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Preferred income

Mortgage REITs deliver income but not always serenity, at least not to their common equity holders. Like other delicate machinery, the REITs are prone to malfunction in hostile operating environments. The common shares pay big dividends until the yield curve becomes disarranged or mortgage prepayments accelerate. Then—poof! Is there no safer yield vehicle than the volatile equity of the likes of Annaly Capital Management (NLY on the NYSE), Capstead Mortgage Corp. (CMO on the NYSE) and American Capital Agency Corp. (AGNC on the Nasdaq)? "Yes, indeed," is the burden of the essay now unfolding.

Preferred stock—the mortgage REITs' own preferred stock—is the No. 1 topic at hand. Subsidiary subjects include an update on Monmouth Real Estate Investment Corp. (MNR on the NYSE), a different kind of real estate investment trust, as well as a word on a pair of business development companies. As to the REIT preferreds, which are rather lost in the shadow of the REITs' big equity capitalizations, they offer relatively high yields and absolutely low volatility. Concerning safety, they pass the *Grant's* Grandmother Test.

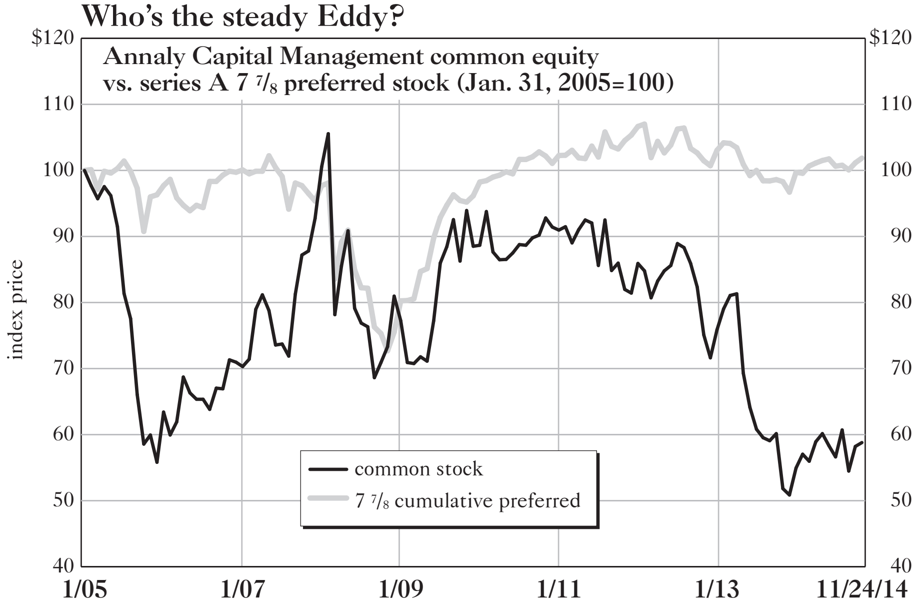
For the would-be investor in Annaly, the biggest mortgage REIT by market cap and assets alike, the common-equity value proposition runs approximately as follows: Accept such income as the portfolio managers may contrive to deliver by juggling prepayment risk, leverage risk, regulatory risk, counterparty risk, duration risk and career risk, among other potential snares. While accepting these dividends, know that rising rates would ding the company's portfolio of mostly fixed-rate agency securities. They would, in fact, ding it to the "Nth degree," "N" being the leverage factor; as of Sept. 30, Annaly deployed $5.40 of debt for every $1 of equity. At a glance, Annaly's 10.4% common dividend seems irresistible. It would look still more so if, over the past two years, book value per Annaly share had not declined by 22%.

Which brings us to the Annaly preferred, of which there are three series, all cumulative, all perpetual and all callable, in the grand total of $953.4 million (as against $12.2 billion in net asset value excluding the preferreds). The functional meaning of "preferred" is that you, the preferred investor, are entitled to a fixed dividend before the common holders take a single cent. "Cumulative" means that the issuing company must make good on preferred dividends that have gone unpaid before it distributes anything to the common.

Not that the preferred payout is in evident jeopardy. In the third quarter, Annaly's core net income (excluding gains and losses on interest rate swaps, asset disposals, and unrealized gains on interest-only securities) was sufficient to cover the preferred dividend by a factor of 17.2:1. It's a level of redundancy that gives us comfort enough to recommend the stock to an income-needy family member or fiduciary—a grandmother, for instance.

The accompanying graph is probably worth a thousand dividend-related words. It plots the price movement of the Annaly 7 ⅞% series A cumulative

Who's the steady Eddy?



source: The Bloomberg

preferred against the movement of the Annaly common. With the exception of the colorful events of 2008, the preferred has traded at par value, plus or minus a few percent. Compare and contrast the common, which fell by 44% between year-end 2004 and year-end 2005 as the yield curve tightened. Compare, too, the performance of preferred and common during the three rounds of QE.

Once upon a time, any who chose to invest in Annaly preferred, as against the common, swapped yield for security. That is still the trade-off, but the advantage has tilted to the preferred. As recently as 12 months ago, the common was priced to yield 14.2%, the 7 ⅞% series A preferred to yield 7.86%, for a spread of 6.34 percentage points. Today, Annaly common yields 10.39%, the Series A preferred 7.79%; the difference is just 2.6 percentage points.

Also on the topic of Annaly, a clarification: Under terms of an external management contract, Annaly's CEO, Wellington Denahan, was bound to purchase a certain amount of NLY common (the volume being a function of her base salary in 2012). This obligation she completed in August. The Oct. 17 issue of *Grant's* characterized her purchase as an expression of executive optimism. In fact, no such conjecture is warranted. Denahan bought what she had to buy, and—so far, according to public filings—no more.

Capstead Mortgage is another issuer of safe and high-yielding preferred. The Capstead 7 ½% series E cumulative and callable preferred, in the sum of $167.1 million, is priced to yield 7.73%; Capstead common, in the sum of $1.2 billion, is priced to yield 10.5%. Net income covered the series E by 9.2 times in the third quarter.

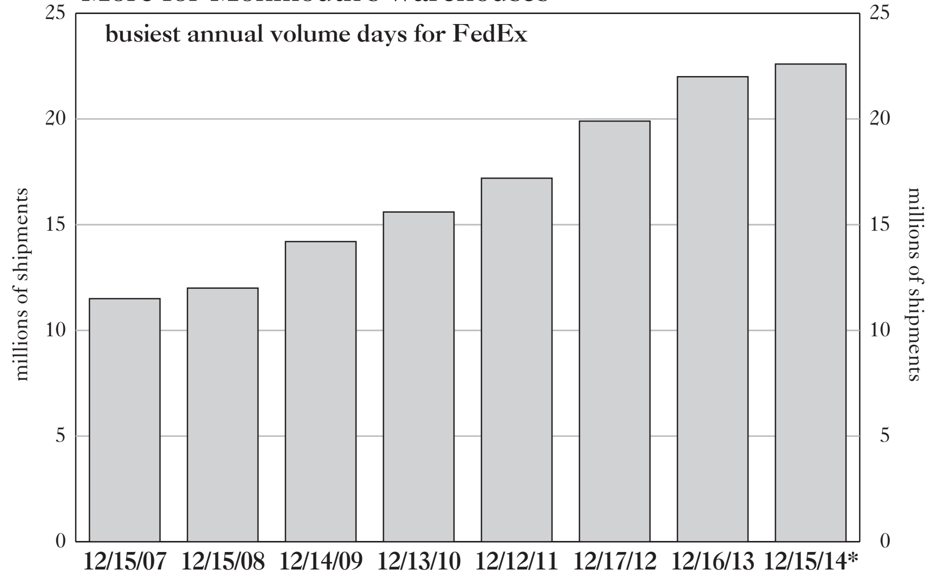
David Peligal of this staff invited Andrew Jacobs, the Capstead CEO, to talk about his preferred shares from a safety and soundness point of view. "The Series E shares are senior to our $1.2 billion in common equity capital," Jacobs said. "And at any quarter end, we have $700 million to $800 million of liquidity at current leverage levels. We have $1.5 billion in capital that we're investing, including the Series E shares and $100 million in long-term unsecured borrowings that mature in 2035-36 that are ranked senior to the Series E. Under our short-duration investment strategy, we strive to have less than 10% of our total capital at risk at any point. I would argue that with a strategy predicated on having less than $150 million of capital at risk and with $1.2 billion in common equity in the first loss position, there's not a lot of risk to the Series E holder. With our short duration portfolio it's just not plausible to lose $1.2 billion, without the United States government and the whole mortgage market just going away. So our Series E stockholders should feel very safe."

On, then, to American Capital Agency Corp., which has issued $352.2 million in 8% cumulative and callable preferred stock, as well as a larger series of 7 ¾% preferred, also cumulative and callable. AGNC common offers a yield of 11.5%, the preferred a yield of around 8%. AGNC, which leveraged its portfolio by 6.7 times as of Sept. 30, shows $9 billion in net asset value excluding the preferreds. In the third quarter, core net income covered preferred dividends by a margin of 43.7:1.

How does Gary Kain, president and chief investment officer of AGNC, suggest that one should think about the safety of his preferred? Simply examine the REIT's equity base, Kain replied. "I think you're looking at our outstanding preferreds being just shy of $400 million out of almost $10 billion in total equity," he said. "The reality is, you're looking at something between 4% to 5%. That should almost immediately end the discussion with respect to coverage."

"Switching gears," Peligal continues, "as the holiday season approaches, let's not forget about Monmouth Real Estate Investment Corp.; (*Grant's*, June 27). FedEx continues to expand its ground network, and Monmouth is a clear beneficiary. Forecasting record holiday volume in an Oct. 22 bulletin, FedEx said that 'Dec. 15 is projected to be the busiest day in company history, with a forecasted 22.6 million shipments moving around the world.' For perspective, the busiest day in 2007 resulted in 11.5 million shipments.

More for Monmouth's warehouses



*projected amount
source: company filings

"I asked Mike Landy, Monmouth's president and CEO, how things have shaped up over the past few months and if there were any investor concerns he'd like to address," Peligal goes on.

"'FFO, or earnings, have been well in excess of the dividend,' Landy replied. 'But as some of your subscribers rightfully pointed out, AFFO, or recurring cash flow (which omits such nonrecurring items as gains on sales of securities or lease-termination income), was not equivalent to the 60-cent dividend. And our point there is we've been generating double-digit AFFO per-share growth. And we've gotten ourselves to the point with our acquisition pipeline—we have about $260 million in acquisitions with favorable spreads—that will continue that accretion. Last year, the shortfall was very small, and this year it will be equivalent. But I think size is still the biggest factor of why we trade at a discount to the other REITs. The other REITs are yielding not even 4%. And we're yielding in the mid-fives. And the reason for over a 150 basis-point spread is mostly size and liquidity, but it's also a perception that recurring earnings are short of the dividend—and that's not the case. And here you're getting long-term leases to investment-grade tenants…. And the visibility and predictability of our earnings is greater than the other REITs because we have long-term leases going out, on average, over seven years. We always point to the Great Recession as a stress test in that REITs with low payout ratios were not able to maintain their dividend, and here Monmouth, with a high payout ratio, didn't miss a beat because occupancy and earnings were high throughout. It's only getting better and we're looking forward to having free recurring cash flow after the dividend requirement, and that's what 2015 is shaping up to be because these are all brand-new deals to investment-grade tenants with yield spreads in excess of 250 basis points.'"

Slightly more venturesome investors may consider Ares Capital Corp. (ARCC on the Nasdaq) and Golub Capital BDC (GBDC on the Nasdaq). Business development companies, the pair lends to and invests in small and mid-size American business. While paying out 90 cents in every dollar in dividend income, each company has managed to build book value. The Oct. 3 issue of *Grant's* identified both ARCC and GBDC as value-laden. In subsequent weeks, Golub has rallied by 8%; it trades at a 13% premium to book value and offers a prospective yield of 7.3%. Ares has rallied by just 1% and trades at a 2% discount to book and offers a 9.3% yield. Which is to say that Ares, unlike Golub, remains in value territory.

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