

CAPSTEAD MORTGAGE CORP
Form 10-Q
July 30, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: June 30, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number: 001-08896

CAPSTEAD MORTGAGE CORPORATION

(Exact name of Registrant as specified in its Charter)

Maryland

(State or other jurisdiction of

incorporation or organization)

8401 North Central Expressway, Suite 800, Dallas, TX

(Address of principal executive offices)

(214) 874-2323

75-2027937

(I.R.S.

Employer

Identification

No.)

75225-4404

(Zip Code)

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

Common Stock (\$0.01 par value) 92,503,016 as of July 30, 2018

CAPSTEAD MORTGAGE CORPORATION
FORM 10-Q
FOR THE QUARTER ENDED JUNE 30, 2018

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ITEM 1. FINANCIAL STATEMENTS

PART I. — FINANCIAL INFORMATION

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except pledged and per share amounts)

	June 30, 2018 (unaudited)	December 31, 2017
Assets		
Residential mortgage investments (\$12.58 and \$12.98 billion pledged at June 30, 2018 and December 31, 2017, respectively)	\$ 13,017,107	\$ 13,454,098
Cash collateral receivable from interest rate swap counterparties	33,630	42,506
Cash and cash equivalents	57,403	103,907
Receivables and other assets	148,215	132,938
	\$ 13,256,355	\$ 13,733,449
Liabilities		
Secured borrowings	\$ 11,936,869	\$ 12,331,060
Interest rate swap agreements at fair value	16,161	23,772
Unsecured borrowings	98,241	98,191
Common stock dividend payable	13,232	18,487
Accounts payable and accrued expenses	22,996	23,063
	12,087,499	12,494,573
Stockholders' equity		
Preferred stock - \$0.10 par value; 100,000 shares authorized: 7.50% Cumulative Redeemable Preferred Stock, Series E, 10,329 shares issued and outstanding (\$258,226 aggregate liquidation preference) at June 30, 2018 and December 31, 2017	250,946	250,946
Common stock - \$0.01 par value; 250,000 shares authorized: 92,446 and 95,698 shares issued and outstanding at June 30, 2018 and December 31, 2017, respectively	924	957
Paid-in capital	1,237,812	1,271,425
Accumulated deficit	(346,570)	(346,570)
Accumulated other comprehensive income	25,744	62,118
	1,168,856	1,238,876
	\$ 13,256,355	\$ 13,733,449

See accompanying notes to consolidated financial statements.

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CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

(unaudited)

	Quarter Ended		Six Months Ended	
	June 30		June 30	
	2018	2017	2018	2017
Interest income:				
Residential mortgage investments	\$65,202	\$56,103	\$134,340	\$110,944
Other	305	238	713	391
	65,507	56,341	135,053	111,335
Interest expense:				
Secured borrowings	(48,241)	(33,850)	(93,262)	(62,090)
Unsecured borrowings	(1,900)	(1,900)	(3,791)	(3,791)
	(50,141)	(35,750)	(97,053)	(65,881)
	15,366	20,591	38,000	45,454
Other revenue (expense):				
Compensation-related expense	(1,560)	(1,833)	(3,608)	(2,948)
Other general and administrative expense	(899)	(1,276)	(2,136)	(2,338)
Miscellaneous other revenue	81	67	152	82
	(2,378)	(3,042)	(5,592)	(5,204)
Net income	\$12,988	\$17,549	\$32,408	\$40,250
Net income available to common stockholders:				
Net income	\$12,988	\$17,549	\$32,408	\$40,250
Less preferred stock dividends	(4,842)	(4,018)	(9,684)	(7,882)
	\$8,146	\$13,531	\$22,724	\$32,368
Net income per common share:				
Basic and diluted	\$0.09	\$0.14	\$0.24	\$0.34
Weighted average common shares outstanding:				
Basic	92,001	95,756	92,709	95,755
Diluted	92,121	95,916	92,810	95,895
Cash dividends declared per share:				
Common	\$0.14	\$0.21	\$0.30	\$0.42
Series E preferred	0.47	0.47	0.94	0.94

See accompanying notes to consolidated financial statements.

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CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands, unaudited)

	Quarter Ended		Six Months Ended	
	June 30		June 30	
	2018	2017	2018	2017
Net income	\$12,988	\$17,549	\$32,408	\$40,250
Other comprehensive (loss) income				
Amounts related to available-for-sale securities:				
Change in net unrealized gains (losses)	(16,512)	(11,420)	(60,565)	(7,424)
Amounts related to cash flow hedges:				
Change in net unrealized gains (losses)	7,873	(6,487)	38,805	1,609
Reclassification adjustment for amounts				
included in net income	(9,971)	(655)	(14,614)	1,006
Comprehensive (loss) income	\$(5,622)	\$(1,013)	\$(3,966)	\$35,441

See accompanying notes to consolidated financial statements.

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, unaudited)

	Six Months Ended June 30	
	2018	2017
Operating activities:		
Net income	\$32,408	\$40,250
Noncash items:		
Amortization of investment premiums	55,939	64,046
Amortization of equity-based awards	842	1,274
Other depreciation and amortization	53	59
Change in recorded measureable hedge ineffectiveness on		
interest rate swap agreements designated as cash flow hedges	–	899
Net change in receivables, other assets, accounts payable and		
accrued expenses	(6,082)	1,716
Net cash provided by operating activities	83,160	108,244
Investing activities:		
Purchases of residential mortgage investments	(1,415,579)	(2,275,907)
Interest receivable acquired with the purchase of residential		
mortgage investments	(2,704)	(3,613)
Principal collections on residential mortgage investments,		
including changes in mortgage securities principal remittance		
receivable	1,721,856	1,913,662
Net cash provided by (used in) investing activities	303,573	(365,858)
Financing activities:		
Proceeds from repurchase arrangements and similar		
borrowings	96,246,580	75,996,185
Principal payments on repurchase arrangements and similar		
borrowings	(96,640,768)	(75,687,347)
Increase (decrease) in cash collateral receivable from interest rate		
swap counterparties	8,876	(17,858)
Net proceeds from interest rate swap settlements	24,222	9,775
Proceeds from issuance of preferred shares	–	9,845
Common stock repurchases	(29,472)	–
Other capital stock transactions	(72)	(261)
Dividends paid	(42,603)	(50,231)

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Net cash (used in) provided by financing activities	(433,237)	260,108
Net change in cash and cash equivalents	(46,504)	2,494
Cash and cash equivalents at beginning of period	103,907		56,732
Cash and cash equivalents at end of period	\$57,403		\$59,226

See accompanying notes to consolidated financial statements.

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CAPSTEAD MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2018

(unaudited)

NOTE 1 — BUSINESS

Capstead Mortgage Corporation operates as a self-managed real estate investment trust for federal income tax purposes (a “REIT”) and is based in Dallas, Texas. Unless the context otherwise indicates, Capstead Mortgage Corporation, together with its subsidiaries, is referred to as “Capstead” or the “Company.” Capstead earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of adjustable-rate mortgage (“ARM”) securities issued and guaranteed by government-sponsored enterprises, either Fannie Mae, Freddie Mac, or by an agency of the federal government, Ginnie Mae. Residential mortgage pass-through securities guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae are referred to as “Agency Securities” and are considered to have limited, if any, credit risk.

NOTE 2 — BASIS OF PRESENTATION

Interim Financial Reporting

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter and six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2018. For further information refer to the audited consolidated financial statements and footnotes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2017.

Recent Accounting Pronouncements

In November 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update No. 2016-18, Statement of Cash Flows: Restricted Cash (“ASU 2016-18”) which clarifies how entities should present restricted cash and restricted cash equivalents in the statement of cash flows. ASU 2016-18 is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The Company adopted ASU 2016-18 on January 1, 2018, which had no effect on the Company’s results of operations, financial condition or cash flows.

In May 2017, the FASB issued Accounting Standards Update No. 2017-09, Compensation-Stock Compensation: Scope of Modification Accounting (“ASU 2017-09”) which allows companies to make certain changes to stock awards without accounting for them as modifications. It does not change the accounting for modifications. ASU 2017-09 is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The Company adopted ASU 2017-09 on January 1, 2018, which had no effect on the Company’s results of operations,

financial condition or cash flows.

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NOTE 3 — NET INCOME PER COMMON SHARE

Basic net income per common share is computed by dividing net income, after deducting dividends paid or accrued on preferred stock and allocating earnings to equity awards deemed to be participating securities pursuant to the two-class method, by the average number of shares of common stock outstanding, calculated excluding unvested stock awards. Participating securities include unvested equity awards that contain non-forfeitable rights to dividends prior to vesting.

Diluted net income per common share is computed by dividing the numerator used to compute basic net income per common share by the denominator used to compute basic net income per common share, further adjusted for the dilutive effect, if any, of equity awards and shares of preferred stock when and if convertible into shares of common stock. Shares of the Company's 7.50% Series E Cumulative Redeemable Preferred Stock are contingently convertible into shares of common stock only upon the occurrence of a change in control and therefore are not considered dilutive securities absent such an occurrence. Any unvested equity awards that are deemed participating securities are included in the calculation of diluted net income per common share, if dilutive, under either the two-class method or the treasury stock method, depending upon which method produces the more dilutive result. Components of the computation of basic and diluted net income per common share were as follows for the indicated periods (dollars in thousands, except per share amounts):

	Quarter Ended		Six Months Ended	
	June 30		June 30	
	2018	2017	2018	2017
Basic net income per common share				
Numerator for basic net income per common share:				
Net income	\$12,988	\$17,549	\$32,408	\$40,250
Preferred stock dividends	(4,842)	(4,018)	(9,684)	(7,882)
Earnings participation of unvested equity awards	(28)	(40)	(60)	(80)
	\$8,118	\$13,491	\$22,664	\$32,288
Denominator for basic net income per common share:				
Average number of shares of common stock outstanding	92,447	96,063	93,153	96,062
Average unvested stock awards outstanding	(446)	(307)	(444)	(307)
	92,001	95,756	92,709	95,755
	\$0.09	\$0.14	\$0.24	\$0.34
Diluted net income per common share				
Numerator for diluted net income per common share:				
Numerator for basic net income per common share	\$8,118	\$13,491	\$22,664	\$32,288
Denominator for diluted net income per common share:				
Denominator for basic net income per common share	92,001	95,756	92,709	95,755
Net effect of dilutive equity awards	120	160	101	140
	92,121	95,916	92,810	95,895
	\$0.09	\$0.14	\$0.24	\$0.34

NOTE 4 — RESIDENTIAL mortgage investments

Residential mortgage investments classified by collateral type and interest rate characteristics as of the indicated dates were as follows (dollars in thousands):

	Unpaid			Carrying	Net	Average	
	Principal	Investment	Amortized	Amount ^(a)	WAC	Yield ^(c)	
	Balance	Premiums	Cost Basis		^(b)		
June 30, 2018							
Agency Securities:							
Fannie Mae/Freddie Mac:							
Fixed-rate	\$ 189	\$ 1	\$ 190	\$ 190	6.50 %	6.21	%
ARMs	9,762,776	295,010	10,057,786	10,053,674	3.15	1.98	
Ginnie Mae ARMs	2,892,545	79,082	2,971,627	2,960,418	3.02	2.06	
	12,655,510	374,093	13,029,603	13,014,282	3.12	2.00	
Residential mortgage loans:							
Fixed-rate	600	1	601	601	6.77	5.44	
ARMs	1,101	7	1,108	1,108	4.04	3.52	
	1,701	8	1,709	1,709	5.00	4.19	
Collateral for structured							
financings	1,098	18	1,116	1,116	8.24	7.43	
	\$ 12,658,309	\$ 374,119	\$ 13,032,428	\$ 13,017,107	3.12	2.00	
December 31, 2017							
Agency Securities:							
Fannie Mae/Freddie Mac:							
Fixed-rate	\$ 265	\$ 1	\$ 266	\$ 266	6.51 %	6.22	%
ARMs	10,216,099	313,547	10,529,646	10,578,364	2.97	1.93	
Ginnie Mae ARMs	2,791,340	84,297	2,875,637	2,872,163	2.78	1.83	
	13,007,704	397,845	13,405,549	13,450,793	2.93	1.91	
Residential mortgage loans:							
Fixed-rate	645	1	646	646	6.74	5.32	
ARMs	1,211	7	1,218	1,218	4.04	3.19	
	1,856	8	1,864	1,864	4.98	3.91	
Collateral for structured							
financings	1,418	23	1,441	1,441	7.94	7.67	
	\$ 13,010,978	\$ 397,876	\$ 13,408,854	\$ 13,454,098	2.93	1.91	

(a) Includes unrealized gains and losses for residential mortgage investments classified as available-for-sale.

(b) Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments net of servicing and other fees as of the indicated balance sheet date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the mortgage loans underlying these investments.

(c) Average yield is presented for the quarter then ended and is based on the cash component of interest income expressed as a percentage calculated on an annualized basis on average amortized cost basis (the “cash yield”) less the effects of amortizing investment premiums. Investment premium amortization is determined using the interest method and incorporates actual and anticipated future mortgage prepayments.

Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest is guaranteed by Fannie Mae and Freddie Mac, which are federally chartered corporations, or Ginnie Mae, which is an agency of the federal government. Residential mortgage loans held by Capstead were originated prior to 1995 when the Company operated a mortgage conduit and the related credit risk is borne by the Company. Collateral for structured financings consists of private residential mortgage securities that are backed by loans obtained through this mortgage conduit and are pledged to secure repayment of related structured financings. Credit risk for these securities is borne by

the related bondholders. The maturity of Residential mortgage investments is directly affected by prepayments of principal on the underlying mortgage loans. Consequently, actual maturities will be significantly shorter than the portfolio's weighted average contractual maturity of 288 months.

Fixed-rate investments consist of residential mortgage loans and Agency Securities backed by residential mortgage loans with fixed rates of interest. ARMs are adjustable-rate Agency Securities backed by residential mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. After the initial fixed-rate period, if applicable, mortgage loans underlying ARM securities typically either (i) adjust annually based on specified margins over the one-year London interbank offered rate ("LIBOR") or the one-year Constant Maturity U.S. Treasury Note Rate ("CMT"), (ii) adjust semiannually based on specified margins over six-month LIBOR, or (iii) adjust monthly based on specified margins over indices such as one-month LIBOR, the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index, usually subject to periodic and lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans.

Capstead classifies its ARM investments based on average number of months until coupon reset ("months to roll"). Months to roll is an indicator of asset duration which is a measure of market price sensitivity to interest rate movements. A shorter duration generally indicates less interest rate risk. Current-reset ARM investments have months to roll of less than 18 months while longer-to-reset ARM investments have months to roll of 18 months or greater. As of June 30, 2018, the average months to roll for the Company's \$6.91 billion (amortized cost basis) in current-reset ARM investments was 6.4 months while the average months to roll for the Company's \$6.12 billion (amortized cost basis) in longer-to-reset ARM investments was 42.6 months.

NOTE 5 — SECURED borrowings

Capstead pledges its Residential mortgage investments as collateral for secured borrowings primarily in the form of repurchase arrangements with commercial banks and other financial institutions (collectively referred to as "counterparties" or "lending counterparties"). Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date and are accounted for as financings. The Company maintains the beneficial interest in the specific securities pledged during the term of each repurchase arrangement and receives the related principal and interest payments.

The terms and conditions of secured borrowings are negotiated on a transaction-by-transaction basis when each such borrowing is initiated or renewed. The amount borrowed is generally equal to the fair value of the securities pledged, as determined by the lending counterparty, less an agreed-upon discount, referred to as a "haircut." Interest rates are generally fixed based on prevailing rates corresponding to the terms of the borrowings. Interest may be paid monthly or at the termination of a borrowing at which time the

Company may enter into a new borrowing at prevailing haircuts and rates with the same lending counterparty or repay that counterparty and negotiate financing with a different lending counterparty. None of the Company's lending counterparties are obligated to renew or otherwise enter into new borrowings at the conclusion of existing borrowings. In response to declines in fair value of pledged securities due to changes in market conditions or the publishing of monthly security pay-down factors, lending counterparties typically require the Company to post additional securities as collateral, pay down borrowings or fund cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements. These actions are referred to as margin calls. Conversely, in response to increases in fair value of pledged securities, the Company routinely margin calls its lending counterparties in order to have previously pledged collateral returned.

Secured borrowings (and related pledged collateral, including accrued interest receivable), classified by collateral type and remaining maturities, and related weighted average borrowing rates as of the indicated dates were as follows (dollars in thousands):

	Collateral Carrying Amount	Accrued Interest Receivable	Borrowings Outstanding	Average Borrowing Rates
Collateral Type June 30, 2018				
Borrowings under repurchase arrangements with maturities of 30 days or less:				
Agency Securities	\$ 12,549,566	\$ 31,684	\$ 11,906,901	2.16