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Annaly 2024 Investor Day
November 21, 2024

Annaly Advantages

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Chief Executive Officer & Chief Investment Officer

David Finkelstein:

Afternoon, everybody. Thank you all for being here. I do recognize many of you. But for those of you who I have not met, my name is David Finkelstein. I'm the CEO and CIO of Annaly Capital, and it is a pleasure to be here today. We have a crowded room, we also have countless more people on our webcast. And so we expect this to be a very substantial event for everybody. So thank you again. We're going to do something a little bit different than what you're accustomed to hearing from Annaly today. We're going to talk about the portfolio strategy and the businesses, but we do want to go broader and give the audience a real lens into how we manage the overall company and things like liquidity and financing management, as well as risk oversight, and also talk about policy.

And we have special guests at the end of the day. Jim Parrott and Mark Zandi, who are two of the foremost authorities on housing finance policy in the U.S., will speak with us through the moderation of our head of government relations Tanya Rakpraja, who has quite a policy background herself. And we have a diverse group of speakers for you today from the management team, people you'll get to meet for the first time. We also have today two of our senior board members with us, Mike Haylon, who's our board chair, and Tom Hamilton, who's the chair of our risk committee. And without whose support, we wouldn't have been able to do many of the things that we've been able to accomplish over the last number of years. So we very much appreciate it.

Now, if you look at the screen, I have four concepts up here and I'd like you to focus on those for a moment because these we believe are the key differentiators for Annaly. First of all, scale. Capital is everything. It opens doors to opportunities and partnerships, and most importantly, it ensures liquidity, and it's the key to our company. People. We have the top talent in the industry in my view. And it's not just the people that you're going to hear from today, but it's the people around them and underneath them that make Annaly what it is and certainly inform our success. Adaptability. Look, markets move at the speed of sound in today's environment and things can change very quickly, and a company like Annaly has to be incredibly agile. And I think as we talk about what we've done over the past number of years, you'll become of the mindset that we've exemplified adaptability over the last number of years.

And lastly, efficiency. We need to be as lean and as efficient as we possibly can because returns are a game of inches. And when we're thinking about investing a dollar, whether it's on the balance sheet or in people or technology or operations, everything is looked at on a return on investment standpoint. And what you'll find is we are the most efficient model in the industry and we're very proud of it. So my role today, to introduce today, will be to talk about both the history of the company, who we are, what we've done, how we've done, and then where we're going. Okay, so with that, let's get going.

All right. I think most of you know Annaly well, but for those who don't, we've been a public company now for 27 years. We came to market at a time of considerable volatility, right during the Russian debt crisis. And then we experienced 9/11 and the financial crisis and COVID and many events of volatility in between. And the point being is that this company has developed a pretty considerable muscle memory for managing through volatile times, and it's in the DNA of the company. And we have a lot of past experiences that we fall on when it comes to managing our portfolio.

Performance. 869% total shareholder returns since inception, roughly 9% average annual returns, something we're very happy with. We have 200 people in the company, which sounds like a lot of people for a mortgage REIT, but when you consider the diversity of the three businesses and the complexity of each of those businesses, we're actually rather lean. We have $26 billion in dividends paid over the history of the company, on average about a billion a year. This is our mission, is to create income for our shareholders. And one of the proudest things about the company is that we've consistently maintained a strong dividend yield and provided income to our shareholders.

And lastly, here we have $12 billion in capital, which is obviously evident, but what I think is most important about our capital base is the quality of the capital. It's 88% common equity, 12% preferred. And we've talked in the past about how we look at the different types of leverage. And capital structure leverage, or the amount of leverage in your capital structure, is evaluated in the context of other forms of leverage, whether it be balance sheet leverage or structural leverage in the assets. And we don't layer leverage, we're responsible about our leverage. And right now we have what we believe to be the cleanest capital structure of any scaled operator in the platform. So we like where we sit from that standpoint.

Now, I wanted to give you a little bit of history of the company, and I know there is a lot going on on this page and I really want to focus on the past five years. But first off, just a little bit of history. When Annaly started in the late '90s, it was a pure play Agency REIT. And the company existed in that form through the financial crisis, and it was a very beneficial time to be invested in Agency MBS, certainly. Now in the aftermath of the financial crisis, credit assets were still extraordinarily cheap, and so the company began to diversify both through organic expansion as well as acquisition. And we added onto the balance sheet, residential credit, commercial real estate, and even corporate middle market lending. And so if you fast-forward to 2020, and the beginning of 2020 is when this management team took over, we had four verticals.

We had Agency MBS, which is the hub and the liquidity engine, Resi-Credit, CRE, and Middle Market Lending. What we wanted to do strategically was bring Annaly back to exclusively housing finance in the residential space. And the reason being is that's our core competency, that's our brand. That's what we knew and we felt like the market would embrace that. And then COVID hit literally the week after we took over. Now, COVID was a material setback for everybody on the planet, including our sector, but what it did for us is it forced us to rethink how we looked at everything in our business, not just market shocks and volatility, but how Americans would use real estate. And in terms of the objective to get back to housing finance, it only sharpened the focus. So at the outset of COVID into the depths of COVID, we very quietly but very deliberately began to engage in three strategic priorities.

First was to package up our commercial real estate business such that when markets healed, spreads rebounded, and the economy began to correct, we could go to market and actually move that off balance sheet. The second thing we did was begin an MSR business on our balance sheet. Now, by way of background, prior to COVID, we did own a servicer, Pingora Loan Servicing. So we had exposure to MSR and we did operate a business that engaged in subservicing oversight. So we had the playbook to do that, but we wanted to do it on balance sheet. So in early 2020, we brought Ken Adler on board to help us build that out. Now the third strategic initiative we engaged in in early 2020 was in residential credit.

One of the things we experienced in 2017, 18, and 19 was the sector was exhibiting somewhat of a scarcity of assets and we needed to make sure we had a way to source assets in an efficient way to make sure we had quality assets coming on the balance sheet. So Mike Fania and his team began the planning stages to launch a residential correspondent channel. So those three things, we started in 2020. In 2021, first half of 2021, as a matter of fact, we sold commercial real estate to Slate without experiencing a loss, which we thought was an accomplishment. We bought our first MSR package in the spring of 2020, and our correspondent channel started acquiring loans also in the spring of 2020. So we were on our way. And growth was relatively slow at the outset, but we were making progress.

Now, fast-forward to 2022 and the Fed starts normalizing policy, rates are selling off, QT is beginning, and there's a lot of volatility in rates markets, and assets in our sector were cheapening. At the same time, corporate credit was doing extraordinarily well. There was such a bid for corporate credit that it just created such a tailwind for our middle market lending portfolio that we said, "Wait a minute, okay, rates are volatile, originators are somewhat disrupted from capital markets activities. They need liquidity. They have all this MSR on their balance sheet that they need to monetize because the origination complex is slowing down." So we sold our middle market lending business to Ares at a profit, and we redeployed that capital largely into MSR. So that left us with three verticals, Agency MBS, Resi-Credit, and MSR.

Now also in that year, the market understood who we were and what our strategy was, and as a consequence, rewarded us with the ability to raise capital in that year. And also in 2022, S&P added us to their index, the S&P 400. Which coincidence or causality, I do think that understanding our business model enabled them to be comfortable with adding us to the index, and that enabled us to grow further. So that leaves us where we are today, which is three fully scaled strategies exclusive to housing finance, but diversity and synergies across the businesses. $80+ billion dollar balance sheet. We're as liquid as we've been in many years. $7.4 billion of unencumbered assets on the balance sheet, $4.7 billion of which is cash and Agency MBS, which gives us a considerable amount of optionality.

And it's that type of liquidity that had enabled us to do the things rapidly in 2022 and beyond, and that will continue to let us do things rapidly as we move forward, but responsibly. We've financed nearly a million homes in the country, something we're very proud about. We're 10 times the size of the average mortgage REIT, and that scale gives us huge advantages, not just as it relates to costs, which we'll get into momentarily. And most notably, as I said, the core mission is to deliver a stable dividend for our shareholders and we yield 13% currently, which is very consistent with our historical average, and we've been very comfortable with the ability to deliver that through strong earnings available for distribution.

All right, let's get a little bit deeper into what we built and how it all fits together. Look, we operate in a world with considerable uncertainty and that uncertainty has only increased over the last number of years as we all know. And it requires diversity in your portfolio. You can't have every asset correlated. Now, I love Agency MBS as much as anybody. I spent the vast majority of my career in Agency MBS. But one thing I will tell you is that negative convexity can be painful when it materializes. That's why you get paid the spread you get paid in Agency. Now, our objective is to minimize the consequences of negative convexity.

Now, anybody who's ever participated in the mortgage market as seasoned veterans and the like, whether you're levered, unlevered, sell side, buy side, there's nobody who's ever spent any length of time in the mortgage market who hasn't been compelled to sell an Agency bond at the wrong price. And we're no exception. What we're trying to do is take advantage of the spread that Agency offers and the liquidity and the guarantee but minimize the consequences of negative convexity. And we think we've achieved that. And that's the biggest benefit to combining these three strategies obviously is the lack of perfect correlation in the returns. But there's many other synergies that we've come to realize over the last couple of years.

Obviously, MSR is a natural rate hedge for Agency, but in addition in this world with a lot of locked-in mortgages, MSR hedges turnover on your discount Agency MBS, which is something we've benefited from over the past couple of years. And also in a period of high policy rates, MSR through float income hedges your front-end exposure on your Agency portfolio. So the synergies are pretty considerable and they've only increased in the current environment. Also, modeling. Now, Srini who you'll speak with next, he will get into some of the modeling aspects of our Agency strategy. But understand that when we're bidding an MSR package, that Agency modeling effort goes hand-in-hand with that, and the synergies between Agency and MSR from an analytical standpoint are as considerable as you can imagine, and it's underappreciated.

Strategic relationships, particularly between resi and MSR and our partnerships. Now, it is no secret, or should be no secret that our largest partners on the residential credit side are also our largest partners on the MSR side in the origination and servicing community. These relationships are institutionalized. We are thought of as a liquidity provider and a capital partner to these institutions. And the relationships run very deep and it's effectively one-stop shopping with Annaly. And you combine that with our large capital base and it gives the origination community a lot of confidence to come to us and rely on us. And that's been a great benefit for having both of those businesses on balance sheet.

Operational synergies. Subservicing oversight on Agency is combined with the oversight of residential credit. Asset management and delinquencies are all harmonized such that we can minimize the costs and make sure we have the best expertise performing each function. And most importantly, financing synergies. We can look at our financing holistically and manage the cost and our liquidity at the top of the house to ensure that A, we're always very liquid, and B, we're overall minimizing the cost of financing by being able to look at these three businesses holistically. So that's just a little bit on the synergies and you're going to hear a lot more about that from the teams.

And just a quick summary on capital allocation over the last five years almost. Again 2020, four businesses, 78% of the capital was in Agency MBS with 22% spread between three credit businesses. Fast-forward to today and we're roughly 60-40 Agency to credit and MSR, which is close to where we want to be. We think the optimal range from a risk-adjusted return standpoint between Agency and the Resi and MSR businesses is 40% Resi/MSR to 50%, with Agency not falling below 50%. Because of the strong liquidity and the levered nature of the business, we want to maintain 50% Agency. But right now we're a little bit overweight Agency at 60% and we're perfectly fine with that. Now what that leads to is a model that has lower leverage, lower volatility, as you'll see when we talk about returns, and less interest rate exposure. And so we think we're in the right wheelhouse for where we want to be long-term but we do have room to increase Resi and MSR. All right. Again, the point about efficiency. So the model is truly built for efficiency. Three fully scaled businesses with all of the benefits of having operating platforms, when you're talking about asset aggregation as well as recapture and other benefits that we derive from the servicing community. But by plugging in to our origination and servicing partners, we avoid the operating leverage that those businesses entail and it's hugely beneficial to us. And it most shows up in our OpEx to equity ratio, which you can see at the bottom. That little sliver down there on the left is our OpEx to equity ratio, which is considerably below that of the monoline Agency REIT sector.

Now admittedly, a lot of those folks are very sub-scale, but we're only a little bit above the largest of the monoline Agency REITs in terms of OpEx to equity. So we do it very efficiently and very lean and considerably below hybrid REITs and MSR REITs for obvious reasons. And we put the mortgage originators in there, not because it's a good comparison but just to show what type of expenses those entities entail and that we're not looking to acquire those types of operations at this point because we think we can do it much more efficiently as we're currently constructed.

All right. Now, quick lens into each of the verticals. So again, Agency is the hub. We methodically invest in specified pools, which you'll learn about next. And for those of you who don't know V.S. Srinivasan, he's been in the Agency market for decades. He's one of the foremost experts of prepayment modeling. And his ability to select collateral and his team's ability to trade and also inform the collateral selection, I think is second to none. And as a consequence, we've developed a very high-quality Agency portfolio. And you see it in the speed environment of the collateral we own, quarter in and quarter out. When you look at our speeds on our premiums and our discounts that generally pay pretty quick. And in addition, he's equipped with a very high-quality rates team with decades of experience. And so we're constantly in the market navigating our duration and making sure we're making smart decisions. And the team does it quite effectively, many of whom you'll meet later on today in the cocktail reception actually. Again, best in class modeling you'll hear about.

Residential Credit. Largest non-bank issuer of prime and expanded prime, second-largest overall. We've securitized $30 billion since 2018 and the pace of that securitization effort has only grown. And we've been very encouraged by what we've seen with the redevelopment of residential credit securitization over the past number of years and we feel like it's a very viable financing arrow in the quiver and will be for the foreseeable future. So we feel very good about it. What we, I think, are most proud about that business and keeps us sleeping well at night is the credit quality of what we've acquired. We have the lowest delinquencies amongst the top 10 issuers in the resi-credit sector. By controlling the product that comes through our channel, Mike and his team has done a very good job of making sure the portfolio remains healthy.

And then lastly, as it relates to Residential Credit, and this isn't something we talk about often, but we do have a large JV with one of the biggest sovereign wealth funds in the world and we are arms locked in this market providing liquidity and capital to the origination community. And we have a very durable platform of capital. Not just Annaly's capital, but we have outside capital as well. And to the extent, there's ever a technical dislocation in the market, we will be there to take advantage of it. Again, arms locked with one of the largest sovereign wealth funds in the world.

All right, MSR. So look, in a little over three years since purchasing our first package, we've become one of the top 10 servicers in the country. Portfolio of critical mass, nearly $3 billion in market value, a couple of hundred billion in principal balance, the highest quality portfolio in the market, hands down. Just a touch over a 3% note rate, so the convexity is incredibly good and the credit quality is impeccable. And so that portfolio allows us to sleep easy at night, both with respect to prepayments but also as it relates to credit. And we've also developed best-in-class recapture capabilities. And it's not consequential now given the note rate of our portfolio, but as we are going higher in coupon, as origination ultimately picks up, these recapture partnerships like the one we just announced with Rocket are going to be hugely valuable for us.

Now the last point I want to note on this page is that none of this works. None of these three businesses work without the best financing in the market. And you're going to hear more about that from Serena, our CFO who you know. But you're also going to meet our treasurer today, Pete Koukouras, who's been with the company for 20 years. So through the financial crisis, financed the company through then, through all the moments of volatility. And he has a tentacle on every part of the financing market. And he has developed a portfolio of financing options for this company that I think makes us more durable than anybody else. From obviously, 50-plus bilateral relationships, we have our own broker-dealer and we have $5+ billion in warehouse financing across both MSR and Resi. And again, he's dialed into every aspect of the financing market. He is one of the most known guys in the sector and we're very proud to have him on our team. So you'll meet him later. But you can't do this without confidence in your financing, I promise you that.

All right, let's get into quickly how it all has worked. So what we have here on the top is just a year-to-date performance chart. And this is through the third quarter. 10.5% economic return, which we think compares quite favorably relative to both the Agency REITs, hybrid REITs, and even the MSR REITs which have led the sector. So overall it's been a good year for us thus far. We've delivered the dividend and generated a touch of book value appreciation. If we look back a slightly longer period of time, we used the last two years here. And the reason being is because Middle Market Lending went off balance sheet in the third quarter of 2022, and that's when MSR really got to scale at that point. So for the last two years, we've had each of these three businesses, we think fully scaled, and we have two years of data through what were quite volatile markets over the past couple of years.

And if you look at the returns, a little over 25%, compares obviously quite favorably to Agency and hybrids and certainly relative to MSR. But one point to note is that the MSR market has had a very good past couple of years and we were fortunate to get into the sector when we did. Now obviously, some of that's luck, but we had a plan and we knew what we wanted to do and we feel like we benefited quite a bit from venturing into or rather establishing ourselves in MSR. And from a Sharpe ratio standpoint, our Sharpe ratio is hands down much better than Agency and hybrids and comparable to the MSR sector. MSR has done well and we certainly acknowledge that and we're very glad to be a large participant in the market. And overall, we think we've had a pretty good beginning of a track record for the past couple of years.

Okay. Where are we going? And I don't want to steal a lot of the thunder of my colleagues, but I did just want to give you a little preview as to how we're looking at the world right now. As everybody knows in the Agency market, monetary policy is becoming more accommodative, but the Fed will continue to unwind its Agency balance sheet even as QT ends, which does present a little bit of a technical overhang on the market. And actually, you combine both those factors and it's pretty encouraging. More accommodative policies should ultimately lower volatility, but spreads are not going to tighten considerably with this backdrop of supply in the market.

Now, the positive technicals from money managers and banks even being involved is good. But nevertheless, we think spreads should tighten modestly or somewhat, but they're not going back to their ten-year historical average at all, which is just fine for us because it enables us to invest at relatively lofty spreads. And we're going to continue to maintain Agency as the hub of the company, and we're going to continue to invest in the technology and modeling capabilities to make sure that as borrower behavior changes, we're always ahead of the curve and we're always going to make that investment.

All right, Residential Credit. So there are structural tailwinds in resi-credit and particularly with this new administration coming on. I think what we saw in Trump 1.0 was that there was a desire to withdraw the footprint of the GSEs, not just recap and release but also reduce the products that they guaranteed. And what that does is create options for our correspondent channel to acquire different types of loans that might have otherwise fit the Agency model. So for example, Agency-eligible investor loans or second homes. We were big in those sectors when the caps were put in place by Calabria. And you'll probably see that type of policy move as well again in this administration, even in the absence of something more significant.

And then second liens and HELOCs, we do acquire through our correspondent channel with higher rates that are likely to remain persistent. That'll continue as folks look to tap equity out of their homes, and we're prepared and already acquiring those loans. We feel like there's room for growth there. And then in MSR... So the sector has changed with banks withdrawing and non-banks coming in because the need for liquidity and capital and partners like us is much more considerable. They're great operating entities, we're the capital partner. And we marry the two and we have a sector that can actually trade and that's not going away. No matter how regulation changes, there will be a need for our liquidity and we'll continue to be able to grow that business on a go-forward basis.

So in short, we're very encouraged by the outlook. And there's a lot of uncertainty heading into 2025. We get it. We'll see how the administration takes shape, but we're encouraged overall. So key takeaways, proven history and management. You can invest in all aspects of the mortgage loan with Annaly and we allocate capital across the cheapest part of the loan. We're afforded opportunities based on our size and scale, and we also have very strong corporate governance and corporate responsibility practices. The synergies we spoke about, you see it come through the returns. And our partnerships are considerable and they're only growing. We do have favorable industry tailwinds that we think are ahead of us. And lastly, and most importantly, we have achieved the purpose of the model, which is providing a stable dividend yield for our investors, and that will always be our obligation in conjunction with preserving capital. So now with that, I'm going to pass it off to our macro strategist Andreas Strzodka, who is going to lead a discussion with our Agency and MSR Heads Srini and Ken Adler.