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# Crossroads Capital, LLC

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Orchid Island Capital (ORC)



June 29<sup>th</sup>, 2020

# Crossroads Capital firm overview

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- Crossroads Capital, LLC is a **concentrated, long-term-oriented** investment manager that employs a **research-intensive**, and often **event-driven** investment approach
- Our objective is to produce consistent, above-average, risk-adjusted returns for our funds' limited partners via **conservative** and **opportunistic** investing in publicly traded securities
- Modeled after partnerships managed by Warren Buffett from 1956 to 1969, the partnership adheres to a solid **value investing** philosophy, employing a balanced tool kit that should generate strong, market-agnostic returns while preserving capital in downturns
- Our approach aims to exploit structurally inefficient pockets of the capital markets, with a particular emphasis on uncovering:
  - **Underfollowed small- and micro-cap growth companies:** under-appreciated high quality “compounders” with market capitalizations ranging from ~\$50mm-\$5bn & limited institutional ownership
  - **Special situations:** investments where near- to medium-term performance is tied to an upcoming event or significant corporate change; i.e. where the unlocking of value isn't correlated to the stock market, but rather company level actions and outcomes
- Long term, the firm aspires to be the single best fund within the US for identifying and owning underappreciated, high-quality businesses undergoing **value-unlocking change**

# Orchid Island Capital (ORC) overview

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Stock price:

\$4.36

Market cap<sup>1</sup>:

\$311.22mn

Tangible book value/share (TBV):

\$5.35

Price to TBV:

.87x

Price to (options and dividend adj.)

TBV<sup>1</sup>:

.73x

Run rate yield<sup>2</sup>:

14.25x

Normalized yield<sup>3</sup>:

21 to 37%

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1. See "option twist" outlined on slide 10.

2. Run rate monthly payout of \$0.05/share.

3. Range runs from a return-to-prior \$0.08 to a \$0.12 "unlimited money" rate at breakeven.

- Orchid Island is an **"agency mREIT"**. It invests solely in mortgage-backed securities (MBS) issued by government-sponsored agencies including Fannie Mae, Freddie Mac, and Ginnie Mae.
- While not all mREITs are created equal, they are the same in one respect: All are in essence simple spread businesses that use extreme leverage to borrow money short-term in order to lend long-term, augmenting returns as a result. These returns that are then paid out as dividends to income-seeking investors stretching for yield.
- Simplistically, the difference between an mREIT's "interest income" (i.e. mortgage rates) and "interest expense" (i.e. repurchase funding rates) equals its "net interest income". Subtract hedging costs and operating expense, and what's left can be distributed to shareholders as dividends. (It can earn this spread because long-term rates are usually higher than short-term rates).
- While mREITs take existential risks, typically blowing up once a cycle in times of severe distress, **government agencies cannot default on agency MBS**, insulating agency mREITs like ORC from credit risk.
- Predictably, recent turmoil in short-term funding markets caused **panic selling during the COVID-19 pandemic**, indiscriminately crushing the share prices of mREITs and agency mREITs alike, creating a rare opportunity to buy shares of agency mREITs like ORC at steep discounts.

# ORC's moat: The full faith and credit of the US government

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- mREITs are not the kind of business we usually invest in. Their business model is not just risky, it's **virtually guaranteed to collapse** at precisely those times when the market tanks and investors panic. We like defensive, highly resilient businesses with growing moats and staying power – businesses that actually do *better* when the economy is weak and investors are scared.
- In the case of agency mREITs, the MBS they hold are backed by the power of the US government, eliminating their credit risk in full: **They literally can't be defaulted on.** This feature makes agency mREITs potentially investable for us in the right scenario.
- This past March, wave after wave of forced selling pressure from low-information investors drove pure agency mREITs like ORC to nonsensical levels, and they remain deeply undervalued despite unlimited purchases of agency MBS and other recent actions from the Fed taken to ensure the proper functioning of mortgage markets. These actions collectively **eliminated liquidity, funding, and interest rate risks, truncating the downside significantly.**
- As a result, we believe ORC offers investors an **“unlimited money” pure play** that is non-correlated to the health of the general economy and the pace of the reopening. Better yet, thanks to the Fed's recent actions, it possesses very certain prospects combined with an extremely low likelihood of permanent loss – a rare combination in our increasingly uncertain and income-starved world.
- This confluence of events created the chance to purchase a government-guaranteed book value at a sizable discount – a book value that will rapidly accrete higher thanks to an imminent step change in earnings power, **a trajectory underwritten with the full faith and credit of Uncle Sam** (creating moat-like protection around the dramatically enhanced returns ORC should earn for the foreseeable future).
- What was once an unthinkable investment is now an absolute slam dunk, an ironic twist of fate to be sure.



# Uncle Sam is more or less acting as ORC's "silent partner"

- The Fed is printing unlimited amounts of money and using it to buy agency MBS – the assets ORC owns. So ORC is a **direct beneficiary** of the Fed's money machine.
- Indeed, ORC and other pure mREITs like AGNC offer investors perhaps the best way to front run the Fed in a decade, akin to buying bank debt and preferreds in the aftermath of the GFC.
- The reality is the Fed has created a nirvana-like backdrop for a pure agency mREIT like Orchid, wielding the power of its printing press to anchor short rates at zero, thus **ensuring ORC's net interest margins will positively explode.**
- The Fed's actions are also guaranteeing the smooth functioning of mortgage markets, essentially **eliminating credit, funding, liquidity, and interest rate risk in one fell swoop.**



# March madness: How we got here

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- In summary, mREITs felt the effects of the pandemic early on. **Severe distress in short-term funding markets** set off a cascade of forced selling pressure as liquidity dried up, repo loans were pulled, and the prices of MBS assets imploded on the back of widespread margin calls (despite their government guarantee). These factors caused the entire sector to plunge 60%.
- Predictably, **mREITs' unsophisticated, yield-oriented shareholder base sold indiscriminately**, ignoring differing levels of credit quality and other variables among the many publicly-traded players in the space. Agency mREITs like ORC, whose investment portfolios are made up almost entirely of risk-free agency MBS, were crushed along with their far riskier peers as the tide rolled out.
- By late March, the Fed had not only cut rates to zero, but had announced it would provide unlimited support of the MBS and repo markets, ensuring the funding and liquidity issues wreaking havoc in mortgage markets would cease. Collectively, **these moves restored the mortgage markets to health**, with agency MBS prices quickly returning to prior highs, signaling to us in early April that it was time to jump in.



In short, with the Fed literally buying the assets mREITs like ORC own and running its printing press to keep its costs of funds near zero, discerning long-term investors have an **opportunity to purchase risk-free dollar bills for 73 cents\*** – despite dramatically enhanced earnings power & normalized dividend yields of over 20%.

# ORC avoids or minimizes various types of risk

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**Credit risk:** The risk of not getting repaid by a borrower

ORC faces no credit risk on its portfolio of agency MBS, payments on which are literally guaranteed by the government.

**Liquidity risk:** The risk of being unable to sell assets at reasonable prices when necessary

The Fed has committed to buying limitless quantities of agency MBS, stabilizing their prices so March's market collapse won't repeat.

**Prepayment risk:** The risk that borrowers refinance loan, depressing portfolio yields

It's hard for borrowers to refinance given log jams in the loan approval process and tighter underwriting standards due to the impact of COVID-19.

**Funding risk:** The risk of being unable to roll over short-term financing

Even if the repo market breaks down, ORC can unwind its repos to get cash by selling the pledged MBS to the Fed at par.

**Interest rate risk:** The risk of interest rate moves hurting one's business

The spread between ORC's interest rates paid and received should stay wide so long as the Fed keeps short-term rates low.

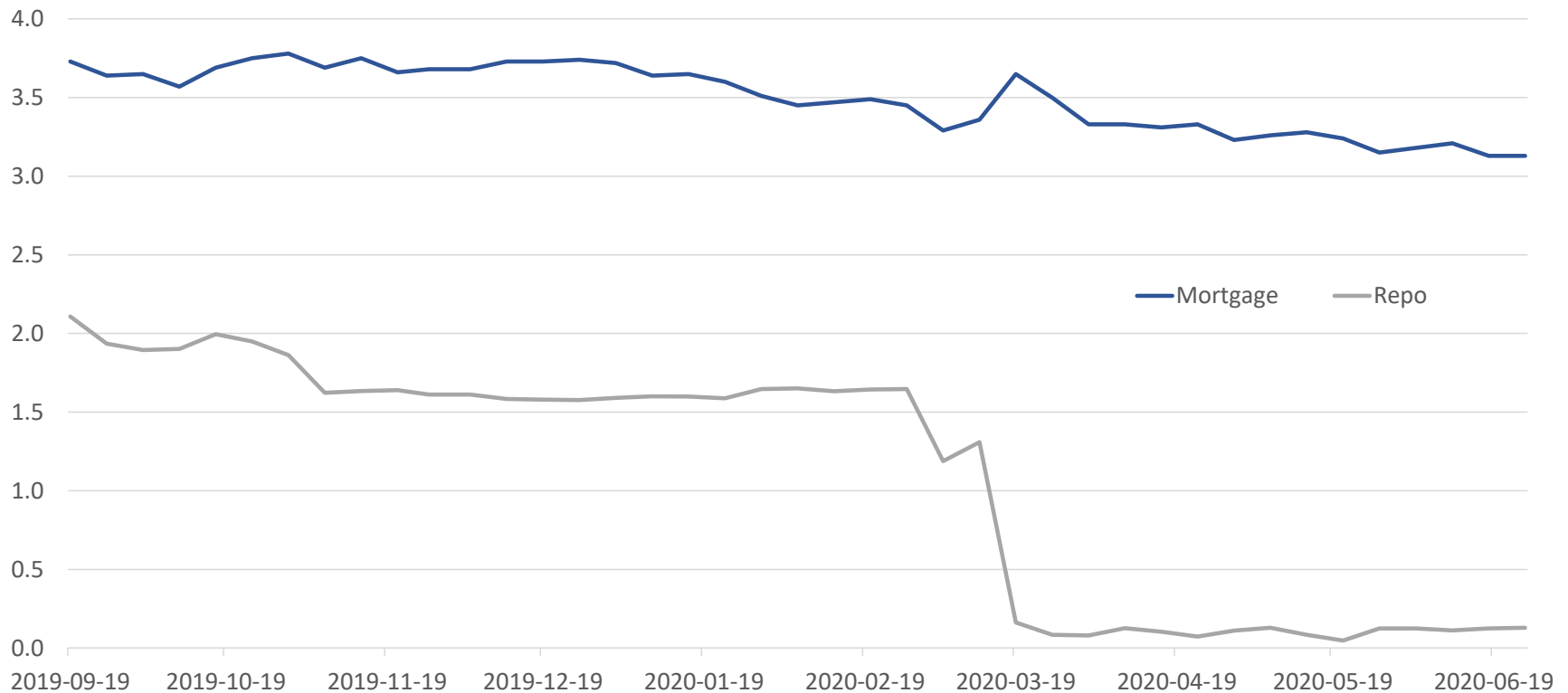
**Higher hedging costs:** The risk that the increased cost of hedging will depress returns

With the Fed committed to keeping short-term rates low, ORC is hedging less and what hedges remain, protects it against lower, not higher rates.



# Wider mortgage-repo spread means greater earnings power

Average US 30-year fixed mortgage rate (%) vs. DTCC GCF Repo Index rate for MBS (%)



Sources: <https://fred.stlouisfed.org/categories/114>, <https://www.dtcc.com/charts/dtcc-qcf-repo-index>

As the spread between the interest rate ORC pays (short-term repo) and receives (30-year mortgages) widened, the company's net interest margins will expand in step change fashion as its higher cost funding resets over the next few quarters. This temporary lag is causing investors to miss the outsized impact to its earnings power as a result.

# Wider NIM translates into step change inflection in dividends

- As you can see, the highly visible step change inflection in the profitability of ORC's business model has an enormous impact on its inherent dividend paying capacity despite a smaller investment portfolio in the wake of the turmoil in March.
- The company's Q1 2020 repo expense averaged 1.68% of AUM, but that cost will fall to 12.5 bips in the aftermath of a 0% Fed funds rate brought about by COVID-19-related distress.
- As a result, the simple back of the envelope model to the right acts as a proxy for ORC's forward looking earnings power: On a 3.4 billion investment portfolio earning a 341 basis point spread that is 9x levered, that is 116 million in normalized net interest income. After subtracting operating expenses it should have \$95 million available to distribute to shareholders, or roughly \$1.64 per share on a \$4.36/share stock that is virtually risk free.
- Assuming ORC pays out 90% of its net interest income going forward as required by the IRS, that puts its normalized annual dividend paying capacity at a truly massive 32.95% annually, or roughly 12 cents per share per month.

<b>30 year Agency MBS yield</b>	<b>3.13%</b>
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(bips)

Agency Repo	12.5
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Hedging cost	15
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<b>Normalized costs of funds</b>	<b>27.5</b>
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Forward net portfolio yield	369
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Cost of funds NTM	27.5
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<b>Normalized NIM</b>	<b>341.5</b>
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Normalized NI	\$116,077,626
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Op Ex Q1	\$10,385,000
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Normalized NI	\$105,692,626
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<b>Normalized DCF (90%)</b>	<b>\$95,123,363</b>
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<b>Normalized NI/share</b>	<b>\$1.60</b>
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<b>Normalized DCF/share</b>	<b>\$1.44</b>
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<b>Normalized yield</b>	<b>32.95%</b>
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<b>Monthly Normalized yield/share</b>	<b>\$0.12</b>
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# Using options to better exploit ORC's special situation

By purchasing ORC common stock while simultaneously writing January 2020 puts, we lowered our purchase price on an unlimited-money pure play, ensuring we get paid to wait while its cost of funding resets, all but guaranteeing a highly attractive risk-adjusted return under a wide range of outcomes. We will profit if the share price rises, stays flat, or drops as much as 19% over the coming seven months.

As a result, we view the fundamental, market, and technical risks associated with this investment as extremely low, creating an extraordinarily asymmetric opportunity for the risk-averse to generate an annualized IRR of potentially 130%. And that's before Mr. Market eventually wakes up.

## **BENEFITS OF BUYING ORC COMMON STOCK:**

- Business model unaffected by the impact of COVID-19 lockdowns.
- Downside is limited by discount to book value – a book value that is government-guaranteed and increasing.
- Earnings power – and hence dividend-paying capacity – underwent a step-change increase as repo rates dropped.
- With the upsurge in prepayments delayed, repo rates near all time lows, and mortgage rates stable, we have entered mREIT nirvana – but the market hasn't caught on – at least not yet.

## **BENEFITS OF WRITING JAN 2021 ORC PUTS:**

- Volatility has spiked on rampant options speculation by day traders, creating the sort of huge premiums on small-cap options we'd expect in a market that just plunged, not one that's flirting with prior highs.
- We have effectively sold insurance for an incredibly unlikely event at incredibly attractive prices, skewing an already asymmetric risk-reward even further in our favor.

	Cash Outlay	Cash Inflow
Buy 1000 ORC common @ \$4.63	\$4,630	
Sell 10 Jan 21 \$5 puts @ \$1.10		\$1,100
<b>Net cash out of pocket</b>	<b>\$3,530</b>	
<b>Total premiums received</b>		<b>\$1,100</b>

## **Base case scenario**

Investment value at tangible book (\$5.35)	\$5,350
stock profit at tangible book value	\$720
plus premium profit	\$1,100
Interim dividends	\$385
<b>Total profit</b>	<b>\$2,205</b>

**Net capital invested** 3,530

<b>Total return on invested capital</b>	<b>62%</b>
Duration of investment (months)	7
<b>Annualized ROIC</b>	<b>130%</b>

## **Breakeven analysis**

Common purchase price	\$4.63
Put strike less put premium	3.9
<b>Breakeven before dividends</b>	<b>\$4.27</b>

Interim dividends	0.39
<b>Breakeven</b>	<b>\$3.88</b>

**Percentage decline before loss** 19%

# Small cap implied volatility is off the charts

- Recent **realized volatility** in small caps has been off the charts given the magnitude and speed of the market's drop followed by its equally violent rally off the lows. This has caused implied vol to spike, creating attractive prices to sell vol (write puts) on low risk names like ORC.
- In addition, **uncertainty** about COVID-19's impact, the election, and recent protests and riots makes the range of potential economic and market outcomes huge. Given small caps' greater economic vulnerability relative to larger businesses, their implied vol remains elevated.
- Finally, the listing of weekly options plus the advent of commission-free trading and a **surge in day trading** by bored sports betters looking for something else to gamble on have generated big swings in certain stocks and options. The result has been to drive small cap volatility even higher.

Small options traders are twice as aggressive as the February peak



High implied volatility has created extremely attractive prices to write puts (i.e., sell volatility) in “bulletproof” names like ORC that aren’t negatively affected by the COVID-19 fallout, social and political upheaval, or other currently pressing matters.

Unlike economically sensitive businesses whose earnings power could get cut in half or more – ORC’s will only grow (substantially). A classic compound mispricing, offering the opportunity to sell mispriced options on a mispriced stock.

# Outcomes range from pretty good to downright amazing...

- Even at ORC's current \$0.005/share monthly dividend run rate, its implied forward yield is **14.3%**.
- If dividends normalize to the old \$0.08/share, its implied yield at breakeven is **24.7%**.
- If our model from prior slides proves even close to correct, the “unlimited money” scenario below translates into a yield at breakeven that should balance out much higher, potentially upwards of **37.0%**.

<b>ORC share price</b>	<b>\$4.63</b>
Tangible book value/share*	\$5.35
P/TBV	87%
Implied P/TBV (premium adj. cost basis)**	80%
<b>Implied P/TBV @ breakeven***</b>	<b>73%</b>

\*TBV as of June 1st, 2020

\*\*Cost basis adusted for option premium received

\*\*\*Cost basis adjusted for premiums and 7 monthly dividends

Monthly yield/share	0.055
Annual yield/share	0.66
<b>Implied forward yield (%)</b>	<b>14.25%</b>
Implied 7 month yield (p/sh)	0.385
Implied 7 month yield (\$)	\$385
<b>Implied YTM</b>	<b>8.31%</b>
Normalzied monthly dividend/share	\$0.08
Normalized annual dividend/share	\$0.96
Unlimited money monthly dividend/share	\$0.12
Unlimited money annual dividend/share	\$1.44
<b>Implied normalized yield at current price (\$4.63)</b>	<b>20.73%</b>
<b>Implied unlimited money yield at current price (\$4.63)</b>	<b>31.03%</b>
<b>Implied normalized yield at breakeven (\$3.88)</b>	<b>24.74%</b>
<b>Implied unlimited money yield at breakeven (\$3.88)</b>	<b>37.02%</b>

## Back of the envelope total return scenario analysis

### Plain vanilla long

Implied upside at tangible book value (\$5.35)	15%
Forward yield at run rate monthly divididdend (0.05)	14%
<b>Implied 1-year total return on common</b>	<b>29%</b>

### Implied options adj. annual return on forward earnings power

Implied upside at tangible book value	37%
Normalized monthly dividend (0.08)	14%
<b>Implied 1-year total return at breakeven</b>	<b>51%</b>

Price target at 1.2x run rate tangible book value \$6.42

Implied upside at 1.2x run rate tangible book value	67%
Normalized monthly dividend (0.08)	25%
<b>Implied 1-year total return at breakeven</b>	<b>92%</b>

Implied upside at 1.2x run rate tangible book value	67%
Unlimited money monthly divididdend (.12)	37%
<b>Implied 1-year total return at breakeven</b>	<b>104%</b>

## ...and management is hinting at “downright amazing”:

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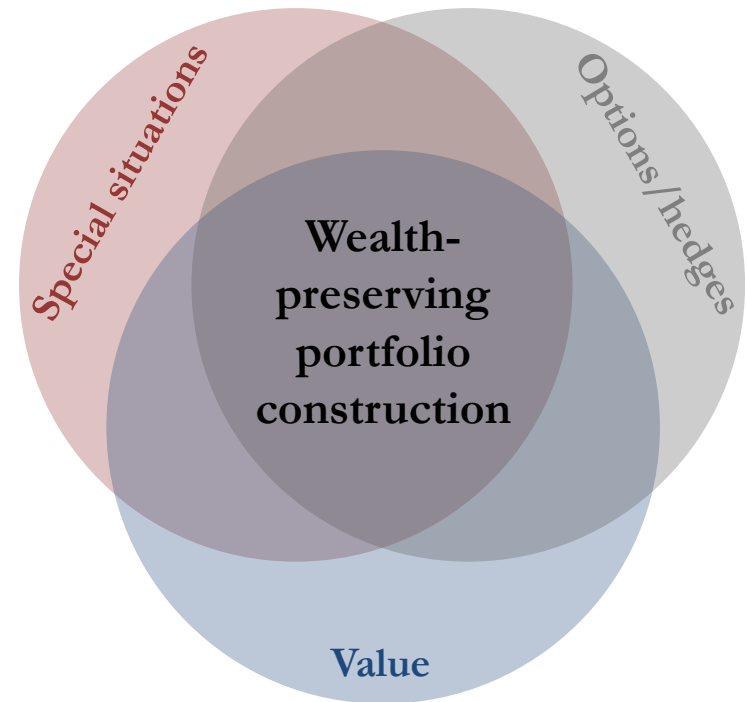
Q1 results meeting comments by Robert E. Cauley, ORC’s President and CEO:

- “NIMs in the market, **net interest margins available today are very, very attractive.** Returns on equity are very compelling, mid-teens, if not higher. And even with a slightly smaller portfolio, once we've realized the full benefits of our lower funding cost, **our earnings could rebound back to where they were.**”
- “**Agency mortgage-backed pass-throughs offer very attractive returns going forward.** As I mentioned, the ROEs on these investments are between 15, even the very high teens. So we've already seen a fair amount of book value recovery as spec pool payoffs have come back. But going forward, even though, we did have to reduce the dividend last month just in reaction to the developments in March, **there's the potential for our NIM to re-expand.** And we look forward to trying to take advantage of our ability to protect against speed and **maybe see some upward movement in the dividend going forward.**”
- “[Our] **interest expense in pennies per share per month has been trending down,** and it peaked in the spring of 2019 to \$0.15 per month, not per quarter. Looking at the most recent data for January, February, March, rates have come well off of their highs, in the mid to high 2% range. And our interest expense was between \$0.25 and \$0.26 per quarter -- for the quarter of 2020, so this quarter. **As our repos roll off and we realize the benefits of the Fed's rate cuts, this number could drop to \$0.03 to \$0.04 per quarter.** So a meaningful reduction.”

# Deep value + special situations + options = Success

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- At Crossroads, we look for **undervalued** companies with **strong, growing** businesses that are **resilient** in all sorts of market environments. That means no-moat mREITs dependent on fluctuating interest rates and vulnerable to collapse in market panics, normally wouldn't be our bag.
- But we don't look for strong, growing businesses out of some sense of moral virtue. We look for them because buying them is highly likely to make our investors money, however markets and the economy fare. In fact, ORC is a classic "**special situation**", which we define as an investment whose near- to medium-term performance is tied to an upcoming event or significant corporate change. It's "special" because the unlocking of value isn't correlated to the stock market, but rather to company-level actions and outcomes.
- Like all of our special situations, it's intrinsically opportunistic, non-recurring, and event-driven – intended to exploit idiosyncratic market dislocations and the mispricings that follow, exactly like what we experienced in March. This category of our investments (like our use of short sales, options and low-cost hedges) promotes survival and tends to outperform in downturns, helping Crossroads generate relatively **strong market-agnostic returns** as a result.
- So a company like ORC would normally never find its way into our portfolio. But now, a **perfect storm** of (1) deep value triggered by a cascade of forced selling and a historic market plunge, (2) a special situation with multiple hard near-term catalysts in which the Fed is all but guaranteeing the ultimate outcome, and (3) our ability to exploit the situation even further by writing grossly mispriced options, has made ORC just the sort of opportunity we look for: A predictable, low-risk, highly profitable, non-correlated one.



# Conclusion

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- **ORC, an agency mREIT, offered us an outstanding “special situations” opportunity, due to several factors:**
  - Payments on its MBS are guaranteed by the US government, eliminating credit risk – but ORC shares sold off along with those of riskier mREITs in the COVID-19-driven crash, despite this protection.
  - Soon after the crash, the Fed stepped in to get the market back on track, cutting short-term rates to zero and announcing it would buy essentially unlimited quantities of agency MBS – two actions that directly benefit ORC’s business, leading to wider net interest margins and much higher earnings, while removing the possibility of reflexive negative feedback loops that get mREITs into trouble for at least the next 18 months.
- **We have been able to exploit this situation even more effectively by writing puts while being long the stock:**
  - Small-cap implied volatility has surged for a variety of reasons, making it possible to write puts (i.e. sell volatility) at extremely lucrative prices, lowering our effective purchase price to 73 cents on the dollar, a 27% discount to its rapidly growing liquidation value.
  - At the same time, the risk of permanent loss in ORC shares is exceptionally low, for all the reasons mentioned above. Heads we win, tails we don’t lose. What's not to love?



# Thank you

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Thank you very much for your time.

We hope you enjoyed this presentation,  
and we look forward to hearing from you.

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