

Western Asset Mortgage Capital Corp
Form 10-Q
November 09, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2015

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: 001-35543

Western Asset Mortgage Capital Corporation

(Exact name of Registrant as specified in its charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

27-0298092
(IRS Employer
Identification Number)

Western Asset Mortgage Capital Corporation

385 East Colorado Boulevard

Pasadena, California 91101

(Address of Registrant's principal executive offices)

(626) 844-9400

(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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, 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 No

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

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 under the Securities Exchange Act of 1934).
Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.

As of November 3, 2015, there were 41,919,801 shares, par value \$0.01, of the registrant's common stock issued and outstanding.

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Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Consolidated Balance Sheets (Unaudited)****(in thousands except share and per share data)**

	September 30, 2015	December 31, 2014
Assets:		
Cash and cash equivalents	\$ 39,703	\$ 47,222
Mortgage-backed securities and other securities, at fair value (\$3,343,683 and \$4,362,532 pledged as collateral, at fair value, respectively)	3,352,509	4,385,723
Residential Whole-Loans, at fair value (amounts related to VIE of \$150,486 and \$7,220, respectively)	150,486	7,220
Linked transactions, net, at fair value		20,627
Receivable under reverse repurchase agreements	758,467	
Investment related receivable	10,734	162,837
Accrued interest receivable (amounts related to VIE of \$1,159 and \$40, respectively)	21,415	27,309
Due from counterparties	236,525	184,757
Derivative assets, at fair value	56,985	73,256
Other assets	773	326
Total Assets	\$ 4,627,597	\$ 4,909,277
Liabilities and Stockholders' Equity:		
Liabilities:		
Borrowings under repurchase agreements	\$ 3,010,268	\$ 3,875,721
Accrued interest payable	21,719	17,573
Investment related payables	10,742	166,608
Due to counterparties	771,784	12,180
Derivative liability, at fair value	227,158	180,280
Accounts payable and accrued expenses (including obligations of VIE of \$5 and \$153, respectively)	2,262	1,794
Payable to related party	2,797	2,705
Dividend payable	25,152	29,204
Total Liabilities	4,071,882	4,286,065
Commitments and contingencies		
Stockholders' Equity:		
Common stock, \$0.01 par value, 500,000,000 shares authorized, 41,919,801 and 41,719,801 shares issued and outstanding, respectively	419	417
Preferred stock, \$0.01 par value, 100,000,000 shares authorized and no shares outstanding		
Additional paid-in capital	762,935	760,925
Retained earnings (accumulated deficit)	(207,639)	(138,130)
Total Stockholders' Equity	555,715	623,212
Total Liabilities and Stockholders' Equity	\$ 4,627,597	\$ 4,909,277

See notes to unaudited consolidated financial statements.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Consolidated Statements of Operations (Unaudited)****(in thousands except share and per share data)**

	For the three months ended September 30, 2015	For the three months ended September 30, 2014	For the nine months ended September 30, 2015	For the nine months ended September 30, 2014
Net Interest Income:				
Interest income	\$ 35,821	\$ 40,718	\$ 117,656	\$ 108,752
Interest expense	6,981	6,468	19,960	15,829
Net Interest Income	28,840	34,250	97,696	92,923
Other Income (Loss):				
Interest income on cash balances and other income (loss), net	(29)	942	1,744	954
Realized gain (loss) on sale of Mortgage-backed securities, other securities and Whole-Loans, net	(2,482)	4,912	9,267	(2,650)
Other loss on Mortgage-backed securities and other securities	(5,917)	(2,857)	(14,884)	(7,565)
Unrealized gain (loss) on Mortgage-backed securities, other securities and Whole-Loans, net	24,723	(4,453)	10,284	140,755
Gain on linked transactions, net		(1,241)		1,666
Loss on derivative instruments, net	(41,363)	(401)	(76,511)	(126,984)
Other Income (Loss), net	(25,068)	(3,098)	(70,100)	6,176
Operating Expenses:				
General and administrative (includes \$509, \$587, \$1,969 and \$1,654 non-cash stock based compensation, respectively)	2,863	2,253	8,862	6,703
Management fee related party	2,761	2,763	8,133	7,127
Total Operating Expenses	5,624	5,016	16,995	13,830
Net income (loss) available to Common Stock and participating securities	\$ (1,852)	\$ 26,136	\$ 10,601	\$ 85,269
Net income (loss) per Common Share Basic	\$ (0.05)	\$ 0.63	\$ 0.24	\$ 2.35
Net income (loss) per Common Share Diluted	\$ (0.05)	\$ 0.63	\$ 0.24	\$ 2.35
Dividends Declared per Share of Common Stock	\$ 0.60	\$ 0.70	\$ 1.91	\$ 2.04

See notes to unaudited consolidated financial statements.

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Western Asset Mortgage Capital Corporation and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

(in thousands, except shares and share data)

	Common Stock			Additional Paid-	Retained		Total
	Shares	Par		In Capital	Earnings (Accumulated) Deficit		
Balance at December 31, 2014	41,719,801	\$ 417	\$	760,925	\$(138,130)	\$	623,212
Grants of restricted stock	200,000	2		(2)			
Vesting of restricted stock				1,969			1,969
Net income					10,601		10,601
Dividends on common stock				43	(80,110)		(80,067)
Balance at September 30, 2015	41,919,801	\$ 419	\$	762,935	\$(207,639)	\$	555,715

See notes to unaudited consolidated financial statements.

Table of Contents**Western Asset Mortgage Capital Corporation and Subsidiaries****Consolidated Statements of Cash Flows (Unaudited)****(in thousands)**

	For the nine months ended September 30, 2015	For the nine months ended September 30, 2014, as Revised (See Note 2)
Cash flows from operating activities:		
Net income	\$ 10,601	\$ 85,269
Adjustments to reconcile net income to net cash provided by operating activities:		
Premium amortization and (discount accretion) on Mortgage-backed securities, other securities and Whole-Loans, net	5,645	8,049
Interest income earned added to principal of Mortgage-backed securities and other securities	(141)	
Amortization of deferred financing costs	295	
Restricted stock amortization expense	1,969	1,654
Premium amortization for MAC interest rate swaps	(1,075)	(928)
Interest payments and basis recovered on MAC interest rate swaps	1,443	(545)
Premium on purchase of Residential Whole-Loans	(2,390)	
Unrealized loss on Mortgage-backed securities, other securities and Whole-Loans, net	(10,284)	(140,755)
Mark-to-market adjustments on linked transactions		1,339
Mark-to-market adjustments on derivative instruments	82,952	126,112
Other loss on Mortgage-backed securities and other securities	14,884	7,565
Realized (gain) loss on sale of Mortgage-backed securities, other securities and Whole-Loans, net	(9,267)	2,650
Realized (gain) loss on sale of Interest-Only Strips accounted for as derivatives, net	(624)	755
Realized loss on termination of MAC interest rate swaps containing an other-than-insignificant financing element	8,658	
Realized (gain) loss on sale of TBAs, net	1,728	(25,169)
Realized loss on sale of swaptions, net	3,873	5,908
Realized loss on forward contracts	980	1,182
Realized loss on futures	627	16,495
Realized gain on option derivatives	(684)	
Realized gain on linked transaction, net		(1,397)
Gain on foreign currency transactions, net	(1,664)	(1,119)
Changes in operating assets and liabilities:		
Decrease (increase) in accrued interest receivable	5,894	(23,365)
Increase in other assets	(279)	(279)
Increase in accrued interest payable	4,146	12,036
Increase in accounts payable and accrued expenses	468	1,008
Increase in payable to related party	92	1,214
Net cash provided by operating activities	117,847	77,679
Cash flows from investing activities:		
Purchase of Mortgage-backed securities and other securities	(570,441)	(3,804,044)
Purchase of securities underlying linked transactions		(38,224)
Proceeds from sale of Mortgage-backed securities and other securities	2,087,678	2,240,338
Proceeds from sale of securities underlying linked transactions		6,214
Principal payments and basis recovered on Mortgage-backed securities and other securities	315,106	233,796

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Principal payments and basis recovered on securities underlying linked transactions		4,408
Purchase of Residential Whole-Loans	(147,336)	
Principal payments on Residential Whole-Loans	9,077	
Purchase of Commercial Whole-Loans	(8,750)	
Principal payments on Commercial Whole-Loans	8,750	
Payment of premium for option derivatives	(10,864)	(2,813)
Premium received from option derivatives	11,548	
Net settlements of TBAs	466	25,169
Payment on termination of futures	(627)	(16,495)
Proceeds from sale of interest rate swaptions	27,899	
Premium for MAC interest rate swaps, net	(3,595)	11,010
Payments on termination of MAC interest rate swaps	(190)	
Interest payments and basis recovered on MAC interest rate swaps	(1,041)	
Proceeds from (payments made) on reverse repurchase agreements, net	(758,467)	
Premium for interest rate swaptions, net	(34,751)	1,615
Net cash provided by (used in) investing activities	924,462	(1,339,026)

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Cash flows from financing activities:			
Proceeds from issuance of common stock			205,380
Proceeds from private placement of common stock (concurrent with initial public offering)			9,653
Payment of offering costs			(409)
Proceeds from repurchase agreement borrowings	13,645,855		18,161,433
Proceeds from repurchase agreement borrowings underlying linked transactions			142,530
Repayments of repurchase agreement borrowings	(14,541,717)		(16,858,373)
Repayments of repurchase agreement borrowings underlying linked transactions			(178,948)
Proceeds from forward contracts	206,240		14,022
Repayments of forward contracts	(207,220)		(15,205)
Premium for MAC interest rate swaps containing an other-than-insignificant financing element			10,579
Payments on termination of MAC interest rate swaps containing an other-than-insignificant financing element	(18,655)		
Interest payments and basis recovered on MAC interest rate swaps containing an other-than-insignificant financing element	(402)		545
Payments made for deferred financing costs	(463)		
Due from counterparties, net	(51,768)		(94,232)
Due to counterparties, net	2,251		(62,554)
Dividends on common stock	(84,119)		(65,532)
Net cash (used in) provided by financing activities	(1,049,998)		1,268,889
Effect of exchange rate changes on cash and cash equivalents		170	
Net (decrease) increase in cash and cash equivalents	(7,519)		7,542
Cash and cash equivalents beginning of period		47,222	48,525
Cash and cash equivalents end of period		\$ 39,703	\$ 56,067
Supplemental disclosure of operating cash flow information:			
Interest paid	\$	20,363	\$ 14,350
Supplemental disclosure of non-cash financing/investing activities:			
Principal payments on Mortgage-backed securities and other securities, not settled	\$		\$ (317)
Mortgage-backed securities and other securities purchased, not settled	\$		\$ (14,832)
Mortgage-backed securities recorded upon unlinking of linked transactions	\$		\$ (69,838)
Obligation to return collateral used to settle short sales	\$	(757,353)	\$
Net unsettled TBAs	\$	(8)	\$
Deferred offering costs payable	\$		\$ (8)
Dividends and distributions declared, not paid	\$	25,152	\$ 29,203

See notes to unaudited consolidated financial statements.

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Western Asset Mortgage Capital Corporation and Subsidiaries

Notes to Consolidated Financial Statements (Unaudited)

(in thousands- except share and per share data)

The following defines certain of the commonly used terms in these Notes to Consolidated Financial Statements: Agency or Agencies refer to a federally chartered corporation, such as the Federal National Mortgage Association (Fannie Mae or FNMA) or the Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC), or an agency of the U.S. Government, such as the Government National Mortgage Association (Ginnie Mae or GNMA); references to MBS refer to mortgage backed securities, including residential mortgage-backed securities or RMBS , commercial mortgage-backed securities or CMBS , and Interest-Only Strips (as defined herein); Agency MBS refer to RMBS, CMBS and Interest-Only Strips issued or guaranteed by the Agencies while Non-Agency MBS refer to RMBS, CMBS and Interest-Only Strips that are not issued or guaranteed by the Agencies; references to ARMs refers to adjustable rate mortgages; references to Interest-Only Strips refer to interest-only (IO) and inverse interest-only (IIO) securities issued as part of or collateralized with MBS; references to Residential Whole-Loans and Commercial Whole-Loans (collectively Whole Loans) refer to individual mortgage loans secured by single family and commercial properties, respectively.

Note 1 Organization

Western Asset Mortgage Capital Corporation and subsidiaries (are collectively referred to throughout this report as the Company) are a real estate finance company. At the Company s launch in May 2012, its initial investment strategy focused primarily on Agency RMBS (including TBAs as defined herein). Over time, the Company expanded its investment strategy to include Non-Agency RMBS and subsequently, Agency and Non-Agency CMBS, including Non U.S. CMBS and Whole-Loans. In addition, and to a significantly lesser extent, the Company has invested in other securities including certain Agency obligations that are not technically MBS and in asset-backed securities (ABS). These changes in the Company s investment strategy, including future changes, are based on the Manager s perspective of which mix of portfolio assets it believes provide the Company with the best risk-reward opportunities at any given time.

The Company is externally managed by Western Asset Management Company (WAM , or the Manager), an investment advisor registered with the Securities and Exchange Commission (SEC). WAM is a wholly-owned subsidiary of Legg Mason, Inc. The Company operates and has elected to be taxed as a real estate investment trust or REIT commencing with its taxable year ended December 31, 2012.

In light of the aforementioned developments and given the Manager s current market outlook and investment view, while it can be expected that Agency RMBS will continue to be a significant part of the Company s portfolio, Agency RMBS will not necessarily be our primary investment in the future. Going forward, the Manager may vary the allocation among various asset classes subject to maintaining the Company s qualification as a REIT and maintaining its exemption from the Investment Company Act of 1940 (the 1940 Act). These restrictions limit the Company s ability to invest in non-real estate assets and/or assets which are not secured by real estate. Accordingly, the Company s portfolio will continue to be principally invested in MBS and other real estate related assets.

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As previously reported in the Company's annual report on Form 10-K for the year ended December 31, 2014, during the process of preparing the Company's 2014 financial statements, the Company discovered that the treatment of premiums received on the market agreed coupon (MAC) interest rate swaps and treatment of proceeds and repayment on rehypothecation of non-cash collateral in its Statements of Cash Flows and a voluntary disclosure surrounding the breakdown between realized and unrealized portion of the change in fair value for derivative instrument were not presented in accordance with GAAP. The Company has evaluated the impact of these errors and has concluded that individually and in the aggregate, these errors were not material to any previously issued financial statements. However, the Company has elected to revise the Statement of Cash Flows for the nine months ended September 30, 2014 and the voluntary disclosure for the three and nine months ended September 30, 2014 in these quarterly financial statements on Form 10-Q to correct the aforementioned errors. The corrections resulted in a reclassification of premiums received and periodic interest payments on interest rate swaps previously reported in cash flows from operating activities and the reclassification of proceeds and repayments on rehypothecation of non-cash collateral previously reported as repurchase agreement proceeds and repayments (as indicated in the tables below). In accordance with the Company's accounting policies, proceeds and repayments on rehypothecation of non-cash collateral is reported on a net basis in Due to counterparties, net. These revisions had no effect on net income, shareholders' equity, net change in cash, or total assets, of the Company reported for these periods.

Statements of Cash Flows (summarized) for the nine months ended September 30, 2014:

Amounts in thousands	For the nine months ended September 30, 2014		
	As Originally Reported	Adjustments	Revised
Statement of Cash Flows (effect on individual line items)			
Net income	\$ 85,269	\$	\$ 85,269
Adjustments to reconcile net income to net cash provided by operating activities:			
Premium amortization for MAC interest rate swaps		(928)	(928)
Interest payments and basis recovered on MAC interest rate swaps		(545)	(545)
Mark-to-market adjustments on derivative instruments	147,968	(21,856)	126,112
All other items	(132,229)		(132,229)
Net cash provided by operating activities	101,008	(23,329)	77,679
Cash flows from investing activities:			
Premium for MAC interest rate swaps, net	(2,235)	13,245	11,010
All other items	(1,350,036)		(1,350,036)
Net cash used in investing activities	(1,352,271)	13,245	(1,339,026)
Cash flows from financing activities:			
Proceeds from repurchase agreement borrowings	18,164,190	(2,757)	18,161,433
Repayments of repurchase agreement borrowings	(16,861,130)	2,757	(16,858,373)
Premium for MAC interest rate swaps containing an other-than-insignificant financing element	1,040	9,539	10,579

Interest payments and basis recovered on
MAC interest rate swaps containing an
other-than-insignificant financing element

545