AEROCENTURY CORP
Form 10KSB/A
March 13, 2007

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

FORM 10-KSB/A
Amendment No. 1

(Mark One)
x Annual Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended December 31, 2006
OR
o Transition Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from ____________ to ____________

Commission File Number: **001-13387**

AeroCentury Corp.
(Name of small business issuer in its charter)

Delaware	**94-3263974**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1440 Chapin Avenue, Suite 310
Burlingame, California 94010
(Address of principal executive offices) (Zip Code)

Issuer's telephone number:
(650) 340-1888

Securities registered under Section 12(b) of the Exchange Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $0.001 par value	**American Stock Exchange**

Securities registered under Section 12(g) of the Exchange Act: **None**

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act **o**
Note: Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Exchange Act from their obligations under these sections.

Check whether the Issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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: o**Yes** **x No**

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained herein, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. **x**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
YesoNo x

State issuer's revenues for its most recent fiscal year: **$18,321,990**

On March 12, 2007, the aggregate market value of the voting and non-voting common equity held by non-affiliates (based upon the closing price as of March 9, 2007) was **$25,071,542.**

As of March 12, 2007, the Issuer had 1,543,257 shares of Common Stock outstanding.

Documents Incorporated by Reference: Part III of this Report on Form 10-KSB incorporates information by reference from the Registrant's Proxy Statement for its 2007 Annual Meeting to be filed on or about March 22, 2007.

Transitional Small Business Disclosure Format (check one): **Yes o No x**

EXPLANATORY NOTE: This Amendment No. 1 to the Annual Report on Form 10-KSB is being filed solely to amend typographical errors in two dates on the cover page of the report relating to incorporation by reference of the Registrant's Proxy Statement. The original filing referred to the Registrant's Proxy Statement for its *2006* Annual Meeting to be filed on or about March *23*, 2007. This has been corrected to refer to the the Proxy Statement for the 2007 Annual Meeting and correct the anticipated filing date to March 22, 2007. Unaffected items have not been repeated in the Amendment No. 1. Except as described above, no other changes have been made to the original Form 10-KSB, and this form 10-KSB/A does not amend, update or change the financial statements or any other items or disclosures in the original Form 10-KSB. This Form 10-KSB/A does not reflect events occurring after the filing of the Form 10-KSB or modify or update those disclosures, including any exhibits to the Form 10-KSB affected by subsequent events. Information not affected by the changes described above is unchanged and reflects the disclosures made at the time of the original filing of the Form 10-KSB on March 12, 2007. Accordingly, this Form 10-KSB/A should be read in conjunction with the Registrant's filings made with the Securities and Exchange Commission subsequent to the filing of the original Form 10-KSB, including any amendments to those filings.

PART I

Forward-Looking Statements

This Annual Report on Form 10-KSB includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”) and Section 21E of the Securities Exchange Act of 1934, as amended (“the Exchange Act”). All statements in this Report other than statements of historical fact are "forward-looking statements" for purposes of these provisions, including any statements of plans and objectives for future operations and any statements of assumptions underlying any of the foregoing. Statements that include the use of terminology such as "may," "will," "expects," "plans," "anticipates," "estimates," "potential," or "continue," or the negative thereof, or other comparable terminology are forward-looking statements. Forward-looking statements include: (i) in Item 1 “Description of Business” statements that the Company can purchase assets at an appropriate price and maintain an acceptable overall on-lease rate for the Company’s assets; that the Company is able and willing to enter into transactions with a wider range of lessees than would be possible for traditional, large lending institutions and leasing companies; that the Company’s cash flow should be sufficient to cover maintenance expenses, interest expense, management fees, professional fees and insurance and provide excess cash flow; that competition may increase if competitors who have traditionally neglected the regional air carrier market begin to focus on that market; and that the Company has a competitive advantage because JMC has developed a reputation as a global participant in the aircraft leasing market; (ii) in Item 6 "Management's Discussion and Analysis or Plan of Operation -- Liquidity and Capital Resources," statements regarding the Company's belief that it will continue to be in compliance with all covenants of its credit facility; and that it will have adequate cash flow to meet its ongoing operational needs; (iii) in Item 6 "Management's Discussion and Analysis or Plan of Operation -- Outlook," statements regarding the Company's belief that the lease for an aircraft that expires in April 2007 will be extended; that the Company's reported net income may be subject to greater fluctuations from quarter to quarter than would have been the case had the Company continued its use of the accrue-in-advance method of accounting for planned major maintenance activities; that beginning with its March 31, 2007 financial reporting requirements, the balance sheet will reflect a catch-up cumulative adjustment to increase retained earnings as of January 1, 2006, as a result of the change to the new accounting method and the comparative 2006 financial results will be presented on a restated basis; (iv) in Item 6 "Management's Discussion and Analysis or Plan of Operation -- Factors that May Affect Future Results,” statements regarding the Company's belief that it will have sufficient cash funds to make any payment that arises due to borrowing base limitations caused by assets scheduled to come off lease in the near term; that it will have sufficient funds to pay increased Sarbanes-Oxley compliance costs; that it will acquire primarily used aircraft equipment; that overseas markets present business opportunities; and that the Company is competitive because of JMC's experience and operational efficiency and will benefit because of JMC's reputation in the marketplace; and (v) in Item 7 “Financial Statements” statements regarding the Company’s belief that the adoption of Statement 157 or Statement 159 will not have an impact on its financial condition, results of operations or cash flows.

These forward-looking statements involve risks and uncertainties, and it is important to note that the Company's actual results could differ materially from those projected or assumed in such forward-looking statements. Among the factors that could cause actual results to differ materially are the factors detailed under the heading "Management's Discussion and Analysis or Plan of Operation -- Factors That May Affect Future Results," including risks related to use of debt financing for acquisitions; the compliance of the Company's lessees with obligations under their respective leases; the Company’s success in finding additional financing and appropriate assets to acquire with such financing; general economic conditions, particularly those that affect the air travel industry; unanticipated sharp increases in interest rates; further disruptions to the air travel industry due to terrorist attacks; and future trends and results which cannot be predicted with certainty, as well as any and all risk factors contained in the periodic reports filed by the Company with the Securities Exchange Commission. The cautionary statements made in this Report should be read as being applicable to all related forward-looking statements wherever they appear herein. All forward-looking statements and risk factors included in this document are made as of the date hereof, based on information available to the Company as of the date hereof, and the Company assumes no obligation to update any forward-looking statement or risk factor.

Item 1. Description of Business.

Business of the Company

AeroCentury Corp. ("AeroCentury"), a Delaware corporation, uses leveraged financing to acquire leased aircraft assets. AeroCentury was formed in 1997. Financial information for AeroCentury and its wholly-owned subsidiaries, AeroCentury Investments V LLC ("AeroCentury V LLC") and AeroCentury Investments VI LLC ("AeroCentury VI LLC") (collectively, the "Company"), is presented on a consolidated basis. All intercompany balances and transactions have been eliminated in consolidation.

The business of the Company is managed by JetFleet Management Corp. ("JMC"), pursuant to a management agreement between the Company and JMC ("the Management Agreement"), which is an integrated aircraft management, marketing and financing business and a subsidiary of JetFleet Holding Corp. ("JHC"). Certain officers of the Company are also officers of JHC and JMC and hold significant ownership positions in both JHC and the Company.

The Company is engaged in the business of investing in used regional aircraft equipment leased to foreign and domestic regional air carriers and has been engaged in such business since its formation. The Company's principal business objective is to increase stockholder value by acquiring aircraft assets and managing those assets in order to provide a return on investment through lease revenue and, eventually, sale proceeds. The Company strives to achieve its business objective by reinvesting cash flow and obtaining short-term and long-term debt and/or equity financing.

The Company's success in achieving its objective will depend in large part on its success in three areas: asset selection, lessee selection and obtaining acquisition financing.

The Company acquires additional assets in one of three ways. The Company may purchase an asset already subject to a lease and assume the rights of the seller, as lessor under the existing lease. In addition the Company may purchase an asset, usually from an air carrier, and lease it back to the seller. Finally, the Company may purchase an asset from a seller and then immediately enter into a new lease for the aircraft with a third party lessee. In this last case, the Company typically does not purchase an asset unless a potential lessee has been identified and has committed to lease the aircraft.

The Company generally targets used regional aircraft and engines with purchase prices between $1 million and $10 million, and lease terms less than five years. In determining assets for acquisition, the Company evaluates, among other things, the type of asset, its current price and projected future value, its versatility or specialized uses, the current and projected future availability of and demand for that asset, and the type and number of future potential lessees. Because JMC has extensive experience in purchasing, leasing and selling used regional aircraft, the Company believes it can purchase these assets at an appropriate price and maintain an acceptable overall on-lease rate for the Company's assets.

In order to improve the remarketability of an aircraft after expiration of the lease, the Company focuses on having lease provisions for its aircraft that contain maintenance and return conditions, such that when the lessee returns the aircraft, the Company receives the aircraft in a condition which allows it to expediently re-lease or sell the aircraft, or receives sufficient payments from the lessee to cover any maintenance or overhaul of the aircraft required to bring the aircraft to such a state.

When considering whether to accept transactions with a lessee, the Company examines the creditworthiness of the lessee, its short- and long-term growth prospects, its financial status and backing, the impact of pending governmental regulation or de-regulation of the lessee's market, all of which are weighed in determining the lease rate that is offered to the lessee. In addition, where applicable, it is the Company's policy to monitor the lessee's business and financial performance closely throughout the term of the lease, and if requested, provide assistance drawn from the experience of the Company’s management in many areas of the air carrier industry. Because of its “hands-on” approach to portfolio management, the Company believes it is able and willing to enter into transactions with a wider range of lessees than would be possible for traditional, large lending institutions and leasing companies.

Working Capital Needs

The Company’s portfolio of assets has historically generated revenues which have exceeded the Company’s cash expenses, which consist mainly of management fees, maintenance expense, financing interest payments, and professional fees and insurance.

The Company's management fees payable to JMC are based upon the size of the asset pool. Other than the maintenance expense accrued when two aircraft were returned at lease end in 2006, the majority of the maintenance expense incurred by the Company during 2006 was paid in cash during the year. As the Company has continued to use acquisition debt financing under its revolving credit facility, which expires on October 31, 2007, interest expense has become an increasingly large portion of the Company’s expenses. Professional fees are paid to third parties for expenses not covered by JMC under the Management Agreement. Insurance expense includes amounts paid for directors and officers insurance, as well as product liability insurance and aircraft insurance for periods when an aircraft is off lease. So long as the Company succeeds in keeping the majority of its assets on lease and interest rates do not rise significantly and rapidly, the Company’s cash flow should be sufficient to cover maintenance expenses, interest expense, management fees, professional fees and insurance and provide excess cash flow.

Competition

The Company competes with other leasing companies, banks, financial institutions, and aircraft leasing partnerships for customers who generally are regional commercial aircraft operators, who are seeking to lease aircraft under an operating lease. Management believes that competition may increase if competitors who have traditionally neglected the regional air carrier market begin to focus on that market. Because competition is largely based on price and lease terms, the entry of new competitors into the market, particularly those with greater access to capital markets than the Company, could lead to fewer acquisition opportunities for the Company and/or lease terms less favorable to the Company on new acquisitions as well as renewals of existing leases or new leases of existing aircraft, all of which could lead to lower revenues for the Company.

The Company, however, believes that it has a competitive advantage due to its experience and operational efficiency in financing the transaction sizes that are desired by the regional air carrier market. Management believes that the Company also has a competitive advantage because JMC has developed a reputation as a global participant in the aircraft leasing market.

Dependence on Significant Customers

For the year ended December 31, 2006, the Company had six significant customers, which accounted for 15%, 14%, 12%, 11%, 11% and 10%, respectively, of lease revenue, aggregating 73% of total revenue. Concentration of credit risk with respect to lease receivables will diminish in the future only if the Company is able to lease additional assets or re-lease assets currently on lease to significant customers to new customers.

Employees

Under the Company’s management contract with JMC, JMC is responsible for all administration and management of the Company. Consequently, the Company does not have any employees.

Item 2. Description of Property.

As of December 31, 2006, the Company did not own or lease any real property, plant or materially important physical properties. The Company maintains its principal office at 1440 Chapin Avenue, Suite 310, Burlingame, California 94010. However, since the Company has no employees and the Company's portfolio of leased aircraft assets is managed and administered under the terms of the Management Agreement with JMC, all office facilities are provided by JMC.

At December 31, 2006, the Company owned eight deHavilland DHC-8-300s, three deHavilland DHC-8-100s, three deHavilland DHC-6s, fourteen Fokker 50s, two Saab 340As, six Saab 340Bs and one turboprop engine.

Item 3. Legal Proceedings.

The Company is not involved in any material legal proceedings.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

PART II

Item 5. Market for Common Equity and Related Stockholder Matters.

The shares of the Company's Common Stock are traded on the American Stock Exchange ("AMEX") under the symbol "ACY."

Market Information

The Company's Common Stock has been traded on the AMEX since January 16, 1998. The following table sets forth the high and low sales prices reported on the AMEX for the Company's Common Stock for the periods indicated:

Period	High	Low
Fiscal year ended December 31, 2007:		
First quarter through March 9, 2007	$ 24.50	$ 6.58
Fiscal year ended December 31, 2006:		
Fourth Quarter	6.79	4.77
Third Quarter	5.48	4.70
Second Quarter	5.54	4.04
First Quarter	4.14	3.15
Fiscal year ended December 31, 2005:		
Fourth Quarter	4.18	2.90
Third Quarter	4.50	3.26
Second Quarter	4.40	2.87
First Quarter	6.78	2.33

On March 9, 2007, the closing stock sale price on the AMEX was $21.02 per share.

Number of Security Holders

According to the Company's transfer agent, the Company had approximately 1,700 stockholders of record as of March 12, 2007.

Dividends

No dividends have been declared or paid to date. The Company has no plans at this time to declare or pay dividends, and intends to re-invest any earnings into acquisition of additional revenue generating aircraft equipment.

Stockholder Rights Plan

In April 1998, in connection with the adoption of a stockholder rights plan, the Company filed a Certificate of Designation detailing the rights, preferences and privileges of a new Series A Preferred Stock. Pursuant to the plan, the Company issued rights to its stockholders of record as of April 23, 1998, giving each stockholder the right to purchase one one-hundredth of a share of Series A Preferred Stock for each share of Common Stock held by the stockholder. Such rights are exercisable only under certain circumstances in connection with a proposed acquisition or merger of the Company.

Item 6. Management's Discussion and Analysis or Plan of Operation.

Overview

The Company is a lessor of regional aircraft and engines which are used by customers pursuant to triple net operating leases. The acquisition of such equipment is generally made using debt financing. The Company's profitability and cash flow are dependent in large part upon its ability to acquire equipment, obtain and maintain favorable lease rates on such equipment, and re-lease or sell owned equipment that comes off lease. The Company is subject to the credit risk of its lessees, both as to collection of rent and to performance by lessees of obligations for maintaining the aircraft. Since lease rates for assets in the Company's portfolio generally decline as the assets age, the Company's ability to maintain revenue and earnings is dependent upon the Company's ability to grow its asset portfolio.

The Company's principal expenditures are for interest costs on its financing, management fees, and maintenance of its aircraft assets. Maintenance expenditures are generally incurred only when aircraft are off lease, are being prepared for re-lease, or require maintenance in excess of lease return conditions.

The most significant non-cash expenses include accruals of maintenance costs to be borne by the Company and aircraft depreciation, both of which are the result of significant estimates. Maintenance expenses are estimated and accrued based upon utilization of the aircraft. Depreciation is recognized based upon the estimated residual value of the aircraft at the end of their estimated lives. Deviation from these estimates could have a substantial effect on the Company's cash flow and profitability.

Critical Accounting Policies, Judgments and Estimates

The discussion and analysis of the Company's financial condition and results of operations are based upon the consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities at the date of the financial statements. Actual results may differ from these estimates under different assumptions or conditions.

The Company's significant accounting policies are described in Note 1 to the consolidated financial statements. The Company believes that the most critical accounting policies include the following: Impairment of Long-lived Assets; Depreciation Policy, Maintenance Reserves and Accrued Costs; Revenue Recognition and Allowance for Doubtful Accounts; and Accounting for Income Taxes.

a. Impairment of Long-lived Assets

The Company periodically reviews its portfolio of assets for impairment in accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets." Such review necessitates estimates of current market values, re-lease rents, residual values and component values. The estimates are based on currently available market data and third-party appraisals and are subject to fluctuation from time to time. The Company initiates its review periodically, whenever events or changes in circumstances indicate that the carrying amount of a long-lived asset may not be recoverable. Recoverability of an asset is measured by comparison of its carrying amount to the expected future undiscounted cash flows (without interest charges) that the asset is expected to generate. Any impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair market value. Significant management judgment is required in the forecasting of future operating results which are used in the preparation of projected undiscounted cash flows and should different conditions prevail, material write downs may occur.

In accordance with its periodic review of its portfolio of assets for impairment, based on the Company's cash flow analysis and third party appraisals, the Company recorded no provisions for impairment for its aircraft in 2006.

b. Depreciation Policy

The Company's interests in aircraft and aircraft engines are recorded at cost, which includes acquisition costs. The Company purchases only used aircraft. It is the Company's policy to hold aircraft for approximately twelve years unless market conditions necessitate earlier disposition. Depreciation is computed using the straight-line method over the twelve year period to an estimated residual value based on appraisal. Decreases in the market value of aircraft could not only affect the current value, discussed above, but could also affect the assumed residual value. The Company periodically obtains a residual value appraisal for its assets and, historically, has not had to write down any assets due to revised estimated residuals.

c. Maintenance Reserves and Accrued Costs

Maintenance costs under the Company's triple net leases are generally the responsibility of the lessees. Maintenance reserves and accrued costs in the accompanying consolidated balance sheet include refundable and non-refundable maintenance payments received from lessees. The Company periodically reviews maintenance reserves for each of its aircraft for adequacy in light of the number of hours flown, airworthiness directives issued by the manufacturer or government authority, and the return conditions specified in the lease, as well as the condition of the aircraft upon return or inspection. As a result of such review, if it is probable that the Company has incurred costs for maintenance in excess of amounts received from lessees, the Company accrues its share of costs for work to be performed.

Significant management judgment is required in determining aircraft condition and estimating maintenance costs. Absent fixed price maintenance agreements, these costs cannot be determined until such work is completed. Because of the potential magnitude of maintenance costs, even slight changes in work scope may have a material impact on operating results.

With respect to estimated maintenance costs, the Company has found its accruals to be generally accurate. Its accruals, however, are based on the assumption that aircraft will be returned at lease end in accordance with the return conditions of the lease. Historically, as a result of two situations, the Company incurred significant maintenance expense when aircraft were returned early and in a condition worse than required by the lease and for which the Company was unable to recover the costs of non-compliance from the lessees.

d. Revenue Recognition and Allowance for Doubtful Accounts

Revenue from leasing of aircraft assets is recognized as operating lease revenue on a straight-line basis over the terms of the applicable lease agreements. The Company estimates and charges to income a provision for bad debts based on its experience in the business and with each specific customer, the level of past due accounts, and its analysis of the lessees' overall financial condition. If the financial condition of the Company's customers deteriorates, it could result in actual losses exceeding the estimated allowances.

e. Accounting for Income Taxes

As part of the process of preparing the Company's consolidated financial statements, management is required to estimate income taxes in each of the jurisdictions in which the Company operates. This process involves estimating the Company's current tax exposure under the most recent tax laws and assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in the consolidated balance sheet. Management must also assess the likelihood that the Company's deferred tax assets will be recovered from future taxable income, and, to the extent management believes it is more likely than not that some portion or all of the deferred tax assets will not be realized, the Company must establish a valuation allowance. To the extent the Company establishes a valuation allowance or changes the allowance in a period, the Company reflects the corresponding increase or decrease within the tax provision in the consolidated statements of operations.

Significant management judgment is required in determining the Company's future taxable income for purposes of assessing the Company's ability to realize any benefit from its deferred taxes. In the event that actual results differ from these estimates or the Company adjusts these estimates in future periods, the Company's operating results and financial position could be materially affected.

Results of Operations

a. Revenues

Operating lease revenue was approximately $4,122,000 higher in 2006 versus 2005, primarily because of increased operating lease revenue from aircraft purchased beginning in April 2005 and revenue from two aircraft which had been off lease in 2005, the effects of which were partially offset by a decrease in revenue from an aircraft which was sold in 2006.

Gain on sale of aircraft was approximately $409,000 in 2006 as a result of the sale of an aircraft in April 2006. Loss on sale of aircraft was approximately $48,000 in 2005 as a result of the sale of one aircraft at a loss of approximately $60,000 and another aircraft at a gain of approximately $12,000.

Other income was approximately $244,000 higher in 2006 than in 2005, primarily as a result of an increase in the amount of non-refundable maintenance reserves retained by the Company, which were recorded as income at lease end.

b. Expense items

Depreciation was approximately $949,000 higher in 2006 versus 2005, primarily because of purchases of aircraft beginning in April 2005, the effect of which was partially offset by aircraft sales in 2005 and 2006. Management fees, which are calculated on the net book value of the aircraft owned by the Company, were approximately $410,000 higher 2006 compared to 2005 for the same reasons.

Interest expense was approximately $1,469,000 higher in 2006 versus 2005, primarily as a result of increases in the index rates upon which the Company’s interest rates are based and a higher average principal balance in 2006 compared to 2005, the effect of which was partially offset by a lower margin in 2006 than in 2005.

Maintenance expense was approximately $1,205,000 higher in 2006 compared to 2005. In 2006 and 2005, the Company retained approximately $2,396,000 and $1,902,000, respectively, of non-refundable maintenance reserves when aircraft were returned to the Company at lease end and recorded such amounts as other income, discussed above. Based on the condition of the aircraft at the time of return, in 2006 and 2005, the Company accrued approximately $2,392,000 and $1,862,000, respectively, of maintenance expense for which the Company is responsible. The Company also accrued approximately $1,112,000 and $437,000 of expense to prepare several aircraft for re-lease in 2006 and 2005, respectively.

Professional fees and general and administrative expenses were approximately $92,000 higher in 2006 versus 2005, primarily because of higher accounting fees and legal fees related to the Company’s leases in 2006.

The Company's insurance expense consists primarily of directors and officers insurance, as well as product liability insurance and insurance for off-lease aircraft and aircraft engines, which varies depending on the type of assets insured during each period and the length of time each asset is insured. As a result of the combination of assets insured during each period and the length of time each was insured, insurance expense was approximately $122,000 lower in 2006 versus 2005.

During 2006, the Company recorded bad debt expense of approximately $49,000 for rent receivable which was written off in connection with a lessee’s early return of an aircraft. During 2005, the Company recorded bad debt expense of approximately $88,000, to fully reserve the balance of a note receivable from the former lessee of one of the Company’s aircraft, based on a notice received from the lessee that it had filed for reorganization, and $79,000 to fully reserve the amount of foreign taxes due from a former lessee which was recorded as other income in 2005.

The Company did not record any impairment charges in 2006. In 2005, the Company recorded an impairment charge of approximately $12,000 for one of its aircraft, based on estimated net sales proceeds pursuant to an agreement to sell the aircraft.

The Company's effective tax rates for the years ended December 31, 2006 and 2005 were approximately 37% and 43%, respectively. The change in rate was primarily a result of the recognition of tax expense in 2005 related to a lessee's non-payment of foreign taxes in a prior year.

Liquidity and Capital Resources

The Company is currently financing its assets primarily through credit facility borrowings, special purpose financing and excess cash flow.

(a) Credit facility

In November 2005, the Company's credit facility was renewed through October 31, 2007. In connection with the renewal, certain financial covenants were modified, including the applicable margin which is added to the index rate for each of the Company's outstanding loans under the credit facility. The margin, which is determined by certain financial ratios, was revised from a range of 275 to 375 basis points to a range of 275 to 325 basis points. In May 2006, a participant was added to the Company's credit facility and the amount of the facility was increased from $50 million to $55 million.

During 2006, the Company borrowed $3,900,000 and repaid $3,000,000 of the outstanding principal under its credit facility. The balance of the note payable at December 31, 2006 was $50,896,000 and interest of $153,250 was accrued.

As a result of maintenance expense in connection with preparing one of the Company's aircraft for lease in the second quarter, on June 30, 2006, the Company was out of compliance with a financial ratio covenant which is based on net income. The Company obtained a waiver from its banks regarding that covenant for the quarter then ended. The Company is currently in compliance with all covenants and, based on its current projections, the Company believes it will continue to be in compliance with all covenants of its credit facility, but there can be no assurance of such compliance in the future. See *"Factors That May Affect Future Results - 'Risks of Debt Financing' and 'Credit Facility Obligations,"'* below.

The Company's interest expense in connection with the credit facility generally moves up or down with prevailing interest rates, as the Company has not entered into any interest rate hedge transactions for the credit facility indebtedness. Because aircraft owners seeking financing generally can obtain financing through either leasing transactions or traditional secured debt financings, prevailing interest rates are a significant factor in determining market lease rates, and market lease rates generally move up or down with prevailing interest rates, assuming supply and demand of the desired equipment remain constant. However, because lease rates for the Company's assets typically are fixed under existing leases, the Company normally does not experience any positive or negative impact in revenue from changes in market lease rates due to interest rate changes until existing leases have terminated and new lease rates are set as the aircraft is re-leased.

(b) Special purpose financing

In September 2000, a special purpose subsidiary acquired a deHavilland DHC-8-100 aircraft using cash and bank financing separate from its credit facility. The financing resulted in a note obligation in the amount of $3,575,000, due April 15, 2006, which bore interest at the rate of one-month LIBOR plus 3%. The note was collateralized by the aircraft and was non-recourse to the Company. Payments due under the note consisted of monthly principal and interest and a balloon principal payment due on the maturity date. The financing also provided for a six month remarketing period at the expiration or early termination of the lease. This note obligation was refinanced in April 2006, using bank financing from another lender, and the subsidiary was dissolved. The aircraft was transferred to AeroCentury VI LLC, a newly formed special purpose limited liability company, which borrowed $1,650,000, due October 15, 2009. The note bears interest at an adjustable rate of one-month LIBOR plus 3%. The note is collateralized by the aircraft and the Company's interest in AeroCentury VI LLC and is non-recourse to the Company. Payments due under the note consist of monthly principal and interest through April 20, 2009, interest only from April 20, 2009 until the maturity date, and a balloon principal payment due on the maturity date. If the aircraft lease agreement is terminated on April 15, 2008 pursuant to a lessee early termination option, the note will be due October

15, 2008, and the interest only period will be from April 20, 2008 through October 15, 2008. During 2006, $1,859,550 of principal was repaid, including $1,566,290 which was repaid to the original lender when the loan was refinanced. The balance of the note payable at December 31, 2006 was $1,421,350 and interest of $3,960 was accrued. As of December 31, 2006, the Company was in compliance with all covenants of this note obligation and is currently in compliance.

In November 2005, the Company refinanced two DHC-8-300 aircraft that had been part of the collateral base for its credit facility. The financing, by a bank separate from its credit facility, was provided to a newly formed special purpose subsidiary, AeroCentury V LLC, to which the aircraft were transferred. The financing resulted in a note obligation in the amount of $6,400,000, due November 10, 2008, which bears interest at the rate 7.87%. The note is collateralized by the aircraft and is non-recourse to the Company. Payments due under the note consist of monthly principal and interest through April 22, 2008, interest only from April 22, 2008 until the maturity date, and a balloon principal payment due on the maturity date. During 2006, AeroCentury V LLC repaid $896,070 of principal. The balance of the note payable at December 31, 2006 was $5,420,710 and interest of $11,850 was accrued. As of December 31, 2006, the Company was in compliance with all covenants of this note obligation and is currently in compliance.

The availability of special purpose financing in the future will depend on several factors including (1) the availability of funds to be used for the equity portion of the financing, (2) the type of asset being financed, (3) the creditworthiness of the underlying lessee and (4) continued compliance with the Company’s credit facility covenants. The availability of funds for the equity portion of the financing will be dependent on the Company's cash flow, as discussed in *"Cash Flow,"* below.

(c) Future maturities of notes payable

As of December 31, 2006, principal payments due under the Company’s credit facility and long-term debt were as follows:

Less than one year	$ 52,178,150
1-3 years	5,559,910
4-5 years	-
After 5 years	-
	$ 57,738,060

(d) Cash flow

The Company's primary source of revenue is lease rentals of its aircraft assets. It is the Company’s policy to monitor each lessee’s needs in periods before leases are due to expire. If it appears that a customer will not be renewing its lease, the Company immediately initiates marketing efforts to locate a potential new lessee or purchaser for the aircraft. The goal of this procedure is to reduce the time that an asset will be off lease. The Company’s aircraft are subject to leases with varying expiration dates through November 2011.

Management believes that the Company will have adequate cash flow to meet its ongoing operational needs, including required repayments under its credit facility, based upon its estimates of future revenues and expenditures. The Company’s expectations concerning such cash flows are based on existing lease terms and rents, as well as numerous estimates, including (i) rents on assets to be re-leased, (ii) sale proceeds of certain assets currently under lease, (iii) the cost and anticipated timing of maintenance to be performed and (iv) acquisition of additional aircraft and the lease thereof at favorable lease terms. While the Company believes that the assumptions it has made in forecasting its cash flow are reasonable in light of experience, actual results could deviate from such assumptions. Among the more significant external factors outside the Company’s control that could have an impact on the accuracy of cash flow assumptions are (i) an increase in interest rates that negatively affects the Company’s profitability and causes the Company to violate covenants of its credit facility, requiring repayment of some or all of the amounts outstanding under its credit facility, (ii) lessee non-performance or non-compliance with lease obligations (which may affect credit facility collateral limitations as well as revenue and expenses) and (iii) an unexpected deterioration of demand for aircraft equipment.

(i) Operating activities

The Company’s cash flow from operations for the year ended December 31, 2006 versus 2005 increased by approximately $1,132,000. The change in cash flow is a result of changes in several cash flow items during the period, including principally the following:

Lease rents, maintenance reserves and security deposits

Payments received from lessees for rent were approximately $4,057,000 higher in 2006 versus 2005, due primarily to the effect of increased lease revenue from aircraft purchased beginning in April 2005. Although increased demand generally in the turboprop market has caused lease rates to stabilize and, in some cases, rise, it cannot be predicted that rental rates on aircraft to be re-leased will not decline, so that, absent additional acquisitions by the Company, aggregate lease revenues for the current portfolio could decline over the long term.

Payments received from lessees for maintenance reserves decreased by approximately $127,000 in 2006 versus 2005, primarily because the Company received substantial sums of maintenance reserves for the lessee’s prior use from the sellers of two aircraft when the Company purchased them in 2005.

Security deposits received decreased by approximately $295,000 in 2006 versus 2005, because the rent, on which security deposits are based, for leases initiated by the Company during 2006 was lower than in 2005.

Expenditures for maintenance

Expenditures for maintenance were approximately $2,620,000 higher in 2006 versus 2005 primarily as a result of higher payments during 2006 for maintenance performed to prepare several of the Company's aircraft for remarketing. The effect of these expenditures was partially offset by lower payments in 2006 by the Company to lessees for maintenance performed by lessees, which were funded by the payout of maintenance reserves held by the Company. The amount of expenditures for maintenance in future periods will be dependent on the amount and timing of maintenance paid from lessee maintenance reserves held by the Company and the off-lease status of the Company's aircraft.

Expenditures for interest

Expenditures for interest increased by approximately $1,731,000 in 2006 versus 2005, primarily as a result of higher average interest rates and a higher average principal balance in 2006. Interest expenditures in future periods will be a product of prevailing interest rates and the outstanding principal balance on financings, which may be influenced by future acquisitions and/or required repayments resulting from changes in the collateral base.

Expenditures for management fees

Expenditures for management fees increased by approximately $649,000 in 2006 versus 2005, as a result of aircraft purchases since April 2005, the effect of which was partially offset by sales of aircraft in November 2005 and April 2006.

Expenditures for acquisition fees

During 2006, the Company paid $314,000 to JMC for the acquisition fee accrued in December 2005 upon the purchase of four aircraft and which was included in the Company's accounts payable balance at December 31, 2005 and $198,000 in connection with the acquisition of three aircraft in November 2006.

Expenditures for professional fees and general and administrative expenses

Expenditures for professional fees and general and administrative expenses increased by approximately $274,000 in 2006 versus 2005 primarily as a result of higher accounting and legal expenditures.

Expenditures for prepaid expenses

Expenditures for prepaid expenses were approximately $367,000 lower in 2006 versus 2005, primarily as a result of purchases in 2005 of equipment which was installed on several of the Company's aircraft in 2006.

Expenditures for aircraft insurance

Expenditures for aircraft insurance were approximately $124,000 lower in 2006 than in 2005 primarily as a result of the combination of assets insured during each year and the length of time each was insured.

Income taxes

Income tax payments were approximately $1,817,000 lower in 2006 compared to 2005 primarily because in early 2005 the Company made a payment of approximately $1,704,000 for 2004 taxes related to the sale of a portfolio of engines in December 2004. In addition, the Company had lower taxable income in 2006 than in 2005.

(ii) Investing activities

The $12,867,000 decrease in cash flow used by investing activities in 2006 versus 2005 was primarily due to a decrease in the amount invested in aircraft assets during 2006, as well as a decrease in the amount received from aircraft sales in 2006.

(iii) Financing activities

The Company borrowed approximately $17,641,000 less in 2006 versus 2005 for aircraft financing and repaid approximately $8,192,000 less of its outstanding debt in 2006, including the debt in the special purpose subsidiaries. In 2006, the Company's borrowings included $1,650,000 for the refinancing of an aircraft and repayments included approximately $1,566,000 which was repaid from the refinancing proceeds.

Outlook

The Company’s future growth will depend on the availability of additional financing for acquisitions of leased assets which will need to be leased at higher rental rates to offset the anticipated stable or decreased lease rates resulting from future re-leases of the Company’s current portfolio. The Company is continuing to pursue additional sources of acquisition financing and the terms of such financing, especially in an environment of rising interest rates, will affect the Company’s results.

In January 2007, the Company and the lessee of the Company's two Saab 340A aircraft, wihch have leases expiring in May and July 2008, began discussing the early return of the aircraft based on the lessee's anticipated financial difficulties. The Company is seeking re-lease or sale opportunities for these assets, but there is no assurance when the Company will be successful in its efforts. The next scheduled expiration of one of the Company’s aircraft leases is in April 2007, and the Company expects it will be extended at that time.

The Company continually monitors the financial condition of its lessees to avoid unanticipated creditworthiness issues, and where necessary, works with lessees to ensure continued compliance with both monetary and non-monetary obligations under their respective leases. Currently, the Company is closely monitoring the performance of two lessees with a total of three aircraft under lease. The Company continues to work closely with these lessees to ensure compliance with their current obligations. During 2006, the Company incurred $49,000 of bad debt expense related to amounts owed by a former lessee at the time the Company and the lessee agreed to the early termination of the lease. If any of the Company's current lessees are unable to meet their lease obligations, the Company's future results could be materially impacted. Any weakening in the aircraft industry may also affect the performance of lessees that currently appear to the Company to be creditworthy. See "*Factors that May Affect Future Results - General Economic Conditions*," below.

Due to the recent adoption of FASB Staff Position AUG AIR-1, as discussed in Note 1 to the Financial Statements, the Company must discontinue the accrue-in-advance method of accounting for planned major maintenance for financial reporting periods beginning on January 1, 2007. Under the accrue-in-advance method of accounting, the collection of non-refundable maintenance reserves for planned major maintenance and disbursements from reserves to lessees to pay for maintenance performed was reflected only on the Company's balance sheet. The Company has evaluated the impact of the adoption of this new staff position and determined that, going forward, it will use the direct expensing method, under which actual costs incurred are expensed directly. The new mandated accounting methods will require the accrual of non-refundable maintenance reserves from the Company’s lessees for planned major maintenance to be reflected as income, and performance of maintenance work in connection with the release of maintenance reserves to be reflected as an expense when maintenance is actually performed. Therefore, beginning in the first quarter of 2007, the Company believes that the Company's reported net income may be subject to greater fluctuations from quarter-to-quarter than would have been the case had the Company continued its use of the accrue-in-advance method of accounting for planned major maintenance activities. Furthermore, because this guidance must be applied retroactively, the Company anticipates that, beginning with its March 31, 2007 financial reporting requirements, the balance sheet will reflect a catch-up cumulative adjustment to increase retained earnings as of January 1, 2006, as a result of the change to the new accounting method and the comparative 2006 financial results will be presented on a restated basis.

Factors that May Affect Future Results

Risks of Debt Financing. The Company's use of debt as the primary form of acquisition financing subjects the Company to increased risks of leveraging. With respect to the credit facility, the loans are secured by the Company's existing assets as well as the specific assets acquired with each financing. In addition to payment obligations, the credit facility also requires the Company to comply with certain financial covenants, including a requirement of positive annual earnings, interest coverage and net worth ratios. Any default under the credit facility, if not waived by the lenders, could result in foreclosure upon not only the asset acquired using such financing, but also the existing assets of the Company securing the loan.

Interest Rate Risk. The Company's current credit facility and the indebtedness of one of its special purpose subsidiaries carry a floating interest rate based upon either the lender's prime rate or a floating LIBOR rate. Lease rates, generally, but not always, move with interest rates, but market demand for the asset also affects lease rates. Because lease rates are fixed at the origination of leases, interest rate increases during the term of a lease have no effect on existing lease payments. Therefore, if interest rates rise significantly, and there is relatively little lease origination by the Company following such rate increases, the Company could experience lower net earnings. Further, even if significant lease origination occurs following such rate increases, if the contemporaneous aircraft market forces result in lower or flat rental rates, the Company could experience lower net earnings as well.

Recent actions by the Federal Reserve Board indicate that its previous moves to increase the prevailing short term borrowing rates have ceased for the time being, but there is no assurance that economic circumstances may not cause the Board to resume moving short term borrowing rates higher. The Company has not hedged its variable rate debt obligations and such obligations are based on short-term interest rate indexes. Consequently, if an interest rate increase were great enough, the Company might not be able to generate sufficient lease revenue to meet its interest payment and other obligations and comply with the net earnings covenant of its credit facility.

Credit Facility Obligations. The Company is obligated to make repayment of principal under the credit facility in order to maintain certain debt ratios with respect to its assets in the borrowing base. Assets that come off lease and remain off-lease for a period of time are removed from the borrowing base. The Company believes it will have sufficient cash funds to make any payment that arises due to borrowing base limitations caused by assets scheduled to come off lease in the near term. The Company's belief is based on certain assumptions regarding renewal of existing leases, a lack of extraordinary interest rate increases, continuing profitability, no lessee defaults or bankruptcies, and certain other matters that the Company deems reasonable in light of its experience in the industry. There can be no assurance that the Company's assumptions will prove to be correct. If the assumptions are incorrect (for example, if an asset in the collateral base unexpectedly goes off lease for an extended period of time) and the Company has not obtained an applicable waiver or amendment of applicable covenants from its lenders to mitigate the situation, the Company may have to sell a significant portion of its portfolio in order to maintain compliance with covenants or face default on its credit facility.

Concentration of Lessees and Aircraft Type. Currently, the Company's six largest customers are located in Belgium, Taiwan, the Caribbean, Norway, the United States and Sweden, and currently account for approximately 14%, 12%, 12%, 11%, 11% and 10%, respectively, of the Company's monthly lease revenue. A lease default by or collection problems with one of these customers could have a disproportionate negative impact on the Company's financial results, and therefore, the Company's operating results are especially sensitive to any negative developments with respect to these customers in terms of lease compliance or collection. Such concentration of lessee credit risk will diminish in the future only if the Company is able to lease additional assets to new lessees.

The Company owns fourteen Fokker 50, eight DHC-8-300, three DHC-8-100 and six Saab 340B aircraft, making these four aircraft types the dominant types in the portfolio and representing 36%, 37%, 10% and 11%, respectively, based on net book value. As a result, a change in the desirability and availability of any of these types of aircraft, which would in turn affect valuations of such aircraft, would have a disproportionately large impact on the Company's portfolio value. Such aircraft type concentration will diminish if the Company acquires additional assets of other types. Conversely, acquisition of these types of aircraft will increase the Company’s risks related to its concentration of those aircraft types.

Increased Compliance Costs. Current Sarbanes-Oxley Act requirements applicable to the Company effective for the year ended December 31, 2007 relating to internal controls could result in significantly higher fees and expenses in connection with auditor services beginning in 2007. The increase will generally arise from increased auditor responsibilities, including broadening of the scope of the auditor's examination to include the Company's internal controls. If the regulations remain unchanged, the Company anticipates that it will have sufficient funds to pay for the increased compliance costs.

Lessee Credit Risk. If a customer defaults upon its lease obligations, the Company may be limited in its ability to enforce remedies. Most of the Company’s lessees are small regional passenger airlines, which may be even more sensitive to airline industry market conditions than the major airlines. As a result, the Company’s inability to collect rent under a lease or to repossess equipment in the event of a default by a lessee could have a material adverse effect on the Company’s revenue. If a lessee that is a certified U.S. airline is in default under the lease and seeks protection under Chapter 11 of the United States Bankruptcy Code, Section 1110 of the Bankruptcy Code would automatically prevent the Company from exercising any remedies for a period of 60 days. After the 60-day period has passed, the lessee must agree to perform the obligations and cure any defaults, or the Company will have the right to repossess the equipment. This procedure under the Bankruptcy Code has been subject to significant recent litigation, however, and it is possible that the Company’s enforcement rights may be further adversely affected by a declaration of bankruptcy by a defaulting lessee. Most of the Company’s lessees are foreign and not subject to U.S. bankruptcy laws but there may be similar applicable foreign bankruptcy debtor protection schemes available to foreign carriers.

Leasing Risks. The Company’s successful negotiation of lease extensions, re-leases and sales may be critical to its ability to achieve its financial objectives, and involves a number of risks. Demand for lease or purchase of the assets depends on the economic condition of the airline industry which is, in turn, sensitive to general economic conditions. The ability to remarket equipment at acceptable rates may depend on the demand and market values at the time of remarketing. The Company anticipates that the bulk of the equipment it acquires will be used aircraft equipment. The market for used aircraft is cyclical, and generally reflects economic conditions and the strength of the travel and transportation industry. The demand for and value of many types of used aircraft in the recent past has been depressed by such factors as airline financial difficulties, increased fuel costs, the number of new aircraft on order and the number of aircraft coming off-lease. Values may also increase for certain aircraft types that become desirable based on market conditions and changing airline capacity. If the Company were to purchase an aircraft during a period of increasing values, it would need a corresponding higher lease rate.

The Company’s current concentration in a limited number of turboprop airframe and aircraft engine types subjects the Company to economic risks if an airframe or engine type owned by the Company should significantly decline in value relative to the assets’ purchase price. If “regional jets” were to be used on short routes previously served by turboprops, even though regional jets are more expensive to operate than turboprops on those routes, the demand for turboprops could lessen. This could result in lower lease rates and values for the Company’s existing turboprop aircraft.

Risks Related to Regional Air Carriers. Because the Company has concentrated its existing leases, and intends to continue to concentrate future leases, on regional air carriers, it is subject to additional risks. Some of the lessees in the regional air carrier market are companies that are start-up, low capital, low margin operations. Often, the success of such carriers is dependent upon contractual arrangements with major trunk carriers or franchises from governmental agencies that provide subsidies for operating essential air routes, both of which may be subject to termination or cancellation with short notice periods,. Because of this exposure, the Company typically is able to obtain generally higher lease rates from these types of lessees. In the event of a business failure of the lessee or its bankruptcy, the Company can generally regain possession of its aircraft, but the aircraft could be in substantially worse condition than would be the case if the aircraft were returned in accordance with the provisions of the lease at lease expiration.

The Company evaluates the credit risk of each lessee carefully, and attempts to obtain a third party guaranty, letters of credit or other credit enhancements, if it deems them necessary. There is no assurance, however, that such enhancements will be available or that, if obtained, they will fully protect the Company from losses resulting from a lessee default or bankruptcy. Also, a significant area of market growth is outside of the United States, where collection and enforcement are often more difficult and complicated than in the United States. During 2006 and 2005, the Company incurred bad debt expense related to amounts owed by three former lessees. This expense materially affected the Company's financial performance. If any of the Company's current lessees are unable to meet their lease obligations, the Company's future results could be materially impacted.

Reliance on JMC. All management of the Company is performed by JMC under a management agreement which is in the ninth year of a 20-year term and provides for an asset-based management fee. JMC is not a fiduciary to the Company or its stockholders. The Company’s Board of Directors has ultimate control and supervisory responsibility over all aspects of the Company and owes fiduciary duties to the Company and its stockholders. The Board has no control over the internal operations of JMC, but the Board does have the ability and responsibility to manage the Company's relationship with JMC and the performance of JMC's obligations to the Company under the management agreement, as it would have for any third party service provider to the Company. While JMC may not owe any fiduciary duties to the Company by virtue of the management agreement, the officers of JMC are also officers of the Company, and in that capacity owe fiduciary duties to the Company and its stockholders. In addition, certain officers of the Company hold significant ownership positions in the Company and JHC, the parent company of JMC.

The JMC management agreement may be terminated if JMC defaults on its obligations to the Company. However, the agreement provides for liquidated damages in the event of its wrongful termination by the Company. All of the officers of JMC are also officers of the Company, and certain directors of the Company are also directors of JMC. Consequently, the directors and officers of JMC may have a conflict of interest in the event of a dispute between the Company and JMC. Although the Company has taken steps to prevent conflicts of interest arising from such dual roles, such conflicts may still occur.

JMC has acted as the management company for two other aircraft portfolio owners, JetFleet III, which raised approximately $13,000,000 from investors, and AeroCentury IV, Inc. (“AeroCentury IV”), which raised approximately $5,000,000 from investors. In the first quarter of 2002, AeroCentury IV defaulted on certain obligations to noteholders. In June 2002, the indenture trustee for AeroCentury IV’s noteholders repossessed AeroCentury IV’s assets and took over management of AeroCentury IV’s remaining assets. JetFleet III defaulted on its bond obligation of $11,076,350 in May 2004. The indenture trustee for JetFleet III bondholders repossessed JetFleet III’s unsold assets in late May 2004.

Ownership Risks. The Company’s portfolio is leased under operating leases, where the terms of the leases are less than the entire anticipated useful life of an asset. The Company’s ability to recover its purchase investment in an asset subject to an operating lease is dependent upon the Company’s ability to profitably re-lease or sell the asset after the expiration of the initial lease term. Some of the factors that have an impact on the Company’s ability to re-lease or sell include worldwide economic conditions, general aircraft market conditions, regulatory changes that may make an asset’s use more expensive or preclude use unless the asset is modified, changes in the supply or cost of aircraft equipment and technological developments which cause the asset to become obsolete. In addition, a successful investment in an asset subject to an operating lease depends in part upon having the asset returned by the lessee in the condition as required under the lease. If the Company is unable to remarket its aircraft equipment on favorable terms when the operating leases for such equipment expire, the Company's business, financial condition, cash flow, ability to service debt and results of operations could be adversely affected.

Furthermore, an asset impairment charge against the Company's earnings may result from the occurrence of unexpected adverse changes that impact the Company's estimates of expected cash flows generated from such asset. The Company periodically reviews long-term assets for impairments, in particular, when events or changes in circumstances indicate the carrying value of an asset may not be recoverable. An impairment loss is recognized when the carrying amount of an asset is not recoverable and exceeds its fair value. The Company may be required to recognize asset impairment charges in the future as a result of a prolonged weak economic environment, challenging market conditions in the airline industry or events related to particular lessees, assets or asset types.

International Risks. The Company has focused on leases in overseas markets, which the Company believes present opportunities. Leases with foreign lessees, however, may present somewhat different risks than those with domestic lessees.

Foreign laws, regulations and judicial procedures may be more or less protective of lessor rights than those which apply in the United States. The Company could experience collection or repossession problems related to the enforcement of its lease agreements under foreign local laws and the remedies in foreign jurisdictions. The protections potentially offered by Section 1110 of the Bankruptcy Code do not apply to non-U.S. carriers, and applicable local law may not offer similar protections. Certain countries do not have a central registration or recording system with which to locally establish the Company's interest in equipment and related leases. This could make it more difficult for the Company to recover an aircraft in the event of a default by a foreign lessee.

A lease with a foreign lessee is subject to risks related to the economy of the country or region in which such lessee is located, which may be weaker than the U.S. economy. On the other hand, a foreign economy may remain strong even though the U.S. economy does not. A foreign economic downturn may impact a foreign lessee's ability to make lease payments, even though the U.S. and other economies remain stable. Furthermore, foreign lessees are subject to risks related to currency conversion fluctuations. Although the Company's current leases are all payable in U.S. dollars, the Company may agree in the future to leases that permit payment in foreign currency, which would subject such lease revenue to monetary risk due to currency fluctuations. Even with U.S. dollar-denominated lease payment provisions, the Company could still be affected by a devaluation of the lessee's local currency that would make it more difficult for a lessee to meet its U.S. dollar-denominated lease payments, increasing the risk of default of that lessee, particularly if its revenue is primarily derived in the local currency.

Government Regulation. There are a number of areas in which government regulation may result in costs to the Company. These include aircraft registration, safety requirements, required equipment modifications, and aircraft noise requirements. Although it is contemplated that the burden and cost of complying with such requirements will fall primarily upon lessees of equipment, there can be no assurance that the cost will not fall on the Company. Furthermore, future government regulations could cause the value of any non-complying equipment owned by the Company to decline substantially.

Competition. The aircraft leasing industry is highly competitive. The Company competes with aircraft manufacturers, distributors, airlines and other operators, equipment managers, leasing companies, equipment leasing programs, financial institutions and other parties engaged in leasing, managing or remarketing aircraft, many of which have significantly greater financial resources. However, the Company believes that it is competitive because of JMC's experience and operational efficiency in identifying and obtaining financing for the transaction types desired by regional air carriers. This market segment, which is characterized by transaction sizes of less than $10 million and lessee credits that may be strong, but are generally unrated, is not well served by the Company's larger competitors. JMC has developed a reputation as a global participant in this segment of the market, and the Company believes that JMC's reputation benefits the Company. There is, however, no assurance that the lack of significant competition from larger aircraft leasing companies will continue or that the reputation of JMC will continue to be strong in this market segment.

Casualties, Insurance Coverage. The Company, as owner of transportation equipment, may be named in a suit claiming damages for injuries or damage to property caused by its assets. As a triple net lessor, the Company is generally protected against such claims, since the lessee would be responsible for, insure against and indemnify the Company for such claims. Further, some protection may be provided by the United States Aviation Act with respect to the Company's aircraft assets. It is, however, not clear to what extent such statutory protection would be available to the Company, and the United States Aviation Act may not apply to aircraft operated in foreign countries. Also, although the Company's leases generally require a lessee to insure against likely risks, there may be certain cases where the loss is not entirely covered by the lessee or its insurance. Though this is a remote possibility, an uninsured loss with respect to the equipment, or an insured loss for which insurance proceeds are inadequate, would result in a possible loss of invested capital in and any profits anticipated from, such equipment, as well as a potential claim directly against the Company.

General Economic Conditions. The Company's business is dependent upon general economic conditions and the strength of the travel and transportation industry. The industry has experienced a severe cyclical downturn which began in 2001. There are signs that the industry is beginning to recover from the downturn, but it is unclear whether any recovery will be a sustained one. Any recovery could be stalled or reversed by any number of events or circumstances, including the global economy slipping back into recession, or specific events related to the air travel industry, such as terrorist attacks, or an increase in operational or labor costs. Recent spikes in oil prices, if they persist, may have a negative effect on airline profits and increase the likelihood of weakening results for airlines that have not hedged aircraft fuel costs, and in the most extreme cases, may initiate or accelerate the failure of many already marginally profitable carriers.

Since regional carriers are generally not as well-capitalized as major air carriers, any economic setback in the industry may result in the increased possibility of an economic failure of one or more of the Company's lessees, particularly since many carriers are undertaking expansion of capacity to accommodate the recovering air passenger traffic. If lessees experience financial difficulties, this could, in turn, affect the Company's financial performance.

During any periods of economic contraction, carriers generally reduce capacity, in response to lower passenger loads, and as a result, there is a reduced demand for aircraft and a corresponding decrease in market lease rental rates and aircraft values. This reduced market value for aircraft could affect the Company's results if the market value of an asset or assets in the Company's aircraft portfolio falls below carrying value, and the Company determines that a write-down of the value on the Company's balance sheet is appropriate. Furthermore, as older leases expire and are replaced by lease renewals or re-leases at decreasing lease rates, the lease revenue of the Company from its existing portfolio is likely to decline, with the magnitude of the decline dependent on the length of the downturn and the depth of the decline in market rents.

Economic downturns can affect specific regions of the world exclusively. As the Company's portfolio is not entirely globally diversified, a localized downturn in one of the key regions in which the Company leases aircraft (e.g., Europe or Asia) could have a significant adverse impact on the Company.

Possible Volatility of Stock Price. The market price of the Company's common stock could be subject to fluctuations in response to the Company's operating results, changes in general conditions in the economy, the financial markets, the airline industry, changes in accounting principles or tax laws applicable to the Company or its lessees, or other developments affecting the Company, its customers or its competitors, some of which may be unrelated to the Company's performance. Also, because the Company has a relatively small capitalization of approximately 1.5 million shares, there is a correspondingly limited amount of trading of the Company's shares. Consequently, a single or small number of trades could result in a market fluctuation not related to any business or financial development concerning the Company.

Item 7. Financial Statements.

(a) Financial Statements and Schedules

(1) Financial statements for the Company:

(2) Schedules:

All schedules have been omitted since the required information is presented in the financial statements or is not applicable.

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
AeroCentury Corp.
Burlingame, California

We have audited the accompanying consolidated balance sheet of AeroCentury Corp. and subsidiaries as of December 31, 2006 and the related consolidated statements of operations, stockholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of AeroCentury Corp. and subsidiaries at December 31, 2006, and the results of its operations and its cash flows for the year then ended**,** in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the Company adopted the provisions of Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements,* as of January 1, 2006.

/s/ BDO Seidman, LLP

BDO Seidman, LLP
March 12, 2007
San Francisco, California

Report of Independent Registered Accounting Firm

To the Stockholders of AeroCentury Corp.:

In our opinion, the accompanying consolidated statements of operations, stockholders' equity and cash flows present fairly, in all material respects, the results of operations and cash flows of AeroCentury Corp. for the year ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP
PricewaterhouseCoopers LLP

San Francisco, California
March 7, 2006

AeroCentury Corp.
Consolidated Balance Sheet

ASSETS		
		December 31, 2006
Assets:		
Cash and cash equivalents	$	3,383,880
Accounts receivable		864,410
Aircraft and aircraft engines held for lease, net of accumulated depreciation of $22,004,790		93,674,970
Prepaid expenses and other		581,820
Total assets	$	98,505,080
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Accounts payable and accrued expenses	$	351,190
Notes payable and accrued interest		57,907,120
Maintenance reserves and accrued costs		14,110,530
Security deposits		4,187,470
Prepaid rent		473,620
Deferred taxes		1,127,180
Total liabilities		78,157,110
Stockholders' equity:		
Preferred stock, $0.001 par value, 2,000,000 shares authorized, no shares issued and outstanding		-
Common stock, $0.001 par value, 3,000,000 shares authorized, 1,606,557 shares issued and outstanding		1,610
Paid in capital		13,821,200
Retained earnings		7,029,230
		20,852,040
Treasury stock at cost, 63,300 shares		(504,070)
Total stockholders' equity		20,347,970
	$	98,505,080

The accompanying notes are an integral part of these statements.

AeroCentury Corp.
Consolidated Statements of Operations

	For the Years Ended December 31,	
	2006	2005
Revenues and other income:		
Operating lease revenue	$ 15,508,840	$ 11,386,950
Gain/(loss) on sale of aircraft	408,840	(48,130)
Other income	2,404,310	

Pursuant to the terms and subject to the conditions set forth in the Merger Agreement, at the effective time of the Merger, each outstanding share of CYS Common Stock will be converted into the right to receive from Two Harbors (a) a number of shares of Two Harbors Common Stock equal to the "Exchange Ratio," determined by dividing (i) (a) CYS adjusted book value per share, multiplied by (b) 96.75% by (ii) (a) Two Harbors adjusted book value per share, multiplied by (b) 94.20%, in each case as determined in accordance with the Merger Agreement (the "Per Share Stock Consideration") and (b) $15,000,000 divided by the sum of the number of shares of CYS Common Stock issued and outstanding immediately prior to the effective time of the Merger (excluding any cancelled shares), including outstanding CYS Restricted Stock that will vest upon completion of the Merger (less any shares surrendered for income tax purposes) (the "Per Share Cash Consideration") pursuant to the Merger Agreement.

Based on the number of shares of CYS Common Stock outstanding on March 31, 2018 and an assumed Exchange Ratio of 0.4872 based on the adjusted book value per share of Two Harbors Common Stock and CYS Common Stock as of March 31, 2018, calculated in accordance with the Merger Agreement, it is expected that approximately 75.7 million shares of Two Harbors Common Stock will be issued in connection with the Merger. The actual Exchange Ratio will be publicly announced at least five business days before the earlier of the special meetings of stockholders described below.

Also at the effective time of the Merger, each outstanding share of CYS Series A Preferred Stock will be converted into the right to receive one share of newly classified Two Harbors Series D Preferred Stock, and each outstanding share of CYS Series B Preferred Stock will be converted into the right to receive one share of newly classified Two Harbors Series E Preferred Stock.

No fractional shares of Two Harbors Common Stock will be issued in the Merger, and the value of any fractional interests to which a holder would otherwise be entitled will be paid in cash.

Recommendation of the Two Harbors Board and Its Reasons for the Merger **(Page [•])**

On April 25, 2018, following careful consideration, the Two Harbors Board unanimously (i) determined that the Merger Agreement and the other transactions contemplated therein, including the Merger and the Two Harbors Common Stock Issuance, are in the best interests of Two Harbors and its stockholders, (ii) approved the Merger Agreement and the other transactions contemplated therein, including the Merger and the Two Harbors Common Stock Issuance, (iii) directed that the Two Harbors Common Stock Issuance Proposal be submitted to the holders of Two Harbors Common Stock for consideration at the Two Harbors special meeting and (iv) recommended that the holders of Two Harbors Common Stock approve the Two Harbors Common Stock Issuance Proposal. Certain factors considered by the Two Harbors Board in reaching its decision to authorize, approve and adopt the

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Merger Agreement, the Merger and the other transactions contemplated by the Merger Agreement can be found in the section entitled "The Merger Recommendation of the Two Harbors Board and Its Reasons for the Merger" beginning on page [•].

The Two Harbors Board unanimously recommends that Two Harbors common stockholders vote "**FOR**" the Two Harbors Common Stock Issuance Proposal and "**FOR**" the Two Harbors Adjournment Proposal.

Recommendation of the CYS Board and Its Reasons for the Merger **(Page [•])**

On April 25, 2018, after careful consideration, the CYS Board, acting upon the unanimous recommendation of a special committee of independent directors of CYS formed for the purpose of, among other things, evaluating and making a recommendation to the CYS Board with respect to the Merger Agreement and the other transactions contemplated therein, unanimously (i) determined that the Merger Agreement and the other transactions contemplated therein, including the merger of Merger Sub with and into CYS, are in the best interests of CYS and its stockholders, (ii) approved the Merger Agreement and declared that the transactions contemplated therein, including the Merger, are advisable, (iii) directed that the Merger and the other transactions contemplated by the Merger Agreement be submitted to the holders of CYS Common Stock for consideration at the CYS special meeting and (iv) recommended that the CYS common stockholders approve the Merger and the other transactions contemplated by the Merger Agreement. Certain factors considered by the CYS Board in reaching its decision to approve the Merger Agreement, the Merger and the other transactions contemplated by the Merger Agreement can be found in the section entitled "The Merger Recommendation of the CYS Board and Its Reasons for the Merger" beginning on page [•].

The CYS Board unanimously recommends that CYS stockholders vote "**FOR**" the Merger Proposal, "**FOR**" the CYS Non-Binding Compensation Advisory Proposal and "**FOR**" the CYS Adjournment Proposal.

Summary of Risk Factors Related to the Merger **(Page [•])**

You should carefully consider the following important risks, together with all of the other information included in this joint proxy statement/prospectus and the risks related to the Merger and the related transactions described under the section "Risk Factors" beginning on page [•], before deciding how to vote:

The Merger is subject to a number of conditions which, if not satisfied or waived in a timely manner, would delay the Merger or adversely impact Two Harbors' and CYS's ability to complete the transaction.

Failure to consummate the Merger as currently contemplated or at all could adversely affect the price of Two Harbors Common Stock or CYS Common Stock and the future business and financial results of Two Harbors and CYS.

The Merger Agreement contains provisions that could discourage a potential competing acquirer of either Two Harbors or CYS or could result in any competing acquisition proposal being at a lower price than it might otherwise be.

The pendency of the Merger could adversely affect Two Harbors' and CYS's business and operations.

Following the Merger, the Combined Company may be unable to integrate Two Harbors' business and CYS's business successfully and realize the anticipated synergies or other expected benefits of the Merger on the anticipated timeframe or at all.

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Because the number of shares of Two Harbors Common Stock exchanged per share of CYS Common Stock is not fixed, any change in Two Harbors' adjusted book value per share or CYS's adjusted book value per share prior to setting the Exchange Ratio will affect the number of shares of Two Harbors Common Stock issued by Two Harbors and received by CYS common stockholders at the Closing.

The Merger and related transactions are subject to Two Harbors common stockholder approval and CYS common stockholder approval.

Two Harbors common stockholders and CYS common stockholders will be diluted by the Merger.

If the Merger is not consummated by October 31, 2018, either Two Harbors or CYS may terminate the Merger Agreement.

The market price of Two Harbors Common Stock may decline as a result of the Merger and the market price of Two Harbors Common Stock after the consummation of the Merger may be affected by factors different from those affecting the price of Two Harbors Common Stock or the price of CYS Common Stock before the Merger.

An adverse judgment in any litigation challenging the Merger may prevent the Merger from becoming effective or from becoming effective within the expected timeframe.

Following the Merger, the Combined Company may not pay dividends at or above the rate currently paid by Two Harbors or CYS.

The Combined Company will have a significant amount of indebtedness and may need to incur more in the future.

The Combined Company is expected to incur substantial expenses related and unrelated to the Merger.

The historical and unaudited pro forma condensed combined financial information included elsewhere in this joint proxy statement/prospectus may not be representative of the Combined Company's results after the Merger, and accordingly, you have limited financial information on which to evaluate the Combined Company following the Merger.

The Merger is expected to be taxable to U.S. stockholders of CYS Stock; however, the cash received by CYS stockholders in the Merger might not be sufficient to pay such tax.

Two Harbors would incur adverse tax consequences if it or CYS failed to qualify as a REIT for U.S. federal income tax purposes.

The Two Harbors Special Meeting (Page [•])

Date, Time and Place. The special meeting of Two Harbors common stockholders will be held at [•] on [•], at [•], Eastern Time.

Purpose. At the Two Harbors special meeting, Two Harbors common stockholders will be asked to consider and vote upon the Two Harbors Common Stock Issuance Proposal and the Two Harbors Adjournment Proposal.

Record Date; Voting Rights. Two Harbors common stockholders at the close of business on [•], 2018 are entitled to vote at the Two Harbors special meeting and any adjournments or postponements thereof. Each holder of Two Harbors Common Stock on the record date is entitled to one vote per share.

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Quorum. The presence, in person or by proxy, of the holders of shares of Two Harbors Common Stock entitled to cast a majority of all votes entitled to be cast at the Two Harbors special meeting, will constitute a quorum at the Two Harbors special meeting. Abstentions will be counted for the purpose of determining a quorum.

Required Vote. Approval of the Two Harbors Common Stock Issuance Proposal requires that the number of votes cast for the Two Harbors Common Stock Issuance Proposal exceeds the number of votes cast against and abstaining from the Two Harbors Common Stock Issuance Proposal, assuming a quorum is present. Approval of the Two Harbors Adjournment Proposal also requires that the number of votes cast for the Two Harbors Adjournment Proposal exceeds the number of votes cast against the Two Harbors Adjournment Proposal. Holders of Two Harbors preferred stock will not be entitled to vote on any matter at the Two Harbors special meeting.

As of the close of business on the record date for the Two Harbors special meeting, the directors and executive officers of Two Harbors owned approximately [•]% of the outstanding shares of Two Harbors Common Stock entitled to vote at the Two Harbors special meeting. Two Harbors currently expects that Two Harbors' directors and executive officers will vote their shares of Two Harbors Common Stock in favor of the Two Harbors Common Stock Issuance Proposal as well as the other proposals to be considered at the Two Harbors special meeting, although none of them are obligated to do so.

Your vote as a Two Harbors common stockholder is very important. Accordingly, please sign and return the enclosed proxy card whether or not you plan to attend the Two Harbors special meeting in person.

The CYS Special Meeting (Page [•])

Date, Time and Place. The special meeting of CYS stockholders will be held at [•], on [•], 2018 at [•], [•] Eastern Time.

Purpose. At the CYS special meeting, the CYS common stockholders will be asked to approve the Merger Proposal, the CYS Non-Binding Compensation Advisory Proposal and the CYS Adjournment Proposal.

Record Date; Voting Rights. CYS stockholders at the close of business on [•], 2018 are entitled to receive this notice and CYS common stockholders are entitled to vote at the CYS special meeting and any adjournments or postponements thereof. Each holder of record of CYS Common Stock on the record date is entitled to one vote per share.

Quorum. The presence, in person or by proxy of the holders of shares of CYS Common Stock entitled to cast a majority of all the votes entitled to be cast at the CYS special meeting, will constitute a quorum at the CYS special meeting. Abstentions will be counted for the purpose of determining a quorum.

Required Vote. Approval of the Merger Proposal requires the affirmative vote of the holders of a majority of the outstanding shares of CYS Common Stock entitled to vote on the Merger Proposal. Approval of the CYS Non-Binding Compensation Advisory Proposal requires, provided a quorum is present, the affirmative vote of a majority of the votes cast on the matter by holders of shares of CYS Common Stock at the CYS special meeting. Approval of the CYS Adjournment Proposal requires, provided a quorum is present, the affirmative vote of a majority of the votes cast on the matter by holders of shares of CYS Common Stock at the meeting.

As of the close of business on the record date for the CYS special meeting, the directors and executive officers of CYS owned approximately [•]% of the outstanding CYS Common Stock

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entitled to vote at the CYS special meeting. CYS currently expects that the CYS directors and officers will vote their shares of CYS Common Stock in favor of the Merger Proposal, although none of them are obligated to do so.

Opinion of Two Harbors' Financial Advisor (Page [•])

In connection with the Merger, the Two Harbors Board received a written opinion, dated April 25, 2018, from JMP, as to the fairness, from a financial point of view and as of the date of the opinion, to Two Harbors of the Per Share Stock Consideration (as defined in the Merger Agreement) to be paid by Two Harbors as part of the merger consideration. The full text of JMP's written opinion, which is attached to this joint proxy statement/prospectus as Annex B sets forth the assumptions made, procedures followed, matters considered and limitations on the review undertaken. **JMP's opinion was directed and addressed to the Two Harbors Board (in its capacity as such) in connection with its consideration of the Merger. JMP's opinion did not address the underlying decision of the Two Harbors Board to proceed with or effect the Merger or the relative merits of the Merger as compared to any alternative strategy or transaction that might exist for Two Harbors. JMP's opinion does not constitute a recommendation as to how the Two Harbors Board or any Two Harbors common stockholder should act or vote with respect to the Merger or any other matter.**

Opinion of CYS's Financial Advisor, Barclays Capital Inc. (Page [•])

Barclays was engaged to act as a financial advisor to the CYS board in connection with a potential transaction involving CYS. At the CYS board meeting on April 25, 2018, Barclays rendered its oral opinion (which was subsequently confirmed in writing) to the CYS board that, as of such date and based upon and subject to the qualifications, limitations and assumptions set forth in the written opinion, the merger consideration to be offered to the holders of CYS common stock in the merger was fair, from a financial point of view, to such holders.

The full text of Barclays' written opinion, dated as of April 25, 2018, is attached to this joint proxy statement/prospectus as Annex C and incorporated by reference herein. Barclays' written opinion sets forth, among other things, the assumptions made, procedures followed, factors considered and limitations upon the review undertaken by Barclays in rendering its opinion. You are encouraged to read the opinion carefully in its entirety. The summary of Barclays' opinion set forth in this joint proxy statement/prospectus is qualified in its entirety by reference to the full text of the opinion. Barclays' opinion is addressed to the CYS board, addresses only the fairness, from a financial point of view, of the merger consideration to be offered to the holders of CYS common stock and does not constitute a recommendation to any stockholder of CYS as to how such stockholder should vote with respect to the merger or any other matter.

For more information, see "The Merger Opinion of CYS's Financial Advisor, Barclays Capital Inc." beginning on page [•] and Annex C.

Opinion of CYS's Financial Advisor, Credit Suisse Securities (USA) LLC (Page [•])

CYS has engaged Credit Suisse to act as a financial advisor to CYS in connection with the proposed merger. In connection with this engagement, Credit Suisse delivered an opinion, dated April 25, 2018, to the CYS board as to the fairness, from a financial point of view and as of the date of such opinion, of the merger consideration to be received by holders of CYS common stock (other than excluded holders (as defined below)) pursuant to the merger agreement. For purposes of Credit Suisse's analyses and opinion, the term "excluded holders" refers to, collectively, CYS, Two Harbors, Merger Sub and any of their respective wholly owned subsidiaries.

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The full text of Credit Suisse's written opinion, dated April 25, 2018, is attached to this joint proxy statement/prospectus as Annex D and sets forth, among other things, the assumptions made, procedures followed, matters considered and limitations and qualifications on the review undertaken by Credit Suisse in connection with such opinion. The description of Credit Suisse's opinion set forth in this joint proxy statement/prospectus is qualified in its entirety by reference to the full text of Credit Suisse's opinion. Credit Suisse's opinion was provided to the CYS board (in its capacity as such) for its information in connection with its evaluation of the merger consideration from a financial point of view and did not address any other terms, aspects or implications of the proposed merger, the relative merits of the proposed merger or related transactions as compared to alternative transactions or strategies that might be available to CYS or the underlying business decision of the CYS board or CYS to proceed with the proposed merger or related transactions. Credit Suisse's opinion does not constitute advice or a recommendation to any stockholder as to how such stockholder should vote or act on any matter relating to the proposed merger or otherwise.

For more information, see "The Merger Opinion of CYS's Financial Advisor, Credit Suisse Securities (USA) LLC" beginning on page [•] and Annex D.

Directors and Management of Two Harbors After the Merger (Page [•])

Following the consummation of the Merger, the number of directors on the Two Harbors Board will be increased to eleven, and will include all of the current nine directors of the Two Harbors Board and two additional independent directors from the CYS Board: James A. Stern and Karen Hammond. Each of the executive officers of Two Harbors immediately prior to the effective time of the Merger will continue as an executive officer of the Combined Company following the effective time of the Merger.

Interests of Two Harbors Directors and Executive Officers in the Merger (Page [•])

In considering the recommendation of the Two Harbors Board to approve the Two Harbors Common Stock Issuance, Two Harbors common stockholders should be aware that directors and executive officers of Two Harbors have certain interests in the Merger that may be different from, or in addition to, the interests of Two Harbors common stockholders generally and that may present actual or potential conflicts of interests. The Two Harbors Board was aware of these interests and considered them, among other matters, in reaching its decision to approve the Merger Agreement and the transactions contemplated thereby.

The Combined Company will continue to be managed by PRCM Advisers under the terms of the Management Agreement. Under the Management Agreement, PRCM Advisers provides the day-to-day management of Two Harbors' business, including providing Two Harbors with its executive officers and all other personnel necessary to support its operations. In exchange for its services, Two Harbors pays PRCM Advisers a management fee as well as reimburses it for certain expenses incurred by it and its affiliates in rendering management services to Two Harbors. Pine River is the parent of PRCM Advisers. Certain directors and executive officers of Two Harbors are partners and employees of Pine River.

Pursuant to the Management Agreement, Two Harbors pays PRCM Advisers a base management fee equal to 1.5% per annum of its stockholders' equity, which is calculated and payable quarterly in arrears. Following the Merger, Two Harbors stockholders' equity will include the additional equity attributable to the acquisition of CYS, thus the amount of the management fees payable to PRCM Advisers will also increase, which gives PRCM Advisers and its parent, Pine River (and therefore, Two Harbors' management), an incentive, not shared by Two Harbors stockholders, to negotiate and effect the Merger, possibly on terms less favorable to Two Harbors than would otherwise have been achieved. However, in connection with the Merger, PRCM Advisers has agreed to amend the Management

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Agreement to provide for: (i) a reduction in the base management fee PRCM Advisers charges Two Harbors with respect to the additional equity under management resulting from the Merger from 1.5% of stockholders' equity on an annualized basis to 0.75% through the first anniversary of the Closing; (ii) a one-time downward adjustment of $15,000,000 to the management fees payable by Two Harbors for the quarter in which the Merger closes; and (iii) a one-time downward adjustment of up to $3.3 million in the management fees payable by Two Harbors for the quarter in which the Merger occurs in order to reimburse Two Harbors for certain expenses it incurs in connection with the Merger. In the event the total amount of the management fee payable for the quarter referenced in clauses (ii) and (iii) above is less than the aggregate amount of the Adjustments, PRCM Advisers will pay to Two Harbors in immediately available funds the difference between (i) such Adjustments and (ii) the base management fee payable to PRCM Advisers with respect to such quarter.

The Fourth Amendment to the Management Agreement between Two Harbors and PRCM Advisers was negotiated between related parties, and the terms, including fees and other amounts payable, may not be as favorable to Two Harbors as if it had been negotiated with an unaffiliated third party.

For additional information, see "The Merger Interests of Two Harbors' Directors and Executive Officers in the Merger" beginning on page [•].

Interests of CYS's Directors and Executive Officers in the Merger (Page [•])

In considering the CYS Board's recommendation for CYS stockholders to approve the Merger Proposal and the CYS Non-Binding Compensation Advisory Proposal, CYS stockholders should be aware that directors and executive officers of CYS have interests in the Merger that may be different from, or in addition to, the interests of CYS stockholders generally and that may present actual or potential conflicts of interests. These interests include:

- immediately prior to the effective time of the Merger, each outstanding award of CYS Restricted Stock granted pursuant to the CYS Stock Plan will automatically vest in full and any forfeiture restrictions applicable to such shares of CYS Restricted Stock shall immediately lapse. As a result, each share of CYS Restricted Stock (less any shares surrendered for income tax purposes) will be treated as a share of CYS Common Stock for all purposes of the Merger, including the right to receive the merger consideration; and

- continued indemnification and insurance coverage for the directors and executive officers of CYS in accordance with the Merger Agreement.

In addition, CYS maintains Employment Agreements with each of Messrs. Grant, DeCicco, Cleary, and Rosenbloom, which provide for payments and other benefits if the individual's employment terminates for a qualifying event or circumstance, such as being terminated without "cause" or leaving employment for "good reason," as these terms are defined in the Employment Agreements. Upon the termination of such individual's employment by CYS or Two Harbors other than for cause, or by such individual for good reason, the individual would be eligible to receive, among other benefits, (i) a lump sum severance payment equal to 2.5 in the case of Mr. Grant and 1.0 in the case of Messrs. DeCicco, Cleary, and Rosenbloom, multiplied by the average of the sum of such individual's base salary and bonus earned during the shorter of (a) the three (3) fiscal years immediately preceding the year in which the termination of employment occurs or (b) the period of time beginning on the date of the individual's employment agreement and ending on the termination date of such individual's employment, (ii) a pro rata bonus for the year of termination, and (iii) certain benefit continuation rights for up to 24 months for Mr. Grant and up to 12 months for Messrs. DeCicco, Cleary, and Rosenbloom, following termination. In addition, under the agreement, such individuals are eligible to receive a "gross-up" payment, if applicable, related to any excise taxes imposed under Section 4999 of the Code.

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Upon Closing, each of James A. Stern and Karen Hammond, independent directors from the CYS Board, will be appointed to the Two Harbors Board and will be entitled to compensation pursuant to Two Harbors' independent director compensation program.

In connection with the approval of the execution of the Merger Agreement, the CYS Board approved an amendment to the Employment Agreements to clarify payment mechanics and timing of severance amounts that may become payable pursuant to the Employment Agreements following a qualifying termination of employment with CYS.

Treatment of CYS Restricted Stock (Page [•])

Pursuant to the Merger Agreement, immediately prior to the effective time of the Merger, each outstanding award of shares of CYS Restricted Stock granted pursuant to the CYS Stock Plan will automatically vest in full and any forfeiture restrictions applicable to such shares of CYS Restricted Stock shall immediately lapse. As a result, each share of CYS Restricted Stock (less any shares surrendered for income tax purposes) will be treated as a share of CYS Common Stock for all purposes of the Merger, including the right to receive the merger consideration.

Fourth Amendment to the Management Agreement (Page [•])

In connection with the Merger Agreement, the Management Agreement was amended pursuant to the Fourth Amendment to the Management Agreement so as to (a) reduce PRCM Advisers' base management fee with respect to the additional equity under management resulting from the Merger and the transactions contemplated by the Merger Agreement to 0.75% from the effective time of the Merger through the first anniversary of such effective time and (b) for the fiscal quarter in which the Closing occurs, make a one-time downward adjustment of $15 million to the management fees payable by Two Harbors for such quarter to offset the Per Share Cash Consideration payable to stockholders of CYS, plus up to an additional $3.3 million downward adjustment for certain transaction-related expenses.

Conditions to Complete the Merger (Page [•])

A number of conditions must be satisfied or, to the extent permitted by law, waived before the Merger can be consummated. These include, among others:

- the approval of the Merger Proposal by CYS common stockholders;
- the approval of the Two Harbors Common Stock Issuance Proposal by Two Harbors common stockholders;
- effectiveness of the registration statement on Form S-4, of which this joint proxy statement/prospectus constitutes a part, and no stop order suspending the effectiveness of the Form S-4 having been initiated or threatened by the SEC;
- no injunction or law prohibiting the Merger;
- approval for listing on the NYSE of the shares of Two Harbors Common Stock, Two Harbors Series D Preferred Stock and Two Harbors Series E Preferred Stock to be issued in the Merger or reserved therefor, subject to official notice of issuance;
- accuracy of each party's representations, subject in most cases to materiality or material adverse effect qualifications;

the absence of a material adverse effect on either Two Harbors or CYS;

material performance and compliance with each party's covenants; and

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the receipt of tax opinions relating to the REIT status of each of Two Harbors and CYS.

Regulatory Approvals Required for the Merger (Page [•])

Two Harbors and CYS are not aware of any material federal or state regulatory requirements that must be complied with, or approvals that must be obtained, in connection with the Merger or the other transactions contemplated by the Merger Agreement.

Listing of Two Harbors Common Stock and Deregistration of CYS Common Stock (Page [•])

It is a condition to the completion of the Merger that the shares of Two Harbors Common Stock issuable in connection with the Merger be approved for listing on the NYSE, subject to official notice of issuance. After the Merger is completed, the CYS Common Stock will no longer be listed on the NYSE and will be deregistered under the Exchange Act.

Accounting Treatment (Page [•])

Each of Two Harbors and CYS prepare their financial statements in accordance with GAAP. The Merger will be accounted for as an asset acquisition, with Two Harbors treated as the acquirer. For more information, see "Accounting Treatment" beginning on page [•].

Comparison of Rights of Two Harbors Common Stockholders and CYS Common Stockholders (Page [•])

Holders of CYS Common Stock will have different rights following the effective time of the Merger because they will hold shares of Two Harbors Common Stock instead of shares of CYS Common Stock, and there are differences between the governing documents of Two Harbors and CYS. For more information regarding the differences in rights of Two Harbors common stockholders and CYS common stockholders, see "Comparison of Rights of Two Harbors Common Stockholders and CYS Common Stockholders" beginning on page [•].

Appraisal Rights (Page [•])

Neither holders of Two Harbors Common Stock nor holders of CYS Common Stock will be entitled to appraisal rights.

No Solicitation; Change in Recommendations (Page [•])

From and after the date of the Merger Agreement until the effective time of the Merger or if earlier, the termination of the Merger Agreement, each of Two Harbors and CYS will not, and will cause its subsidiaries and will instruct its representatives not to, among other things, directly or indirectly:

initiate, solicit or knowingly encourage the making of a Competing Proposal (as defined in "The Merger Agreement Competing Proposals" beginning on page **[•]**);

engage in any discussions or negotiations with any person with respect to a Competing Proposal or furnish any non-public information regarding Two Harbors or CYS or any of their subsidiaries, as applicable, or access to the properties, assets or employees of Two Harbors or CYS or any of their subsidiaries, as applicable, to any person in connection with or in response to any Competing Proposal;

enter into any binding or nonbinding letter of intent or agreement in principle, or other agreement providing for a Competing Proposal (other than certain confidentiality agreements);

withdraw, modify or qualify, or propose publicly to withdraw, modify or qualify, in a manner adverse to the other party, the Two Harbors board recommendation or the CYS board recommendation, as applicable, or publicly recommend the approval or adoption of, or publicly approve or adopt, any Competing Proposal;

fail to include the Two Harbors board recommendation or the CYS board recommendation, as applicable, in this joint proxy statement or any amendment or supplement thereto; or

fail publicly to reaffirm without qualification the Two Harbors board recommendation or the CYS board recommendation, as applicable, within five business days after the written request of the other party following a Competing Proposal that has been publicly announced (or such fewer number of days as remain prior to the Two Harbors special meeting or CYS special meeting, as applicable, as it may be adjourned or postponed).

Notwithstanding the restrictions set forth above, at any time prior to obtaining the applicable approval of their stockholders at their respective stockholder meetings, each of Two Harbors and CYS may, directly or indirectly through one or more of its representatives, engage in discussions or negotiations with any person with respect to a Competing Proposal or furnish non-public information regarding Two Harbors or CYS or any of their subsidiaries, or access to the properties, assets or employees of Two Harbors or CYS or any of their subsidiaries, to any person in connection with or in response to a Competing Proposal, in either case, if certain conditions are met and such proposal is reasonably expected to lead to a Superior Proposal.

At any time prior to obtaining the applicable approval of their stockholders at their respective stockholder meetings, each of Two Harbors and CYS may effect a change in its board recommendation (i) in response to a *bona fide* written Competing Proposal from a third party that was not solicited at any time following the execution of the Merger Agreement and did not arise from a material breach of the obligations set forth in certain provisions of the Merger Agreement, if the Two Harbors Board or the CYS Board, as applicable, so chooses, and (ii) if the Two Harbors Board or the CYS Board, as applicable, determines in good faith, after consultation with outside legal counsel, that the failure to take such action would be inconsistent with its legal duties under applicable law and Two Harbors or CYS, as applicable, have given notice to the other party that it intends to effect a change in its board recommendation. Additionally, CYS may terminate the Merger Agreement, if prior to taking such action, among other things, the CYS Board determines in good faith after consultation with its financial advisors and outside legal counsel that such CYS Competing Proposal is a CYS Superior Proposal and the CYS Board has approved, and concurrently with the termination thereunder, CYS enters into, a definitive agreement providing for the implementation of such CYS Superior Proposal.

For more information regarding what constitutes a "Competing Proposal" and what constitutes a "CYS Superior Proposal," see "The Merger Agreement Competing Proposals" beginning on page [•].

Termination of the Merger Agreement (Page [•])

The Merger Agreement may be terminated at any time before the effective time of the Merger by the mutual written consent of Two Harbors and CYS.

The Merger Agreement may also be terminated prior to the effective time of the Merger by either Two Harbors or CYS if:

any governmental entity of competent jurisdiction has issued a final and non-appealable order, decree, ruling or injunction or taken any other action permanently restraining, enjoining or otherwise prohibiting the consummation of the Merger, or if there shall have been adopted prior to the effective time of the Merger any law that permanently makes the consummation of the Merger illegal or otherwise permanently prohibited;

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the Merger has not been consummated on or before 5:00 p.m. New York, New York time, on October 31, 2018 (the "End Date") (provided that this termination right will not be available to any party whose breach of any representation, warranty, covenant or agreement contained in this Agreement has been the cause of or resulted in the failure of the Merger to occur on or before such date);

the other party breaches any of its representations, warranties, covenants or other agreements (other than a breach of its non-solicitation covenant), if such breach resulted in a failure of a closing condition, and such breach cannot be or has not been cured within 30 days (or, if earlier, the End Date), provided that the other party may not terminate if such other party is similarly in breach;

the other party commits a willful and material breach of its non-solicitation covenant;

Two Harbors common stockholders have failed to approve the issuance of shares of Two Harbors Common Stock in connection with the Merger, or CYS common stockholders have failed to approve Merger and the other transactions contemplated by the Merger Agreement, as applicable; or

the other party's board of directors has effected a change in its board recommendation prior to the time that such party has obtained the applicable approval of its stockholders at its respective stockholder meeting.

In addition to the termination rights set forth above, CYS may also terminate the Merger Agreement upon entering into a definitive agreement providing for the implementation of a CYS Superior Proposal.

For more information regarding termination of the Merger Agreement, see "The Merger Agreement Termination of the Merger Agreement" beginning on page [•].

Termination Fees and Expenses (Page [•])

Generally, all fees and expenses incurred in connection with the Merger and the other transactions contemplated by the Merger Agreement will be paid by the party incurring those fees and expenses; provided that, in certain circumstances, Two Harbors may be obligated to pay to CYS a termination fee of $51.8 million or an expense amount equal to $20.6 million, or CYS may be obligated to pay to Two Harbors a termination fee of $43.2 million or an expense amount equal to $8.6 million.

For further discussion of the termination fees, see "The Merger Agreement Termination Fees and Expenses" beginning on page [•].

Material U.S. Federal Income Tax Consequences (Page [•])

Assuming that the Merger is completed as currently contemplated, CYS and Two Harbors expect that the receipt of (i) cash and Two Harbors Common Stock in exchange for CYS Common Stock, (ii) Two Harbors Series D Preferred Stock in exchange for CYS Series A Preferred Stock, or (iii) Two Harbors Series E Preferred Stock in exchange for CYS Series B Preferred Stock, as applicable, by U.S. stockholders pursuant to the Merger will be a taxable transaction for U.S. federal income tax purposes. Generally, for U.S. federal income tax purposes, U.S. stockholders of CYS Common Stock will recognize gain or loss as a result of the Merger measured by the difference, if any, between (i) the sum of the fair market value of the Two Harbors Common Stock received and the amount of any cash received, and (ii) the stockholder's adjusted tax basis in its CYS Common Stock. In addition, generally, for U.S. federal income tax purposes, U.S. stockholders of CYS Series A Preferred Stock or CYS Series B Preferred Stock will recognize gain or loss as a result of the Merger measured by the difference, if any, between (i) the fair market value of the Two Harbors Series D Preferred Stock or

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Two Harbors Series E Preferred Stock received, as applicable, and (ii) the stockholder's adjusted tax basis in its CYS Series A Preferred Stock or CYS Series B Preferred Stock, as applicable. Because the consideration to be given to stockholders of (i) CYS Common Stock consists primarily of Two Harbors Common Stock and (ii) CYS Series A Preferred Stock and CYS Series B Preferred Stock consists solely of Two Harbors Series D Preferred Stock and Two Harbors Series E Preferred Stock, respectively, U.S. stockholders of CYS Stock may need to sell their Two Harbors stock received in the Merger, or raise cash from other sources, to pay any tax obligations resulting from the Merger. Generally, non-U.S. stockholders are not expected be subject to U.S. federal income tax or U.S. federal withholding tax on any gain recognized from the Merger. See "Material U.S. Federal Income Tax Consequences Consequences of the Merger to Non-U.S. Stockholders of CYS Stock." CYS and Two Harbors anticipate that the Merger will have no material U.S. federal income tax consequences to Two Harbors stockholders who do not own any CYS stock.

The tax consequences to you of the Merger will depend on your own situation. You should consult your tax advisor for a full understanding of the tax consequences to you of the Merger. For more information regarding the U.S. federal income tax consequences of the Merger to CYS stockholders, please see "Material U.S. Federal Income Tax Consequences of the Merger" beginning on page [•].

Description of Two Harbors Common Stock (Page [•])

As of May 23, 2018, 175,467,421 shares of Two Harbors Common Stock were issued and outstanding and 5,750,000 shares of Two Harbors Series A Preferred Stock, 11,500,000 shares of Two Harbors Series B Preferred Stock, and 11,800,000 shares of Two Harbors Series C Preferred Stock, were issued and outstanding. Based on an assumed exchange ratio of 0.4872 based on book values as of March 31, 2018, upon consummation of the Merger, the Combined Company would be expected to have approximately 251.1 million shares of Two Harbors Common Stock, 5,750,000 shares of Two Harbors Series A Preferred Stock, 11,500,000 shares of Two Harbors Series B Preferred Stock, 11,800,000 shares of Two Harbors Series C Preferred Stock, [•]shares of Two Harbors Series D Preferred Stock and [•] shares of Two Harbors Series E Preferred Stock issued and outstanding.

Voting rights are generally vested in the holders of the Two Harbors Common Stock, and such holders are entitled to receive dividends on such Two Harbors Common Stock if, as and when authorized by the Two Harbors Board, and declared by Two Harbors out of assets legally available therefor.

Selected Historical Financial Information of Two Harbors (Page [•])

The following selected historical financial information for each of the years during the five-year period ended December 31, 2017 and the selected balance sheet data as of December 31 for each of the years in the five-year period ended December 31, 2017, have been derived from Two Harbors' audited consolidated financial statements.

The selected historical financial information as of March 31, 2018 and for the three months ended March 31, 2018 and 2017 have been derived from Two Harbors' unaudited interim consolidated financial statements included in Two Harbors' Quarterly Report on Form 10-Q for the quarter ended March 31, 2018, which is incorporated herein by reference. The following selected historical financial information as of March 31, 2017 has been derived from Two Harbors' unaudited interim consolidated financial statements not included or incorporated herein by reference.

You should read the selected historical financial information presented below together with the consolidated financial statements and the related notes thereto and management's discussion and analysis of financial condition and results of operations of Two Harbors included in Two Harbors' Annual Report on Form 10-K for the year ended December 31, 2017 and its Quarterly Report on Form 10-Q for the quarter ended March 31, 2018, which are incorporated herein by reference. See also "Where You Can Find More Information and Incorporation by Reference" on page [•].

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TWO HARBORS SELECTED FINANCIAL DATA

(in thousands, except per share data)	For the three months ended March 31, 2018 unaudited	2017 unaudited	For the year ended December 31, 2017	2016	2015	2014	2013
Statement of comprehensive income data:							
Interest income:							
Available-for-sale securities	$ 190,716	$ 135,327	$ 631,853	$ 414,050	$ 458,515	$ 506,268	$ 507,180
Trading securities					8,676	12,913	5,963
Residential mortgage loans held-for-investment in securitization trusts		31,628	102,886	133,993	95,740	41,220	19,220
Residential mortgage loans held-for-sale	307	398	1,704	23,037	28,966	16,089	22,185
Other	2,996	1,801	8,646	4,000	982	717	1,043
Total interest income	194,019	169,154	745,089	575,080	592,879	577,207	555,591
Interest expense:							
Repurchase agreements	86,580	32,256	210,430	88,850	72,653	76,177	89,470
Collateralized borrowings in securitization trusts		25,386	82,573	97,729	57,216	26,760	10,937
Federal Home Loan Bank advances	4,458	8,793	36,911	26,101	11,921	4,513	
Revolving credit facilities	804	429	2,341	604			
Convertible senior notes	4,718	3,821	17,933				
Total interest expense	96,560	70,685	350,188	213,284	141,790	107,450	100,407
Net interest income	97,459	98,469	394,901	361,796	451,089	469,757	455,184
Other-than-temporary impairments:							
Total other-than-temporary impairment losses	(94)		(789)	(1,822)	(535)	(392)	(1,662)
Other income (loss):							
(Loss) gain on investment securities	(20,671)	(52,352)	(34,695)	(107,374)	363,379	87,201	(54,430)
Servicing income	71,190	39,773	209,065	143,579	127,398	128,160	11,795
Gain (loss) on servicing asset	71,807	(14,565)	(91,033)	(83,531)	(99,584)	(128,388)	13,881
Gain (loss) on interest rate swaps and swaption agreements	150,545	9,927	(9,753)	45,371	(210,621)	(345,647)	245,229
Gain (loss) on other derivative instruments	8,053	(27,864)	(70,159)	99,379	(5,049)	(17,529)	95,345
Other income (loss)	1,058	9,496	30,141	9,964	(7,686)	35,836	(19,011)
Total other income (loss)	281,982	(35,585)	33,566	107,388	167,837	(240,367)	292,809
Expenses:							
Management fees	11,708	9,808	40,472	39,261	49,116	48,803	41,707
Servicing expenses	14,554	5,298	35,289	32,119	28,028	25,925	3,761
Securitization deal costs				6,152	8,971	4,638	4,153

Other operating expenses	14,492	13,764	54,160	56,605	56,764	56,231	37,259
Restructuring charges				2,990			
Total expenses	40,754	28,870	129,921	137,127	142,879	135,597	86,880
Income from continuing operations before income taxes	338,593	34,014	297,757	330,235	475,512	93,401	659,451
Provision for (benefit from) income taxes	3,784	(24,517)	(10,482)	12,314	(16,560)	(73,738)	84,411
Net income from continuing operations	334,809	58,531	308,239	317,921	492,072	167,139	575,040
Income from discontinued operations, net of tax		13,454	44,146	35,357	138		3,999
Net income	334,809	71,985	352,385	353,278	492,210	167,139	579,039
Income from discontinued operations attributable to non-controlling interest			3,814				
Net income attributable to Two Harbors Investment Corp.	334,809	71,985	348,571	353,278	492,210	167,139	579,039
Dividends on preferred stock	13,747		25,122				
Net income attributable to common stockholders	$ 321,062	$ 71,985	$ 323,449	$ 353,278	$ 492,210	$ 167,139	$ 579,039
Basic per common share data:							
Net income from continuing operations per weighted average common share	$ 1.83	$ 0.33	$ 1.62	$ 1.83	$ 2.70	$ 0.91	$ 3.28
Income from discontinued operations per weighted average common share		0.08	0.23	0.20			0.02
Net income per weighted average common share	$ 1.83	$ 0.41	$ 1.85	$ 2.03	$ 2.70	$ 0.91	$ 3.30
Weighted average number of shares of common stock outstanding	175,145,964	174,281,965	174,433,999	174,036,852	182,623,869	183,005,928	175,180,914
Diluted per common share data:							
Net income from continuing operations per weighted average common share	$ 1.69	$ 0.33	$ 1.60	$ 1.83	$ 2.70	$ 0.91	$ 3.28
		0.08	0.21	0.20			0.02

Income from discontinued operations per weighted average common share													
Net income per weighted average common share	$	1.69	$	0.41	$	1.81	$	2.03	$	2.70	$	0.91	$ 3.30

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(in thousands, except per share data)	For the three months ended March 31, 2018 unaudited	2017 unaudited	For the year ended December 31, 2017	2016	2015	2014	2013
Weighted average number of shares of common stock outstanding	192,818,531	174,281,965	188,133,341	174,036,852	182,623,869	183,005,928	175,496,194
Dividends declared per common share	$ 0.24	$ 0.25	$ 1.01	$ 0.93	$ 1.04	$ 1.04	$ 1.17
Comprehensive income:							
Net income	$ 334,809	$ 71,985	$ 352,385	$ 353,278	$ 492,210	$ 167,139	$ 579,039
Other comprehensive (loss) income, net of tax:							
Unrealized (loss) gain on available-for-sale securities	(344,777)	73,762	135,586	(159,834)	(496,728)	411,054	(251,723)
Other comprehensive (loss) income	(344,777)	73,762	135,586	(159,834)	(496,728)	411,054	(251,723)
Comprehensive (loss) income	(9,968)	145,747	487,971	193,444	(4,518)	578,193	327,316
Comprehensive income attributable to non-controlling interest			3,814				
Comprehensive (loss) income attributable to Two Harbors Investment Corp.	(9,968)	145,747	484,157	193,444	(4,518)	578,193	327,316
Dividends on preferred stock	13,747		25,122				
Comprehensive (loss) income attributable to common stockholders	$ (23,715)	$ 145,747	$ 459,035	$ 193,444	$ (4,518)	$ 578,193	$ 327,316

	As of March 31, 2018 unaudited	2017 unaudited	As of December 31, 2017	2016	2015	2014	2013
Balance sheet data:							

Available-for-sale securities	$ 21,059,377	$ 17,318,697	$ 21,220,819	$ 13,116,171	$ 7,825,320	$ 14,341,102	$ 12,256,727
Mortgage servicing rights	$ 1,301,023	$ 747,580	$ 1,086,717	$ 693,815	$ 493,688	$ 452,006	$ 514,402
Total assets	$ 24,077,165	$ 24,270,844	$ 24,789,313	$ 20,112,056	$ 14,575,772	$ 21,084,309	$ 17,173,862
Repurchase agreements	$ 19,148,679	$ 13,640,720	$ 19,451,207	$ 8,865,184	$ 4,948,926	$ 12,932,463	$ 12,250,450
Federal Home Loan Bank advances	$ 865,024	$ 3,571,762	$ 1,215,024	$ 4,000,000	$ 3,785,000	$ 2,500,000	$
Total stockholders' equity	$ 3,467,685	$ 3,602,561	$ 3,571,424	$ 3,401,111	$ 3,576,561	$ 4,068,042	$ 3,854,995

Selected Historical Financial Information of CYS (Page [•])

The following selected historical financial information for each of the years during the five-year period ended December 31, 2017 and the selected balance sheet data as of December 31 for each of the years in the five-year period ended December 31, 2017 have been derived from CYS's audited consolidated financial statements. The selected historical financial information for the three months ended March 31, 2018 and the selected balance sheet data as of March 31, 2018 have been derived from CYS's unaudited interim consolidated financial statements. The "Key Performance Metrics" have been derived from CYS's underlying books and records.

You should read the selected historical financial information presented below together with the consolidated financial statements and the related notes thereto and management's discussion and analysis of financial condition and results of operations of CYS included in CYS's Annual Report on Form 10-K for the year ended December 31, 2017, and its Quarterly Report on Form 10-Q for the quarter ended March 31, 2018, which are incorporated herein by reference. See also "Where You Can Find More Information and Incorporation by Reference" on page [•].

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CYS SELECTED FINANCIAL DATA

(In thousands, except per share numbers)	For the three months ended March 31, 2018	For the three months ended March 31, 2017	For the year ended December 31, 2017	2016	2015	2014**	2013**
Income Statement Data:							
Interest income:							
Agency RMBS	$ 85,986	$ 73,227	$ 304,421	$ 291,097	$ 328,286	$ 301,996	$ 330,430
Other	2,692	86	6,362	3,440	2,909	15,080	1,481
Total interest income	88,678	73,313	310,783	294,537	331,195	317,076	331,911
Interest expense:							
Repurchase agreements	41,117	21,221	114,616	70,230	40,700	33,825	52,763
FHLBC Advances				4,049	5,429		
Total interest expense	41,117	21,221	114,616	74,279	46,129	33,825	52,763
Net interest income	47,561	52,092	196,167	220,258	285,066	283,251	279,148
Other income (loss):							
Net realized gain (loss) on investments	(71,191)	(66,044)	(114,737)	19,463	13,652	132,563	(595,116)
Net unrealized gain (loss) on investments	(166,009)	63,478	94,463	(132,500)	(129,764)	233,763	(314,530)
Net unrealized gain (loss) on FHLBC Advances				(1,299)	1,299		
Other income	39	47	163	1,361	867	269	120
Net realized and unrealized gain (loss) on investments, FHLBC Advances and other income	(237,161)	(2,519)	(20,111)	(112,975)	(113,946)	366,595	(909,526)
Interest rate hedge expense, net	(2,508)	(8,327)	(29,550)	(55,798)	(100,110)	(90,812)	(93,497)
Net realized and unrealized gain (loss) on derivative instruments	89,468	(1,012)	57,750	(11,483)	(54,932)	(110,542)	269,128
Net gain (loss) on derivative instruments	86,960	(9,339)	28,200	(67,281)	(155,042)	(201,354)	175,631
Total other income (loss)	(150,201)	(11,858)	8,089	(180,256)	(268,988)	165,241	(733,895)
Expenses:							
Compensation and benefits	3,192	3,776	13,759	12,934	12,121	14,105	12,599
General, administrative and other	2,676	2,438	9,236	10,677	8,722	8,778	8,436

Total expenses	5,868	6,214	22,995	23,611	20,843	22,883	21,035
Net income (loss)	$ (108,508)	$ 34.020	$ 181,261	$ 16,391	$ (4,765)	$ 425,609	$ (475,782)
Dividend on preferred stock	(5,203)	(5,203)	(20,812)	(20,812)	(20,813)	(20,812)	(15,854)
Net income (loss) available to common stockholders	$ (113,711)	$ 28,817	$ 160,449	$ (4,421)	$ (25,578)	$ 404,797	$ (491,636)
Net income (loss) per common share basic & diluted	$ (0.74)	$ 0.19	$ 1.05	$ (0.04)	$ (0.17)	$ 2.50	$ (2.90)
Dividends per common share	$ 0.22	$ 0.25	$ 1.00	$ 1.01	$ 1.10	$ 1.24	$ 1.32

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(In thousands, except per share numbers)	For the three months ended March 31, 2018	For the three months ended March 31, 2017	For the year ended December 31, 2017	2016	2015	2014**	
Key Balance Sheet Metrics							
Average settled Debt Securities(1)	$ 11,701,609	$ 10,819,433	$ 11,233,526	$ 11,781,920	$ 12,962,340	$ 12,198,178	$
Average total Debt Securities(2)	$ 13,185,053	$ 12,485,920	$ 12,701,093	$ 13,212,278	$ 14,223,921	$ 13,910,227	$
Average repurchase agreements and FHLBC Advances(3)	$ 10,215,763	$ 9,264,522	$ 9,697,163	$ 10,290,967	$ 11,395,383	$ 10,559,856	$
Average Debt Securities liabilities(4)	$ 11,699,207	$ 10,931,009	$ 11,164,730	$ 11,721,325	$ 12,656,964	$ 12,271,905	$
Average stockholders' equity(5)	$ 1,480,291	$ 1,539,245	$ 1,561,583	$ 1,704,701	$ 1,856,455	$ 1,922,938	$
Average common shares outstanding(6)	155,198	151,572	152,700	151,522	156,686	161,950	
Leverage ratio (at period end)(7)	8.06:1	7.15:1	7.33:1	7.06:1	6.77:1	6.44:1	
Liquidity as % of stockholders' equity(8)	61%	69%	65%	61%	66%	67%	
Hedge ratio(9)	101%	99%	99%	92%	94%	90%	
Book value per common share (at period end)(10)	$ 7.41	$ 8.26	$ 8.38	$ 8.33	$ 9.36	$ 10.50	$
Weighted-average amortized cost of Agency RMBS and U.S. Treasuries(11)	$ 102.95	103.26	$ 102.92	$ 103.78	$ 103.69	$ 103.98	$

(In thousands, except per share numbers)	For the three months ended March 31, 2018	For the three months ended March 31, 2017	For the year ended December 31, 2017	2016	2015	2014**	2013**
Key Performance Metrics*							
Average yield on settled Debt Securities(12)	3.02%	2.71%	2.77%	2.50%	2.56%	2.60%	2.24%
Average yield on total Debt Securities including Drop Income(13)	2.80%	2.65%	2.68%	2.48%	2.56%	2.72%	2.39%
Average cost of funds(14)	1.61%	0.92%	1.18%	0.72%	0.40%	0.32%	0.41%
Average cost of funds and hedge(15)	1.71%	1.28%	1.49%	1.26%	1.28%	1.18%	1.14%
Adjusted average cost of funds and hedge(16)	1.49%	1.08%	1.29%	1.11%	1.16%	1.02%	0.92%
Interest rate spread net of hedge(17)	1.31%	1.43%	1.28%	1.24%	1.28%	1.42%	1.10%
Interest rate spread net of hedge including Drop Income(18)	1.31%	1.57%	1.39%	1.37%	1.40%	1.70%	1.47%
Operating expense ratio(19)	1.59%	1.61%	1.47%	1.39%	1.12%	1.19%	0.98%
Total stockholder return on common equity(20)	(8.95)%	2.16%	12.61%	(0.21)%	(0.38)%	27.06%	(20.66)%
CPR (weighted-average experienced 1-month)(21)	7.1%	8.1%	8.6%	12.1%	10.4%	7.9%	11.6%

(1)
The average settled Debt Securities is calculated by *averaging* the month end cost basis of settled Debt Securities during the period.

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(2)
The average total Debt Securities is calculated by *averaging* the month end cost basis of total Debt Securities and unsettled Debt Securities (inclusive of TBA Derivatives) during the period.

(3)
The average repurchase agreements and FHLBC Advances are calculated by *averaging* the month-end repurchase agreements and FHLBC Advances balances during the period.

(4)
The average Debt Securities liabilities are calculated by *adding* the average month-end repurchase agreements and FHLBC Advances balances plus average unsettled Debt Securities (inclusive of TBA Derivatives) during the period.

(5)
The average stockholders' equity is calculated by *averaging* the month-end stockholders' equity during the period.

(6)
The average common shares outstanding is calculated by *averaging* the daily common shares outstanding during the period.

(7)
The leverage ratio is calculated by *dividing* (i) CYS's repurchase agreements and FHLBC Advances balance plus payable for securities purchased *minus* receivable for securities sold, *plus* or *minus* the net TBA Derivatives positions by (ii) stockholders' equity.

(8)
Liquidity as % of stockholders' equity is calculated by dividing unencumbered liquid assets by stockholders' equity.

(9)
The hedge ratio for the period is calculated by *dividing* the combined total Interest Rate Swaps, Swaptions and Interest Rate Caps notional amount by total repurchase agreements and FHLBC Advances balances.

(10)
Book value per common share is calculated by *dividing* total stockholders' equity *less* the liquidation value of preferred stock at period end by common shares outstanding at period end.

(11)
The weighted-average amortized cost of Agency RMBS and U.S. Treasuries is calculated using the weighted-average amortized cost by security *divided* by the current face at period end.

(12)
The average yield on settled Debt Securities for the period is calculated by *dividing* total interest income by average settled Debt Securities.

(13)
Average yield on total Debt Securities including Drop Income for the period is calculated by *dividing* total interest income *plus* Drop Income by average total Debt Securities. Drop Income was $29.9 million, $32.9 million, $32.6 million, $60.7 million and $94.5 million for the years ended December 31, 2017, 2016, 2015, 2014 and 2013, respectively. Drop Income is a component of CYS's net realized and unrealized gain (loss) on investments and derivative instruments in the Consolidated Statements of Operations. Drop Income is the difference between the spot price and the forward-settlement price for the same security on the trade date.

(14)

The average cost of funds for the period is calculated by *dividing* repurchase agreement and FHLBC Advances interest expense by average repurchase agreements and FHLBC Advances for the period.

(15)
The average cost of funds and hedge for the period is calculated by *dividing* repurchase agreement and FHLBC Advances interest expense and interest rate hedge expense, net by average repurchase agreements and FHLBC Advances.

(16)
The adjusted average cost of funds and hedge for the period is calculated by *dividing* repurchase agreement and FHLBC Advances interest expense and interest rate hedge expense, net by average Debt Securities liabilities.

(17)
The interest rate spread net of hedge for the period is calculated by *subtracting* average cost of funds and hedge from average yield on settled Debt Securities.

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(18)
The interest rate spread net of hedge including Drop Income for the period is calculated by *subtracting* adjusted average cost of funds and hedge from average yield on total Debt Securities including Drop Income.

(19)
The operating expense ratio for the period is calculated by *dividing* operating expenses by average stockholders' equity.

(20)
The total stockholder return on common equity is calculated as the change in book value *plus* dividend distributions on common stock *divided* by book value at the beginning of the period.

(21)
CPR represents the weighted-average 1-month CPR of CYS's Agency RMBS during the period.

*
All percentages are annualized except total stockholder return on common equity.

**
Previously reported under specialized accounting, ASC 946 Financial Services Investment Companies. Se
Notes to consolidated financial statements, in CYS's Form 10-K for the year ended December 31, 2017 and Form 10-Q for the quarterly period ended March 31, 2018.

(in thousands, except per share numbers)	As of March 31, 2018	As of March 31, 2017	As of December 31, 2017	2016	2015	2014	2013
Balance Sheet Data:							
Investments in securities, at fair value	$ 11,535,960	$ 11,060,851	$ 12,634,654	$ 12,648,731	$ 13,027,707	$ 14,601,507	$ 13,858,848
Total assets	12,930,261	11,240,918	13,145,582	13,245,268	14,330,704	14,895,863	14,633,064
Repurchase agreements and other debt	10,084,643	9,015,594	10,089,917	9,691,544	11,086,477	11,289,559	11,206,950
Stockholders' equity	1,426,945	1,527,670	1,574,247	1,535,719	1,694,614	1,975,168	1,768,656
Book value per common share	$ 7.41	$ 8.26	$ 8.38	$ 8.33	$ 9.36	$ 10.50	$ 9.24

(in thousands, except per share numbers)	For the three months ended March 31, 2018	For the three months ended March 31, 2017	For the year ended December 31, 2017	2016	2015	2014	2013
Non-GAAP Reconciliation:							
Net income (loss) available to common stockholders	$ (113,711)	$ 28,817	$ 160,449	$ (4,421)	$ (25,578)	$ 404,797	$ (491,636)
Net realized (gain) loss on investments	71,191	66,044	114,737	(19,463)	(13,652)	(132,563)	595,116
Net unrealized (gain) loss on investments	166,009	(63,478)	(94,463)	132,500	129,764	(233,763)	314,530

Net realized and unrealized (gain) loss on derivative instruments	(89,468)	1,012	(57,750)	11,483	54,932	110,542	(269,128)
Net unrealized (gain) loss on FHLBC Advances				1,299	(1,299)		
Core Earnings	$ 34,021	$ 32,395	$ 122,973	$ 121,398	$ 144,167	$ 149,013	$ 148,882

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Selected Unaudited Pro Forma Condensed Combined Financial Statements (Page [•])

The following table shows summary unaudited pro forma condensed combined financial information about the combined financial condition and operating results of Two Harbors and CYS after giving effect to the Merger. The unaudited pro forma financial information assumes that the Merger is accounted for as an asset acquisition with Two Harbors as the acquiring entity. The unaudited pro forma condensed combined balance sheet data gives effect to the Merger as if it had occurred on March 31, 2018. The unaudited pro forma condensed combined statements of operations data gives effect to the Merger as if it had occurred on January 1, 2017. The summary unaudited pro forma condensed combined financial information listed below has been derived from and should be read in conjunction with (1) the more detailed unaudited pro forma condensed combined financial statements, including the notes thereto, appearing elsewhere in this joint proxy statement/prospectus and (2) the historical consolidated financial statements and related notes of both Two Harbors and CYS, incorporated herein by reference. See "Unaudited Pro Forma Condensed Combined Financial Statement" beginning on page **[•]** and "Where You Can Find More Information and Incorporation by Reference" beginning on page **[•]**.

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	As of, or for the Three Months Ended, March 31, 2018 (in thousands, except for per share data)			
	Two Harbors Historical(1)	CYS Historical(1)	Pro Forma Adjustments	Two Harbors Pro Forma
Statement of Comprehensive Income (Loss) Data:				
Interest income	$ 194,019	$ 88,678	$	$ 282,69
Interest expense	96,560	41,117		137,67
Net interest income	97,459	47,561		145,02
Other-than-temporary impairment losses	(94)			(9
Other income (loss)	281,982	(150,201)	167,039	298,82
Expenses	40,754	5,868		46,62
Provision for income taxes	3,784			3,78
Net income (loss)	334,809	(108,508)	167,039	393,34
Dividends on preferred stock	13,747	5,203		18,95
Net income (loss) attributable to common stockholders	$ 321,062	$ (113,711)	$ 167,039	$ 374,39
Per Share Data:				
Net income (loss) per weighted average common share basic	$ 1.83	$ (0.74)	$ 0.40	$ 1.4
Net income (loss) per weighted average common share diluted	$ 1.69	$ (0.74)	$ 0.46	$ 1.4
Weighted average number of shares of common stock outstanding basic	175,145,964	154,230,144	(78,517,301)	250,858,80
Weighted average number of shares of common stock outstanding diluted	192,818,531	154,230,144	(78,517,301)	268,531,37
Comprehensive loss:				
Net income (loss)	$ 334,809	$ (108,508)	$ 167,039	$ 393,34
Other comprehensive loss, net of tax:				
Unrealized loss on available-for-sale securities	(344,777)		(167,039)	(511,81
Other comprehensive loss	(344,777)		(167,039)	(511,81
Comprehensive loss	(9,968)	(108,508)		(118,47
Dividends on preferred stock	13,747	5,203		18,95
Comprehensive loss attributable to common stockholders	$ (23,715)	$ (113,711)	$	$ (137,42
Balance sheet data:				
Available-for-sale securities	$ 21,059,377	$ 11,535,960	$	$ 32,595,33
Mortgage servicing rights	$ 1,301,023	$	$	$ 1,301,02
Total assets	$ 24,077,165	$ 12,930,261	$ (15,000)	$ 36,992,42
Repurchase agreements	$ 19,148,679	$ 10,084,643	$	$ 29,233,32
Federal Home Loan Bank advances	$ 865,024	$	$	$ 865,02
Total liabilities	$ 20,609,480	$ 11,503,316	$ 21,061	$ 32,133,85

Total stockholders' equity	$ 3,467,685	$ 1,426,945	$ (36,061)	$ 4,858,56

(1) The historical financial information of Two Harbors and CYS is derived from their respective Quarterly Reports filed on Form 10-Q for the three months ended March 31, 2018. Certain historical CYS amounts have been reclassified to conform to Two Harbors' financial statement presentation.

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	For the year ended December 31, 2017 (in thousands, except for per share data)			
	Two Harbors Historical(1)	CYS Historical(1)	Pro Forma Adjustments	Two Harbors Pro Forma
Statement of Comprehensive Income Data:				
Interest income	$ 745,089	$ 310,783	$	$ 1,055,87
Interest expense	350,188	114,616		464,80
Net interest income	394,901	196,167		591,06
Other-than-temporary impairment losses	(789)			(78
Other income (loss)	33,566	8,089	(93,490)	(51,83
Expenses	129,921	22,995		152,91
Benefit from income taxes	(10,482)			(10,48
Net income (loss) from continuing operations	308,239	181,261	(93,490)	396,01
Income from discontinued operations, net of tax	44,146			44,14
Net income (loss)	352,385	181,261	(93,490)	440,15
Income from discontinued operations attributable to non-controlling interest	3,814			3,81
Net income (loss) attributable to Two Harbors or CYS (as applicable)	348,571	181,261	(93,490)	436,34
Dividends on preferred stock	25,122	20,812		45,93
Net income (loss) attributable to common stockholders	$ 323,449	$ 160,449	$ (93,490)	$ 390,40
Per Share Data:				
Net income (loss) per weighted average common stock basic	$ 1.85	$ 1.05	$ (1.34)	$ 1.5
Net income (loss) per weighted average common stock diluted	$ 1.81	$ 1.05	$ (1.32)	$ 1.5
Weighted average number of shares of common stock outstanding basic	174,433,999	151,757,485	(76,044,642)	250,146,84
Weighted average number of shares of common stock outstanding diluted	188,133,341	151,757,485	(76,044,642)	263,846,18
Comprehensive income:				
Net income (loss) attributable to Two Harbors or CYS (as applicable)	$ 348,571	$ 181,261	$ (93,490)	$ 436,34
Other comprehensive income, net of tax:				
Unrealized gain on available-for-sale securities	135,586		93,490	229,07
Other comprehensive income	135,586		93,490	229,07
Comprehensive income	484,157	181,261		665,41
Dividends on preferred stock	25,122	20,812		45,93
Comprehensive income attributable to common stockholders	$ 459,035	$ 160,449	$	$ 619,48

(1) The historical financial information of Two Harbors and CYS is derived from their respective Annual Reports on Form 10-K for the year ended December 31, 2017. Certain historical CYS amounts have been reclassified to conform to Two Harbors' financial statement presentation.

Unaudited Comparative Per Share Information (Page [•])

The following table sets forth for the year ended December 31, 2017 and as of, and for the three months ended, March 31, 2018, selected per share information for Two Harbors Common Stock on a historical and pro forma combined basis and for CYS Common Stock on a historical and pro forma equivalent basis. Except for the historical information for the year ended December 31, 2017, the

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information in the table is unaudited. You should read the table below together with the historical consolidated financial statements and related notes thereto of Two Harbors and CYS contained in Two Harbors' Annual Report on Form 10-K for the year ended December 31, 2017, CYS's Annual Report on Form 10-K for the year ended December 31, 2017, and each of Two Harbors' and CYS's respective Quarterly Reports on Form 10-Q for the quarter ended March 31, 2018, all of which are incorporated herein by reference into this joint proxy statement/prospectus. See "Where You Can Find More Information and Incorporation by Reference" beginning on page [•].

The Two Harbors pro forma combined amounts were calculated using the methodology as described above under the heading "Unaudited Pro Forma Condensed Combined Financial Statements," and are subject to all the assumptions, adjustments and limitations described thereunder. The unaudited pro forma condensed combined balance sheet data gives effect to the Merger as if it occurred on March 31, 2018. The unaudited pro forma condensed combined statements of operations data gives effect to the Merger as if it occurred on January 1, 2017. The unaudited pro forma condensed combined financial statements are not necessarily indicative of what the actual financial position and operating results would have been had the Merger occurred on March 31, 2018 or January 1, 2017, respectively, nor do they purport to represent Two Harbors' future financial position or operating results. The CYS pro forma equivalent amounts were calculated by multiplying the Two Harbors pro forma combined amounts by the assumed Exchange Ratio of 0.4872 based on the adjusted book value per share of Two Harbors Common Stock and CYS Common Stock as of March 31, 2018, calculated in accordance with the Merger Agreement.

	CYS Historical	Two Harbors Historical	Pro Forma Combined	Pro Forma Equivalent CYS Share
For the year ended December 31, 2017				
Net income per weighted share of common stock, basic	$ 1.05	$ 1.85	$ 1.56	$ 0.76
Net income per weighted share of common stock, diluted	$ 1.05	$ 1.81	$ 1.54	$ 0.75
Dividends declared per share	$ 1.00	$ 3.02(1)	(2)	(2)
For the quarter ended March 31, 2018				
Net income (loss) per weighted share of common stock, basic	$ (0.74)	$ 1.83	$ 1.49	$ 0.73
Net income (loss) per weighted share of common stock, diluted	$ (0.74)	$ 1.69	$ 1.41	$ 0.69
Dividends declared per share	$ 0.22	$ 0.47	(2)	(2)
As of March 31, 2018				
Net book value per share of common stock	$ 7.41	$ 15.63	$ 15.36(3)	$ 7.48

(1) Includes the special dividend of Granite Point common stock of $1.78 per common share.

(2) Pro forma dividends per share of common stock are not presented as the dividend policy for the Combined Company will be determined by the Two Harbors board following the completion of the Merger. It is anticipated that the initial per share dividend for the first full quarter following Closing will be $0.47.

(3) Net book value per share of common stock for Pro Forma Combined does not reflect approximately $9.0 million of compensation related expenses (i.e., non-executive severance, retention, etc.) which will be recognized subsequent to the Closing in accordance with GAAP.

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RISK FACTORS

In addition to other information included elsewhere in this joint proxy statement/prospectus and in the annexes to this joint proxy statement/prospectus, including the matters addressed in the section entitled "Cautionary Statement Regarding Forward-Looking Statements" beginning on page [•], you should carefully consider the following risk factors in deciding whether to vote for the Two Harbors Common Stock Issuance Proposal or the Merger Proposal. In addition, you should read and consider the risks associated with the businesses of each of Two Harbors and CYS. These risks can be found in the Annual Report on Form 10-K for the year ended December 31, 2017 and Quarterly Report on Form 10-Q for the quarter ended March 31, 2018 of CYS and the Annual Report on Form 10-K for the year ended December 31, 2017 and Quarterly Report on Form 10-Q for the quarter ended March 31, 2018 of Two Harbors, which reports are incorporated by reference into this joint proxy statement/prospectus, including particularly the sections therein titled "Risk Factors" and "Tax Risks". You should also read and consider the other information in this joint proxy statement/prospectus and the other documents incorporated by reference into this joint proxy statement/prospectus. Please also see "Where You Can Find More Information and Incorporation by Reference" on page [•].

Risks Related to the Merger

The Merger is subject to a number of conditions which, if not satisfied or waived in a timely manner, would delay the Merger or adversely impact Two Harbors' and CYS's ability to complete the transaction.

The completion of the Merger is subject to the satisfaction or waiver of a number of conditions. In addition, under circumstances specified in the Merger Agreement, Two Harbors or CYS may terminate the Merger Agreement. In particular, completion of the Merger requires (i) the approval of the Merger Proposal by the CYS common stockholders, and (ii) the approval of the Two Harbors Common Stock Issuance Proposal by Two Harbors common stockholders. While it is currently anticipated that the Merger will be completed shortly after the later of the CYS special meeting to approve the Merger Proposal and the Two Harbors special meeting to approve the Two Harbors Common Stock Issuance Proposal, there can be no assurance that the conditions to Closing will be satisfied in a timely manner or at all, or that an effect, event, circumstance, occurrence, development or change will not transpire that could delay or prevent these conditions from being satisfied. Accordingly, Two Harbors and CYS cannot provide any assurances with respect to the timing of the Closing, whether the Merger will be completed at all and when the CYS stockholders would receive the consideration for the Merger, if at all.

Failure to consummate the Merger as currently contemplated or at all could adversely affect the price of Two Harbors Common Stock or CYS Common Stock and the future business and financial results of Two Harbors and/or CYS.

Completion of the Merger is subject to the satisfaction or waiver of a number of conditions, including approval by the Two Harbors common stockholders of the Two Harbors Common Stock Issuance Proposal and approval by the CYS common stockholders of the Merger Proposal. Two Harbors and CYS cannot guarantee when or if these conditions will be satisfied or that the Merger will be successfully completed. The consummation of the Merger may be delayed, the Merger may be consummated on terms different than those contemplated by the Merger Agreement, or the Merger may not be consummated at all. If the Merger is not completed, or is completed on different terms than as contemplated by the Merger Agreement, Two Harbors and CYS could be adversely affected and subject to a variety of risks associated with the failure to consummate the Merger, or to consummate the Merger as contemplated by the Merger Agreement, including the following:

- the Two Harbors stockholders and the CYS stockholders may be prevented from realizing the anticipated benefits of the Merger;

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the market price of Two Harbors Common Stock or CYS Common Stock could decline significantly;

reputational harm due to the adverse perception of any failure to successfully consummate the Merger;

Two Harbors and CYS being required, under certain circumstances, to pay to the other party a termination fee or expense amount;

incurrence of substantial costs relating to the proposed Merger, such as legal, accounting, financial advisor, filing, printing and mailing fees; and

the attention of Two Harbors' and CYS's management and employees may be diverted from their day-to-day business and operational matters as a result of efforts relating to attempting to consummate the Merger.

Any delay in the consummation of the Merger or any uncertainty about the consummation of the Merger on terms other than those contemplated by the Merger Agreement, or if the Merger is not completed, could materially adversely affect the business, financial results and stock price of Two Harbors and CYS.

The Merger Agreement contains provisions that could discourage a potential competing acquirer of either Two Harbors or CYS or could result in any competing acquisition proposal being at a lower price than it might otherwise be.

The merger agreement contains provisions that, subject to limited exceptions, restrict the ability of each of Two Harbors and CYS to solicit, initiate, knowingly encourage or facilitate any Competing Proposal. With respect to any written, bona fide Competing Proposal received by either Two Harbors or CYS, the other party generally has an opportunity to offer to modify the terms of the Merger Agreement in response to such proposal before the Two Harbors Board or CYS Board, as the case may be, or committee thereof, may withdraw or modify its recommendation to their respective stockholders in response to such Competing Proposal. In the event that either party's board of directors withdraws or modifies its recommendation, the other party may terminate the Merger Agreement, in which case CYS may be required to pay to Two Harbors a termination fee of $43.2 million or Two Harbors may be required to pay to CYS a termination fee of $51.8 million, payable by the party whose board withdrew or modified its recommendation. Similarly, such termination fees may be payable in certain circumstances if the Merger Agreement is terminated because of a failure to obtain stockholder approval following the announcement of a competing acquisition proposal. See "The Merger Agreement Competing Proposals" beginning on page [•], "The Merger Agreement Termination o the Merger Agreement" beginning on page [•] and "The Merger Agreement Termination Fees and Expenses" beginning on page [•].

These provisions could discourage a potential competing acquirer that might have an interest in acquiring all or a significant part of Two Harbors or CYS from considering or proposing a competing acquisition, even if the potential competing acquirer was prepared to pay consideration with a higher per share cash value than that market value proposed to be received or realized in the Merger, or might result in a potential competing acquirer proposing to pay a lower price than it might otherwise have proposed to pay because of the added expense of the termination fee or expense amount that may become payable in certain circumstances under the Merger Agreement.

The pendency of the Merger could adversely affect Two Harbors' and CYS's business and operations.

In connection with the pending Merger, some of the parties with whom Two Harbors or CYS does business may delay or defer decisions, which could negatively impact Two Harbors' or CYS's revenues, earnings, cash flows and expenses, regardless of whether the Merger is completed. In addition, under

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the Merger Agreement, Two Harbors and CYS are each subject to certain restrictions on the conduct of its respective business prior to completing the Merger. These restrictions may prevent Two Harbors or CYS from pursuing certain strategic transactions, acquiring and disposing assets, undertaking certain capital projects, undertaking certain financing transactions and otherwise pursuing other actions that are not in the ordinary course of business, even if such actions could prove beneficial. These restrictions may impede Two Harbors' or CYS's growth which could negatively impact its respective revenue, earnings and cash flows. Additionally, the pendency of the Merger may make it more difficult for Two Harbors or CYS to effectively retain and incentivize key personnel.

Because the number of shares of Two Harbors Common Stock exchanged per share of CYS Common Stock is not fixed, any change in Two Harbors' adjusted book value per share or CYS's adjusted book value per share prior to the Determination Date will affect the number of shares of Two Harbors Common Stock issued by Two Harbors and received by CYS common stockholders at the Closing.

The number of shares of Two Harbors Common Stock to be received by CYS stockholders will be based on the Exchange Ratio to be determined by dividing 96.75% of the CYS adjusted book value per share by 94.20% of the Two Harbors adjusted book value per share. As defined in the Merger Agreement as "Company Adjusted Book Value Per Share" and "Parent Adjusted Book Value Per Share," as applicable, adjusted book value per share for each company means (i) such company's total consolidated common stockholders' equity after giving pro forma effect to any dividends or other distributions for which the record date is after the exchange ratio but prior to the Closing and as modified for potential transaction-related adjustments, divided by (ii) each respective company's number of shares of common stock issued and outstanding, including shares issuable upon the vesting of restricted stock (less any shares surrendered for income tax purposes). Changes in the adjusted book value per share of either Two Harbors or CYS prior to the Determination Date will affect the consideration that CYS stockholders will receive on the date of Closing.

Changes in Two Harbors' adjusted book value per share and CYS's adjusted book value per share may result from a variety of factors (some of which may be beyond the control of Two Harbors and CYS), including the following factors:

- changes in interest rates;
- changes in prepayment rates of mortgages;
- the occurrence, extent and timing of credit losses within Two Harbors' and CYS's respective portfolios;
- exposure to adjustable-rate and negative amortization mortgage loans;
- the state of the credit markets and other general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers;
- the concentration of the credit risks to which Two Harbors and CYS are exposed;
- legislative and regulatory actions affecting Two Harbors' and CYS's businesses;
- the availability and cost of Two Harbors' and CYS's target assets;
- the availability and cost of financing for Two Harbors' and CYS's target assets, including repurchase agreement financing, lines of credit, revolving credit facilities and, with respect to Two

Harbors, financing through the Federal Home Loan Bank of Des Moines;

declines in home prices;

increases in payment delinquencies and defaults on the mortgages;

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changes in liquidity in the market for real estate securities, the re-pricing of credit risk in the capital markets, inaccurate ratings of securities by rating agencies, rating agency downgrades of securities, and increases in the supply of real estate securities available-for-sale; and

other factors beyond the control of either Two Harbors or CYS, including those described or referred to elsewhere in this "Risk Factors" section.

Two Harbors' adjusted book value per share and CYS's adjusted book value per share at the Determination Date may vary from their respective adjusted book values per share on March 31, 2018, the date used to determine the illustrative Exchange Ratio of 0.4872 used in this joint proxy statement/prospectus and on the dates of Two Harbors' and CYS's special meetings. As a result, the market value of the consideration for the Merger represented by the Exchange Ratio may also vary. Therefore, Two Harbors common stockholders cannot be sure of the Exchange Ratio or the market value of the consideration that will be paid to CYS common stockholders upon completion of the Merger, and CYS common stockholders cannot be sure of the Exchange Ratio or the market value of the consideration they will receive upon completion of the Merger. Neither Two Harbors nor CYS has the right to terminate the Merger Agreement based on an increase or decrease in their respective adjusted book value per share or the market price of Two Harbors Common Stock.

The Merger and related transactions are subject to Two Harbors common stockholder approval and CYS common stockholder approval.

The Merger cannot be completed unless (i) CYS common stockholders approve the Merger Proposal by the affirmative vote of the holders of at least a majority of all outstanding shares of CYS Common Stock entitled to vote on the Merger Proposal and (ii) Two Harbors common stockholders approve the Two Harbors Common Stock Issuance Proposal by the affirmative vote of a majority of the votes cast on such proposal, provided a quorum is present. Pursuant to the guidance of the NYSE, abstentions with regard to the Two Harbors Common Stock Issuance Proposal will have the effect of a vote against such proposal. If stockholder approval is not obtained from either CYS common stockholders or Two Harbors common stockholders, the Merger and related transactions cannot be completed.

Two Harbors common stockholders and CYS common stockholders will be diluted by the Merger.

The Merger will dilute the ownership position of Two Harbors common stockholders and result in CYS common stockholders having an ownership stake in the Combined Company that is smaller than their current stake in CYS. Following the Two Harbors Common Stock Issuance, Two Harbors and CYS estimate that current Two Harbors common stockholders will own in the aggregate approximately 70% of outstanding Two Harbors Common Stock immediately after the Merger, and CYS common stockholders will own in the aggregate approximately 30% of outstanding Two Harbors Common Stock immediately after the Merger. Consequently, Two Harbors common stockholders and CYS common stockholders, as a general matter, will have less influence over the Combined Company's management and policies after the effective time of the Merger than they currently exercise over the management and policies of Two Harbors and CYS, respectively.

If the Merger is not consummated by October 31, 2018, Two Harbors or CYS may terminate the Merger Agreement.

Either Two Harbors or CYS may terminate the Merger Agreement under certain circumstances, including if the Merger has not been consummated by October 31, 2018. However, this termination right will not be available to a party if that party failed to fulfill its obligations under the Merger Agreement and that failure was the cause of, or resulted in, the failure to consummate the Merger on or before such date.

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The market price of Two Harbors Common Stock may decline as a result of the Merger and the market price of Two Harbors Common Stock after the consummation of the Merger may be affected by factors different from those affecting the price of Two Harbors Common Stock or the price of CYS Common Stock before the Merger.

The market price of Two Harbors Common Stock may decline as a result of the Merger if the Combined Company does not achieve the perceived benefits of the Merger or the effect of the Merger on the Combined Company's financial results is not consistent with the expectations of financial or industry analysts.

In addition, upon consummation of the Merger, Two Harbors stockholders and CYS stockholders will own interests in the Combined Company operating an expanded business with a different mix of assets, risks and liabilities. Two Harbors current stockholders and CYS's current stockholders may not wish to continue to invest in the Combined Company, or for other reasons may wish to dispose of some or all of their shares of Two Harbors Common Stock. If, following the effective time of the Merger, a large amount of Two Harbors Common Stock is sold, the price of Two Harbors Common Stock could decline.

Further, the Combined Company's results of operations, as well as the market price of Two Harbors Common Stock after the Merger may be affected by factors in addition to those currently affecting Two Harbors' or CYS's results of operations and the market prices of Two Harbors Common Stock and CYS Common Stock, particularly the increase in the Combined Company's leverage compared to that in place for Two Harbors and CYS today, and other differences in assets and capitalization. Accordingly, Two Harbors' and CYS's historical market prices and financial results may not be indicative of these matters for the Combined Company after the Merger.

An adverse judgment in any litigation challenging the Merger may prevent the Merger from becoming effective or from becoming effective within the expected timeframe.

It is possible that Two Harbors stockholders or CYS stockholders may file lawsuits challenging the Merger or the other transactions contemplated by the Merger Agreement, which may name Two Harbors, CYS, Two Harbors Board and/or the CYS Board as defendants. The outcome of such lawsuits cannot be assured, including the amount of costs associated with defending these claims or any other liabilities that may be incurred in connection with the litigation of these claims. If plaintiffs are successful in obtaining an injunction prohibiting the parties from completing the Merger on the agreed-upon terms, such an injunction may delay the consummation of the Merger in the expected timeframe, or may prevent the Merger from being consummated altogether. Whether or not any plaintiff's claim is successful, this type of litigation may result in significant costs and divert management's attention and resources, which could adversely affect the operation of Two Harbors' business and/or CYS's business.

Risks Related to the Combined Company Following the Merger

Following the Merger, the Combined Company may be unable to integrate Two Harbors' business and CYS's business successfully and realize the anticipated synergies and other expected benefits of the Merger on the anticipated timeframe or at all.

The Merger involves the combination of two companies that currently operate as independent public companies. The Combined Company expects to benefit from the elimination of duplicative costs associated with supporting a public company platform and operating the respective businesses, and the resulting economies of scale. These savings are not expected to be realized until full integration, which is not expected to occur until 2019. The Combined Company will be required to devote significant management attention and resources to the integration of Two Harbors' and CYS's business practices

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and operations. The potential difficulties the Combined Company may encounter in the integration process include, but are not limited to, the following:

- the inability to successfully combine Two Harbors' and CYS's business in a manner that permits the Combined Company to achieve the cost savings anticipated to result from the Merger, which would result in the anticipated benefits of the Merger not being realized in the timeframe currently anticipated or at all;
- the complexities associated with integrating personnel from the two companies;
- the complexities of combining two companies with different histories, cultures, geographic footprints and portfolio assets;
- difficulties or delays in redeploying the capital acquired in connection with the Merger into the target assets of the Combined Company;
- potential unknown liabilities and unforeseen increased expenses, delays or conditions associated with the Merger; and
- performance shortfalls as a result of the diversion of management's attention caused by completing the Merger and in