National Mortgage News

EARNINGS

How REITs have been bearing up under pressure

Volatility in the mortgage market has challenged real estate investment trusts, but so far this earnings season, the sector hasn't been weakened the way it was early in the pandemic.

"Going back to the first quarter of 2020, no matter what your strategy was, the financing market was locked up and there were margin calls coming left and right. It was a liquidity problem. This is interest rate driven, and it is affecting each company differently," David Freed, a partner in Mayer Brown's office and a member of its capital markets practice.

REITs have a range of positions in the mortgage market; and some investors believe they could be bought at a discount now, potentially gaining value later when interest rate stability returns.

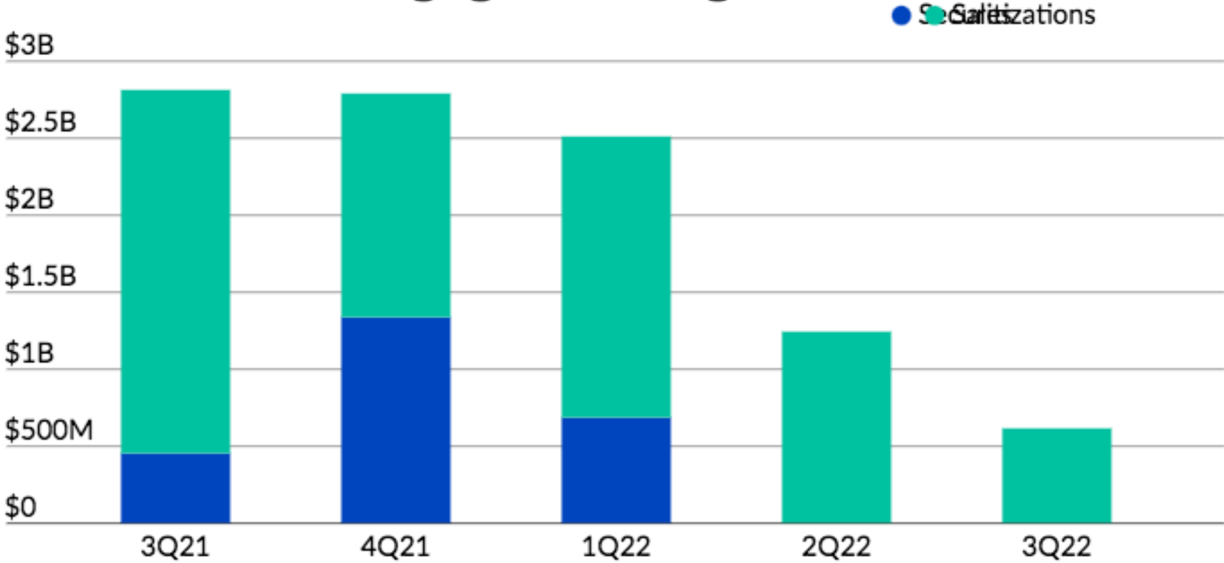
"With the recent rise in interest rates and mortgage rates, the mortgage REITs have indirectly been the beneficial recipients as earnings results in the mortgage REIT sector have been 'significantly' better than expected despite the bad quarter for the lending markets," said David Auerbach, managing director of Armada ETF Advisors, in an email. "The companies that focus on floating-rate lending have reported better results. In comparison, the book value declines have been more steep for the companies that focus on agency debt."

But rate uncertainty bedevils all REITs to some degree.

"You're going to continue to see a lot of volatility and it's going to negatively impact the REITs," said Nick Smith, managing partner and CEO of Rice Park Capital Management, a private investment firm. "REITs are very levered

businesses. They own securities. They use a lot of leverage to purchase those securities and the cost of that financing is also pegged directly to interest rates. So, as interest rates have gone up that financing has become more expensive and has put some pressure on their income generating ability."

They're under pressure to diversify away from consumer home lending as a result.



Redwood Trust, for example, has been backing off consumer residential mortgage banking and continued to do so in the third quarter after recording a loss of $50 million or $0.44 per share. That improved upon a loss of $100 million in the second quarter but was down from $88 million in net income [a year ago.] Its adjusted EPS of $0.16 per share beat Zacks' consensus estimate for a loss of $0.03 per share. The company recorded just $600 million in sales through its Sequoia residential mortgage banking unit during the third quarter, down from nearly $1.24 billion in the second, and more than $2.36 billion a year ago.

REITs may be invested in the large government-related securitized market, and/or the private one. They tend to be more of a big fish in the latter because it's a small pond, so their challenges could have an amplified effect there.

Redwood, for example, has been a key securitizer of non-agency mortgages, but while it's engaged in other types of securitizations, hasn't engaged in a consumer transaction of this type for the past two quarters, contributing to a slowing in the latter market.

"We were successful during the third quarter in distributing [business purpose loans] through both securitization and whole loan sales," noted Redwood President Dashiell Robinson, during the company's earnings call. "Our team completed a $274 million private [single-family rental securitization] with a large global institutional buyer at the end of the quarter, and we sold $85 million of loans, including SFR loans to an existing institutional buyer and single asset bridge loans produced by Riverbend to a handful of whole loan partners."

However, Redwood executives noted during the call that they do see one recent development as possibly revitalizing the private mortgage market to some degree: the Federal Housing Finance Agency's less advantageous pricing for cash-out refinances could push some into the non-agency space to the extent consumer demand persists.

"FHFA's announcement....to reduce fees for certain mission-driven loans ultimately represents a tailwind for private capital, as markets normalize, given the expectation that [guarantee] fees will rise for other parts of the GSE footprint, within which issuers like ourselves have historically been competitive," Robinson said.

Ultimately, though, what happens with mortgage REITs will depend a lot on the Fed and the fate of the larger housing finance market.

"Note that most Wall Street pundits are expecting a 75 basis point interest rate hike this week followed by another 50 basis point interest rate increase at the December meeting. The cards are not off the table yet with further rate increases as we move into 1Q of 2023," Auerbach said.