November 2, 2011

Jefferies

Annaly Capital Management (NLY)
3Q11 First Take

HOLD
Price target $17.50
Price $16.66

EQUITY RESEARCH AMERICAS

Key Takeaway

Annaly Capital Management reported adjusted EPS of $0.65, in line with the Street estimate of $0.65 and $0.07 below our estimate of $0.72. The company reported a marginal Q/Q book value decline from $16.55 at 2Q11 to $16.22 at 3Q11 and experienced Q/Q CPR increase from 11 to 18.

3Q11 Performance - NLY reported $0.65 EPS, which excludes the impact of unrealized gains/losses on their interest rate swaps and their interest-only MBS securities. The $0.07 miss to our estimate was primarily driven by a lower portfolio value, as we expected NLY to deploy and lever the July capital raise. Spread income per share declined $0.15/share Q/Q and was driven by both spread compression and higher outstanding shares. The Q/Q book value decline from $16.55 to $16.22 was driven by a decrease in the value of the company's derivatives portfolio.

Uncertainty + Large Portfolio = Large Cash Balance at Quarter-end - NLY ended the quarter with $3.5B in cash on the balance sheet, equating to about 3.25% of the FMV of the MBS portfolio. This 325bps is about 6.5x larger than typical period-end cash, which has averaged approximately 55bps of the MBS portfolio over the prior six quarters. We expect this large cash position is due to the tandem effects of the equity raise in July ($2.4B) and increased caution surrounding repo counter parties and higher prepayments during 3Q11. A more cautious approach is necessary considering a portfolio this large ($106B) will be less agile than smaller portfolios, and it is likely to contain a higher percentage of TBA securities. (TBA securities tend to exhibit weak prepayment performance.)

Portfolio Growth, Higher CPRs, and Lower Swap Costs - NLY grew their portfolio 10% Q/Q from $96.7BN in 2Q11 to $106.6BN in 3Q11. As of 3Q11 their portfolio was 90% fixed, 9% ARM and 1% floating. The Company experienced a 65% Q/Q CPR increase from 11 to 18. Higher prepayments led to a Q/Q increase in premium amortization from $126M in 2Q11 to $201M in 3Q11, or a $0.08 change in diluted EPS. As NLY continues to replace its vintage swaps, the weighted average pay rate continues to show modest improvement. Over the past three quarters, the weighted average pay rate declined from 2.92% in 1Q11 to 2.79% in 2Q11 and to 2.57% in 3Q11. As of 3Q11, the Company had $40.5BN in notional swaps representing 38% of their MBS portfolio. While 38% is a comparatively low ratio for the comp group, NLY also employs I/O strip securities as a book value hedge. The high pay rate on their vintage swap book (which is over 100bps higher than many competitors) has likely resulted in management's decision to use I/O strip securities since increasing the swap book will negatively impact net asset spreads.

Net Interest Spread Tightens - The annualized yield and cost of funds for the quarter were 3.71% and 1.63%, respectively. The resulting net asset spread of 2.08% was 37bps, or 15% lower than the 2Q11 net asset yield of 2.45%. The 37bps decline in asset spread was due to the combined effects of higher premium amortization and lower investment yields on mortgage securities. We anticipate NLY's reported 15% Q/Q decline in net asset spreads will be about average for the mortgage REIT comp group for 3Q11.

The Market Portfolio - NLY's MBS portfolio had a fair value of $107B by quarter-end, or approximately 2.7x larger than the nearest publicly traded mortgage REIT. The sheer size of this portfolio leads us to view NLY as the "market portfolio" for Agency MBS, and 3Q11 results bear this out. Book value (down 2%), prepayment rates (up 65%), and net asset spread (down 15%) were all more or less in line with what has been expected for the entire universe of Agency MBS. While not a knock on the company, NLY has successfully used size as a competitive advantage in the capital markets, but it nonetheless comes with trade-offs -- especially in periods of heightened volatility.

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Company Description

NLY is a public real estate investment trust (REIT) incorporated in Maryland. The company placed its initial public offering in 1997, raising approximately $100M of common equity. Annaly Capital Management (NYSE: NLY) focuses on investing in Agency mortgage securities, which includes RMBS and debt issued by Fannie Mae, Freddie Mac, Ginnie Mae, and Federal Home Loan Banks. Principal and interest payments are guaranteed by government agencies and carry virtually no credit risk as a result. While these assets have similar structure to non-agency securities, the agency market tends to have greater liquidity and lower volatility. Annaly principally invests in securities issued by Fannie and Freddie, and Ginnie Mae, to a lesser extent. The company is internally managed, and does not pay management or incentive fees. NLY also owns two taxable REIT subsidiaries, FIDAC and Merganser, which are fixed-income asset management vehicles that focus on non-core asset classes. The Company earns asset advisory and incentive fees based on the value of assets under management and performance at FIDAC and Merganser. The company generally finances the acquisition of mortgage securities using repurchase agreements (Repo) with short-term maturities (usually less than one year). NLY aims to maintain leverage ratios in a target debt-to-equity range of 5:1 to 12:1. Essentially, the company will profit by collecting the excess interest income after all financing costs, including hedging activity, corporate and administrative expenses have been deducted. Given the negligible level of credit risk exposure, agency mortgage REITs basically assume interest rate risk, prepayment risk, and liquidity risk.

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Risk which may impede the achievement of our Price Target

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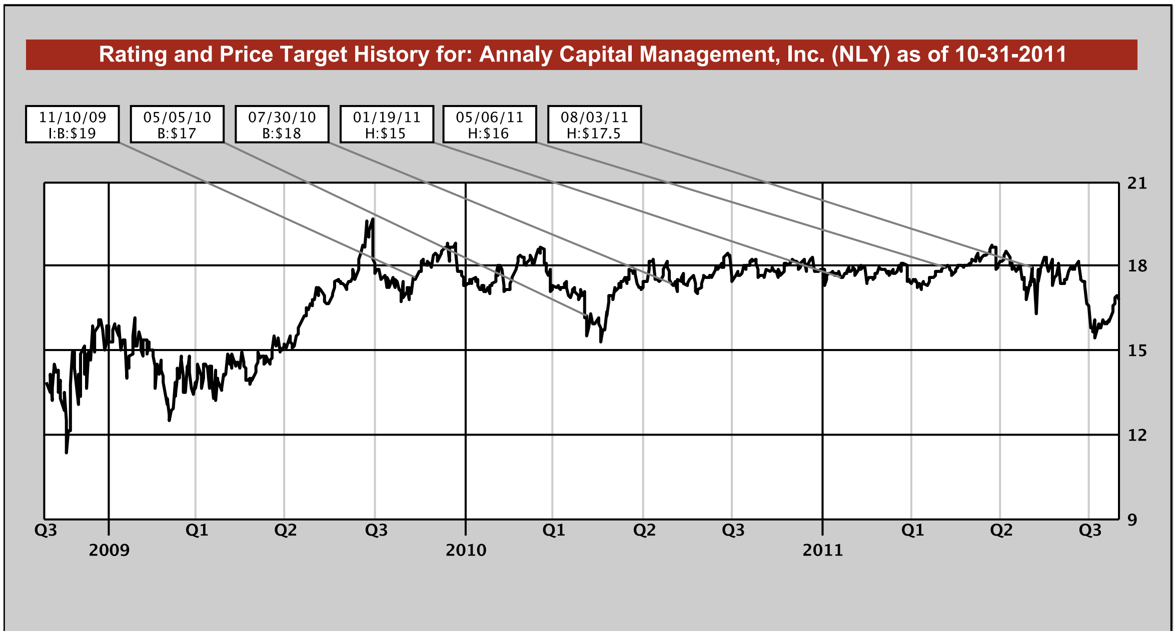

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