

Mortgage REIT IPOs: Real Estate Dislocation Offers Opportunities

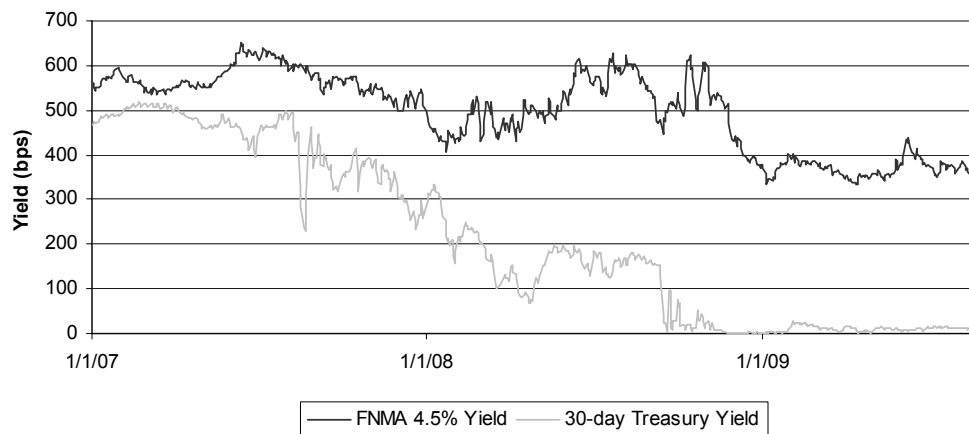
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Wall Street is justifiably adept at figuring out how to make money from the many messes that Wall Street creates. The current onslaught of newly formed REIT IPOs planning to buy distressed residential and commercial mortgage-backed securities (MBS) and whole loans is the latest manifestation of the financial industry's adaptability.

This year, four mortgage REITs have raised \$1.4 billion, with another sixteen queued up in the pipeline that could raise nearly \$6 billion more. Starwood Property (STWD), run by respected, opportunistic commercial real estate investor Barry Sternlicht, was the largest, raising over \$800 million after increasing its deal size twice. The other three, residential-focused Cypress Sharpridge (CYS), Invesco Mortgage Capital (IVR) and PennyMac Mortgage (PMT) raised more modest amounts. In addition, several publicly traded mortgage REITs have completed secondary offerings in the last several months, raising \$2.3 billion in total.

While these REITs have different focuses and strategies, the golden premise is that with capital in short supply and many parties ranging from troubled financial institutions to the FDIC looking to dump real estate holdings, these REITs can buy mortgages and securitized instruments at steep discounts and achieve double-digit returns. Even if more loans than expected turn out to be non-performing, the high yields on the performing mortgages offer a substantial cushion. In addition, these firms can take advantage of 1) historically low short-term borrowing rates (see chart below) and 2) government financing under the TALF and PPIP programs, by leveraging their portfolios and magnifying their strategies over a larger asset base. While it is unclear how long this window of opportunity will last, the managers are uniformly making the case that it will be long enough to sustain strong ROEs (in some cases north of 20%) for an extended period of time.

Mortgage-backed securities currently offer attractive spreads over borrowing costs

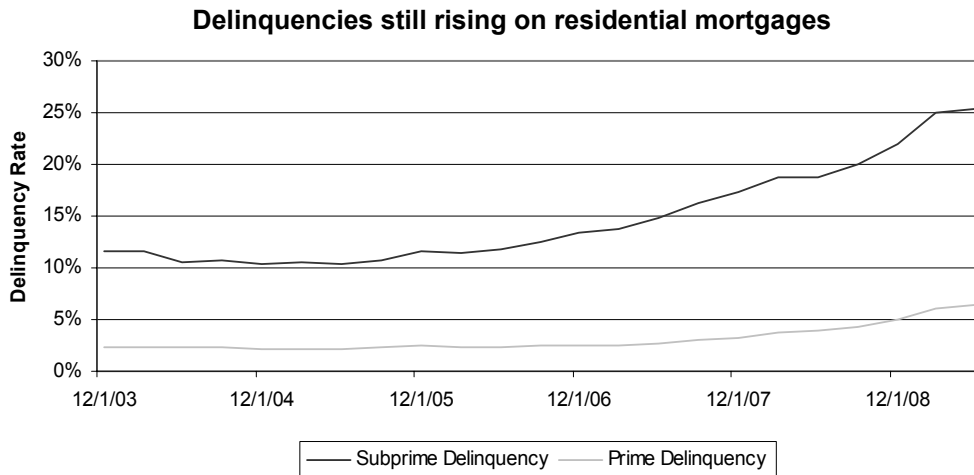


Source: Bloomberg

Residential Market: Stabilizing home values and wide spreads on Agency securities

Three of this year's mortgage REIT IPOs are focused on the residential market, as are six of the deals in the pipeline. One of their implicit assumptions is that the housing market is bottoming, which is to some extent supported up the 7.2% uptick in July existing home sales as well as sequential gains for the S&P/Case Shiller home price indices in May and June, the first since mid 2006. However, we are entering a period in which Alt-A and option ARMs are about to be reset off teaser rates. Delinquencies are rising (see chart below) and an alarming number of owners with high Loan-to-Value ratios are opting for strategic defaults, which according to one estimate accounted for 26% of US defaults at mid year. Some of the residential-focused REITs, such as Cypress Sharpridge, skirt these issues by sticking to Agency-backed MBS (i.e. by Ginnie/Fannie/Freddie) and using 6-10x leverage to boost their yields. While this lets them avoid exposure to credit risk, it makes them dependent on the Fed keeping short-term borrowing rates near zero indefinitely. The other major risk of the Agency MBS strategy is that government reform of Fannie and Freddie may cause a significant rise in prepayments, curbing the yields earned by these vehicles.

There are only two Agency-focused REITs in the IPO pipeline, one of which, Madison Square, failed in its attempt to raise \$200 million in February 2009. The other pending residential REITs are focusing instead on non-Agency MBS or whole loans, both of which require monitoring of home values and credit risk. While these companies target returns in the mid-teens, their results will be dependent on keeping losses low despite rising delinquencies. We highlight these firms in our REIT pipeline table at the end of this report.



Source: Mortgage Bankers Association, Bloomberg

Commercial Market: Still uncertain, but the need for capital offers a significant opportunity

Unlike in the residential market, there have been few signs of stability in the commercial market. At the end of the first quarter, 2.3% of the \$1.1 trillion of commercial mortgages held by US banks were in default. Real Estate Econometrics forecasts a rise in the default rate to 4.1% by year-end and 5.3% in 2011, when the loans (typically five years) issued in 2006 come due. By comparison, the highest previous default rate in the last two decades was 4.6% during the S&L crisis in 1992. However, the sheer size of the opportunity and limited refinancing options has caught the eye of Starwood Property as well as eight of the companies in the pipeline, which are listed at the end of this report.

While some of the commercial-focused REITs are sticking to the diversification of commercial MBS, others are looking to zero in on specific opportunities by refinancing or originating existing loans, or by purchasing loans from ailing financial institutions or the FDIC at steep discounts. Despite the arguments for this strategy, with vacancy rates increasing and property values falling, there is no certainty that it will work and the spectrum of possibilities is wide. One unfortunate recent event in the commercial real estate market was the decision by CalPERS to walk away from the Koin Center in Portland, OR, leaving New York Life holding the bag for a \$70 million mortgage. The property was purchased for \$109 million at the top of the market in 2007 and given that Portland has been hit less hard than many other markets, the news gives some indication of how rough the commercial market could still be.

Recent IPOs mostly trading water as investors wait for results

So far, the results for the four IPOs priced in 2009 are mixed. Only Cypress Sharpridge has performed particularly well (up 27%) because, in contrast to the other newly formed REITs, its existing portfolio allowed the IPO to be priced at a substantial discount to book value. The others have traded water, trading at slight premiums to book value (see table) as investors wait for more information on initial results and dividend levels.

Mortgage REIT IPOs (YTD)

Company	Strategy	Incentive Fee*	Offer Date	Proceeds*	Price/book	Est. 2010 Yield†	Stock Performance
Cypress Sharpridge (CYS)	Agency RMBS	none	6/11	\$100	1.10x	19.1%	27%
Invesco Mortgage (IVR)	Non-Agency RMBS	none	6/25	\$170	1.03x	15.9%	1%
PennyMac Mortgage (PMT)	Residential Loans	20% over 8%	7/29	\$320	1.05x	14.1%	-3%
Starwood Property (STWD)	Commercial Loans	20% over 8%**	8/11	\$810	1.08x	11.0%	0%

*Proceeds in millions. Incentive fees are based on profits above the stated hurdle rate. **Half paid in stock.

†IVR, PMT and STWD yields do not assume TALF or PPIP financing.

Source: Renaissance Capital

Despite uncertain real estate outlook, upcoming IPOs offer opportunities

It is a fact of life in the IPO market that the early IPOs in a particular sector do well and performance then declines as quality standards begin to fall and investor demand wanes. That said, investors are clearly differentiating between different strategies and different managers, and so the most attractive deals will continue to be those with very experienced managers, a lack of high cash incentive fees, and competitive dividend yields. We currently have an outperform rating on Starwood Property, which we believe will be a strong performer thanks to the experience of its management team, whose similar funds have performed well over the past decade, and which has an early edge on the commercial-focused firms yet to raise money. Of the sixteen IPOs in the pipeline, we would highlight Apollo Commercial Real Estate (ARI) and CreXus Investment (CXS), both backed by experienced investors (Apollo and Annaly, respectively) and planning to pay no incentive fees. Also worthy of mention is Ellington Financial (EFC), the only company in the pipeline with an existing portfolio that gives IPO investors wiggle room on the valuation (similar to Cypress Sharpridge, the best performing of this year's REITs).

For an IPO investor, investing in these IPOs is a question of timing and risk tolerance. At the low-risk end of the spectrum, the Agency REITs avoid credit risk by investing in government-backed securities; however, their impressive returns are contingent on record low short-term borrowing rates and their strategy is unlikely to sustain these returns in the long term. Other residential mortgage REITs in the pipeline may have already missed the boat, with home prices stabilizing and RMBS values appreciating, but canny management could still yield impressive results if these companies negotiate the risks posed by rising delinquencies. The companies with the most uncertainty are those with a commercial focus, as this market is still far from a recovery and it is unclear how much worse it will get. However, these firms have the highest potential rewards because of the basic supply/demand picture, as long as they can navigate through the current period of falling values, rising vacancies and uncertain cash flows.

While the risk of many new entrants is likely to squeeze returns for any of these strategies, investors should be able to reap rewards from the mortgage REIT fad as long as they are selective on managers and strategies and can successfully time real estate market trends.

Mortgage REIT Pipeline

Company (Proposed Ticker)	File Date	Strategy	Manager	Estimated Proceeds*	Incentive Fee*
Residential					
Ellington Financial (EFC)	7/14/09	Non-Agency RMBS	Ellington Management	\$200	25% over 9%
Western Asset Mortgage (WMC)	6/12/09	Non-Agency RMBS	Legg Mason	\$500	unstated
Sutherland Asset Mgmt. (SLD)	5/21/09	Non-Agency RMBS	Waterfall/MD Sass	\$250	none
MFResidential (MFR)	2/12/08	Non-Agency RMBS	MFA Financial	\$250	none
Madison Square Capital (MDQ)	4/25/08	Agency RMBS	Highland Financial	\$200	none
Point Asset Management (PNT)	2/29/08	Agency RMBS	Federated Investors	\$250	none
Commercial					
Ladder Capital Realty (LCG)	7/17/09	Commercial Loans	TowerBrook/GI Partners	\$400	20% over 8%
Colony Financial (CLNY)	6/30/09	Commercial Loans	Colony Capital	\$500	20% over 8%
Petra Real Estate	6/4/08	Commercial Loans	Petra Capital	\$200	20% over 2.4%
CWCapital Realty (CWR)	8/15/08	CMBS	CW Financial Services	\$250	unstated
Transwestern Realty	7/29/09	CMBS/Commercial Loans	Transwestern	\$500	20% over 8%
Apollo Commercial (ARI)	7/10/09	CMBS/Commercial Loans	Apollo	\$600	none
CreXus Investment (CXS)	6/26/09	CMBS/Commercial Loans	Annaly	\$500	none
Residential/Commercial					
AG Financial (AGFI)	7/13/09	RMBS/CMBS	Angelo, Gordon	\$300	unstated
Bayview Mortgage (BAY)	7/28/09	RMBS/CMBS/Loans	Bayview/Blackstone	\$500	20% over 8%
Foursquare Capital	7/9/09	RMBS/CMBS/Loans	AllianceBernstein	\$500	unstated

*Proceeds in millions. Incentive fees are based on profits above the stated hurdle rate.

Source: Renaissance Capital

About Renaissance Capital

Renaissance Capital LLC, founded in Greenwich, Connecticut in 1991, is the global leader in IPO research. Its clients represent the "Who's Who" list of the largest and most active institutional IPO investors. In addition to IPO research, Renaissance Capital, in conjunction with its index partner FTSE Group, maintains the FTSE Renaissance IPO Composite Index, the definitive benchmark of IPO activity and performance, and it manages the IPO Plus Fund, the first mutual fund to focus solely on investing in IPOs.

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