Western Asset
Mortgage Capital Corp.

2021 Annual Report

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Letter to Stockholders

Dear Fellow Stockholders:

On behalf of the entire Western Asset Mortgage Capital Corporation (WMC) team, it is a privilege to address you in our Annual Report for the first time in my position as Chief Executive Officer. I was a member of WMC's Portfolio Management Team during its early years as a public company and I have enjoyed partnering over the years with both Greg Handler, our Chief Investment Officer, and Sean Johnson, our Deputy Chief Investment Officer. It is my honor to rejoin WMC to work with the team on strategies that we believe will ultimately add value for you, our stockholders.

As you may recall, in December 2021 we announced our plan to focus on residential real estate related investments and to transition out of commercial investments. We expect this transition to occur over the course of the coming quarters as we remain intent on maximizing the value of our commercial assets and strategically focusing our resources on the residential market. This will allow us to address attractive market opportunities while maintaining alignment with WMC core competencies. WMC has been investing in residential non-QM whole loans since 2014 and has a strong track record—experiencing no principal losses for non-QM whole loans since it first began investing in the sector. As always, we will update you on our progress regarding the transition.

2021 was a year of headwinds for the REIT sector and for WMC, including ongoing interest volatility challenges, fluctuating asset values, the impact of transitioning our primary investment focus and the underperformance of a concentrated number of investments. The financial results we share with you today reflect these challenges. However, over the course of 2021 and during the first quarter of 2022, we have taken a series of decisive actions to strengthen our balance sheet and position our portfolio for improved earnings potential:

- In May 2021, we reduced the interest rate on our Non-Agency CMBS and Non-Agency RMBS financing facility and extended its term for 12 months. The amended facility now bears interest at a rate of three-month LIBOR plus 2.0%, down from LIBOR plus 5.0%.
- In May 2021, we converted our Commercial Whole Loan Facility from a monthly facility to a 12-month facility with up to a 12-month extension option.
- In August and September 2021, we took a number of steps to extend the overall maturity of our convertible debt:
  - o Repurchased $22 million aggregate principal amount of our 6.75% Convertible Senior Unsecured Notes due in 2022 (the "2022 Notes") at an approximate 2.8% discount to par value.
  - o Issued $86 million aggregate principal amount of 6.75% Convertible Senior Unsecured Notes due in 2024 (the "2024 Notes").
  - o In conjunction with the 2024 Notes issuance, used the net proceeds and $20 million in cash on hand to repurchase $100 million of our 2022 notes at a price of par plus accrued interest.

- In the fourth quarter of 2021, we repurchased an additional $8 million principal amount of our 2022 Notes at an approximate 1% premium to par value, plus accrued interest.
- In November 2021, we amended our Residential Whole Loan Facility to a 12-month term, a stated capacity of $500 million, and an interest rate of LIBOR plus 2.0%, with a LIBOR floor of 0.25%.
- In December 2021, we obtained a 25% reduction in management fees for 2022 from our external manager, Western Asset Management Company, LLC.
- In February 2022, we completed our third securitization of residential whole loans, securing $399 million of long-term fixed-rate financing on $432 million of loans at a weighted average interest rate of 3.1%.
- Also in February 2022, we sold the hotel property on which we foreclosed in 2021, receiving $36 million in net proceeds and recording a gain on sale of the property of $6.7 million.

During 2021, we acquired $428 million of residential whole loans, as we continue to view these investments as an attractive value proposition given the ongoing strength in the housing market, which is supported by generally solid consumer balance sheets. In addition, we received $190 million in proceeds from payoffs and sales in our commercial portfolio, including both whole loans and non-agency CMBS investments, which we mainly used to redeploy into our target residential assets and repurchase our 2022 Notes.

Looking forward, we remain committed to growing our portfolio, improving our earnings and protecting shareholder value. In March, we made the decision to reset our quarterly dividend to better reflect our near-term earnings power as we reposition the portfolio. As we continue to make progress on the repositioning, we will reassess the level of the dividend based on a number of factors, including the future earnings power of the portfolio and the expected level of taxable income.

We have included additional commentary from our manager on our current investment outlook and our portfolio, which follows below. We encourage you to review the financial statements included in our Annual Report. In particular, please note the risk factors related to our business contained within the report on Form 10-K for the year ended December 31, 2021.

In closing, as fellow stockholders, we are keenly focused on preserving and growing the value of the portfolio. We are confident that we are taking the right steps to resolve our challenged investments, strengthen our balance sheet and improve the earnings power of the portfolio. We believe our progress on these steps will be reflected in our stock price over time. As always, we remain focused on and committed to generating sustainable earnings that support an attractive dividend and enhance stockholder value.

Sincerely,

Bonnie M. Wongtrakool
Chief Executive Officer
May 2, 2022

2022 Outlook

by Western Asset Management Company, LLC – May 2, 2022

During the first quarter of 2022, bond yields rose and risk assets weakened as the Federal Reserve (Fed) hiked the federal funds rate for the first time since 2018 amid a string of upside inflation surprises and strong employment data. Subsequent hawkish rhetoric from the Fed reinforced investor expectations for an accelerated pace of monetary tightening. US Treasury yields surged during the quarter, led by the front end, which resulted in a much flatter yield curve. The Fed has meaningfully altered its posture in 2022 given the persistent inflationary pressures in the economy. In addition, Russia's invasion of Ukraine has caused global commodity prices to rise, which also threatens economic growth. We believe the recent spike in inflationary pressures will abate as it mostly reflects the impact of Covid-related supply chain pressures and the impact of the Russia/Ukraine conflict on energy prices, both of which we expect will moderate as we move into the second half of the year.

We remain positive on overall credit fundamentals. As of April 2022, credit spreads are at wider levels than they were pre-Covid, and currently are wider than at any point over the past year in spite of the overall strength of the US economy, primarily due to the remaining uncertainties and unevenness of the recovery. In terms of monetary policy, we anticipate the Fed will become less accommodative over the course of the year, while being mindful that the risk of commodity price shocks might lead to stagflation.

Home price appreciation posted a year-over-year gain of 19.2% as of March 2022. The housing market continues to be in a strong position, but one that is decelerating from the rapid home price appreciation we saw during the peak Covid demand surge. Fueling the housing boom of the post-Covid world are historically low mortgage rates, a historic lack of housing supply on the market, tight lending conditions and a rebirth of household formations. After record-breaking home price growth in 2021, prices are expected to rise through 2022 albeit at lower levels as record low supply is expected to normalize. Declining affordability will likely curb housing demand with rising mortgage rates, which has caused us to adjust our home price growth forecast slightly downward for the year. Housing starts should continue to rise to meet the strong demand, and as supply-chain issues ease, we believe that new home construction may pick up to close to 1.5 million units. This should help to reduce the supply and demand imbalance. We believe that this will translate into another year of strong mortgage origination volumes, with net supply of agency mortgages anticipated to reach approximately $500 billion, which would be the second highest year on record after 2021's $800 billion.

Our residential portfolio continues to perform well, with only 1% percent of our total loans being more than 30 days delinquent as of December 31, 2021. This underscores the effectiveness of our credit underwriting standards, where we focus on high-quality borrowers that have meaningful equity in their homes. We believe this creates a strong incentive for them to prioritize their mortgage payment and remain current on that financial obligation.

We continue to believe residential whole loans represent attractive investment opportunities. Throughout the last several years, we have developed strategic relationships with residential mortgage loan originators who understand our specifications well and have been able to provide us with loans that meet our disciplined criteria. We plan to continue to grow this portion of our portfolio in the near-term, with the goal of financing these investments through additional securitizations.

As we reported in March 2022, with respect to our commercial real estate investments, we are strategically focused on optimizing the value of our existing commercial portfolio but plan to transition away from these investments in the future. The proceeds will be redeployed primarily into residential-related investments. While most of our commercial investments are performing in line with our expectations, a few continue to be challenged, including those that were hit hardest by the pandemic. These challenged commercial investments are further behind than expected in terms of operating performance, including one significant investment that is currently in default. Our teams continue to proactively communicate with our borrowers, which includes working with them to preserve the value of their properties and protect our collateral, increasing the probability of an eventual recovery in asset values.

In the meantime, we believe we are well-positioned to benefit from the strength that we expect to continue in the housing market and any ongoing recovery of commercial real estate asset values. We remain focused on maintaining sufficient liquidity and positioning our portfolio for future appreciation.

Board of Directors

Edward D. Fox
Chairman and Chief Executive Officer of
Vantage Property Investors, LLC

James W. Hirschmann III
Chairman of the Board of the Company and
Chief Executive Officer of our Manager

Ranjit M. Kripalani
Consultant

M. Christian Mitchell
Managing Partner, THG Advisory Services, LLC

Lisa G. Quateman
Chief Executive Officer of Voyager Advisory LLC

Bonnie M. Wongtrakool
Chief Executive Officer of the Company and Global Head of ESG
Investments and a Portfolio Manager of our Manager

Stockholder Information

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Executive Officers

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Chief Executive Officer of the Company and Global Head of
ESG Investments and a Portfolio Manager of our Manager

Greg Handler
Chief Investment Officer of the Company and Head of our
Manager's Mortgage and Consumer Credit Group

Sean O. Johnson
Deputy Chief Investment Officer of the Company and
Portfolio Manager in our Manager's Mortgage and
Consumer Credit Group

Lisa Meyer
President, Chief Financial Officer and Treasurer of the
Company

Elliott Neumayer
Chief Operating Officer of the Company and Product
Specialist and Head of Mortgage-Related Business of our
Manager