



COMPANY UPDATE | COMMENT

FEBRUARY 9, 2012

Annaly Capital Management (NYSE: NLY) 4Q11 Misses Estimates, Though Longer-Term Risk/Return Outlook Positive

Outperform Average Risk

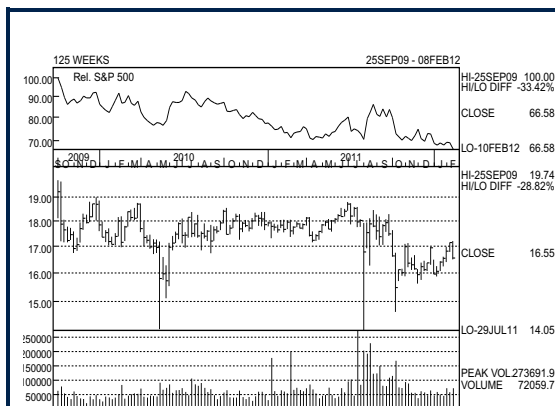
Price:	16.55	Price Target:	20.00
Shares O/S (MM):	970.2	Implied All-In Return:	34%
Dividend:	2.25	Market Cap (MM):	16,057
BVPS:	16.06	Yield:	13.6%
Float (MM):	964.5	P/BVPS:	1.0x
		Tr. 12 ROE:	NM
		Avg. Daily Volume (MM):	17.90

Represents forward 12-month dividend estimate

Core Diluted EPS of \$0.43, Misses on Higher Premium Amortization

Investment Opinion

- **Earnings Summary:** 4Q11 core diluted EPS was \$0.43, missing our estimate and consensus of \$0.56 (range \$0.49-\$0.66). GAAP diluted EPS of \$0.44 includes negative swap book mark to market and gain on the sale of MBS securities. Core earnings miss was driven by lower-than-expected portfolio spread via higher premium amortization and lower-than-expected leverage.
- **Spread Contracts on Higher Premium Amortization:** Portfolio spread declined 0.37% sequentially to 1.71%, compared to 2.08% in the previous quarter. Spread contraction was a result of a decline in asset yields due primarily to higher prepaes. Average borrowing costs fell modestly to 1.60% from 1.63% in 3Q11. We expect spread to improve as prepaes slow and higher interest rate swaps continue to roll off in 2012 and 2013.
- **Portfolio Declines:** MBS/agency debt investments fell 2.1% to \$105.1B from \$107.4B in 3Q11. Leverage declined to 5.4x, from 5.5x in 3Q11. Prepayments rose to 22% CPR, compared to 18% in 3Q11 and 23% in the previous year. Prepayment speeds were up due to higher refinance activity in 4Q11, and may remain near current levels as HARP II comes online - that said, it's important to note that prepaes remain in the 20% +/- historical band witnessed by NLY.
- **Book Value Falls Modestly:** Book value fell to \$16.06 p/s, compared to \$16.22 in 3Q11 - in line with our 4Q11 book value estimates. The decline in book is primarily due to negative swap marks and somewhat less robust MBS price upside this quarter.
- **Estimate Revisions:** Lowering our core 2012 estimate to \$2.28 from \$2.60, and initiating a 2013 EPS estimate at \$2.25. Our estimate revisions reflect higher prepaes near-term, and lower leverage for 2012. While returns are modestly lower than previously expected, they remain very healthy without taking on added risk via higher leverage.
- **NLY Still Cheap, Attractive Return Outlook Extended:** We continue to expect fundamental performance at Annaly to support a mid-teens ROE and 14% dividend yield - now for the next several years given the Fed's extension of low rates through late 2014. With NLY shares trading at 1.0x book value, we view the risk/return tradeoff as still very attractive.



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FY Dec	2010A	2011A	2012E	2013E
EPS (Op) - FD	2.31	2.30	2.28	2.25
Prev.		2.46	2.60	
P/E	7.2x	7.2x	7.3x	7.4x
EPS (Op) - FD	Q1	Q2	Q3	Q4
2010	0.60A	0.59A	0.60A	0.52A
2011	0.61A	0.70A	0.55A	0.43A
Prev.		0.60E		
2012	0.56E	0.57E	0.57E	0.58E
Prev.	0.63E	0.64E	0.65E	0.69E
2013	0.56E	0.56E	0.56E	0.57E

EPS (Op): Core EPS - excludes gain/loss on securities/derivatives and one-time impairment charges

All values in USD unless otherwise noted.

Priced as of prior trading day's market close, EST (unless otherwise noted).

For Required Conflicts Disclosures, see Page 4.

Details

4Q11 Earnings Summary: 4Q11 core diluted EPS was \$0.43, missing our estimate and consensus \$0.56, range \$0.49-\$0.66). GAAP diluted EPS was \$0.44, which includes non-cash swap marks and gains on sale of MBS securities. Core earnings miss was driven by spread contraction as a result of lower-than-anticipated asset yields (primarily via higher premium amortization and elevated repo rates), although borrowing costs were slightly lower. We continue to view fundamental trends for NLY as very favorable, supporting attractive returns in the year ahead.

Portfolio Falls Sequentially: MBS and agency investments fell 2.1% sequentially to \$105.1 billion from \$107.4 billion in 3Q11 and \$79.5 billion in the previous year. NLY sold \$10.3 billion of MBS during the quarter, resulting in a gain of \$80.7 million. As of December 31, 2011, Annaly's portfolio consisted of 90% fixed-rate MBS, 9% adjustable-rate MBS, and 1% floating-rate MBS, although with the effect of interest rate swaps the portfolio mirrored a composition of 42% floating rate, 9% adjustable-rate and 49% fixed rate. Cost basis of the portfolio increased sequentially to 102.7% - still at relatively low levels in general compared to most peers. Leverage fell to 5.4x D/E, vs. 5.5x at 3Q11 - the lowest in NLY's history. While we'd hoped for modestly higher leverage ahead than what seems to be likely over the next couple quarters, capital preservation and conservative risk management is better than betting the firm's capital on a what recently has been a volatile market.

Prepayment Speeds Increase: Prepayment speeds increased to 22% CPR (constant prepayment rate), up from 18% in the prior quarter and 23% in the previous year. While recent interest rate moves along with HARP II will likely lead to an observable (yet still likely relatively modest) uptick in prepaids over the next couple months, prepayment speeds should stabilize around historical levels (20% +/-). Weak organic mortgage/housing market activity along with some signs of refi burnout are key drivers of our view that prepaids will remain manageable.

Book Value Falls Modestly: Book value fell 1.0% to \$16.06 p/s compared to \$16.22 p/s in the previous quarter and in line with our 4Q11 estimate. The decrease in book value was primarily driven by negative swap marks, which more than offset higher MBS prices.

NLY Remains Cheap, Remains a Favorite in the Sector: We continue to view NLY as a very attractive risk/return play in the financials sector. The Fed's runway to lower rates through late 2014 along with a still relatively steep yield curve supports our healthy performance outlook ahead. Valuation is attractive at 1.0x current book value, relative to what we expect to be a forward dividend yield of roughly 14% in the year ahead.

Valuation

NLY shares trade at 7.3x 2012E EPS and 1.0x stated book value, relative to peer group averages of 6.5x and 1.0x, respectively. Our valuation approach is two-pronged: First, using a relatively conservative 12.5%-15% forward dividend yield expectation (Annaly and its peers historically trade at an 8-10% forward yield, so we are adding a 25%-50% premium to the high end of the range for potential for rate volatility) and our forward 12-month dividend estimate, shares are worth roughly \$15-\$19 per share. Second, on a justified price-to-book value multiple basis, the likelihood of NLY achieving a mid-teens percent ROE over at least the couple years suggests that a P/B multiple of 1.3x 4Q11 book value is fair, supporting a price target of \$21 per share. Combining the two methods, we think shares are fairly valued at \$20.

Price Target Impediment

Our earnings, dividend estimates, and price target could be too high if short-term interest rates move meaningfully higher over the near term without a commensurate increase in longer-term rates, or if long-term interest rates fall dramatically from current levels and residential mortgage prepayments rise significantly. Our earnings, dividend estimates, and price target could be too low if short-term interest rates fall further or more rapidly than expected, and/or long-term interest rates trend higher. Interest rate volatility could serve to impair book value, which would also likely result in impediment to our price target. Further credit market volatility or the failure of another large broker/dealer could also lead to perceived or real funding challenges, which could lead to shares not reaching our price target.

Company Description

Annaly Capital Management, Inc., a Maryland corporation, owns and manages a portfolio of high-quality agency mortgage-backed securities. The company's principal business objective is to generate net income for distribution to stockholders from the spread between the interest income on its mortgage-backed securities and the costs of borrowing to finance its acquisition of mortgage-backed securities. The company also operates a fixed-income investment management subsidiary, FIDAC, which currently holds net and gross assets under management of \$12.2 billion and \$19.9 billion, respectively. The company has elected to be taxed as a real estate investment trust (REIT).

Annaly Capital Management, Inc. (\$ millions, except per share data and where otherwise noted) Source: Company Filings and RBC CM Estimates																			NLY Jason Arnold, CFA - (415) 633-8594	
INCOME STATEMENT	FY06A	FY07A	FY08A	FY09A	FY10A	1Q11A	2Q11A	3Q11A	4Q11A	FY11A	1Q12E	2Q12E	3Q12E	4Q12E	FY12E	1Q13E	2Q13E	3Q13E	4Q13E	FY13E
Interest Income	1,221.9	2,355.4	3,115.4	2,922.6	2,683.1	844.0	957.1	930.8	847.7	3,579.6	941.0	941.1	928.1	918.0	3,728.2	905.3	903.2	891.7	893.5	3,593.6
Interest Expense	1,055.0	1,926.5	1,888.9	1,295.8	1,163.3	321.6	330.1	353.3	357.8	1,362.7	341.0	333.8	319.0	304.7	1,298.5	301.3	292.6	280.9	280.5	1,155.3
Net Interest Income	166.9	429.0	1,226.5	1,626.8	1,519.8	522.4	627.0	577.5	489.9	2,216.9	600.0	607.2	609.1	613.3	2,429.7	604.0	610.5	610.7	613.0	2,438.3
Gain(Loss) on Sale of Securities, Other Income	10.6	40.4	(745.1)	452.2	(106.3)	224.5	(456.9)	(1,439.6)	15.6	(1,656.4)	-	-	-	-	-	-	-	-	-	-
General & Admin Expense	39.9	62.7	103.6	130.2	171.5	51.8	57.2	65.2	63.1	237.3	61.8	62.5	59.2	59.1	242.6	61.1	61.6	59.8	60.5	243.0
Other Expenses	54.8	1.2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Contribution From FIDAC	11.5	9.5	0.3	12.8	22.3	3.6	7.9	5.4	3.2	20.2	8.1	8.7	9.7	11.2	37.7	-	1.6	-	-	-
Net Income	94.2	416.2	378.1	1,961.7	1,264.3	698.8	120.8	(921.8)	445.6	343.3	546.3	553.4	559.6	565.5	2,224.8	542.9	550.4	550.9	552.5	2,195.3
Preferred Stock	19.4	21.5	21.2	18.5	18.0	4.3	4.3	4.2	4.1	16.9	4.1	4.1	4.1	4.1	16.6	4.1	4.1	4.1	4.1	16.6
Net Income to Common	74.5	394.1	356.9	1,943.5	1,249.2	695.6	116.6	(926.0)	441.4	327.6	542.2	549.2	555.4	561.3	2,208.2	538.8	546.3	546.8	548.4	2,178.7
Avg. Diluted Shares Outstanding	171.5	305.6	513.7	553.1	625.3	791.0	827.8	948.5	1,011.5	874.5	970.2	970.2	970.2	970.2	970.2	970.2	970.2	970.2	970.2	970.2
End of Period Shares Outstanding	205.3	401.8	541.5	553.1	631.6	804.4	831.0	969.9	970.2	970.2	970.2	970.2	970.2	970.2	970.2	970.2	970.2	970.2	970.2	970.2
GAAP Earnings Per Share	\$0.33	\$1.29	\$0.70	\$3.51	\$2.04	\$0.88	\$0.14	(\$0.98)	\$0.44	\$0.37	\$0.56	\$0.57	\$0.57	\$0.58	\$2.28	\$0.56	\$0.56	\$0.56	\$0.57	\$2.25
Operating Earnings Per Share	\$0.70	\$1.21	\$2.16	\$2.73	\$2.31	\$0.61	\$0.70	\$0.55	\$0.43	\$2.30	\$0.56	\$0.57	\$0.57	\$0.58	\$2.28	\$0.56	\$0.56	\$0.56	\$0.57	\$2.25
Dividends Per Share	\$0.57	\$1.04	\$2.08	\$2.54	\$2.65	\$0.62	\$0.65	\$0.60	\$0.57	\$2.44	\$0.56	\$0.57	\$0.56	\$0.56	\$2.25	\$0.55	\$0.55	\$0.55	\$0.55	\$2.20
Payout Ratio	81%	86%	96%	93%	115%	100%	94%	93%	100%	106%	100%	100%	98%	97%	99%	99%	97%	98%	98%	98%
BALANCE SHEET	FY06A	FY07A	FY08A	FY09A	FY10A	1Q11A	2Q11A	3Q11A	4Q11A	FY11A	1Q12E	2Q12E	3Q12E	4Q12E	FY12E	1Q13E	2Q13E	3Q13E	4Q13E	FY13E
Assets																				
Cash & Cash Equivalents	\$92	\$104	\$909	\$1,505	\$283	\$357	\$402	\$3,474	\$994	\$994	\$994	\$994	\$994	\$994	\$994	\$994	\$994	\$994	\$994	\$994
Mortgage-Backed Securities/Debentures	\$30,217	\$53,133	\$55,646	\$65,721	\$79,549	\$94,059	\$97,477	\$107,413	\$105,141	\$105,141	\$106,919	\$107,569	\$107,641	\$107,101	\$107,101	\$108,436	\$109,192	\$108,288	\$111,659	\$111,659
Total Earning Assets	\$30,309	\$53,237	\$56,555	\$67,226	\$79,831	\$94,416	\$97,878	\$110,887	\$106,135	\$106,135	\$107,913	\$108,563	\$108,635	\$108,095	\$108,095	\$109,430	\$110,186	\$109,282	\$112,653	\$112,653
Liabilities																				
Repurchase Agreements	27,514	46,047	46,675	54,598	65,534	79,984	78,447	86,496	84,098	84,098	90,436	90,986	91,047	90,590	90,590	91,719	92,360	91,595	95,204	95,204
Convertible Debt					600	600	600	557	540	540	540	540	540	540	540	540	540	540	540	540
Series A Cum. Rdmble Pfd.	177	177	177	177	177	177	177	177	177	177	177	177	177	177	177	177	177	177	177	177
Series B Cum. Convert. Pfd.	111	111	96	63	40	40	40	34	32	32	32	32	32	32	32	32	32	32	32	32
Common Shareholders Equity	2,366	5,028	7,006	9,377	9,688	12,676	13,752	15,733	15,584	15,584	15,734	15,834	15,845	15,762	15,762	15,967	16,083	15,944	15,705	15,705
Book Value Per Share	\$11.52	\$12.51	\$12.94	\$16.95	\$15.34	\$15.76	\$16.55	\$16.22	\$16.06	\$16.06	\$16.22	\$16.32	\$16.33	\$16.25	\$16.25	\$16.46	\$16.58	\$16.43	\$16.19	\$16.19
Leverage (Debt/Equity)	10.4	8.7	6.4	5.7	6.7	6.3	5.7	5.5	5.4	5.4	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.8	5.8
PROFITABILITY / EFFICIENCY	FY06A	FY07A	FY08A	FY09A	FY10A	1Q11A	2Q11A	3Q11A	4Q11A	FY11A	1Q12E	2Q12E	3Q12E	4Q12E	FY12E	1Q13E	2Q13E	3Q13E	4Q13E	FY13E
Yield on Average Earning Assets	5.24%	5.77%	5.57%	5.00%	4.02%	3.79%	4.04%	3.71%	3.31%	3.71%	3.55%	3.51%	3.45%	3.42%	3.48%	3.36%	3.32%	3.28%	3.25%	3.30%
Wtd Avg Annl Cost of Preferred Stock	7.88%	7.88%	7.15%	7.15%	7.88%	7.15%	7.15%	7.15%	7.15%	7.88%	7.15%	7.15%	7.15%	7.15%	7.88%	7.15%	7.15%	7.15%	7.15%	7.88%
Cost of Funding	4.87%	5.08%	3.76%	2.50%	1.94%	1.62%	1.59%	1.63%	1.60%	1.61%	1.54%	1.45%	1.38%	1.32%	1.42%	1.30%	1.25%	1.20%	1.18%	1.23%
Portfolio Spread	0.37%	0.68%	1.81%	2.51%	2.09%	2.17%	2.45%	2.08%	1.71%	2.10%	2.01%	2.06%	2.07%	2.10%	2.06%	2.06%	2.07%	2.08%	2.07%	2.07%
G&A/Average Earning Assets	0.18%	0.15%	0.18%	0.21%	0.23%	0.23%	0.23%	0.23%	0.23%	0.23%	0.23%	0.23%	0.23%	0.22%	0.23%	0.23%	0.23%	0.22%	0.22%	0.22%
ROAE (a)	6.8%	11.1%	16.9%	17.6%	13.3%	25.0%	3.7%	-25.0%	11.4%	3.8%	14.0%	14.0%	14.1%	14.3%	14.1%	13.7%	13.7%	13.8%	14.0%	13.8%
GROWTH	FY06A	FY07A	FY08A	FY09A	FY10A	1Q11A	2Q11A	3Q11A	4Q11A	FY11A	1Q12E	2Q12E	3Q12E	4Q12E	FY12E	1Q13E	2Q13E	3Q13E	4Q13E	FY13E
Net Income		342%	-9%	419%	-36%	-45%	-83%	-863%	-148%	-73%	59%	1%	1%	1%	548%	-76%	1%	0%	0%	-1%
Earnings Per Share		294%	-46%	406%	-42%	-57%	-84%	-793%	-145%	-82%	49%	1%	1%	1%	508%	-76%	1%	0%	0%	-1%
Dividends Per Share	-45%	82%	100%	22%	4%	-77%	5%	-8%	-5%	-8%	-77%	1%	-1%	0%	-8%	-76%	-1%	1%	0%	-2%
Earning Assets	90%	76%	6%	19%	19%	18%	4%	13%	-4%	33%	2%	1%	0%	0%	2%	1%	1%	-1%	3%	4%
Total Debt	103%	67%	1%	17%	20%	22%	-2%	10%	-3%	28%	8%	1%	0%	-1%	8%	1%	1%	-1%	4%	5%

Notes: (A) Actual, (E) Estimates, (a) Annualized

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Conflicts Disclosures

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Ratings

Top Pick (TP): Represents analyst's best idea in the sector; expected to provide significant absolute total return over 12 months with a favorable risk-reward ratio.

Outperform (O): Expected to materially outperform sector average over 12 months.

Sector Perform (SP): Returns expected to be in line with sector average over 12 months.

Underperform (U): Returns expected to be materially below sector average over 12 months.

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Above Average Risk (AA): Volatility and risk expected to be above sector; below average revenue and earnings predictability; may not be suitable for a significant class of individual equity investors; may have negative cash flow; low market cap or float.

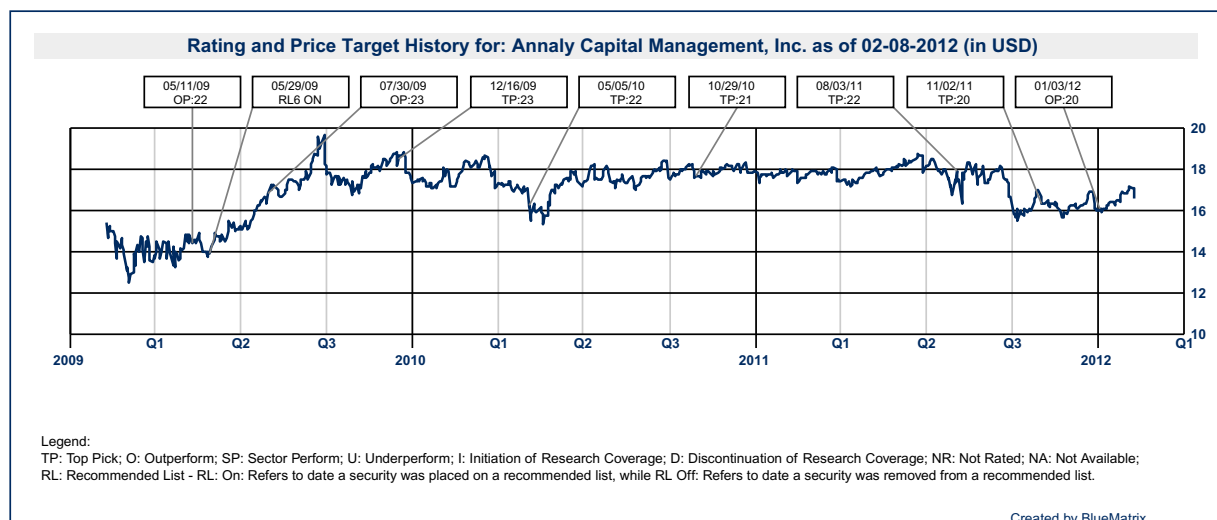
Speculative (Spec): Risk consistent with venture capital; low public float; potential balance sheet concerns; risk of being delisted.

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Rating	Count	Percent	Investment Banking Serv./Past 12 Mos.	
			Count	Percent
BUY[TP/O]	773	51.80	225	29.11
HOLD[SP]	648	43.40	146	22.53
SELL[U]	71	4.80	5	7.04





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