Invesco Mortgage Capital Inc.
Form 10-Q
August 08, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2016
OR
o 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 001-34385

(Exact Name of Registrant as Specified in Its Charter)

Maryland	26-2749336
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
1555 Peachtree Street, N.E., Suite 1800 Atlanta, Georgia	30309
(Address of Principal Executive Offices)	(Zip Code)

(404) 892-0896
(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 ý No o

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 ý No o

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

Large Accelerated filer	ý	Accelerated filer	o
Non-Accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	o

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

As of August 2, 2016, there were 111,583,435 outstanding shares of common stock of Invesco Mortgage Capital Inc.

INVESCO MORTGAGE CAPITAL INC.
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PART I
ITEM 1. FINANCIAL STATEMENTS
INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

$ in thousands except share amounts	As of June 30, 2016	December 31, 2015
ASSETS		
Mortgage-backed and credit risk transfer securities, at fair value	15,625,027	16,065,935
Commercial loans, held-for-investment	272,502	209,062
U.S. Treasury securities, at fair value	152,701	—
Cash and cash equivalents	144,084	53,199
Due from counterparties	267,015	110,009
Investment related receivable	37,186	154,594
Accrued interest receivable	49,282	50,779
Derivative assets, at fair value	5,502	8,659
Other assets	108,283	115,072
Total assets	16,661,582	16,767,309
LIABILITIES AND EQUITY		
Liabilities:		
Repurchase agreements	11,768,647	12,126,048
Secured loans	1,650,000	1,650,000
Exchangeable senior notes	395,800	394,573
Derivative liabilities, at fair value	447,738	238,148
Dividends and distributions payable	50,919	51,734
Investment related payable	87,668	167
Accrued interest payable	17,625	21,604
Collateral held payable	5,560	4,900
Accounts payable and accrued expenses	2,080	2,376
Due to affiliate	10,094	10,851
Total liabilities	14,436,131	14,500,401
Equity:		
Preferred Stock, par value $0.01 per share; 50,000,000 shares authorized:		
7.75% Series A Cumulative Redeemable Preferred Stock: 5,600,000 shares issued and outstanding ($140,000 aggregate liquidation preference)	135,356	135,356
7.75% Fixed-to-Floating Series B Cumulative Redeemable Preferred Stock: 6,200,000 shares issued and outstanding ($155,000 aggregate liquidation preference)	149,860	149,860
Common Stock, par value $0.01 per share; 450,000,000 shares authorized; 111,583,435 and 113,619,471 shares issued and outstanding, respectively	1,116	1,136
Additional paid in capital	2,382,689	2,407,372
Accumulated other comprehensive income	558,954	318,624
Retained earnings (distributions in excess of earnings)	(1,028,354)	(771,313)
Total stockholders' equity	2,199,621	2,241,035
Non-controlling interest	25,830	25,873
Total equity	2,225,451	2,266,908
Total liabilities and equity	16,661,582	16,767,309

The accompanying notes are an integral part of these condensed consolidated financial statements.

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INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
$ in thousands, except share amounts	2016	2015	2016	2015
Interest Income				
Mortgage-backed and credit risk transfer securities	112,860	128,491	235,106	267,539
Residential loans [(1)]	—	30,247	—	59,621
Commercial loans	5,947	4,491	10,840	7,606
Total interest income	118,807	163,229	245,946	334,766
Interest Expense				
Repurchase agreements	31,260	40,931	73,060	84,241
Secured loans	2,688	1,553	5,403	3,017
Exchangeable senior notes	5,614	5,613	11,227	11,220
Asset-backed securities [(1)]	—	22,329	—	44,227
Total interest expense	39,562	70,426	89,690	142,705
Net interest income	79,245	92,803	156,256	192,061
Reduction in provision for loan losses	—	70	—	132
Net interest income after reduction in provision for loan losses	79,245	92,873	156,256	192,193
Other Income (loss)				
Gain (loss) on investments, net	1,414	10,896	13,015	12,986
Equity in earnings of unconsolidated ventures	202	1,231	1,263	7,237
Gain (loss) on derivative instruments, net	(90,363)	56,003	(328,906)	(66,742)
Realized and unrealized credit derivative income (loss), net	17,228	614	25,638	21,976
Other investment income (loss), net	(2,745)	1,673	(3,063)	779
Total other income (loss)	(74,264)	70,417	(292,053)	(23,764)
Expenses				
Management fee – related party	9,061	9,343	18,573	18,758
General and administrative	1,896	1,952	3,933	3,679
Consolidated securitization trusts [(1)]	—	2,256	—	4,412
Total expenses	10,957	13,551	22,506	26,849
Net income (loss)	(5,976)	149,739	(158,303)	141,580
Net income (loss) attributable to non-controlling interest	(75)	1,712	(1,958)	1,618
Net income (loss) attributable to Invesco Mortgage Capital Inc.	(5,901)	148,027	(156,345)	139,962
Dividends to preferred stockholders	5,716	5,716	11,432	11,432
Net income (loss) attributable to common stockholders	(11,617)	142,311	(167,777)	128,530
Earnings (loss) per share:				
Net income (loss) attributable to common stockholders				
Basic	(0.10)	1.16	(1.49)	1.04
Diluted	(0.10)	1.06	(1.49)	1.00
Dividends declared per common share	0.40	0.45	0.80	0.90

(1) The condensed consolidated statements of operations for the three and six months ended June 30, 2015 include income and expenses of consolidated variable interest entities ("VIEs"). The Company deconsolidated these VIEs in December 2015. Refer to Note 2 - "Summary of Significant Accounting Policies" for further discussion.

The accompanying notes are an integral part of these condensed consolidated financial statements.

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INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
$ in thousands	2016	2015	2016	2015
Net income (loss)	(5,976)	149,739	(158,303)	141,580
Other comprehensive income (loss):				
Unrealized gain (loss) on mortgage-backed and credit risk transfer securities, net	117,116	(195,715)	238,576	(73,544)
Reclassification of unrealized (gain) loss on sale of mortgage-backed and credit risk transfer securities to gain (loss) on investments, net	(1,037)	(1,689)	(11,581)	(4,541)
Reclassification of amortization of net deferred losses on de-designated interest rate swaps to repurchase agreements interest expense	3,238	16,313	16,162	35,458
Currency translation adjustments on investment in unconsolidated venture	274	—	225	—
Total other comprehensive income (loss)	119,591	(181,091)	243,382	(42,627)
Comprehensive income (loss)	113,615	(31,352)	85,079	98,953
Less: Comprehensive income (loss) attributable to non-controlling interest	(1,435)	357	(1,094)	(1,133)
Less: Dividends to preferred stockholders	(5,716)	(5,716)	(11,432)	(11,432)
Comprehensive income (loss) attributable to common stockholders	106,464	(36,711)	72,553	86,388

The accompanying notes are an integral part of these condensed consolidated financial statements.

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INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF EQUITY
For the six months ended June 30, 2016
(Unaudited)

	Attributable to Common Stockholders									
$ in thousands except share amounts	Series A Preferred Stock		Series B Preferred Stock		Common Stock		Additional Paid in Capital	Accumulated Other Comprehensive Income	Retained Earnings (Distributions in excess of earnings)	Total Stockhol Equity
	Shares	Amount	Shares	Amount	Shares	Amount				
Balance at December 31, 2015	5,600,000	135,356	6,200,000	149,860	113,619,471	1,136	2,407,372	318,624	(771,313)	2,241,03
Net loss	—	—	—	—	—		—	—	(156,345)	(156,345
Other comprehensive income	—	—	—	—	—	—	—	240,330	—	240,330
Proceeds from issuance of common stock, net of offering costs	—	—	—	—	3,201	—	35	—	—	35
Repurchase of shares of common stock	—	—	—	—	(2,063,451)	(20)	(24,980)	—	—	(25,000
Stock awards	—	—	—	—	24,214	—	—	—	—	—
Common stock dividends	—	—	—	—	—	—	—	—	(89,264)	(89,264
Common unit dividends	—	—	—	—	—	—	—	—	—	—
Preferred stock dividends	—	—	—	—	—	—	—	—	(11,432)	(11,432
Amortization of equity-based compensation	—	—	—	—	—	—	262	—		262
Balance at June 30, 2016	5,600,000	135,356	6,200,000	149,860	111,583,435	1,116	2,382,689	558,954	(1,028,354)	2,199,62

The accompanying notes are an integral part of this condensed consolidated financial statement.

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INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

$ in thousands	Six Months Ended June 30, 2016	2015
Cash Flows from Operating Activities		
Net income (loss)	(158,303)	141,580
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization of mortgage-backed and credit risk transfer securities premiums and (discounts), net	53,664	59,075
Amortization of residential loans and asset-backed securities premiums (discount), net	—	(254)
Amortization of commercial loan origination fees	(139)	(22)
Reduction in provision for loan losses	—	(132)
Unrealized (gain) loss on derivative instruments, net	211,261	(66,192)
Unrealized (gain) loss on credit derivatives, net	(19,229)	(11,867)
(Gain) loss on investments, net	(13,015)	(12,986)
Realized (gain) loss on derivative instruments, net	63,569	41,315
Realized (gain) loss on credit derivatives, net	6,017	2,468
Equity in earnings of unconsolidated ventures	(1,263)	(7,237)
Amortization of equity-based compensation	265	307
Amortization of deferred securitization and financing costs	1,227	1,594
Amortization of net deferred losses on de-designated interest rate swaps to repurchase agreements interest expense	16,162	35,458
(Gain) loss on foreign currency transactions, net	4,741	619
Changes in operating assets and liabilities:		
(Increase) decrease in operating assets	1,893	(4,114)
(Decrease) increase in operating liabilities	(5,039)	7,846
Net cash provided by operating activities	161,811	187,458
Cash Flows from Investing Activities		
Purchase of mortgage-backed and credit risk transfer securities	(1,061,651)	(1,416,277)
Purchase of U.S. Treasury securities	(152,256)	—
Proceeds from sale of U.S. Treasury securities	122,736	—
(Contributions) distributions (from) to investment in unconsolidated ventures, net	6,863	6,432
Change in other assets	1,125	(7,250)
Principal payments from mortgage-backed and credit risk transfer securities	1,131,028	1,267,293
Proceeds from sale of mortgage-backed and credit risk transfer securities	659,959	242,543
Payments on sale of credit derivatives	(6,017)	(2,468)
Payment of premiums for interest rate swaptions	—	(1,485)
(Payments) proceeds (for) from termination of futures, forwards, swaps, swaptions and TBAs, net	(62,083)	(33,577)
Purchase of residential loans held-for-investment	—	(372,305)
Principal payments from residential loans held-for-investment	—	271,700
Principal payments from commercial loans held-for-investment	15,000	63,131
Origination and advances of commercial loans, net of origination fees	(83,005)	(72,965)
Net cash provided by (used in) investing activities	571,699	(55,228)
Cash Flows from Financing Activities		
Proceeds from issuance of common stock	35	122
Repurchase of common stock	(25,000)	—

Cost of issuance of preferred stock	—	(14)
Due from counterparties	(158,132)	(10,026)
Change in collateral held payable	660	(8,390)
Proceeds from repurchase agreements	61,581,699	70,442,045
Principal repayments of repurchase agreements	(61,939,100)	(70,889,813)
Proceeds from asset-backed securities issued by securitization trusts	—	336,077
Principal repayments of asset-backed securities issued by securitization trusts	—	(255,848)
Proceeds from secured loans	125,000	600,000
Principal repayments on secured loans	(125,000)	(300,000)
Payments of deferred costs	(136)	—
Payments of dividends and distributions	(102,651)	(123,524)
Net cash used in financing activities	(642,625)	(209,371)
Net change in cash and cash equivalents	90,885	(77,141)
Cash and cash equivalents, beginning of period	53,199	164,144
Cash and cash equivalents, end of period	144,084	87,003
Supplement Disclosure of Cash Flow Information		
Interest paid	74,037	103,352
Non-cash Investing and Financing Activities Information		
Net change in unrealized gain on mortgage-backed and credit risk transfer securities	226,995	(78,085)
Dividends and distributions declared not paid	50,919	61,770
Net change in investment related payable (receivable)	206,034	152,580
Repurchase agreements, not settled	—	(49)
Net change in due from counterparties	1,126	2,523

The accompanying notes are an integral part of these condensed consolidated financial statements.

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INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 – Organization and Business Operations

Invesco Mortgage Capital Inc. (the “Company”) is a Maryland corporation primarily focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans. The Company conducts its business through IAS Operating Partnership LP (the “Operating Partnership”), a variable interest entity ("VIE"), as its sole general partner. As of June 30, 2016, the Company owned 98.7% of the Operating Partnership, and a wholly-owned subsidiary of Invesco owned the remaining 1.3%. The Company has one operating segment.

The Company primarily invests in:

- Residential mortgage-backed securities ("RMBS") that are guaranteed by a U.S. government agency such as the Government National Mortgage Association, or a federally chartered corporation such as the Federal National Mortgage Association ("Fannie Mae") or the Federal Home Loan Mortgage Corporation ("Freddie Mac") (collectively "Agency RMBS");
- RMBS that are not guaranteed by a U.S. government agency (“non-Agency RMBS”);
- Credit risk transfer securities that are unsecured obligations issued by government-sponsored enterprises ("GSE CRT");
- Commercial mortgage-backed securities ("CMBS");
- Residential and commercial mortgage loans; and
- Other real estate-related financing agreements.

The Company is externally managed and advised by Invesco Advisers, Inc. (the "Manager"), a registered investment adviser and an indirect, wholly-owned subsidiary of Invesco Ltd. (“Invesco”), a leading independent global investment management firm. The Company elected to be taxed as a real estate investment trust (“REIT”) for U.S. federal income tax purposes under the provisions of the Internal Revenue Code of 1986, as amended, commencing with the Company's taxable year ended December 31, 2009. To maintain the Company’s REIT qualification, the Company is generally required to distribute at least 90% of its REIT taxable income to its stockholders annually. The Company operates its business in a manner that permits exclusion from the "Investment Company" definition under the Investment Company Act of 1940, as amended.

Note 2 – Summary of Significant Accounting Policies

Basis of Presentation and Consolidation

Certain disclosures included in the Company’s Annual Report on Form 10-K are not required to be included on an interim basis in the Company’s quarterly reports on Form 10-Q. The Company has condensed or omitted these disclosures. Therefore, this Form 10-Q should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2015.

In the opinion of management, the condensed consolidated financial statements reflect all adjustments, consisting of normal recurring accruals, which are necessary for a fair presentation of the financial condition and results of operations for the periods presented. All significant intercompany transactions, balances, revenues and expenses are eliminated upon consolidation.

The condensed consolidated financial statements have been prepared in accordance with U.S. GAAP and consolidate the financial statements of the Company and its controlled subsidiaries. During the period from January 1, 2015 through December 9, 2015, the condensed consolidated financial statements also include the results of operations of certain residential loan securitization trusts (the "residential securitizations") that meet the definition of a VIE. On December 9, 2015, the Company completed the sale of certain beneficial interests in the residential securitizations and deconsolidated the residential securitizations.

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Revision of Previously Issued Financial Statements

During the second quarter of 2016, the Company corrected errors in its accounting for premiums and discounts associated with non-Agency RMBS not of high credit quality. The Company concluded that the errors are immaterial to each of the annual and interim consolidated financial statements which were included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 and its interim report on Form 10-Q for the quarter ended March 31, 2016. The Company has corrected its financial statements for previous periods included in this filing on Form 10-Q and will correct its previously issued financial statements for these errors as the financial statements are presented in future periodic filings.

Refer to Note 17 - "Revision of Previously Issued Financial Statements" for additional details.

Use of Estimates

The preparation of condensed consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Examples of estimates include, but are not limited to, estimates of the fair values of financial instruments, interest income on mortgage-backed and credit risk transfer securities, allowance for loan losses and other-than-temporary impairment charges. Actual results may differ from those estimates.

Significant Accounting Policies

There have been no changes to the Company's accounting policies included in Note 2 to the consolidated financial statements of the Company’s Annual Report on Form 10-K for the year ended December 31, 2015, other than the significant accounting policies disclosed below.

U.S. Treasury Securities

U.S. Treasury Securities are classified as trading securities and are recorded at fair value. The Company records its purchases of U.S. Treasury Securities on the trade date. Changes in fair value are recognized in gain (loss) on investments, net in the Company’s consolidated statements of operations. Interest income is accrued based on the outstanding principal balance of the securities and their contractual terms. Premiums are amortized into interest income over the contractual lives of the securities using a level yield method.

Interest Income Recognition

Mortgage-Backed Securities

Interest income on MBS is accrued based on the outstanding principal balance of the securities and their contractual terms. Premiums or discounts are amortized or accreted into interest income over the life of the investment using the effective interest method.

Interest income on the Company's non-Agency MBS (and other prepayable mortgage-backed securities where the Company may not recover substantially all of its initial investment) is based on estimated future cash flows. Management estimates future expected cash flows at the time of purchase and determines the effective interest rate based on these estimated cash flows and the Company’s purchase price. Over the life of the investments, management updates these estimated future cash flows and computes a revised yield based on the current amortized cost of the investment. In estimating these future cash flows, there are a number of assumptions that are subject to uncertainties and contingencies, including the rate and timing of principal payments (prepayments, repurchases, defaults and liquidations), the pass through or coupon rate, and interest rate fluctuations. These uncertainties and contingencies are difficult to predict and are subject to future events that may impact management’s estimates and the Company's interest income. When actual cash flows vary from expected cash flows, the difference is recorded as an adjustment to the amortized cost of the security and the security's yield is revised prospectively. Changes in cash flows from the Company's original or most recent projection may result in a prospective change in interest income recognized on these securities, or the amortized cost of these securities.

For Agency RMBS that cannot be prepaid in such a way that the Company would not recover substantially all of its initial investment, interest income recognition is based on contractual cash flows. The Company does not estimate prepayments in applying the effective interest method.

Reclassifications

Certain prior period reported amounts have been reclassified to be consistent with the current presentation. Such reclassifications had no impact on net income or equity attributable to common stockholders.

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Accounting Pronouncements Recently Adopted and Pending Accounting Pronouncements

Effective January 1, 2016, the Company adopted the newly issued accounting guidance for presentation of debt issuance costs. Under the new standard, debt issuance costs are required to be presented in the consolidated balance sheets as a direct deduction from the carrying value of the associated debt liability. The Company adopted the accounting standard on a retrospective basis, which required the restatement of the Company's December 31, 2015 balance sheet. The adoption resulted in a $5.4 million reduction in exchangeable senior notes and a corresponding reduction in other assets.

Effective January 1, 2016, the Company adopted the newly issued accounting guidance for reporting entities that are required to determine whether they should consolidate certain legal entities. The Company adopted the accounting standard on a modified retrospective approach which did not require restatement of prior periods to conform to the post adoption presentation. The Company did not consolidate or deconsolidate any legal entities as a result of implementing the new guidance.

In January 2016, the FASB issued guidance to improve certain aspects of classification and measurement of financial instruments, including significant revisions in accounting related to the classification and measurement of investments in equity securities and presentation of certain fair value changes for financial liabilities when the fair value option is elected. The guidance also amends certain disclosure requirements associated with the fair value of financial instruments. The Company is required to adopt the new guidance in the first quarter of 2018. Early adoption is permitted. The Company is currently evaluating the potential impact of the new guidance on its consolidated financial statements, as well as available transition methods.

In June 2016, the FASB issued an amendment to the guidance on reporting credit losses for assets measured at amortized cost and available-for-sale securities. The Company is required to adopt the new guidance in the first quarter of 2020. Early adoption is permitted. The Company is currently evaluating the potential impacts of the new guidance on its consolidated financial statements, as well as available transition methods.

Note 3 – Variable Interest Entities

The Company's maximum risk of loss in VIEs in which the Company is not the primary beneficiary at June 30, 2016 is presented in the table below.

$ in thousands	Carrying Amount	Company's Maximum Risk of Loss
Non-Agency RMBS	2,248,974	2,248,974
CMBS	2,733,442	2,733,442
Investments in unconsolidated ventures	33,037	33,037
Total	5,015,453	5,015,453

Refer to Note 4 - "Mortgage-Backed and Credit Risk Transfer Securities" and Note 7 - "Other Assets" for additional details regarding these investments.

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Note 4 – Mortgage-Backed and Credit Risk Transfer Securities

The following tables summarize the Company's MBS and GSE CRT portfolio by asset type as of June 30, 2016 and December 31, 2015.

June 30, 2016

$ in thousands	Principal/ Notional Balance	Unamortized Premium (Discount)	Amortized Cost	Unrealized Gain/ (Loss), net	Fair Value	Net Weighted Average Coupon (1)	Period-end Weighted Average Yield (2)	Quarterly Weighted Average Yield (3)
Agency RMBS:								
15 year fixed-rate	2,417,736	112,107	2,529,843	33,507	2,563,350	3.39 %	2.36 %	1.87 %
30 year fixed-rate	3,509,579	228,288	3,737,867	88,566	3,826,433	4.22 %	2.88 %	2.74 %
ARM*	351,704	3,332	355,036	9,298	364,334	2.71 %	2.62 %	2.30 %
Hybrid ARM	2,774,976	50,477	2,825,453	54,535	2,879,988	2.72 %	2.53 %	2.10 %
Total Agency pass-through	9,053,995	394,204	9,448,199	185,906	9,634,105	3.48 %	2.63 %	2.31 %
Agency-CMO(4)	1,718,714	(1,340,005)	378,709	16,556	395,265	2.18 %	3.50 %	2.55 %
Non-Agency RMBS(5)(6)(7)	4,349,423	(2,178,234)	2,171,189	77,785	2,248,974	2.18 %	5.21 %	4.74