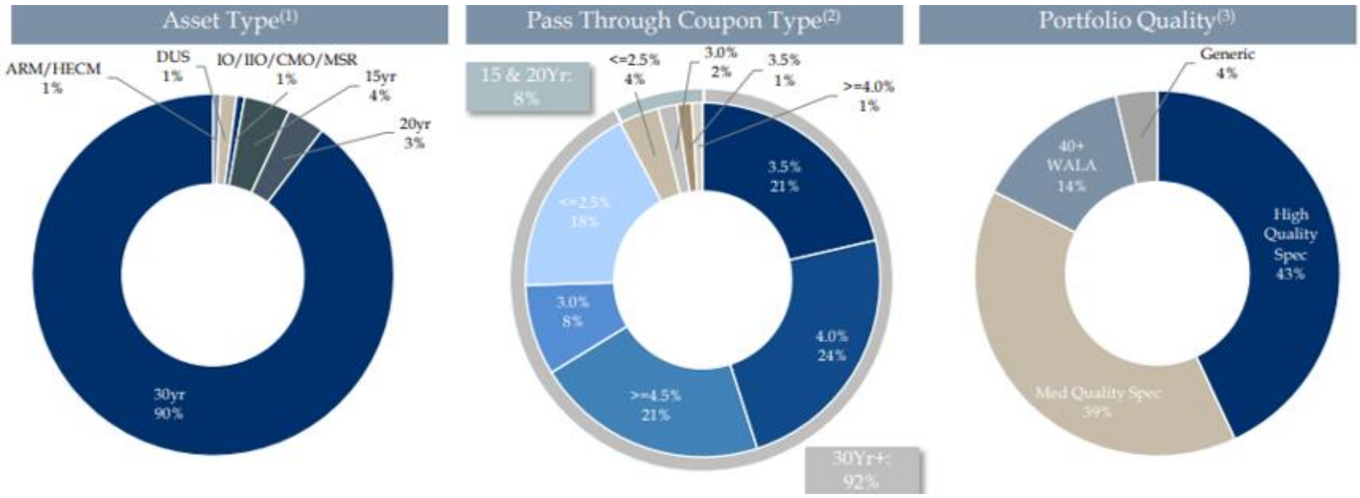


Source: [Annaly Capital Management]

Annaly's RMBS Assets Provide Increased Safety

As we saw above, the overwhelming majority of Annaly's assets are invested in Agency Residential Mortgage Backed Securities (RMBS) which provide a high level of safety because the underlying mortgages that these securities represent are backed by US government sponsored enterprises (GSEs) such as Fannie Mae, Freddie Mac, or Ginnie Mae. As such, they have very limited default risk. Mortgage REITs (such as NLY) take advantage of their low-risk agency portfolio to borrow a significant amount of short-term debt by tapping the highly liquid and large repo market. Since short term debt interest rates are lower than the yield on longer term RMBSs that these entities hold, mREITs earn a positive interest margin. In a nutshell, that is Annaly's business (i.e. borrow short-term at low rates, invest longer-term at higher rates).

For more perspective, the vast majority of NLY's large Agency RMBS asset portfolio is concentrated in GSE backed 30-year fixed rate securities, thereby providing a very high level of safety to its core interest earnings.

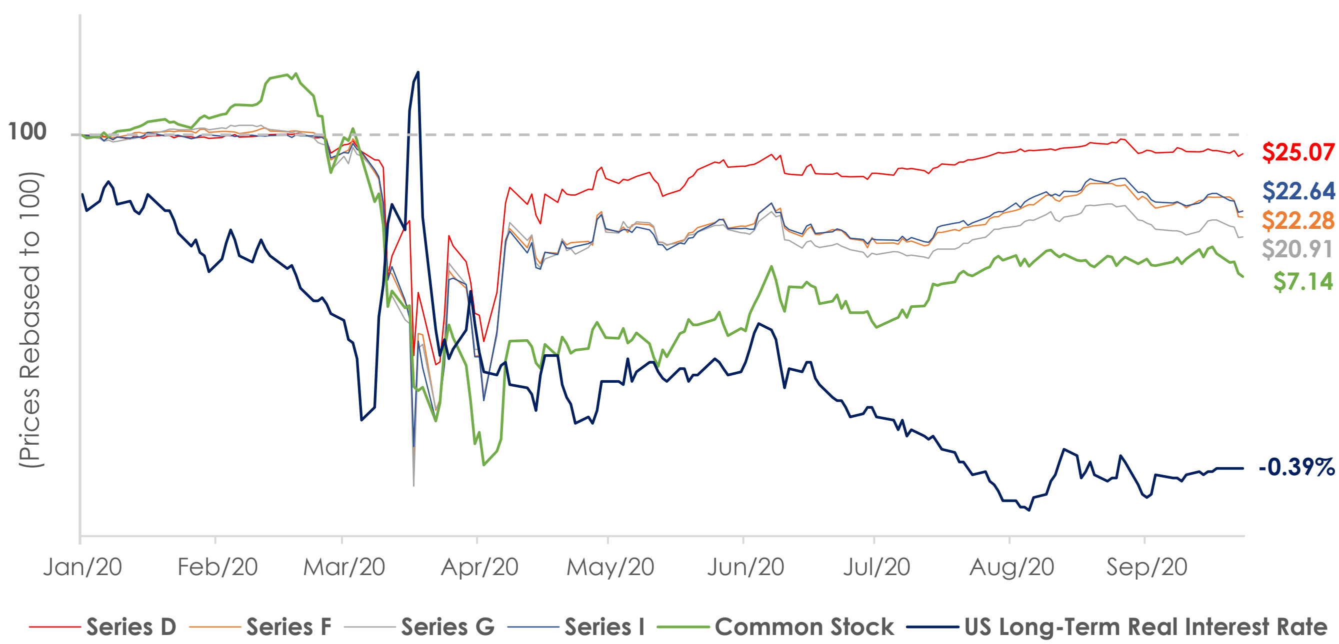


Source: [Annaly Capital Management]

What Happened this Year

As you can see in the price chart below, it has been a wild ride for Annaly this year as the common shares have traded at over $10.50 and below $4.25. The volatility has NOT been due to default risk of the underlying holdings (remember, Agency-backed MBS are extremely safe) but rathter the volatility has been due to a liquidity crisis in the bond market (including Agency MBS), which the Fed has worked with a "whatever it takes" approach to clear up (a very good thing for mREITs).

NLY Preferred Shares Price Sensitivity to Common Stock Price and Interest Rates



Source: Yahoo Finance, US Department of Treasury, Blue Harbinger Research

We'll get into the details of what has been happening with market prices in a moment, but first it is important to note that Annaly offers multiple series of preferred shares that are much lower risk than the common (preferred shares are ahead of common in the capital structure).

Preferred Shares

Annaly has four sets of preferred shares with a total liquidation value of $1.9 billion. The Series D preferred shares carry a fixed coupon rate, while the others have fixed-to-floating rates.

Series D preference shares are cumulative redeemable preference shares that carry a fixed coupon of 7.5% and became callable in 2017. Understandably, these shares trade at a price very close to their face value (i.e. $25) as the market anticipates them to be called any time in the near future (i.e. Annaly may choose to redeem and replace them with a lower coupon preferred share series as soon as there is an improvement in the prevailing economic conditions).

Series F preference shares, which are trading at an 11% discount to their face value and offer a 7.8% dividend yield, carry a fixed coupon of 6.95% and upon becoming callable in September 2022, would pay the prevailing 3-month LIBOR plus a spread of 4.993%.

Series G preference shares trade at a 16% discount to their face value and have a dividend yield of 7.77%. These shares have a fixed coupon rate of 6.50% and would pay the prevailing 3-month LIBOR plus 4.172% over LIBOR upon becoming callable in March 2023. The dividend is cumulative.

Series I preference shares yield 7.45% in dividends and are available at a 9% discount to their face value. The coupon rate on these preference shares is 6.95% and the floating rate upon becoming callable in June 2024 will be the then prevailing 3-month LIBOR plus a spread of 4.989%. The dividend is cumulative.

Summary of NLY's Outstanding Preference Shares

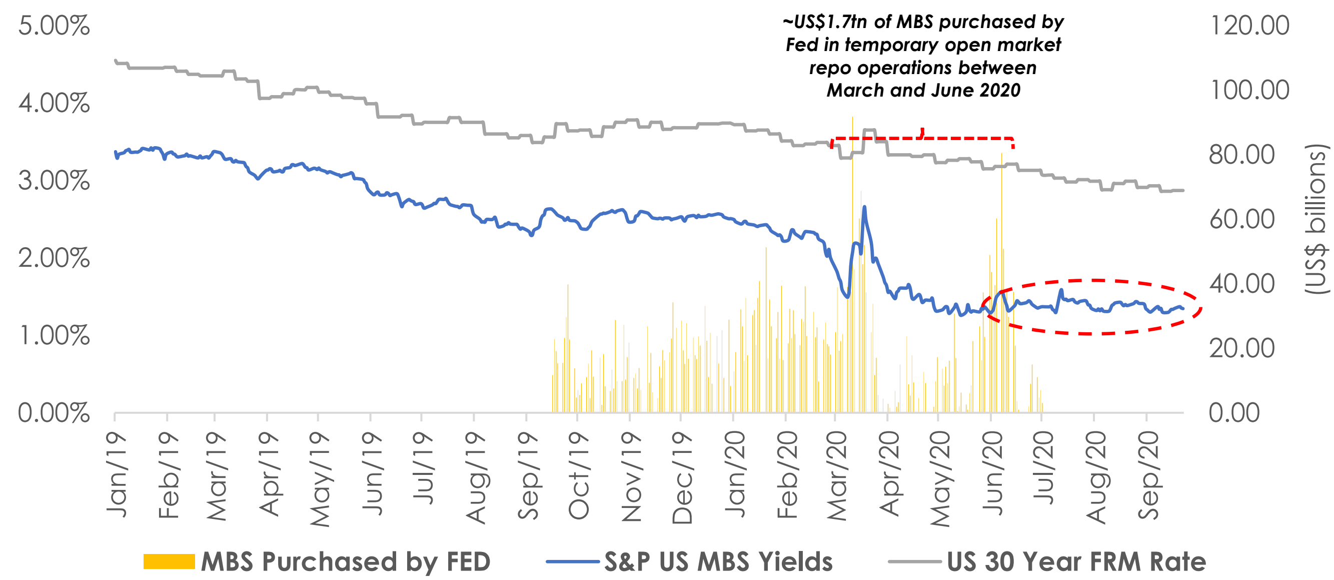
Preferred Stock	Preferred Stock Feature	Outstanding Preferred Shares	Face Value	Liquidation Value ($ million)	Coupon Rate	Current Price*	Premium / (Discount) to Face Value	Current Dividend Yield	Call Date
Series D	CRP**	16,000,000	$25.00	400	7.500%	$25.07	0%	7.48%	09/13/2017
Series F	Fixed-to-Floating CRP	28,000,000	$25.00	700	6.950%	$22.28	-11%	7.80%	09/30/2022
Series G	Fixed-to-Floating CRP	17,000,000	$25.00	425	6.500%	$20.91	-16%	7.77%	03/31/2023
Series I	Fixed-to-Floating CRP	16,000,000	$25.00	400	6.750%	$22.64	-9%	7.45%	06/30/2024
							Average Dividend Yield	**7.63%**	

* As on 09/24/2020
** Cumulative Redeemable Preferred

Source: Annaly Capital Management, Blue Harbinger Research

Fed's Intervention Provides Stability to the MBS Market

At the peak of the COVID-19 sell-off earlier this year, mREITs (such as Annaly) were not spared and their share prices traded significantly lower despite the fact that many of them (such as Annaly) held extremely safe agency MBS securities. This created "margin call" problems for many over-levered mREITs whereby they were forced to sell assets at fire sale prices to meet short-term liquidity requirements (i.e. they had no choice but to sell assets for far less than they were worth just to meet short-term cash flow needs). Ultimately, the Fed stepped in with an unlimited amount of "open market operation" buying (see chart below) to free up liquidity and basically solve the problem with its "whatever it takes" approach.



Source: SP Global, Freddie Mac Primary Mortgage Market Survey, Federal Reserve Bank

As such, companies that were reasonably well position during the stress period (such as Annaly) have emerged strong amid a dramatically more stable market environment.

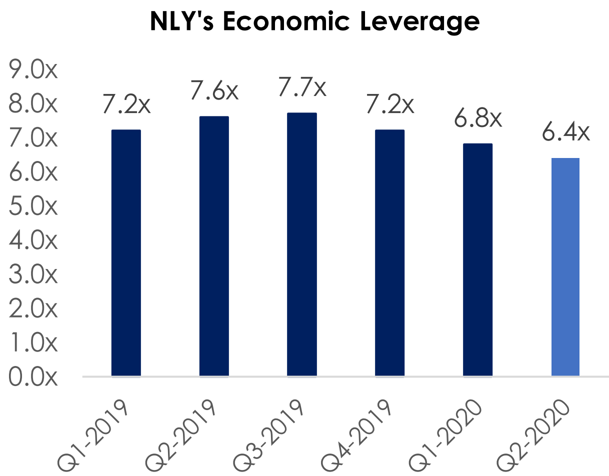
Conservative Approach Has Helped Manage Liquidity

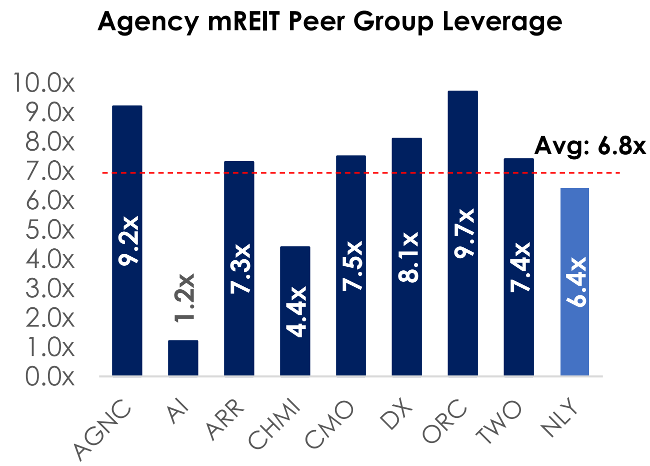
Annaly has remained relatively stronger than its peers due to its conservative approach in managing its businesses as well as its balance sheet (to maintain a strong liquidity position). According to the company's Q2-2020 Earnings Call:

"We were certainly careful to take prudent steps during the early phase of the market recovery to ensure we are well positioned to capitalize on the opportunities that are sure to arise. And as part of our preparation, we have chosen to be conservative with our leverage, as well as our dividend. Our goal has been to maintain optimal liquidity thresholds and to manage the portfolio within conservative risk parameters to produce the highest level of quality earnings in this smart environment."

Annaly's business has relatively lower leverage and higher-quality assets (versus peers)that helped it mitigate pandemic related disruption and position the business well for recovery.

For example, Annaly's overall economic leverage is at the lowest level seen in many quarters and stood at 6.4x at the end of Q2-2020. This is well below the leverage levels of its Agency mREIT peers, a couple of which have over 9x leverage.



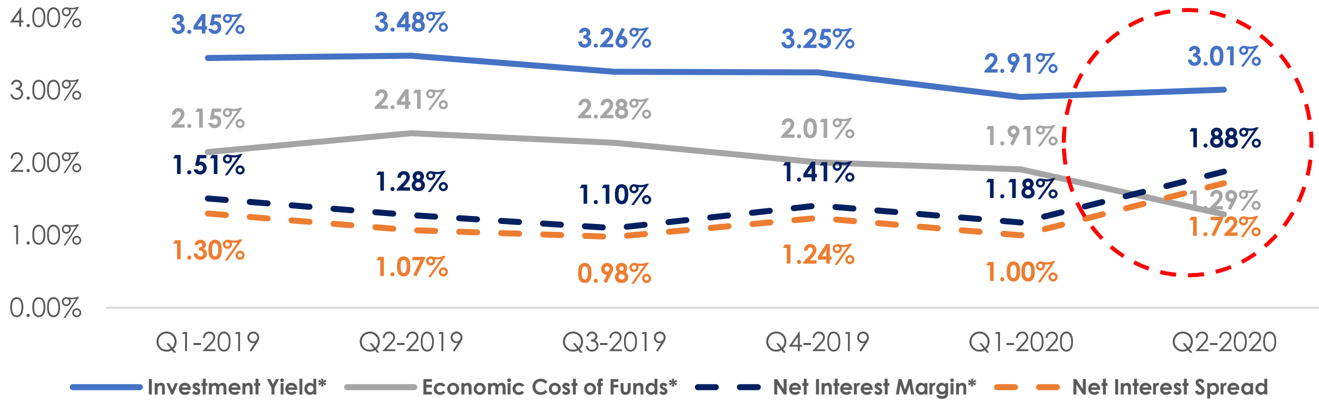


Source: Annaly Capital Management, Blue Harbinger Research

Additionally, NLY had $7.9bn of total unencumbered assets including $5.3bn of cash and unencumbered Agency MBS at the end of Q2-2020. These assets can be used as a buffer for raising its liquidity position in an unforeseen event.

Current Interest Rate Environment and Impacts

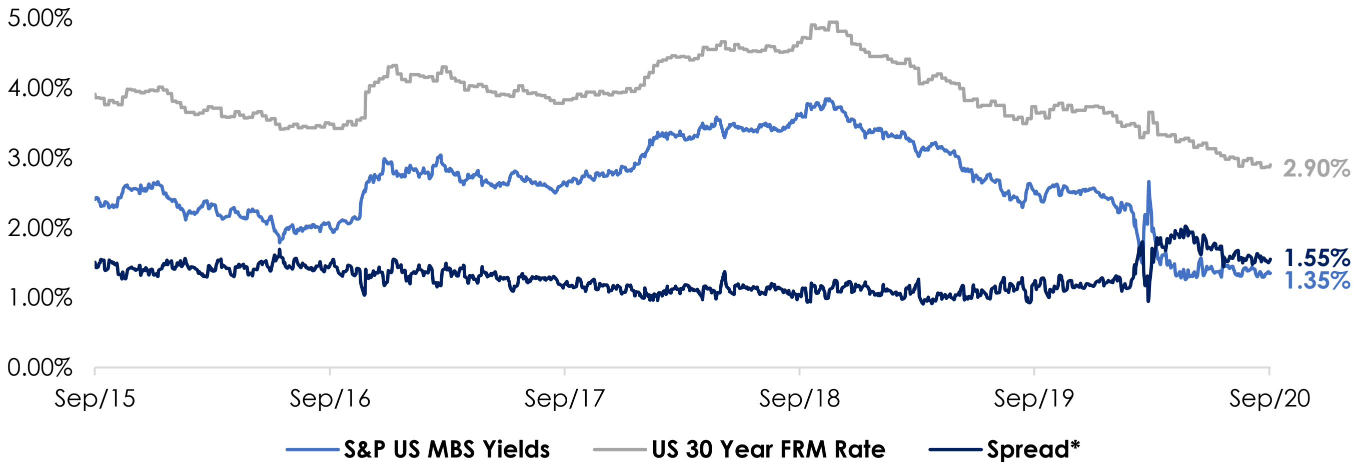
Amid the current uncertain economic environment, interest rates have fallen to near zero levels, and this has dramatically reduced the cost of funds for mREITs such as Annaly. For example, during Q2-2020, Annaly's economic cost of funds declined by 62 bps, which improved the net interest margin by 70 bps and the net interest spread by 72 bps. However, the yield on investments improved only by a modest 10 bps, partially reflecting widened MBS spreads.



* Excluding Premium Amortization Adjustments (PAA)

Source: Annaly Capital Management

MBS spreads have widened due to the expectation of increased prepayment activity as 30-year mortgage rates have dropped to all time low levels. For example, borrowers who purchased mortgages just a few years ago will be tempted to refinance as the 30-year mortgage rate has fallen from nearly 5% in 2018 to 2.9% currently, thus impacting the yield that MBS holders earn (see chart below).



* Represents difference between S&P US MBS Yields and 30 Year Fixed Rate Mortgage

Source: SP Global, Freddie Mac Primary Mortgage Market Survey, Federal Reserve Bank

While it is difficult to forecast what rates will be in the future, recent improvements in net interest spreads is a positive for mREITs.

Effective Hedging Strategy to Manage Interest Rate Volatility

Worth mentioning, Annaly attempts to reduce its exposure to interest rate risks through its hedging program. For example, Annaly employs a strategy whereby duration and convexity risks are hedged through the use of swaps, swaptions, and futures to protect book value across various interest rate and spread environments. During the Q2-2020 earnings call, management highlighted the hedging strategy:

"With respect to our hedges, we added to our swap portfolio, primarily in the front end, the short-term swaps with pay rates close to 0%, provide an attractive hedge to our financing. This reduced our pay rate, as well as shortened the maturity of our swap portfolio. We further reduced the LIBOR footprint of our hedge portfolio with our swap book now 80% in OIS and we reinitiated our treasury future short position that was unwound in the first quarter. We also continue to take advantage of the attractive low levels of volatility to answer the tail risk of a sharp rise in rates in the long end of the yield curve, and as such, we replaced much of our legacy swaption position with additional out of the money payer swaptions."

Internalization and Buybacks Highlight Long-Term Value

Annaly recently closed its previously announced transaction, to internalize its management team. This allows the company to increase transparency and better align decision-making with shareholder priorities to long-term value. The company also continues to utilize its share buyback program and has recently repurchased another $175 million of common shares since the start of Q2.

Dividend Safety

The vast majority of Annaly's portfolio consists of agency RMBS, which are basically guaranteed by GSEs. Unless these GSEs default (not happening), the company will generate most of its cash flows (if not all of them). Since the likelihood of GSE defaulting is negligible, there is a safety net around much of Annaly's cash flow—thereby adding added support to the dividend payments to investors.

Additionally, preferred shareholders have priority over a company's income, and are paid dividends before common shareholders. Notably, all of NLY's traded preferred shares are cumulative, which means that even if the company withholds part of, or all, of the preferred dividends, they will be considered as arrears and must be paid before any other dividends. Nonetheless, NLY has not withheld dividends on its preference shares historically, and has continued to pay them consistently.

Valuation

In our view, the fixed-to-floating rate preferred shares offer reasonable valuations and attractive dividend yields. And the "Yield to Call" for each series is compelling.

Preferred Stock	Call Date	Current Dividend Yield	Yield to Call	Yield if Floating Today
Series F	09/30/2022	7.80%	13.06%	5.86%
Series G	03/31/2023	7.77%	14.17%	5.26%
Series I	06/30/2024	7.45%	9.72%	5.76%

Yields are as on 09/24/2020. Yield to Call is calculated on www.preferred-stock.com/calculator_ytc.php

Source: Annaly Capital Management, Blue Harbinger Research

And even if/when these shares were to convert to floating rates, they're still attractive relative to other interest rates and yield opportunities in the market (even after considering that the price of preferred shares have a negative correlation to the prevailing market-wide interest rates, meaning their prices increase when interest rates decrease).

Worth mentioning, many mREITs (including Annaly) currently trade at a discount to their book values, which has not always been the case, as you can see in the chart below.

The liquidity challenges (and perceived risks) associated with this year's volatility has driven price-to-book values to historic lows, and they have not yet fully recovered as investors have been slow to reenter positions. In our view, Annaly's agency-backed book, combined with its strong balance sheet, and the Fed's "whatever it takes" approach (to freeing up liquidity through open market operations) make Annaly an attractive investment at its current price.

Risks

Stress in the short-term funding market could erode earnings: As indicated earlier, the Annaly's business model is highly reliant on access to short term funding at reasonable rates. Stress in the system could increase the costs of repo financing which will have a negative impact on the company's earnings power. While Annaly does undertake hedging activities, it is usually not enough to insulate the company from the all negative impacts.

Increased mortgage prepayment: As 30-year mortgage rates have dropped to all time low levels, borrowers that purchased mortgages just a few years ago will tend to prepay them (to benefit from lower rates). An increase in mortgage prepayment activity will negatively impact the yield that MBS holders earn and thus put pressure on the company's earnings.

Diversification strategy could fail: The company is entering and expanding into areas that it has limited experience in for the purpose of diversifying its portfolio (for example, see our "Summary of NLY's portfolio" graphic earlier in this report) . Failure to appropriately consider and manage risks associated with new businesses could put pressure on the balance sheet. Having said that, the company has taken a measured approach in its diversification strategy so far (for example, on the middle market lending side, 62% of its portfolio is made up of safer first-lien secured loans).

Conclusion

In our view, Annaly's common shares are very attractive at their currently discounted price, considering the mostly agency-backed book, strong balance sheet, high dividend yield (currently over 13%) and open-market backing from the Fed. However, if you are simply looking for "low-drama" income, the fixed-to-floating rate preferred shares (series F, G and I) are trading at discounts to face value thereby offering an attractive opportunity in their own right (i.e. price appreciation and healthy dividend income). While there are potential risks to Annaly's business, we believe they are small compared to the benefits of investing in the common shares and especially the preferred shares (the preferred dividend is safer than the common). Depending on your individual situation and risk tolerance, Annaly's common shares, and especially the preferred shares, are worth considering for a spot in your income-focused portfolio.