Annaly 2024 Investor Day
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Onslow Bay Correspondent Channel & Securitization Platform

Mike Fania, *Deputy Chief Investment Officer & Head of Residential Credit*

Mike Fania:

My name's Mike Fania, I'm Deputy CIO and Head of Residential Credit at Annaly. Over the next 25 minutes, we're going to talk about the current state of the Residential Credit portfolio. We're going to talk about the Onslow Bay Correspondent channel. It was launched in April of 2021, so a little over 3.5 years since implementation. We're going to talk about our securitization program. We're one of the largest securitizers across residential credit since 2018. We're going to talk about some key business initiatives that we have that we think can further entrench ourselves as a leader within the correspondent channel. And then lastly, we'll talk about some key differentiated advantages. So advantages that we think are unique to Annaly.

So first in terms of the state of the residential credit portfolio. So we ended Q3 with $6.5 billion market value of assets, $2.3 billion of capital, which represents 18% of the firm's capital. Of that $6.5 billion, $3.9 billion is coming directly from OBX and residential whole loans. So about 60% of the portfolio is proprietary assets organically created. We think that's something that is pretty significant, difficult to replicate. When you think about the GAAP consolidated whole loan portfolio, it's $23.5 billion. So that doesn't show up in the economic market value of the portfolio.

But I think it's important to note because Onslow Bay is the sponsor of all those securitizations and ultimately we have the ability to call and re-lever those deals to the extent that that optionality exists. So very large residential whole loan portfolio that has been securitized. When you think about how this portfolio is actually financed, of that $2.3 billion in terms of your debt outstanding, we're using bilateral repo on the credit security side. Usually the tenor of the repo is called four to six months. So it is not necessarily short-term, but we'll call it something in the intermediate term.

Speaker 1:

[Building fire safety announcement].

Mike Fania:

Hopefully they add some time back for me. So we got a lot to go through. So in terms of the residential whole loan portfolio, we have a number of slides, we'll detail that, but that is financed through warehouse facilities and we have a very broad and diversified set of facilities. I think what you don't see within this slide, but that does show up in terms of a competitive advantage. Ken did a very good job in terms of talking about it, but it's also similar with the residential credit portfolio.

Speaker 1:

[Building fire safety announcement].

Mike Fania:

So when you think about this portfolio, it's levered 1.8x. So that's the debt-to-equity on this portfolio. If this was a standalone company, if it's a standalone hybrid REIT, you're probably maintaining, call it 2 to 2.5 turns of balance sheet leverage. So in the same example that Ken gave where we have the implicit advantage of using Agency financing, we also have that same advantage on the residential credit portfolio as well. The difference in cost of financing Agency, which we'll call SOFR plus 10 to 20 basis points versus funding residential credit securities probably 100 basis points.

It's pretty significant. So significant advantage. And the reason we're able to do that is because of our liquidity. As Dave mentioned, we have $4.7 billion of cash and unencumbered Agency MBS at the end of the quarter. So that's a key differentiator in terms of the three businesses and the diversified housing finance

model. So then let's talk about what is Onslow Bay Financial. So Onslow Bay Financial is a taxable REIT subsidiary. So this is where all our mortgage activities occur. This is where we have 50 first lien and...

Speaker 1:

[Building fire safety announcement].

Mike Fania:

I'll keep going, 50 first and second lien licenses. This is where all our mortgage activities occur. This is where we buy MSR, it sits in Onslow Bay Financial. When we buy residential whole loans before we securitize, it sits in Onslow Bay Financial. What I think is very important about this is that there's full alignment between Onslow Bay Financial and Annaly. It is wholly owned. If you think about a number of asset management companies that have bought originators, there's some inherent conflicts of interest unless they own that entire origination platform. If you only own a minority share, there's potentially conflicts between senior management of that originator relative to the asset manager. But I think what's important is that we have that full alignment.

In terms of the correspondent channel, we've put over $27 billion of locks through the correspondent, we funded close to $17 billion of loans, and we currently have 240 approved correspondents. Just as important as the volume is our ability to distribute the risk. So in terms of our securitizations, David mentioned this, we've done $30 billion in securitization since 2018. We've generated $3.8 billion of assets. That's a 13-14% retention ratio on our securitizations. I think the most important part about the correspondent is that we control every facet of it. We control who our origination partners are, our servicing partners, we control loss mitigation, the diligence firms. We control all aspects of the acquisition of these assets. But I think also what's very important is that we control the pricing. We're the ones setting the gain on sale margin. We're the ones that are setting those ROE targets. So from soup to nuts, you have the entire chain of asset acquisition, mortgage loan acquisition from the entirety.

Speaker 1:

[Building fire safety announcement].

Mike Fania:

Why is the correspondent important? If you look at the graphs here, effectively what you're seeing is, capital deployment over the last 3.5 years, it's been significant. So we've gone from $3.2 billion market value since the launch of the correspondent to $6.5 billion today. So over $3 billion of assets on our balance sheet. And it also represents 58% of the dedicated capital. So 60% of assets, 58% of dedicated capital.

But I think what's important is since the launch of the correspondent, we've gone through what I'll say is many cycles in terms of interest rates, in terms of credit spreads. So since the launch of this channel, we've had Fed Funds go from zero to 5.30%, to now, I think 4.58%, 4.59%. We've seen the 10-year trade in the range of 1.20% to 5%, and we've seen CDX, which is a reflection of high-yield spreads, corporate credit spreads, been anywhere from 270 to 625. Throughout all of that, we've had the ability to generate these assets, and we think without this channel it would have been very challenging to do so given how volatile the environment has been.

So very, very excited about where we stand today, but we have a number of key business initiatives. On the correspondent channel, everything that we do is fully delegated. So what that means is that we publish underwriting guidelines, we publish pricing, and it's up to the originator to underwrite that loan in accordance with our guidelines and deliver us that loan back best efforts. What we're effectively going to launch in the first half of this year is non-delegated platform.

Effectively what we are going to do, there's a number of small originators out there, they don't staff themselves with non-QM and DSCR underwriters. They may only get three or four leads per month. Right now, they may be brokering those loans. They'll broker them to a non-QM originator. We are going to help them underwrite the credit file. So that is a relationship that is very sticky because they need us from an operational perspective. So we're very bullish on the number of originators that are out there that need these non-delegated underwriting services.

That also coincides with the growth of the correspondent. Right now at 240 we think that there's 50 to 100 originators that are out there that are either doing non-del or they're fully delegated and they're not partners of ours. We have five full-time business development people, and they're very hard at work in terms of this.

The next one is just incremental originator tools. Anything that you can put out there to further ingratiate yourself with the origination community is very important. One is bank statements. We don't need to go through what it is, but effectively you're providing them a bank statement calculation. You're providing them a level of service that they're not able to get from our peers that puts them in our sphere and continues to do business with us.

The last is improved in terms of originator experience, so technology. A lot of these originators, they want to recycle their capital. They do not want to have loans on warehouse facilities. They don't want them on gestation facilities. It's very important the turn times and how quickly you can buy those loans. We've had a number of initiatives, whether it's enhancing our custody product, e-docs, electronic docs of the mortgage, and the title policy to help speed the gestation and the cycle time of those.

So from a balance sheet perspective, we're already positioned for growth. So you could look at the bottom part of this graph. Nine different warehouse providers. That's a pretty healthy number of providers, operationally that's very intensive, but there's a reason that we do that. We do it because we don't feel any of our providers have any leverage over us. We know where the market is. We can drive where the market is in terms of advanced rates, in terms of financing costs, if you had two to three warehouse providers, you would not have that position. So at the end of the quarter, we had $3.5 billion of warehouse capacity, $1.3 billion in terms of what's funded against it. So over $2 billion of excess capacity. We're running 36%, 37% utilization. So we have significant balance sheet to be able to grow this business. What also is important, we have closed-end seconds. David mentioned this. HELOCs, we have over $700 million of capacity. Non-mark to market, limited mark to market, $750 million of capacity as well. So very well positioned.

Where do we stand today? We can walk through some of these graphs. You can see the volumes. They're pretty significant in terms of how much correspondent locks and funded we've put through. I think what's important for everyone here to understand is that we are not gaining market share through price. We are gaining market share through what we think is best-in-class services, a white glove experience for our correspondents. One of the first things that we set out to do when we launched the correspondent is that we want to be flexible, we want to be commercial, we want to be easy to work with. And I think that has reaped dividends in terms of the origination experience.

Now, our pricing is competitive, but one thing that these originators get in the originator community, they also get certainty of execution. So they get Annaly, they get $12.4 billion of capital at the end of Q3. They feel very good when they lock a loan that ultimately what stands behind that. And there's been a lot of cycles, whether it was COVID, whether it was 2022 and rates rose pretty quickly, where aggregators and private equity entities that we compete with didn't necessarily behave in the same way. So when you look at these graphs, it's not price and we feel very, very confident about that.

But in terms of just the actual lock volumes. We did $4.4 billion in Q3, that's up over $2 billion year-over-year. It's up 83%. When we do fundings, we did $2.9 billion in Q3. That's up 140% year over year. If you look at the bottom left, in terms of the month of October, this was record volumes. We did $1.8 billion of locks, $1.4 billion of fundings. And normally October isn't the month at which you're setting records. So really what this shows you is that the maturation of the correspondent is still not necessarily at that final stage. We still think we're in growth mode. The month of November, we've already done $1 billion dollars of locks. So we've now had 12 consecutive months of $1 billion dollars plus in locks, expanded credit locks. The last chart, I think, to the right is also important because this shows the correspondents, 240 correspondents. If you look at some of the large Agency correspondents, they may have 600 to 800 correspondents. We're not necessarily looking to achieve that, but I think what this graph shows is that we've only added 70 correspondents over the last year. So there's a rigorous onboarding, there's a rigorous renewal process associated with being an approved Onslow Bay seller. We're not just out there casting this wide net and anyone who wants to do business with us can. So the growth in terms of the correspondent, our partners, it's been measured.

We have one more chart in terms of just the production and we'll look at Onslow Bay standing as a correspondent lender. This is through the first six months of the year. And I think what really jumps out on the page here is we are a top 10 correspondent lender. Over the first six months we did north of $5 billion. And when we talk about correspondent, these are true loan level locks. We're not talking about bulk and we put it through correspondent. It's true best efforts locks. I think what's important about this is that we're only focusing on 4% to 5% of the market. So if you think of the total mortgage market, it's $1.5 trillion to $1.75 trillion, non-QM and DSCR is 4% to 5% of that. So it's a $75-$85 billion market. Even with that context, you're still one of the largest platforms. What does that mean? It means that we have optionality to the

extent that we wanted to go into different areas of the market, we feel that we have the capabilities and the infrastructure to do that.

David made mention of securitization. If you look at the top, I think this is noteworthy in that, we are the largest issuer of expanded credit. We are the second largest issuer of expanded credit and prime jumbo, but we are the seventh largest issuer worldwide. So if you look at ABS and MBS combined, and this was a year to date, we are the seventh largest issuer. And of the six that are ahead of us, three really focus on auto loan securitization, which is a commoditized product. There's a lot of volume, standardized structures.

The last, I'll just talk about in terms of the growth of securitization. This is a little outdated. We've actually done 20 deals this year. We just priced our latest NQM17 yesterday. We've done 20 deals, $10.5 billion. We've been very prudent in terms of distributing this risk.

This shows how do we stack up relative to the peer set. We're telling you we're so large, we're doing all this volume. Over $11 billion of loans in the last 12 months. 85% of those loans are expanded credit loans. I think that's noteworthy, because again, there's a scarcity value to these assets. It's 4% to 5% of origination. If you think of a sector like prime jumbo, traditionally that's been 15% to 20% of the market. So not only are you doing more volume than the entire peer set, you're doing it in a product that is actually difficult to scale.

The chart to the right shows our actual securitization volume. This is important because we're not running a mortgage banking business. We're not buying these loans with the intent to sell them and get some onetime gain on sale. That is not in the scope of the business. When you think of what we're securitizing, non-QM and DSCR, you're generating assets that are three to four year weighted average life assets. They are on your balance sheet for three to four years, you're going to earn mid-teen returns. If you were to buy prime jumbo loans and express and wanted a 15% return, the amount of capital that you're deploying, it's 2% to 3%. So within non-QM and DSCR, the same return per each $100 of loans, you're deploying three to four times more capital than you would if you expressed this through a prime jumbo strategy.

The other one is residential transition loans. This is an area of the market that we haven't necessarily been active in. We've done a lot of work in it, but I'll say the same thing in terms of, those assets are six to 12 month weighted average life assets. So they pay off very quickly. The amount of recycling of that capital, trying to build that on your balance sheet is challenging. We'd much rather have assets that we have for the next three to four years. So sustainability of non-QM and DSCR, we think, is very important and very, very powerful.

So what are some of the key differentiated advantages that we have? The first slide here, we don't need to walk through it in too much of granular detail, but when anyone tells you they're earning 15%, you should make sure that you understand how you're getting to 15%. Very high level, we're buying loans call it 315 to 320 over SOFR swaps. That's an unleveraged spread. We're going to the securitization market, we're getting 88% advance. So that's seven turns of structural leverage that you're getting against your whole loan portfolio. The cost of funds is 155 to 160 basis points. So we're earning 160 basis points of NIM and seven turns of structural leverage at the inception of the securitization when we come to market. So that gives you an unleveraged spread of 900 over. From there, we use a modest amount of recourse leverage, less than one turn of balance sheet leverage, in this example it's 0.7x, and you're deploying 8 cents of capital per each dollar. So $13, $14 of asset generation and then $8 of capital deployment. And that gets you to those mid-teens.

Why is that important? You look at the next slide. This is really the investible market across residential credit. One of the first things I'll say is that if you think of where corporate credit spreads are. Everyone knows that corporate credit spread, it's easy to source, it's easy to track. Corporate credit spreads are at the tightest levels they've been in the past 25 years. You'd have to go back to 1997, 1998, to an environment to where corporate credit spreads have sit post-election. They've widened out a little bit, but very tight. That has bled into structured finance. That has also bled into residential credit.

So when you look across the menu of options, what can we actually invest in as a levered credit investor? The market itself does not look that appealing. The majority of assets are 10% area or inside. Every asset that's listed here uses more recourse and balance sheet leverage than what we're producing. I'd also make mention of if you look at the gross issuance. That's total issuance, so that includes senior bonds. The actual amount of sub bonds that you'd be able to invest, it's 5-20% of the UPB that's here. So if you're a levered credit investor, high cost of capital, very challenging without an asset generation platform to be able to compete within this market.

Another key differentiated advantage, and David mentioned this as well, is our performance. Volume in and of itself is not a goal. There's not a single person within our firm that's paid on volume. It's a little challenging when you have salespeople to try to incentivize them when you can't pay them on volume, but we deal with that I guess. However, when you look at what we're ultimately producing, we're buying the right loans as well. We're not just out there buying everything and leading with price. You're buying a pretty tight credit box.

But when you look across our performance, we think it's industry leading. In terms of the top 10 non-QM / DSCR providers, you have the lowest delinquencies. If you look across all issuers that have $1 billion dollars of outstanding issuance, non-QM and DSCR, there's only two issuers that have lower delinquencies than us. When you look at what actual they've issued, it's a very nominal amount, but I think it's pretty powerful in terms of you're controlling all the asset acquisition. You have asset management sitting on top of this. We have a satellite office in Dallas, 35, 40 people, a number of them are focused on loss mitigation. So it's not just the credit strategy on the front end, it's also the back end as well. With that $30 billion that we've securitized, we've only taken $1 million dollars of realized losses. Of that $1 million, about $750,000 is actually deferrals. Deferrals is where there was a forbearance. You're actually giving somebody a deferral, you add it to the end of the loan, the borrower still owes that. So we actually think that that number could come down. Now these losses will go higher, but ultimately we've outperformed our initial model expectations, and I think that's what's important and that's what this is trying to show.

What does it mean in terms of how the market actually values us? What is the brand recognition that we get as OBX, as Onslow Bay Financial? And I think this slide really tries to show that. We've had 175 investors participate in our deals. Haven't seen many other people publish the number of investors that they have so I have nothing to compare it to, but I will say that there's a number of insurance companies, there's a number of asset managers who participate in our deals who do not participate in other shelves. They'll tell us that. Or if they're opening up non-QM for the first time, we are one of the first issuers that they're doing it with. Don't know where we stand, but I think we feel pretty good that we have a very deep sponsorship of our securitization.

To show you the brand recognition, we actually picked a time. The third week of October there was four non-QM deals out in the market. There was three deals plus our deal. When all was said and done and we priced those transactions, our deal priced 6 to 26 basis points tighter from a spread perspective relative to our peers. So if you took the midpoint of that and say on average we transact 15 basis points tighter, two year spread duration, that's 30 basis points in price. We are executing better than the company that's right across the street from us. Buying that same loan, going through the Onslow Bay name, our brand recognition, we're executing better.

What does that mean? You could do two different things. One, you could push that volume through, you can increase our pricing. So I can give a better price to our origination community than the guy next to me and still get the same ROEs, or you're creating value for shareholders. So of the $8.2 billion of non-QM that we did this year, that 30 basis points is $25 million in actual value that we think we've created with the brand itself.

What are the takeaways? In terms of the portfolio, we think it's very well positioned. Hard to replicate. You need an asset generation tool. We feel very good in terms of what we've put forth. Correspondent channel, unique advantages. So not only are we doing this volume, we control every aspect of loan acquisition to asset management and all our associated partners as well. Capital markets presence, we just walked through the example. So we are executing better than our peers for that same loan. So inherently strong competitive advantage there.

And then lastly is just we think we're maybe 75-80% of the way there in terms of the full maturation of the correspondent. So that's why you continue to see those growth in even non-seasonal months. We feel there's a lot of bandwidth, we feel very well positioned. David's mandate of increasing our Resi Credit to 30%, we have a lot of resources, and we think we're as well positioned as you could be heading into 2025.

With that, we're going to take a short five to 10 minute break and the next panel will be risk and liquidity management.