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TWO HARBORS INVESTMENT CORP.

Form 10-Q

November 07, 2018

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2017-12-31 0001465740 us-gaap:MortgageBackedSecuritiesIssuedByUSGovernmentSponsoredEnterprisesMember

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two:NetLongPositionMember 2017-06-30 0001465740 us-gaap:OptionMember 2017-07-01 2017-09-30 0001465740
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2018-09-30 0001465740 two:LessThanSixMonthsRemainingMaturityMember two:UnderlyingSwapMember us-gaap:LongMember us-gaap:VariableIncomeInterestRateMember 2018-01-01 2018-09-30 0001465740 two:LessThanSixMonthsRemainingMaturityMember two:UnderlyingSwapMember us-gaap:LongMember us-gaap:VariableIncomeInterestRateMember 2018-09-30 0001465740 two:LessThanSixMonthsRemainingMaturityMember us-gaap:InterestRateSwaptionMember us-gaap:ShortMember us-gaap:FixedIncomeInterestRateMember 2018-09-30 0001465740 two:LessThanSixMonthsRemainingMaturityMember two:UnderlyingSwapMember us-gaap:ShortMember us-gaap:FixedIncomeInterestRateMember us-gaap:LondonInterbankOfferedRateLIBORMember 2018-09-30 0001465740 two:LessThanSixMonthsRemainingMaturityMember two:UnderlyingSwapMember us-gaap:ShortMember us-gaap:FixedIncomeInterestRateMember 2018-09-30 0001465740 two:LessThanSixMonthsRemainingMaturityMember us-gaap:InterestRateSwaptionMember us-gaap:LongMember us-gaap:VariableIncomeInterestRateMember 2018-09-30 0001465740 two:LessThanSixMonthsRemainingMaturityMember two:UnderlyingSwapMember us-gaap:ShortMember us-gaap:FixedIncomeInterestRateMember 2018-01-01 2018-09-30 0001465740 two:LessThanSixMonthsRemainingMaturityMember two:UnderlyingSwapMember us-gaap:LongMember us-gaap:VariableIncomeInterestRateMember us-gaap:LondonInterbankOfferedRateLIBORMember 2018-09-30 0001465740 us-gaap:InterestRateSwapMember us-gaap:ShortMember 2018-09-30 0001465740 two:DerivativeMaturityOverThreeAndWithinFourYearsFromBalanceSheetDateMember us-gaap:InterestRateSwapMember us-gaap:ShortMember 2018-01-01 2018-09-30 0001465740 two:DerivativeMaturityOverFourYearsFromBalanceSheetDateMember us-gaap:InterestRateSwapMember us-gaap:ShortMember 2018-09-30 0001465740 two:DerivativeMaturityOverFourYearsFromBalanceSheetDateMember us-gaap:InterestRateSwapMember us-gaap:ShortMember 2018-01-01 2018-09-30 0001465740 us-gaap:InterestRateSwapMember us-gaap:ShortMember 2018-01-01 2018-09-30 0001465740 two:DerivativeMaturityOverTwoAndWithinThreeYearsFromBalanceSheetDateMember us-gaap:InterestRateSwapMember us-gaap:ShortMember 2018-09-30 0001465740 two:DerivativeMaturityOverThreeAndWithinFourYearsFromBalanceSheetDateMember us-gaap:InterestRateSwapMember us-gaap:ShortMember 2018-09-30 0001465740 two:DerivativeMaturityOverTwoAndWithinThreeYearsFromBalanceSheetDateMember us-gaap:InterestRateSwapMember us-gaap:ShortMember 2018-01-01 2018-09-30 0001465740 us-gaap:TotalReturnSwapMember 2017-12-31 0001465740 two:MaturityDate1122043Member us-gaap:TotalReturnSwapMember 2017-12-31 0001465740 two:MaturityDate1122044Member us-gaap:TotalReturnSwapMember 2017-12-31 0001465740 two:DerivativeMaturityOverOneAndWithinTwoYearsFromBalanceSheetDateMember us-gaap:InterestRateCapMember us-gaap:LongMember 2018-09-30 0001465740 two:DerivativeMaturityOverTwoAndWithinThreeYearsFromBalanceSheetDateMember us-gaap:InterestRateCapMember us-gaap:LongMember 2018-01-01 2018-09-30 0001465740 two:DerivativeMaturityOverTwoAndWithinThreeYearsFromBalanceSheetDateMember us-gaap:InterestRateCapMember us-gaap:LongMember 2018-09-30 0001465740 two:DerivativeMaturityOverOneAndWithinTwoYearsFromBalanceSheetDateMember us-gaap:InterestRateCapMember us-gaap:LongMember 2018-01-01 2018-09-30 0001465740 us-gaap:InterestRateCapMember us-gaap:LongMember 2018-01-01 2018-09-30 0001465740 us-gaap:InterestRateCapMember us-gaap:LongMember 2018-09-30 0001465740 two:DerivativeMaturityOverTwoAndWithinThreeYearsFromBalanceSheetDateMember us-gaap:InterestRateSwapMember us-gaap:ShortMember 2017-01-01 2017-12-31 0001465740 two:DerivativeMaturityOverThreeAndWithinFourYearsFromBalanceSheetDateMember us-gaap:InterestRateSwapMember us-gaap:ShortMember 2017-12-31 0001465740 two:DerivativeMaturityOverFourYearsFromBalanceSheetDateMember us-gaap:InterestRateSwapMember us-gaap:ShortMember 2017-12-31 0001465740 two:DerivativeMaturityOverTwoAndWithinThreeYearsFromBalanceSheetDateMember us-gaap:InterestRateSwapMember us-gaap:ShortMember 2017-12-31 0001465740 us-gaap:InterestRateSwapMember

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2018-09-30 0001465740 two:PRCMAdvisersLLCMember 2018-07-01 2018-09-30 0001465740
two:GranitePointMortgageTrustInc.Member 2017-12-31 0001465740 two:PRCMAdvisersLLCMember 2017-01-01
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two:PRCMAdvisersLLCMember 2017-07-01 2017-09-30 xbrli:pure iso4217:USD xbrli:shares iso4217:USD
xbrli:shares two:position two:loan two:counterparty

**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, 2018

Commission File Number 001-34506

TWO HARBORS INVESTMENT CORP.

(Exact Name of Registrant as Specified in Its Charter)

Maryland **27-0312904**
(State or Other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification No.)
575 Lexington Avenue, Suite 2930 **10022**
New York, New York
(Address of Principal Executive Offices) (Zip Code)
(612) 629-2500
(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 x No o

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer o

Non-accelerated filer o Smaller reporting company o

Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

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

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

As of November 6, 2018 there were 248,081,058 shares of outstanding common stock, par value \$.01 per share, issued and outstanding.

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****TWO HARBORS INVESTMENT CORP.****CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**

(in thousands, except share data)

	September 30,	December 31,
	2018	2017
ASSETS		
Available-for-sale securities, at fair value	\$ 25,938,916	\$ 21,220,819
Mortgage servicing rights, at fair value	1,664,024	1,086,717
Residential mortgage loans held-for-sale, at fair value	27,537	30,414
Cash and cash equivalents	422,851	419,159
Restricted cash	888,632	635,836
Accrued interest receivable	85,257	68,309
Due from counterparties	1,217,828	842,303
Derivative assets, at fair value	403,231	309,918
Reverse repurchase agreements	759,375	—
Other assets	122,428	175,838
Total Assets	\$ 31,530,079	\$ 24,789,313
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Repurchase agreements	\$ 23,806,631	\$ 19,451,207
Federal Home Loan Bank advances	865,024	1,215,024
Revolving credit facilities	310,000	20,000
Convertible senior notes	283,555	282,827
Derivative liabilities, at fair value	797,504	31,903
Due to counterparties	556,992	88,898
Dividends payable	96,259	12,552
Accrued interest payable	117,008	87,698
Other liabilities	21,124	27,780
Total Liabilities	26,854,097	21,217,889
Stockholders' Equity		
Preferred stock, par value \$0.01 per share; 50,000,000 shares authorized and 40,050,000 and 29,050,000 shares issued and outstanding, respectively (\$1,001,250 and \$726,250 liquidation preference, respectively)	977,550	702,537
Common stock, par value \$0.01 per share; 450,000,000 shares authorized and 248,078,170 and 174,496,587 shares issued and outstanding, respectively	2,481	1,745
Additional paid-in capital	4,806,520	3,672,003
Accumulated other comprehensive (loss) income	(154,729) 334,813
Cumulative earnings	2,886,906	2,386,604
Cumulative distributions to stockholders	(3,842,746) (3,526,278)
Total Stockholders' Equity	4,675,982	3,571,424
Total Liabilities and Stockholders' Equity	\$ 31,530,079	\$ 24,789,313

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

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME (unaudited)
(in thousands, except share data)

	Three Months Ended		Nine Months Ended	
	September 30, 2018	2017	September 30, 2018	2017
Interest income:				
Available-for-sale securities	\$230,607	\$163,904	\$604,790	\$449,141
Residential mortgage loans held-for-investment in securitization trusts	—	29,865	—	92,319
Residential mortgage loans held-for-sale	332	479	988	1,380
Other	5,759	1,841	12,299	7,144
Total interest income	236,698	196,089	618,077	549,984
Interest expense:				
Repurchase agreements	138,343	59,694	322,735	135,756
Collateralized borrowings in securitization trusts	—	23,970	—	74,199
Federal Home Loan Bank advances	5,301	10,317	14,655	30,554
Revolving credit facilities	3,973	701	5,776	1,727
Convertible senior notes	4,779	4,745	14,204	13,157
Total interest expense	152,396	99,427	357,370	255,393
Net interest income	84,302	96,662	260,707	294,591
Other-than-temporary impairments:				
Total other-than-temporary impairment losses	(95) —	(363) (429
Other income (loss):				
(Loss) gain on investment securities	(42,996) 5,618	(95,549) (15,485
Servicing income	89,618	57,387	238,473	148,468
Gain (loss) on servicing asset	20,591	(29,245) 102,251	(90,440
Gain (loss) on interest rate swap, cap and swaption agreements	75,857	(207) 255,535	(66,990
Loss on other derivative instruments	(31,463) (18,924) (15,735) (66,328
Other income	907	8,431	2,695	21,053
Total other income (loss)	112,514	23,060	487,670	(69,722
Expenses:				
Management fees	(5,041) 10,146	18,120	29,801
Servicing expenses	16,433	8,560	42,526	25,154
Other operating expenses	17,033	13,138	47,040	44,373
Acquisition transaction costs	86,703	—	86,703	—
Restructuring charges	8,238	—	8,238	—
Total expenses	123,366	31,844	202,627	99,328
Income from continuing operations before income taxes	73,355	87,878	545,387	125,112
Provision for (benefit from) income taxes	37,409	(5,342) 35,142	(21,100
Net income from continuing operations	35,946	93,220	510,245	146,212
Income from discontinued operations, net of tax	—	11,518	—	39,169
Net income	35,946	104,738	510,245	185,381
Income from discontinued operations attributable to noncontrolling interest	—	2,674	—	2,714
Net income attributable to Two Harbors Investment Corp.	35,946	102,064	510,245	182,667
Dividends on preferred stock	18,951	8,888	46,445	13,173

Net income attributable to common stockholders \$16,995 \$93,176 \$463,800 \$169,494

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

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME (unaudited),
continued

(in thousands, except share data)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Basic earnings per weighted average common share:				
Continuing operations	\$0.08	\$ 0.48	\$2.42	\$ 0.76
Discontinued operations	—	0.05	—	0.21
Net income	\$0.08	\$ 0.53	\$2.42	\$ 0.97
Diluted earnings per weighted average common share:				
Continuing operations	\$0.08	\$ 0.47	\$2.28	\$ 0.76
Discontinued operations	—	0.05	—	0.21
Net income	\$0.08	\$ 0.52	\$2.28	\$ 0.97
Dividends declared per common share	\$0.47	\$ 0.52	\$1.41	\$ 1.54
Weighted average number of shares of common stock:				
Basic	224,399,436	174,488,296	191,846,212	174,415,232
Diluted	224,399,436	188,907,356	209,607,146	174,415,232
Comprehensive (loss) income:				
Net income	\$35,946	\$ 104,738	\$510,245	\$ 185,381
Other comprehensive (loss) income, net of tax:				
Unrealized (loss) gain on available-for-sale securities	(119,796)	68,433	(499,460)	223,823
Other comprehensive (loss) income	(119,796)	68,433	(499,460)	223,823
Comprehensive (loss) income	(83,850)	173,171	10,785	409,204
Comprehensive income attributable to noncontrolling interest	—	2,682	—	2,724
Comprehensive (loss) income attributable to Two Harbors Investment Corp.	(83,850)	170,489	10,785	406,480
Dividends on preferred stock	18,951	8,888	46,445	13,173
Comprehensive (loss) income attributable to common stockholders	\$(102,801)	\$ 161,601	\$(35,660)	\$ 393,307

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

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (unaudited)
(in thousands)

	Preferred Stock	Common Stock Par Value	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Cumulative Earnings	Cumulative Distributions to Stockholders	Total Stockholders' Equity	Non-controlling Interest	Total Equity
Balance, December 31, 2016	\$ —	\$ 1,738	\$ 3,661,712	\$ 199,227	\$ 2,038,033	\$ (2,499,599)	\$ 3,401,111	\$ —	\$ 3,401,111
Net income	—	—	—	—	182,667	—	182,667	2,714	185,381
Other comprehensive income before reclassifications, net of tax expense of \$35,708	—	—	—	215,994	—	—	215,994	10	216,004
Amounts reclassified from accumulated other comprehensive income, net of tax benefit of \$2,722	—	—	—	7,815	—	—	7,815	—	7,815
Other comprehensive income, net of tax expense of \$32,986	—	—	—	223,809	—	—	223,809	10	223,819
Contribution of TH Commercial Holdings LLC to Granite Point	—	—	(13,777)	6	—	—	(13,771)	195,646	181,875
Acquisition of noncontrolling interests	—	—	(69)	—	—	—	(69)	(5,376)	(5,445)
Issuance of preferred stock, net of offering costs	416,966	—	—	—	—	—	416,966	—	416,966
Issuance of common stock, net of offering costs	—	—	332	—	—	—	332	—	332
Preferred dividends declared	—	—	—	—	—	(13,173)	(13,173)	—	(13,173)
Common dividends declared	—	—	—	—	—	(268,697)	(268,697)	(3,177)	(271,874)
Non-cash equity award compensation	—	7	12,382	—	—	—	12,389	—	12,389
Balance, September 30, 2017	\$ 416,966	\$ 1,745	\$ 3,660,580	\$ 423,042	\$ 2,220,700	\$ (2,781,469)	\$ 3,941,564	\$ 189,817	\$ 4,131,381
Balance, December 31, 2017	\$ 702,537	\$ 1,745	\$ 3,672,003	\$ 334,813	\$ 2,386,604	\$ (3,526,278)	\$ 3,571,424	\$ —	\$ 3,571,424
Cumulative effect of adoption of new accounting principles	—	—	25	9,918	(9,943)	—	—	—	—
Adjusted balance, January 1, 2018	702,537	1,745	3,672,028	344,731	2,376,661	(3,526,278)	3,571,424	—	3,571,424
Net income	—	—	—	—	510,245	—	510,245	—	510,245
Other comprehensive loss before reclassifications, net of tax benefit of \$14,890	—	—	—	(552,477)	—	—	(552,477)	—	(552,477)
Amounts reclassified from accumulated other comprehensive income, net of tax benefit of \$0	—	—	—	53,017	—	—	53,017	—	53,017
Other comprehensive loss, net of tax benefit of \$14,890	—	—	—	(499,460)	—	—	(499,460)	—	(499,460)
Acquisition of CYS Investments, Inc.	275,000	726	1,124,388	—	—	—	1,400,114	—	1,400,114
Issuance of preferred stock, net of offering costs	13	—	—	—	—	—	13	—	13
Issuance of common stock, net of offering costs	—	—	329	—	—	—	329	—	329
Preferred dividends declared	—	—	—	—	—	(46,445)	(46,445)	—	(46,445)
Common dividends declared	—	—	—	—	—	(270,023)	(270,023)	—	(270,023)
Non-cash equity award compensation	—	10	9,775	—	—	—	9,785	—	9,785
Balance, September 30, 2018	\$ 977,550	\$ 2,481	\$ 4,806,520	\$ (154,729)	\$ 2,886,906	\$ (3,842,746)	\$ 4,675,982	\$ —	\$ 4,675,982

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

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)
(in thousands)

	Nine Months Ended	
	September 30,	
	2018	2017
Cash Flows From Operating Activities:		
Net income from continuing operations	\$510,245	\$146,212
Adjustments to reconcile net income from continuing operations to net cash provided by operating activities:		
Amortization of premiums and discounts on investment securities, net	73,441	45,500
Amortization of deferred debt issuance costs on convertible senior notes	728	429
Other-than-temporary impairment losses	363	429
Realized and unrealized losses on investment securities	96,842	15,485
(Gain) loss on servicing asset	(102,251)	90,440
Gain on residential mortgage loans held-for-sale	(851)	(2,149)
Gain on residential mortgage loans held-for-investment and collateralized borrowings in securitization trusts	—	(14,884)
Realized and unrealized (gain) loss on interest rate swaps, caps and swaptions	(221,649)	56,123
Unrealized loss on other derivative instruments	27,457	37,586
Equity based compensation	9,785	11,703
Depreciation of fixed assets	504	776
Excess consideration in the acquisition of CYS Investments, Inc.	77,602	—
Purchases of residential mortgage loans held-for-sale	—	(567)
Proceeds from sales of residential mortgage loans held-for-sale	—	3,708
Proceeds from repayment of residential mortgage loans held-for-sale	3,325	5,019
Net change in assets and liabilities:		
Decrease (increase) in accrued interest receivable	13,698	(20,653)
Decrease (increase) in deferred income taxes, net	35,094	(21,505)
(Increase) decrease in income taxes receivable	(460)	1,411
Decrease (increase) in prepaid and fixed assets	7,367	(251)
(Increase) decrease in other receivables	(9,136)	10,244
Decrease in servicing advances	4,916	5,489
Increase in accrued interest payable	1,823	31,551
Increase in income taxes payable	4	142
Decrease in accrued expenses and other liabilities	(7,481)	(11,753)
Net cash provided by operating activities of discontinued operations	—	28,280
Net cash provided by operating activities	\$521,366	\$418,765

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

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited), continued
(in thousands)

	Nine Months Ended	
	September 30,	
	2018	2017
Cash Flows From Investing Activities:		
Purchases of available-for-sale securities	\$(6,319,252)	\$(13,677,423)
Proceeds from sales of available-for-sale securities	9,156,686	5,726,616
Principal payments on available-for-sale securities	1,792,168	1,075,961
Purchases of mortgage servicing rights, net of purchase price adjustments	(475,451)	(327,341)
Proceeds from sales of mortgage servicing rights	395	132
(Purchases) short sales of derivative instruments, net	(82,971)	(93,812)
Proceeds from sales and settlement (payments for termination and settlement) of derivative instruments, net	498,425	84,791
Proceeds from reverse repurchase agreements	1,442,798	—
Repayments of reverse repurchase agreements	(1,440,713)	—
Proceeds from repayment of residential mortgage loans held-for-investment in securitization trusts	—	285,695
Net cash paid for the acquisition of CYS Investments, Inc.	(13,552)	—
Purchases of equity securities	—	(5,445)
Proceeds from sales of equity securities	31,276	—
Redemptions of Federal Home Loan Bank stock	12,981	82,681
Decrease in due to counterparties, net	(187,146)	(32,881)
Net cash used in investing activities of discontinued operations	—	(753,021)
Net cash provided by (used in) investing activities	4,415,644	(7,634,047)
Cash Flows From Financing Activities:		
Proceeds from repurchase agreements	103,348,835	113,602,702
Principal payments on repurchase agreements	(107,736,938)	(105,645,758)
Principal payments on collateralized borrowings in securitization trusts	—	(282,468)
Principal payments on Federal Home Loan Bank advances	(350,000)	(2,001,238)
Proceeds from revolving credit facilities	377,400	123,000
Principal payments on revolving credit facilities	(87,400)	(153,000)
Proceeds from convertible senior notes	—	282,469
Proceeds from issuance of preferred stock, net of offering costs	13	416,966
Proceeds from issuance of common stock, net of offering costs	329	332
Dividends paid on preferred stock	(39,443)	(4,285)
Dividends paid on common stock	(193,318)	(261,400)
Net cash provided by financing activities of discontinued operations	—	1,205,947
Net cash (used in) provided by financing activities	(4,680,522)	7,283,267
Net increase in cash, cash equivalents and restricted cash	256,488	67,985
Cash, cash equivalents and restricted cash of continuing operations at beginning of period	1,054,995	758,916
Cash, cash equivalents and restricted cash of discontinued operations at beginning of period	—	56,279
Cash, cash equivalents and restricted cash at beginning of period	1,054,995	815,195
Cash, cash equivalents and restricted cash at end of period	\$1,311,483	\$883,180

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

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TWO HARBORS INVESTMENT CORP.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited), continued
(in thousands)

	Nine Months Ended	
	September 30,	
	2018	2017
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	\$300,573	\$169,464
Cash paid (received) for taxes	\$502	\$(1,152)
Noncash Activities:		
Acquisition of the assets and liabilities of CYS Investments, Inc.		
Available-for-sale securities	\$10,034,557	\$—
Cash and cash equivalents	\$386	\$—
Restricted cash	\$1,062	\$—
Accrued interest receivable	\$30,646	\$—
Reverse repurchase agreements	\$761,460	\$—
Other assets	\$11,977	\$—
Repurchase agreements	\$(8,743,527)	\$—
Derivative liabilities, net	\$(451,026)	\$—
Due to counterparties, net	\$(279,715)	\$—
Accrued interest payable	\$(27,487)	\$—
Other liabilities	\$(821)	\$—
Issuance of preferred stock in connection with the acquisition of CYS Investments, Inc.	\$275,000	\$—
Issuance of common stock in connection with the acquisition of CYS Investments, Inc.	\$1,125,114	\$—
Transfers of residential mortgage loans held-for-sale to other receivables for foreclosed government-guaranteed loans	\$403	\$2,909
Transfer of fair value of mortgage servicing rights to fair value of Ginnie Mae residential mortgage loans held-for-sale upon buyout	\$—	\$9
Additions to mortgage servicing rights due to sale of residential mortgage loans held-for-sale	\$—	\$20
Cumulative-effect adjustment for adoption of new accounting principle	\$9,918	\$—
Dividends declared but not paid at end of period	\$96,259	\$102,799
Reconciliation of residential mortgage loans held-for-sale:		
Residential mortgage loans held-for-sale at beginning of period	\$30,414	\$40,146
Purchases of residential mortgage loans held-for-sale	—	567
Transfers to other receivables for foreclosed government-guaranteed loans	(403)	(2,909)
Transfer of fair value of mortgage servicing rights to fair value of Ginnie Mae residential mortgage loans held-for-sale upon buyout	—	(9)
Proceeds from sales of residential mortgage loans held-for-sale	—	(3,708)
Proceeds from repayment of residential mortgage loans held-for-sale	(3,325)	(5,019)
Realized and unrealized gains on residential mortgage loans held-for-sale	851	2,129
Residential mortgage loans held-for-sale at end of period	\$27,537	\$31,197

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

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

Note 1. Organization and Operations

Two Harbors Investment Corp., or the Company, is a Maryland corporation investing in, financing and managing Agency residential mortgage-backed securities, or Agency RMBS, non-Agency securities, mortgage servicing rights, or MSR, and other financial assets. The Company's Chief Investment Officer manages the investment portfolio as a whole and resources are allocated and financial performance is assessed on a consolidated basis. The Company is externally managed and advised by PRCM Advisers LLC, or PRCM Advisers, which is a subsidiary of Pine River Capital Management L.P., or Pine River. The Company's common stock is listed on the NYSE under the symbol "TWO".

The Company was incorporated on May 21, 2009, and commenced operations as a publicly traded company on October 28, 2009, upon completion of a merger with Capitol Acquisition Corp., or Capitol, which became a wholly owned indirect subsidiary of the Company as a result of the merger.

The Company has elected to be treated as a real estate investment trust, or REIT, as defined under the Internal Revenue Code of 1986, as amended, or the Code, for U.S. federal income tax purposes. As long as the Company continues to comply with a number of requirements under federal tax law and maintains its qualification as a REIT, the Company generally will not be subject to U.S. federal income taxes to the extent that the Company distributes its taxable income to its stockholders on an annual basis and does not engage in prohibited transactions. However, certain activities that the Company may perform may cause it to earn income which will not be qualifying income for REIT purposes. The Company has designated certain of its subsidiaries as taxable REIT subsidiaries, or TRSs, as defined in the Code, to engage in such activities.

On June 28, 2017, the Company completed the contribution of its portfolio of commercial real estate assets to Granite Point Mortgage Trust Inc., or Granite Point, a newly formed Maryland corporation intended to qualify as a REIT, externally managed and advised by Pine River, and focused on directly originating, investing in and managing senior floating-rate commercial mortgage loans and other debt and debt-like commercial real estate investments. The Company contributed its equity interests in its wholly owned subsidiary, TH Commercial Holdings LLC, to Granite Point and, in exchange for its contribution, received approximately 33.1 million shares of common stock of Granite Point, which represented approximately 76.5% of the outstanding stock of Granite Point upon completion of the initial public offering, or IPO, of its common stock on June 28, 2017. On November 1, 2017, the Company distributed, on a pro rata basis, the 33.1 million shares of Granite Point common stock that it acquired in connection with the contribution to stockholders holding shares of Two Harbors common stock outstanding as of the close of business on October 20, 2017.

On April 26, 2018, the Company announced that it had entered into a definitive merger agreement pursuant to which the Company would acquire CYS Investments, Inc., or CYS, a Maryland corporation investing in primarily Agency RMBS and treated as a REIT for U.S. federal income tax purposes. The transaction was approved by the stockholders of both the Company and CYS on July 27, 2018, and the merger was completed on July 31, 2018, at which time CYS became a wholly owned subsidiary of the Company. In exchange for all of the shares of CYS common stock outstanding immediately prior to the effective time of the merger, the Company issued approximately 72.6 million new shares of common stock, as well as aggregate cash consideration of \$15.0 million, to CYS common stockholders. In addition, the Company issued 3 million shares of newly classified Series D cumulative redeemable preferred stock and 8 million shares of newly classified Series E cumulative redeemable preferred stock in exchange for all shares of CYS's Series A and Series B cumulative redeemable preferred stock outstanding prior to the effective time of the merger.

Note 2. Basis of Presentation and Significant Accounting Policies

Consolidation and Basis of Presentation

The interim unaudited condensed consolidated financial statements of the Company have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission, or SEC. Certain information and note disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles, or U.S. GAAP, have been condensed or omitted according to such SEC rules and regulations. However, management believes that the disclosures included in these interim condensed consolidated financial statements are adequate to make the information presented not misleading.

Table of Contents**TWO HARBORS INVESTMENT CORP.****Notes to the Condensed Consolidated Financial Statements (unaudited)**

The condensed consolidated financial statements of the Company include the accounts of all subsidiaries; inter-company accounts and transactions have been eliminated. Certain prior period amounts have been reclassified to conform to the current period presentation. All per share amounts, common shares outstanding and restricted shares for all prior periods presented have been adjusted on a retroactive basis to reflect the Company's one-for-two reverse stock split effected on November 1, 2017 (refer to Note 18 - *Stockholders' Equity* for additional information). The accompanying condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at September 30, 2018 and results of operations for all periods presented have been made. The results of operations for the three and nine months ended September 30, 2018 should not be construed as indicative of the results to be expected for future periods or the full year.

Due to its controlling ownership interest in Granite Point through November 1, 2017, the Company consolidated Granite Point on its financial statements. Effective November 1, 2017 (the date the 33.1 million shares of Granite Point common stock were distributed to the Company's common stockholders), the Company no longer had a controlling interest in Granite Point and, therefore, deconsolidated Granite Point and its subsidiaries from its financial statements and reclassified all of Granite Point's prior period assets, liabilities and results of operations to discontinued operations.

The Company retains debt securities and excess servicing rights purchased from securitization trusts sponsored by either third parties or the Company's subsidiaries. The securitization trusts are considered variable interest entities, or VIEs, for financial reporting purposes and, thus, are reviewed for consolidation under the applicable consolidation guidance. Whenever the Company has both the power to direct the activities of a trust that most significantly impact the entities' performance, and the obligation to absorb losses or the right to receive benefits of the entities that could be significant, the Company consolidates the trust. During the majority of 2017, the Company retained the most subordinate security in each of the securitization trusts, which gave the Company the power to direct the activities of the trusts that most significantly impact the trusts' performance and the obligation to absorb losses or the right to receive benefits of the securitization trusts that could be significant. As a result, the Company consolidated all of the securitization trusts on its condensed consolidated balance sheet. During the fourth quarter of 2017, the Company sold all of the retained subordinated securities thereby removing the Company's power to direct the activities of the trusts and the obligation to absorb losses or the right to receive benefits of the securitization trusts. As a result, the securitization trusts are no longer consolidated on the Company's condensed consolidated balance sheet and the remaining retained securities are included within non-Agency available-for-sale, or AFS, securities.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make a number of significant estimates. These include estimates of fair value of certain assets and liabilities, amount and timing of credit losses, prepayment rates, the period of time during which the Company anticipates an increase in the fair values of real estate securities sufficient to recover unrealized losses in those securities, and other estimates that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. It is likely that changes in these estimates (*e.g.*, valuation changes due to supply and demand, credit performance, prepayments, interest rates, or other reasons) will occur in the near term. The Company's estimates are inherently subjective in nature and actual results could differ from its estimates and the differences may be material.

Significant Accounting Policies

Included in Note 2 to the Consolidated Financial Statements of the Company's 2017 Annual Report on Form 10-K is a summary of the Company's significant accounting policies. Provided below is a summary of additional accounting policies that are significant to the Company's consolidated financial condition and results of operations for the nine months ended September 30, 2018.

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

Asset Acquisition

In accordance with U.S. GAAP, the acquirer in a merger transaction is to evaluate whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. If that threshold is met, the set of acquired assets and associated activities is not deemed a business and is required to be accounted for as an asset acquisition. Upon completion of the merger with CYS on July 31, 2018, approximately 89% of the CYS assets acquired were Agency RMBS. The Company concluded that they were similar identifiable assets to be grouped to evaluate whether the “substantially all” threshold was met as the Agency RMBS are financial assets with similar risk characteristics associated with managing these assets. Given the concentration of the fair value of the Agency RMBS of the gross assets acquired, the Company concluded that the fair value of the gross assets acquired was concentrated in a group of similar identifiable assets and, therefore, the merger was accounted for as an asset acquisition. The financial results of CYS since the closing date of the acquisition have been included in the Company’s condensed consolidated financial statements.

Asset acquisitions are generally accounted for by allocating the cost of the acquisition plus direct transaction costs to the individual assets acquired, including identified intangible assets, and liabilities assumed on a relative fair value basis. This allocation may cause identified assets to be recognized at amounts that are greater than their fair values. However, “non-qualifying” assets, which include financial assets and other current assets, should not be assigned an amount greater than their fair value. The gross assets acquired in the merger consisted most significantly of financial assets and other current assets. The cost of the acquisition of CYS plus direct transaction costs exceeded gross assets acquired less liabilities assumed in the merger. As there were no meaningful nonfinancial assets and non-current assets in this transaction and no identified intangible assets to assign value, the excess consideration and transaction costs were recognized in the condensed consolidated statements of comprehensive (loss) income as an expense and an associated reduction in stockholders’ equity.

Reverse Repurchase Agreements

The Company may borrow U.S. Treasury securities through reverse repurchase transactions under its master repurchase agreements to cover short sales. The Company accounts for these reverse repurchase agreements as securities borrowing transactions and records them at amortized cost, which approximates fair value due to their short-term nature, on its condensed consolidated balance sheets.

Offsetting Assets and Liabilities

Certain of the Company’s repurchase agreements are governed by underlying agreements that provide for a right of setoff in the event of default by either party to the agreement. The Company also has netting arrangements in place with all derivative counterparties pursuant to standard documentation developed by the International Swap and Derivatives Association, or ISDA, or central clearing exchange agreements, in the case of centrally cleared interest rate swaps. The Company and the counterparty or clearing agency are required to post cash collateral based upon the net underlying market value of the Company’s open positions with the counterparty. Additionally, the Company’s centrally cleared interest rate swaps require that the Company posts an “initial margin” amount determined by the clearing exchange, which is generally intended to be set at a level sufficient to protect the exchange from the interest rate swap’s maximum estimated single-day price movement. The Company also exchanges “variation margin” based upon daily changes in fair value, as measured by the exchange.

Under U.S. GAAP, if the Company has a valid right of setoff, it may offset the related asset and liability and report the net amount. As a result of amendments to rules governing certain central clearing activities, the exchange of variation margin is considered a settlement of the interest rate swap, as opposed to pledged collateral. Accordingly, beginning in the first quarter of 2018 and in subsequent periods, the Company accounts for the receipt or payment of variation margin as a direct reduction to the carrying value of the interest rate swap asset or liability. The receipt or payment of initial margin will continue to be accounted for separate from the interest rate swap asset or liability. As of December 31, 2017, variation margin pledged or received was netted on a counterparty basis and classified within restricted cash, due from counterparties, or due to counterparties on the Company’s condensed consolidated balance

sheets.

The Company presents repurchase agreements subject to master netting arrangements or similar agreements on a gross basis and derivative assets and liabilities (other than centrally cleared interest rate swaps) subject to such arrangements on a net basis, based on derivative type and counterparty, in its condensed consolidated balance sheets. Separately, the Company presents cash collateral subject to such arrangements (other than variation margin on centrally cleared interest rate swaps) on a net basis, based on counterparty, in its condensed consolidated balance sheets. However, the Company does not offset repurchase agreements or derivative assets and liabilities (other than centrally cleared interest rate swaps) with the associated cash collateral on its condensed consolidated balance sheets.

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The following tables present information about the Company's assets and liabilities that are subject to master netting arrangements or similar agreements and can potentially be offset on the Company's condensed consolidated balance sheets as of September 30, 2018 and December 31, 2017:

September 30, 2018

(in thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets (Liabilities) Presented in the Consolidated Balance Sheets	Gross Amounts Not Offset with Financial Assets (Liabilities) in the Consolidated Balance Sheets ⁽¹⁾	Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets							
Derivative assets	\$864,680	\$ (461,449)	\$403,231	\$(44,643)	\$		—\$358,588
Reverse repurchase agreements	759,375	—	759,375	(752,861)	—		6,514
Total Assets	\$1,624,055	\$ (461,449)	\$1,162,606	\$(797,504)	\$		—\$365,102
Liabilities							
Repurchase agreements	\$(23,806,631)	\$ —	\$(23,806,631)	\$23,806,631	\$		—\$—
Derivative liabilities	(1,258,953)	461,449	(797,504)	797,504	—		—
Total Liabilities	\$(25,065,584)	\$ 461,449	\$(24,604,135)	\$24,604,135	\$		—\$—

December 31, 2017

(in thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in the Consolidated Balance Sheets	Net Amounts of Assets (Liabilities) Presented in the Consolidated Balance Sheets	Gross Amounts Not Offset with Financial Assets (Liabilities) in the Consolidated Balance Sheets ⁽¹⁾	Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets							
Derivative assets	\$340,576	\$ (30,658)	\$309,918	\$(31,903)	\$		—\$278,015
Total Assets	\$340,576	\$ (30,658)	\$309,918	\$(31,903)	\$		—\$278,015
Liabilities							
Repurchase agreements	\$(19,451,207)	\$ —	\$(19,451,207)	\$19,451,207	\$		—\$—
Derivative liabilities	(62,561)	30,658	(31,903)	31,903	—		—
Total Liabilities	\$(19,513,768)	\$ 30,658	\$(19,483,110)	\$19,483,110	\$		—\$—

Amounts presented are limited in total to the net amount of assets or liabilities presented in the condensed consolidated balance sheets by instrument. Excess cash collateral or financial assets that are pledged to counterparties may exceed the financial liabilities subject to a master (1) netting arrangement or similar agreement, or counterparties may have pledged excess cash collateral to the Company that exceed the corresponding financial assets. These excess amounts are excluded from the table above, although separately reported within restricted cash, due from counterparties, or due to counterparties in the Company's condensed consolidated balance sheets.

Table of Contents**TWO HARBORS INVESTMENT CORP.****Notes to the Condensed Consolidated Financial Statements (unaudited)*****Recently Issued and/or Adopted Accounting Standards******Revenue from Contracts with Customers***

In May 2014, the Financial Accounting Standards Board, or FASB, issued ASU No. 2014-09, which is a comprehensive revenue recognition standard that supersedes virtually all existing revenue guidance under U.S. GAAP. The standard's core principle is that an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. As a result of the issuance of ASU No. 2015-14 in August 2015 deferring the effective date of ASU No. 2014-09 by one year, the ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2017, with early adoption prohibited. The Company has evaluated the new guidance and determined that interest income, gains and losses on financial instruments and income from servicing residential mortgage loans are outside the scope of ASC 606, *Revenues from Contracts with Customers*, or ASC 606. For income from servicing residential mortgage loans, the Company considered that the FASB Transition Resource Group members generally agreed that an entity should look to ASC 860, *Transfers and Servicing*, to determine the appropriate accounting for these fees and ASC 606 contains a scope exception for contracts that fall under ASC 860. As a result, the adoption of this ASU did not have a material impact on the Company's financial condition, results of operations or financial statement disclosures.

Lease Classification and Accounting

In February 2016, the FASB issued ASU No. 2016-02, which requires lessees to recognize on their balance sheets both a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term. The ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2018, with early adoption permitted. The Company has determined this ASU will not have a material impact on the Company's financial condition, results of operations or financial statement disclosures.

Measurement of Credit Losses on Financial Instruments

In June 2016, the FASB issued ASU No. 2016-13, which changes the impairment model for most financial assets and certain other instruments. Valuation allowances for credit losses on AFS debt securities will be recognized, rather than direct reductions in the amortized cost of the investments, regardless of whether the impairment is considered to be other-than-temporary. The new model also requires the estimation of lifetime expected credit losses and corresponding recognition of allowance for losses on trade and other receivables, held-to-maturity debt securities, loans, and other instruments held at amortized cost. The ASU requires certain recurring disclosures and is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2019, with early adoption permitted for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2018. The Company is evaluating the adoption of this ASU to determine the impact it may have on its condensed consolidated financial statements, which at the date of adoption, will establish an allowance for credit losses on AFS securities which will be derived from the current designated credit reserve with a resulting increase to amortized cost on the securities. The Company also expects adoption of this ASU to impact the recording for the purchase of certain non-Agency securities with purchased credit deterioration by recording an allowance for credit losses with an increase in amortized cost above the purchase price of the same amount. Subsequent changes in expected credit losses will be recognized immediately in earnings as a provision for credit losses until the allowance is reduced to zero. Further favorable changes will result in prospective yield adjustments.

Clarifying the Definition of a Business

In January 2017, the FASB issued ASU No. 2017-01, which changes the definition of a business to assist entities with evaluating when a set of transferred assets and activities is a business. The ASU requires an entity to evaluate if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets; if so, the set of transferred assets and activities is not a business. The guidance also requires a business to include at least one substantive process and narrows the definition of outputs by more closely aligning it

with how outputs are described in ASC 606. The ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2017, with early adoption permitted. The Company's adoption of this ASU impacted how the Company accounted for the acquisition of CYS (see discussion above).

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TWO HARBORS INVESTMENT CORP.

Notes to the Condensed Consolidated Financial Statements (unaudited)

Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income

In February 2018, the FASB issued ASU No. 2018-02, which permits entities to reclassify tax effects stranded in accumulated other comprehensive income as a result of the Tax Cuts and Jobs Act, or TCJA, to retained earnings and requires entities to disclose whether or not they elected to reclassify the tax effects related to the TCJA as well as their policy for releasing income tax effects from accumulated other comprehensive income. The ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2018, with early adoption permitted. Early adoption of this ASU was elected and applied by recording a cumulative-effect adjustment of \$9.9 million to retained earnings, with the offsetting impact to accumulated other comprehensive income as of January 1, 2018.

Accounting for Share-Based Payments to Nonemployees

In June 2018, the FASB issued ASU No. 2018-07 to simplify the accounting for share-based payments to nonemployees by aligning it with the accounting for share-based payments to employees, with certain exceptions. Under the guidance, equity-classified nonemployee awards will be measured on and fixed at the grant date, rather than measured at fair value at each reporting date until the date at which the nonemployee's performance is complete. The ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2018, with early adoption permitted. Early adoption of this ASU was elected on July 1, 2018 and applied by recording a cumulative-effect adjustment to retained earnings as of January 1, 2018, which did not have a material impact on the Company's financial condition, results of operations or financial statement disclosures.

Fair Value Measurement Disclosure Requirements

In August 2018, the FASB issued ASU No. 2018-13, which eliminates, adds and modifies certain disclosure requirements for fair value measurements. Under the guidance, entities are no longer required to disclose the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, but public companies are required to disclose (1) the changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements of instruments held at the end of the reporting period and (2) the range and weighted average used to develop significant unobservable inputs for Level 3 fair value measurements. The ASU is effective for annual periods, and interim periods within those annual periods, beginning on or after December 15, 2019, with early adoption permitted. Early adoption of this ASU did not have an impact on the Company's financial condition or results of operations but resulted in some modified financial statement disclosures.

SEC Disclosure Update and Simplification

In August 2018, the SEC adopted a final rule that amends certain disclosure requirements that have become duplicative, overlapping, or outdated in light of other SEC disclosure requirements,