Ellington Residential Mortgage REIT
Form 10-Q
May 08, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

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

For the quarterly period ended March 31, 2015

OR

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

For the transition period from to

Commission file number 001-35896

Ellington Residential Mortgage REIT
(Exact Name of Registrant as Specified in Its Charter)

Maryland	46-0687599
(State or Other Jurisdiction of Incorporation)	(IRS Employer Identification No.)

53 Forest Avenue
Old Greenwich, CT 06870
(Address of principal executive offices, zip code)
(203) 698-1200
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large Accelerated Filer	¨	Accelerated Filer	x
Non-Accelerated Filer (do not check if a smaller reporting company)	¨	Smaller Reporting Company	¨

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

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

Class	Outstanding at May 1, 2015
Common Shares of Beneficial Interest, $0.01 par value per share	9,149,274

ELLINGTON RESIDENTIAL MORTGAGE REIT
INDEX

PART I. FINANCIAL INFORMATION
Item 1. Consolidated Financial Statements (unaudited)
ELLINGTON RESIDENTIAL MORTGAGE REIT
CONSOLIDATED BALANCE SHEET
(UNAUDITED)

(In thousands except for share amounts)	March 31, 2015	December 31, 2014
ASSETS		
Cash and cash equivalents	$53,340	$45,237
Mortgage-backed securities, at fair value	1,388,460	1,393,303
Due from brokers	28,740	18,531
Financial derivatives–assets, at fair value	1,479	3,072
Reverse repurchase agreements	62,973	13,987
Receivable for securities sold	36,649	41,834
Interest receivable	4,451	4,793
Other assets	610	317
Total Assets	$1,576,702	$1,521,074
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES		
Repurchase agreements	$1,211,110	$1,323,080
Payable for securities purchased	117,493	4,227
Due to brokers	1,609	583
Financial derivatives–liabilities, at fair value	14,201	8,700
U.S. Treasury securities sold short, at fair value	62,848	13,959
Dividend payable	5,032	5,032
Accrued expenses	908	890
Management fee payable	610	551
Interest payable	851	687
Total Liabilities	1,414,662	1,357,709
SHAREHOLDERS' EQUITY		
Preferred shares, par value $0.01 per share, 100,000,000 shares authorized; (0 shares issued and outstanding, respectively)	—	—
Common shares, par value $0.01 per share, 500,000,000 shares authorized; (9,149,274 and 9,149,274 shares issued and outstanding, respectively)	91	91
Additional paid-in-capital	181,312	181,282
Accumulated deficit	(19,363)	(18,008)
Total Shareholders' Equity	162,040	163,365
Total Liabilities and Shareholders' Equity	$1,576,702	$1,521,074

See Notes to Consolidated Financial Statements
3

ELLINGTON RESIDENTIAL MORTGAGE REIT
CONSOLIDATED STATEMENT OF OPERATIONS
(UNAUDITED)

	Three Month Period Ended March 31, 2015	Three Month Period Ended March 31, 2014
(In thousands except for per share amounts)		
INTEREST INCOME (EXPENSE)		
Interest income	$10,280	$11,959
Interest expense	(1,258)	(1,155)
Total net interest income	9,022	10,804
EXPENSES		
Management fees	610	592
Professional fees	143	139
Other operating expenses	663	663
Total expenses	1,416	1,394
OTHER INCOME (LOSS)		
Net realized gains (losses) on mortgage-backed securities	6,722	(3,025)
Net realized gains (losses) on financial derivatives	(8,743)	(3,409)
Change in net unrealized gains (losses) on mortgage-backed securities	5,186	17,581
Change in net unrealized gains (losses) on financial derivatives	(7,094)	(17,796)
Total other income (loss)	(3,929)	(6,649)
NET INCOME	$3,677	$2,761
NET INCOME PER COMMON SHARE:		
Basic and Diluted	$0.40	$0.30
CASH DIVIDENDS PER COMMON SHARE:		
Dividends declared	$0.55	$0.55

See Notes to Consolidated Financial Statements

ELLINGTON RESIDENTIAL MORTGAGE REIT
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(UNAUDITED)

(In thousands except for share amounts)	Common Shares	Common Shares, par value	Preferred Shares	Preferred Shares, par value	Additional Paid-in-Capital	Accumulated (Deficit) Earnings	Total
BALANCE, December 31, 2013	9,139,842	$91	—	$—	$ 181,147	$(14,058)	$167,180
Share based compensation					41		41
Dividends declared						(5,027)	(5,027)
Net income						2,761	2,761
BALANCE, March 31, 2014	9,139,842	$91	—	$—	$ 181,188	$(16,324)	$164,955
BALANCE, December 31, 2014	9,149,274	$91	—	$—	$ 181,282	$(18,008)	$163,365
Share based compensation					30		30
Dividends declared						(5,032)	(5,032)
Net income						3,677	3,677
BALANCE, March 31, 2015	9,149,274	$91	—	$—	$ 181,312	$(19,363)	$162,040

See Notes to Consolidated Financial Statements
5

ELLINGTON RESIDENTIAL MORTGAGE REIT
CONSOLIDATED STATEMENT OF CASH FLOWS
(UNAUDITED)

	Three Month Period Ended March 31, 2015	Three Month Period Ended March 31, 2014
(In thousands)		
Cash flows provided by (used in) operating activities:		
Net income	$3,677	$2,761
Reconciliation of net income (loss) to net cash provided by (used in) operating activities:		
Net realized (gains) losses on mortgage-backed securities	(6,722)	3,025
Change in net unrealized (gains) losses on mortgage-backed securities	(5,186)	(17,581)
Net realized (gains) losses on financial derivatives	8,743	3,409
Change in net unrealized (gains) losses on financial derivatives	7,094	17,796
Amortization of premiums and accretion of discounts (net)	2,477	1,367
Share based compensation	30	41
(Increase) decrease in assets:		
Due from brokers	(10,209)	7,622
Interest receivable	342	(756)
Other assets	(293)	(78)
Increase (decrease) in liabilities:		
Due to brokers	1,026	(11,024)
Accrued expenses	18	51
Interest payable	164	(180)
Management fees payable	59	(8)
Net cash provided by operating activities	1,220	6,445
Cash flows provided by (used in) investing activities:		
Purchases of mortgage-backed securities	(482,987)	(524,541)
Proceeds from sale of mortgage-backed securities	584,903	536,934
Principal repayments of mortgage-backed securities	31,207	19,085
Proceeds from investments sold short	214,417	10,015
Repurchase of investments sold short	(165,926)	(10,055)
Proceeds from disposition of financial derivatives	4,457	6,288
Purchase of financial derivatives	(13,200)	(9,698)
Payments made on reverse repurchase agreements	(2,092,173)	(20,088)
Proceeds from reverse repurchase agreements	2,043,187	20,088
Net cash provided by investing activities	123,885	28,028
Cash flows provided by (used in) financing activities:		
Offering costs paid	—	(32)
Dividends paid	(5,032)	(4,570)
Borrowings under repurchase agreements	1,421,636	1,616,676
Repayments of repurchase agreements	(1,533,606)	(1,645,553)
Cash used in financing activities	(117,002)	(33,479)
NET INCREASE IN CASH AND CASH EQUIVALENTS	8,103	994
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	45,237	50,112
CASH AND CASH EQUIVALENTS, END OF PERIOD	$53,340	$51,106
Supplemental disclosure of cash flow information:		
Interest paid	$1,094	$1,335

See Notes to Consolidated Financial Statements

ELLINGTON RESIDENTIAL MORTGAGE REIT
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2015
(UNAUDITED)

1. Organization and Investment Objective

Ellington Residential Mortgage REIT, or "EARN," was formed as a Maryland real estate investment trust, or "REIT," on August 2, 2012, and commenced operations on September 25, 2012. EARN conducts its business through its wholly owned subsidiaries, EARN OP GP LLC, or the "General Partner," and Ellington Residential Mortgage LP, or the "Operating Partnership," which were formed as a Delaware limited liability company and a Delaware limited partnership, respectively, on July 31, 2012 and commenced operations on September 25, 2012. The Operating Partnership conducts its business of acquiring, investing in, and managing residential mortgage-related and real estate-related assets through its wholly owned subsidiaries. EARN, the General Partner, the Operating Partnership, and their consolidated subsidiaries are hereafter defined as the "Company."

Ellington Residential Mortgage Management LLC, or the "Manager," serves as the Manager of the Company pursuant to the terms of a management agreement (the "Management Agreement"). The Manager is an affiliate of Ellington Management Group, L.L.C., or "EMG," an investment management firm that is registered as an investment adviser with a 20-year history of investing in a broad spectrum of mortgage-backed securities and related derivatives, with an emphasis on the residential mortgage-backed securities, or "RMBS," market. In accordance with the terms of the Management Agreement and the Services Agreement, as discussed in Note 10, the Manager is responsible for administering the Company's business activities and day-to-day operations, and performs certain services, subject to oversight by the Board of Trustees. See Notes 8 and 10 for further information on the Management Agreement.

The Company was formed through an initial strategic venture among affiliates of EMG and the Blackstone Tactical Opportunity Funds, or the "Blackstone Funds." These initial investors made an aggregate investment of approximately $31.5 million on September 25, 2012. On May 1, 2013, the Company priced an initial public offering of its common shares, pursuant to which it sold 6,450,000 shares to the public at a price of $20.00 per share. Concurrent with the initial public offering, the Company completed a private placement of 1,050,000 common shares to its initial investors at a purchase price of $20.00 per share which generated gross proceeds of $21.0 million. Proceeds to the Company from the initial public offering and concurrent private placement, net of offering costs, were approximately $148.5 million.

The Company acquires and manages Agency and non-Agency RMBS, including Agency pools and Agency collateralized mortgage obligations, or "CMOs," and non-Agency CMOs, both investment grade and non-investment grade. The Company may also acquire and manage mortgage servicing rights, residential mortgage loans, and other mortgage- and real estate-related assets. The Company may also invest in other instruments including, but not limited to, forward-settling To-Be-Announced Agency pass-through certificates, or "TBAs," interest rate swaps and swaptions, U.S. Treasury securities, Eurodollar and U.S. Treasury futures, other financial derivatives, and cash equivalents. The Company's targeted investments may range from unrated (first loss) securities to AAA senior securities.

The Company made the election to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, or "the Code," commencing with the Company's short taxable year ended December 31, 2013. As a REIT, the Company is required to distribute annually at least 90% of its taxable income. As long as the Company continues to qualify as a REIT, it will not be subject to U.S. federal or state corporate taxes on its taxable income to the extent that it distributes all of its annual taxable income to its shareholders. It is the intention of the Company to distribute at least 100% of its taxable income, after application of available tax attributes, within the limits prescribed by the Code, which may extend into the subsequent taxable year.

2. Significant Accounting Policies

(A) Basis of Presentation: The Company's unaudited interim consolidated financial statements have been prepared in conformity with generally accepted accounting principles in the United States of America, or "U.S. GAAP." Entities in which the Company has a controlling financial interest, through ownership of the majority of the entities' voting equity interests, or through other contractual right that give the Company control, are consolidated by the Company.

All inter-company balances and transactions have been eliminated. The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and those differences could be material. In management's opinion, all material adjustments, considered necessary for a fair presentation of the Company's interim consolidated financial statements have been included and are only of a normal recurring nature. Interim results are not necessarily indicative of the results that may be

expected for the entire fiscal year. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2014.
(B) Valuation: The Company applies ASC 820-10, Fair Value Measurement and Disclosures ("ASC 820-10"), to its holdings of financial instruments. ASC 820-10 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the observability of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

- Level 1—inputs to the valuation methodology are observable and reflect quoted prices (unadjusted) for identical assets or liabilities in active markets. Currently, the types of financial instruments the Company generally includes in this category are, exchange-traded derivatives and cash and cash equivalents;
- Level 2—inputs to the valuation methodology other than quoted prices included in Level 1 are observable for the asset or liability, either directly or indirectly. Currently, the types of financial instruments that the Company generally includes in this category are Agency RMBS, non-Agency RMBS determined to have sufficiently observable market data, U.S. Treasury securities, actively traded derivatives such as TBAs, interest rate swaps, and swaptions; and
- Level 3—inputs to the valuation methodology are unobservable and significant to the fair value measurement. Currently, this category includes RMBS where there is less price transparency.

For certain financial instruments, the various inputs that management uses to measure fair value for such financial instrument may fall into different levels of the fair value hierarchy. In such cases, the determination of which category within the fair value hierarchy is appropriate for such financial instrument is based on the lowest level of input that is significant to the fair value measurement. The assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the financial instrument. The Company may use valuation techniques consistent with the market and income approaches to measure the fair value of its assets and liabilities. The market approach uses third-party valuations and information obtained from market transactions involving identical or similar assets or liabilities. The income approach uses projections of the future economic benefits of an instrument to determine its fair value, such as in the discounted cash flow methodology. The inputs or methodology used for valuing financial instruments are not necessarily an indication of the risk associated with investing in these financial instruments. Transfers between levels of the fair value hierarchy are assumed to occur at the end of the reporting period.
Summary Valuation Techniques
For financial instruments that are traded in an "active market," the best measure of fair value is the quoted market price. However, many of the Company's financial instruments are not traded in an active market. Therefore, management generally uses third-party valuations when available. If third-party valuations are not available, management uses other valuation techniques, such as the discounted cash flow methodology. The following are summary descriptions, for the various categories of financial instruments, of the valuation methodologies management uses in determining fair value of the Company's financial instruments in such categories. Management utilizes such methodologies to assign a good faith fair value (the estimated price that, in an orderly transaction at the valuation date, would be received to sell an asset, or paid to transfer a liability, as the case may be) to each such financial instrument.
Valuations for fixed rate RMBS pass-throughs issued by a U.S government agency or government-sponsored enterprise, or "GSE," are typically based on observable pay-up data (pay-ups are price premiums for specified categories of fixed rate pools relative to their TBA counterparts) or models that use observable market data, such as interest rates and historical prepayment speeds, and are validated against third-party valuations. With respect to the Company's other RMBS investments and TBAs, management seeks to obtain at least one third-party valuation, and often obtains multiple valuations when available. Management has been able to obtain third-party valuations on the vast majority of these instruments and expects to continue to solicit third-party valuations in the future. Management generally values each financial instrument at the average of third-party valuations received and not rejected as described below. Third-party valuations are not binding, and while management generally does not adjust the valuations it receives, management may challenge or reject a valuation when, based on its validation criteria, management determines that such valuation is unreasonable or erroneous. Furthermore, based on its validation criteria management may determine that the average of the third-party valuations received for a given instrument does not result in what management believes to be the fair value of such instrument, and in such circumstances management

may override this average with its own good faith valuation. The validation criteria may take into account output from management's own models, recent trading activity in the same or similar instruments, and valuations received from third parties. The use of proprietary models requires the use of a significant amount of judgment and the application of various assumptions including, but not limited to, assumptions concerning future prepayment rates and default rates. Given their relatively high level of price transparency, Agency RMBS pass-throughs and TBAs are typically designated as Level 2 assets, although Agency interest only and inverse interest only RMBS are currently designated as Level 3 assets since they generally have less price transparency. Non-Agency RMBS are generally classified as either Level 2 or Level 3 based on analysis of available market data such as recent trades, executable bids, and reported "market color." Furthermore, the methodology used by the third-party valuation providers is reviewed at least annually by management, so as to ascertain whether such providers are utilizing observable market data to determine the valuations that they provide.

Interest rate swaps and swaptions are typically valued based on internal models that use observable market data, including applicable interest rates in effect as of the measurement date; the model-generated valuations are then typically compared to counterparty valuations for reasonableness. These financial derivatives are generally designated as Level 2 instruments.

The Company's repurchase and reverse repurchase agreements are carried at cost, which approximates fair value. Repurchase agreements and reverse repurchase agreements are classified as Level 2 assets and liabilities based on the adequacy of the collateral and their short term nature.

The Company's valuation process, including the application of validation criteria, is overseen by the Manager's Valuation Committee. The Valuation Committee includes senior level executives from various departments within the Manager, and each quarter the Valuation Committee reviews and approves the valuations of the Company's investments. The valuation process also includes a monthly review by the Company's third party administrator. The goal of this review is to replicate various aspects of the Company's valuation process based on the Company's documented procedures.

Because of the inherent uncertainty of valuation, the estimated fair value of the Company's financial instruments may differ significantly from the values that would have been used had a ready market for the financial instruments existed, and the differences could be material to the consolidated financial statements.

(C) Accounting for Mortgage-Backed Securities: Purchases and sales of investments are recorded on trade date and realized and unrealized gains and losses are calculated based on identified cost.

The Company has chosen to make a fair value election pursuant to ASC 825-10, Financial Instruments, for its mortgage-backed securities portfolio. Electing the fair value option allows the Company to record changes in fair value in the Consolidated Statement of Operations, which, in management's view, more appropriately reflects the results of operations for a particular reporting period as all securities activities will be recorded in a similar manner. As such, mortgage-backed securities are recorded at fair value on the Consolidated Balance Sheet and the period change in fair value is recorded in current period earnings on the Consolidated Statement of Operations as a component of Change in net unrealized gains (losses) on mortgage-backed securities.

(D) Interest Income: Coupon interest income on investment securities is accrued based on the outstanding principal balance or notional amount and the current coupon rate on each security. The Company amortizes premiums and accretes discounts on its fixed income securities. For RMBS that are deemed to be of high credit quality at the time of purchase, premiums and discounts are generally amortized/accreted into interest income over the life of such securities using the effective interest method. For securities whose cash flows vary depending on prepayments, an effective yield retroactive to the time of purchase is periodically recomputed based on actual prepayments and changes in projected prepayment activity, and a catch-up adjustment is made to amortization to reflect the cumulative impact of the change in effective yield. For RMBS that are deemed not to be of high credit quality at the time of purchase, interest income is recognized based on the effective interest method. For purposes of determining the effective interest rate, management estimates the future expected cash flows of its investment holdings based on assumptions including, but not limited to, assumptions for future prepayment rates, default rates, and loss severities (each of which may in turn incorporate various macro-economic assumptions, such as future housing prices). These assumptions are re-evaluated not less than quarterly. Principal write-offs are generally treated as realized losses. Changes in projected cash flows, as applied to the current amortized cost of the security, may result in a prospective change in the yield/interest income recognized on such securities.

The Company's accretion of discounts and amortization of premiums on securities for U.S. federal and other tax purposes is likely to differ from the accounting treatment under U.S. GAAP of these items as described above.

(E) Cash and Cash Equivalents: Cash and cash equivalents include cash and short term investments with original maturities of three months or less at the date of acquisition. Cash equivalents are recorded at cost plus accrued interest,

which approximates fair value. Cash and cash equivalents typically include amounts held in an interest bearing overnight account and amounts held in money market funds, and these balances generally exceed insured limits.
(F) Due from brokers/Due to brokers: Due from brokers and Due to brokers accounts on the Consolidated Balance Sheet include collateral transferred to or received from counterparties, including clearinghouses, along with receivables and payables for open and/or closed derivative positions.

(G) Financial Derivatives: The Company may enter into various types of financial derivatives subject to its investment guidelines, which include restrictions associated with maintaining qualification as a REIT. The Company's financial derivatives are predominantly subject to bilateral collateral arrangements or clearing in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Company may be required to deliver or may receive cash or securities as collateral upon entering into derivative transactions. In addition, changes in the relative value of financial derivative transactions may require the Company or the counterparty to post or receive additional collateral. In the case of cleared financial derivatives, the clearinghouse becomes the Company's counterparty and a futures commission merchant acts as intermediary between the Company and the clearinghouse with respect to all facets of the related transaction, including the posting and receipt of required collateral. Collateral received by the Company is reflected on the Consolidated Balance Sheet a