

CAPSTEAD MORTGAGE CORP

Form 10-Q

November 04, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: September 30, 2016

OR

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: 001-08896

CAPSTEAD MORTGAGE CORPORATION

(Exact name of Registrant as specified in its Charter)

Maryland

(State or other jurisdiction of incorporation or organization)

75-2027937

(I.R.S. Employer Identification No.)

8401 North Central Expressway, Suite 800, Dallas, TX 75225-4404

(Address of principal executive offices)

(Zip Code)

(214) 874-2323

(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 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 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.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Edgar Filing: CAPSTEAD MORTGAGE CORP - Form 10-Q

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Common Stock (\$0.01 par value) 95,988,971 as of November 4, 2016

CAPSTEAD MORTGAGE CORPORATION
FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2016

INDEX

PART I. $\frac{3}{4}$ FINANCIAL INFORMATION

	<u>Page</u>
ITEM 1. Financial Statements (unaudited)	
<u>Consolidated Balance Sheets $\frac{3}{4}$ September 30, 2016 and December 31, 2015</u>	3
<u>Consolidated Statements of Income $\frac{3}{4}$ Quarter and Nine Months Ended September 30, 2016 and 2015</u>	4
<u>Consolidated Statements of Comprehensive Income (Loss) $\frac{3}{4}$ Quarter and Nine Months Ended September 30, 2016 and 2015</u>	5
<u>Consolidated Statements of Cash Flows $\frac{3}{4}$ Nine Months Ended September 30, 2016 and 2015</u>	6
<u>Notes to Consolidated Financial Statements</u>	7
ITEM 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	21
ITEM 3. <u>Quantitative and Qualitative Disclosure of Market Risk</u>	47
ITEM 4. <u>Controls and Procedures</u>	47
PART II. $\frac{3}{4}$ OTHER INFORMATION	
ITEM 6. <u>Exhibits</u>	48
<u>SIGNATURES</u>	50

Index

ITEM 1. FINANCIAL STATEMENTS

PART I. ¾ FINANCIAL INFORMATION

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except pledged and per share amounts)

	September 30, 2016 (unaudited)	December 31, 2015
Assets		
Residential mortgage investments (\$13.09 and \$13.54 billion pledged at September 30, 2016 and December 31, 2015, respectively)	\$ 13,582,323	\$ 14,154,737
Cash collateral receivable from interest rate swap counterparties	73,191	50,193
Interest rate swap agreements at fair value	2,501	7,720
Cash and cash equivalents	83,697	54,185
Receivables and other assets	164,102	179,531
	\$ 13,905,814	\$ 14,446,366
Liabilities		
Secured borrowings	\$ 12,431,839	\$ 12,958,394
Interest rate swap agreements at fair value	46,954	26,061
Unsecured borrowings	98,065	97,986
Common stock dividend payable	22,687	25,979
Accounts payable and accrued expenses	36,159	39,622
	12,635,704	13,148,042
Stockholders' equity		
Preferred stock - \$0.10 par value; 100,000 shares authorized: 7.50% Cumulative Redeemable Preferred Stock, Series E, 8,204 and 8,156 shares issued and outstanding (\$205,107 and \$203,902 aggregate liquidation preferences) at September 30, 2016 and December 31, 2015, respectively	198,331	197,172
Common stock - \$0.01 par value; 250,000 shares authorized: 95,989 and 95,825 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	960	958
Paid-in capital	1,296,550	1,310,563
Accumulated deficit	(346,464) (346,464
Accumulated other comprehensive income	120,733	136,095
	1,270,110	1,298,324
	\$ 13,905,814	\$ 14,446,366

See accompanying notes to consolidated financial statements.

IndexCAPSTEAD MORTGAGE CORPORATION
CONSOLIDATED STATEMENTS OF INCOME(in thousands, except per share amounts)
(unaudited)

	Quarter Ended		Nine Months Ended	
	September 30		September 30	
	2016	2015	2016	2015
Interest income:				
Residential mortgage investments	\$49,845	\$49,485	\$162,654	\$158,471
Other	174	88	494	281
	50,019	49,573	163,148	158,752
Interest expense:				
Secured borrowings	(26,636)	(22,272)	(80,232)	(61,584)
Unsecured borrowings	(1,970)	(2,122)	(5,923)	(6,367)
	(28,606)	(24,394)	(86,155)	(67,951)
	21,413	25,179	76,993	90,801
Other revenue (expense):				
Compensation-related expense	(1,299)	(3,064)	(6,565)	(7,573)
Separation of service charge	(2,740)	–	(2,740)	–
Other general and administrative expense	(1,239)	(1,309)	(3,565)	(3,628)
Miscellaneous other revenue	305	261	1,300	368
	(4,973)	(4,112)	(11,570)	(10,833)
Net income	\$16,440	\$21,067	\$65,423	\$79,968
Net income available to common stockholders:				
Net income	\$16,440	\$21,067	\$65,423	\$79,968
Less preferred stock dividends	(3,846)	(3,809)	(11,515)	(11,339)
	\$12,594	\$17,258	\$53,908	\$68,629
Net income per common share:				
Basic and diluted	\$0.13	\$0.18	\$0.56	\$0.72
Weighted average common shares outstanding:				
Basic	95,678	95,530	95,647	95,500
Diluted	95,866	95,721	95,799	95,695
Cash dividends declared per share:				
Common	\$0.23	\$0.26	\$0.72	\$0.88
Series E preferred	0.47	0.47	1.41	1.41

See accompanying notes to consolidated financial statements.

IndexCAPSTEAD MORTGAGE CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands, unaudited)

	Quarter Ended		Nine Months Ended	
	September 30		September 30	
	2016	2015	2016	2015
Net income	\$16,440	\$21,067	\$65,423	\$79,968
Other comprehensive income (loss)				
Amounts related to available-for-sale securities:				
Change in net unrealized gains	(19,155)	(11,130)	10,245	(23,770)
Amounts related to cash flow hedges:				
Change in net unrealized losses	12,558	(21,235)	(41,714)	(36,226)
Reclassification adjustment for amounts included in net income	4,927	7,183	16,107	20,494
	(1,670)	(25,182)	(15,362)	(39,502)
Comprehensive income (loss)	\$14,770	\$(4,115)	\$50,061	\$40,466

See accompanying notes to consolidated financial statements.

IndexCAPSTEAD MORTGAGE CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, unaudited)

	Nine Months Ended September 30	
	2016	2015
Operating activities:		
Net income	\$ 65,423	\$ 79,968
Noncash items:		
Amortization of investment premiums	95,139	92,458
Amortization of equity-based awards	1,241	1,708
Other depreciation and amortization	97	100
Change in measureable hedge ineffectiveness related to interest rate swap agreements designated as cash flow hedges	506	130
Net change in receivables, other assets, accounts payable and accrued expenses	(953)	6,389
Net cash provided by operating activities	161,453	180,753
Investing activities:		
Purchases of residential mortgage investments	(2,319,819)	(2,757,199)
Interest receivable acquired with the purchase of residential mortgage investments	(3,139)	(4,202)
Principal collections on residential mortgage investments, including changes in mortgage securities principal remittance receivable	2,773,344	2,577,985
Decrease (increase) in lending counterparty investments	50,000	(46,002)
Net cash provided by (used in) investing activities	500,386	(229,418)
Financing activities:		
Proceeds from repurchase arrangements and similar borrowings	94,430,910	84,927,006
Principal payments on repurchase arrangements and similar borrowings	(92,332,463)	(87,281,325)
Proceeds from other secured borrowings	1,175,000	2,450,000
Principal payments on other secured borrowings	(3,800,000)	(150,000)
Increase in cash collateral receivable from interest rate swap counterparties	(22,998)	(12,729)
Proceeds from issuance of preferred shares	1,167	12,679
Other capital stock transactions	(57)	(429)
Dividends paid	(83,886)	(103,561)
Net cash used in financing activities	(632,327)	(158,359)
Net change in cash and cash equivalents	29,512	(207,024)
Cash and cash equivalents at beginning of period	54,185	307,526
Cash and cash equivalents at end of period	\$ 83,697	\$ 100,502

See accompanying notes to consolidated financial statements.

Index

CAPSTEAD MORTGAGE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2016
(unaudited)

NOTE 1 ¾ BUSINESS

Capstead Mortgage Corporation operates as a self-managed real estate investment trust for federal income tax purposes (a “REIT”) and is based in Dallas, Texas. Unless the context otherwise indicates, Capstead Mortgage Corporation, together with its subsidiaries, is referred to as “Capstead” or the “Company.” Capstead earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of adjustable-rate mortgage (“ARM”) securities issued and guaranteed by government-sponsored enterprises, either Fannie Mae, Freddie Mac, or by an agency of the federal government, Ginnie Mae. Residential mortgage pass-through securities guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae are referred to as “Agency Securities” and are considered to have limited, if any, credit risk.

NOTE 2 ¾ BASIS OF PRESENTATION

Interim Financial Reporting

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2016. For further information refer to the audited consolidated financial statements and footnotes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2015.

Recent Accounting Pronouncements

In November 2014 the Financial Accounting Standards Board issued ASU 2014-16, Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share is More Akin to Debt or to Equity (“ASU 2014-16”). ASU 2014-16 provides guidance in evaluating whether the nature of the host contract is more debt-like or equity-like when determining whether derivative financial instruments embedded in the hybrid financial instrument, such as call rights and conversion features, should be bifurcated and accounted for separately. The Company adopted ASU 2014-16 on January 1, 2016. The provisions of this ASU had no effect on the Company’s results of operations, financial condition, or cash flows.

NOTE 3 ¾ SEPARATION OF SERVICE CHARGE

Effective July 14, 2016, Mr. Andrew F. Jacobs resigned as a director of Capstead and from his positions as President and Chief Executive Officer (“CEO”). Pursuant to an agreement entered into with Mr. Jacobs, he is entitled to payments aggregating \$2.3 million in addition to continuing to participate in the Company’s short- and long-term incentive compensation and employee benefit programs through year-end. Currently estimated costs associated with Mr. Jacobs’ resignation, net of equity award cost accrual reversals, are recorded in Separation of service charge for the quarter ended September 30, 2016. Currently estimated amounts payable to Mr. Jacobs totaling \$2.8 million are included in Accounts payable and accrued expenses.

Index

NOTE 4 ¾ NET INCOME PER COMMON SHARE

Basic net income per common share is computed by dividing net income, after deducting dividends paid or accrued on preferred stock and allocating earnings to equity awards deemed to be participating securities pursuant to the two-class method, by the average number of shares of common stock outstanding, calculated excluding unvested stock awards. Participating securities include unvested equity awards that contain non-forfeitable rights to dividends prior to vesting.

Diluted net income per common share is computed by dividing the numerator used to compute basic net income per common share by the denominator used to compute basic net income per common share, further adjusted for the dilutive effect, if any, of equity awards and shares of preferred stock when and if convertible into shares of common stock. Shares of the Company's 7.50% Series E Cumulative Redeemable Preferred Stock are contingently convertible into shares of common stock only upon the occurrence of a change in control and therefore are not considered dilutive securities absent such an occurrence. Any unvested equity awards that are deemed participating securities are included in the calculation of diluted net income per common share, if dilutive, under either the two-class method or the treasury stock method, depending upon which method produces the more dilutive result. Components of the computation of basic and diluted net income per common share were as follows for the indicated periods (dollars in thousands, except per share amounts):

	Quarter Ended		Nine Months Ended	
	September 30		September 30	
	2016	2015	2016	2015
Basic net income per common share				
Numerator for basic net income per common share:				
Net income	\$16,440	\$21,067	\$65,423	\$79,968
Preferred stock dividends	(3,846)	(3,809)	(11,515)	(11,339)
Earnings participation of unvested equity awards	(40)	(28)	(123)	(95)
	\$12,554	\$17,230	\$53,785	\$68,534
Denominator for basic net income per common share:				
Average number of shares of common stock outstanding	95,978	95,814	95,946	95,814
Average unvested stock awards outstanding	(300)	(284)	(299)	(314)
	95,678	95,530	95,647	95,500
	\$0.13	\$0.18	\$0.56	\$0.72
Diluted net income per common share				