High Yields at Annaly Capital[1]

Early 2012 marked a period of unusually low yields for financial securities. The dividend yield on the S&P 500 was less than 2%, while the yield on the 10 Year U.S. T-Note was at a record low 1.5%. According to Mohamed El-Erian, CEO of PIMCO, this was all part of the 'new normal' for the global economy. Yet one industry continued to defy the new normal, sporting exceptionally high yields. This industry was the relatively obscure mortgage REIT industry.

The acronym 'REIT' stands for Real Estate Investment Trust. REITs are corporate entities that invest primarily in real estate or related securities. Special provisions in the tax code allow REITs to avoid corporate income tax so long as they distribute at least 90% of their taxable income as dividends. Mortgage REITs specialize in investing in real estate loans rather than investing in real estate itself. Most mortgage REITs purchase mortgage-backed securities issued by securitization trusts. The trusts purchase individual mortgages, then pool and securitize them. The largest issuers of such securities are the government-sponsored enterprises Fannie Mae, Freddie Mac and Ginnie Mae. Many private institutions also set up securitization trusts in the lead-up to the financial crisis, but demand for privately issued mortgage backed securities plummeted in the aftermath of the financial crisis.

By the spring of 2012, dividend yields in the mortgage REIT industry averaged over 12%. The biggest mortgage REIT was Annaly Capital Management, Inc., representing over 20% of the FTSE NAREIT Mortgage REIT Index. Annaly closed 2011 with a stock price of $16 and trailing 12 month dividends per common share of $2.44, representing a trailing 12 month

[1]This case was prepared by Professor Richard Sloan as the basis for class discussion, rather than to illustrate either effective or ineffective handling of a business situation.

dividend yield of over 15%. Moving into 2012, Annaly's high yield showed little signs of abating, with analysts forecasting dividends for the coming year of over $2 per common share.

Detailed information on Annaly's business strategy and financial situation is provided in Annaly's Form 10-K for the year ended December 31, 2011. This document is available online at www.lundholmandsloan.com in the 'New Cases' section.

QUESTIONS

Business Strategy Analysis

1. Summarize Annaly's business strategy and identify the key success factors associated with this strategy.
2. Identify the key risks associated with Annaly's business strategy.

Accounting Analysis

3. Annaly's net income declined from $1,249,247,000 in 2010 to 327,607,000 in 2011. Identify the major reason for this decline.
4. In 2011, Annaly reported net income of $327,607,000 and comprehensive income of $2,188,807,000. Which of these two numbers do you think provides a better indication of Annaly's underlying economic performance? Briefly explain your answer.

Ratio and Cash Flow Analysis

5. Compute Annaly's return on common equity for 2011. Use comprehensive income in the numerator and average total common equity in the denominator.
6. Use the advanced Dupont model to decompose Annaly's ROE (as computed in question 5 above) into RNOA, leverage and spread.

7. Annaly's 2011 Form 10-K, lists its 2011 'Net Interest Rate Spread' as 2.09% (see table on page 41) and its leverage at December 31 2011 and 2010 as 5.4:1 and 6.7:1 respectively (see top of page 54). Compare these amounts to the corresponding amounts you computed in question 6 above and explain the source(s) of any significant differences.
8. Between 2010 and 2011, Annaly's 'Net cash provided by operating activities' declined from $10,863,110 to $2,420,063 (see page F-5 of Form 10-K). Identify the major reason(s) for this decline and comment on whether it is cause for concern.

Forecasting and Valuation

9. Do you think that Annaly's high dividend yield makes it a good investment opportunity at the beginning of 2012? Briefly explain your answer.