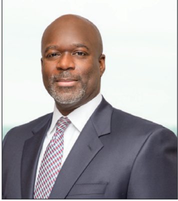
REAL ASSET SECTORS

Mortgage REITs – attractive double-digit yields



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Real Estate Investment Trusts ("REITs") typically fall into two categories: 1) Equity REITs, which generally own and operate real estate (i.e. retail, industrial, office) and 2) Mortgage REITs, which generally acquire real estate-related debt. While Equity REITs typically generate rental income from leasing space to tenants, Mortgage REITs typically generate revenues from the interest earned by investing in a pool of mortgage loans.

Mortgage REITs generally provide liquidity and/or funding for both residential and commercial property owners by either purchasing or originating new mortgages. Commercial Mortgage REITs purchase commercial mortgages and commercial mortgage-backed securities ("CMBS", pools of securitized commercial mortgages), providing liquidity and mortgage credit for property owners in the commercial real estate industry.

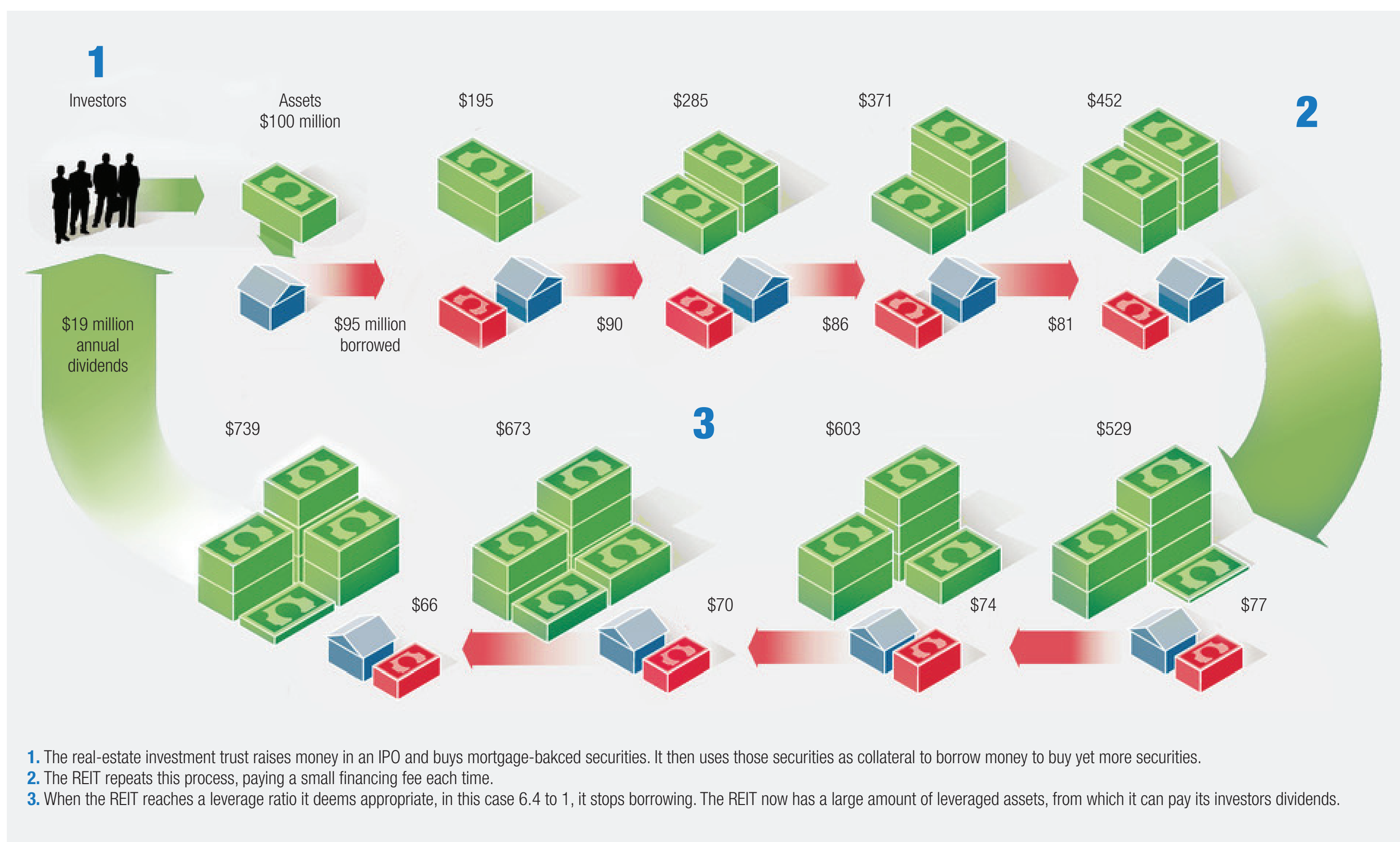
Mortgage REITs focused on the residential housing market purchase or originate residential mortgages and mortgage-backed securities ("MBS", pools of securitized residential mortgages) which provides liquidity and mortgage credit for property owners in the residential real estate industry. In the U.S., residential mortgages can be further subdivided into Agency loans and Non-Agency loans.

Agency loans are created and guaranteed by one of three government-sponsored agencies: Government National Mortgage Association ("Ginnie Mae"), Federal National Mortgage ("Fannie Mae"), and Federal Home Loan Mortgage Corp. ("Freddie Mac"). Investors generally treat these agency loans as obligations of the U.S. government and so they are relatively low-yielding and very liquid. Non-agency loans are issued by financial institutions and tend to trade at higher yields since they are less liquid and carry a risk of default.

Mortgage REITs can generate revenues from servicing mortgages (collecting and distributing principal and interest payments), underwriting and/or originating mortgages and trading mortgage securities for gains. However, the largest source of revenue for Mortgage REITs is the spread they earn on their investments over their cost of capital.

A Mortgage REIT might use $1 million of equity capital and $4 million of leverage to purchase $5 million of MBS. If the MBS portfolio earns a 5% yield and the leverage has a cost of 3% then the Mortgage REIT will generate a 2% net interest margin. Leaving aside other expenses, this example would result in equity investors generating a 13% return on equity with 4x leverage. In the case of Mortgage REITs, the Return on Equity (ROE) is usually a close proxy for the ultimate dividend yield.

Raising the roof: An example of how a mortgage REIT could build assets.



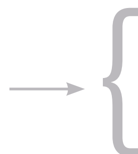
Source: UBS; Wall Street Journal reporting

The amount of leverage and the resulting ROE the Mortgage REIT generates is largely a function of the type of securities that are being leveraged. Agency MBS is the gold standard and the lower yields these securities distribute require higher leverage to generate an attractive dividend yield. On the other end of the spectrum, CMBS generate higher yields but are usually purchased with less leverage to account for the increased credit risk. In general, Mortgage REITs earn ROEs in the 10% to 15% range with similar dividend yields.

New Residential Investment Corp. (NYSE: NRZ) ("NRZ"), is a publicly traded Mortgage REIT that focuses on investments in non-agency residential MBS. NRZ generates revenue from servicing and trading activity. Following the acquisition of Shellpoint Partners LLC in 2018, NRZ also generates revenue from a suite of ancillary businesses, including title insurance, appraisal management and real estate owned management. On June 18, 2019, NRZ announced that it had entered into an asset purchase agreement to acquire Ditech Financial LLC’s forward Fannie Mae, Ginnie Mae and non-agency Mortgage Servicing Rights (“MSR”) with an aggregate unpaid principal balance of approximately US$63 billion as of March 31, 2019. Since inception (May 2, 2013 – March 29, 2019), NRZ has generated 65% growth in book value, a 147% total shareholder return, and has paid approximately US$2.7 billion in dividends to shareholders. NRZ currently yields 12.9% (as at July 1, 2019), and has over US$33 billion in total assets. NRZ is managed by an affiliate of Fortress Investment Group LLC, a global investment management firm.

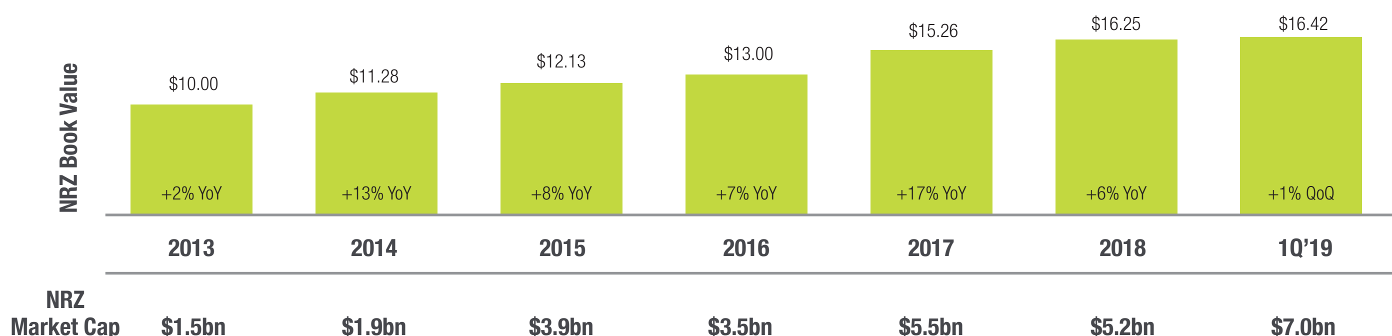
Hypothetical Mortgage Loan	
Principal Balance	$100,000
Loan Term	30 Years
Annual Interest Rate	6%

Monthly payment	$600
Monthly MSR Fee (30 bps/yr)	($25)
Paid to Mortgage Owner	$575



Hypothetical MSR		
MSR	30bps	
Basic Servicing	(6bps)	Fixed fee paid to servicer
Excess MSR	(24bps)	Amount in excess of basic fee

New residential has a strong track record of executing on core investment strategies, making attractive opportunistic investments and delivering consistent growth



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