Western Asset
Mortgage Capital Corp.

2022 Annual Report

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Letter to Stockholders

Dear Fellow Stockholders:

During 2022 we continued executing upon our plan to focus on residential real estate and transition out of commercial real estate investments, a strategy that we had previously announced in December 2021. In addition, over the course of last year and during the first quarter of 2023, we have taken a series of proactive steps to deleverage, build liquidity and strengthen our balance sheet.

- In 2022, we acquired $412 million of Residential Whole Loans. Our portfolio continues to perform well. Delinquencies over 30 days have declined to just 0.92% of the total portfolio, reinforcing the effectiveness of our credit underwriting standards.
- In the first and third quarters of 2022, we completed two securitizations totaling $834 million of Residential Whole Loans, securing $751 million of long-term fixed rate financing, which is essential to our strategy, particularly in light of the rapid rise in interest rates last year.
- In February 2022, we sold the unencumbered hotel property we foreclosed on in 2021, receiving $36 million in net proceeds and recording a gain on sale of the property of approximately $9 million.
- During the year, we received $216 million from the repayment or paydown of Residential Whole Loans and $21 million of Commercial Whole Loans as well as $56 million from the sale of Non-Agency RMBS, CMBS and other securities.
- In July, we implemented a 1-for-10 reverse stock split of our outstanding shares of common stock.
- We repurchased $12 million aggregate principal amount of our outstanding 6.75% Convertible Senior Unsecured Notes due in 2022 and, in October, we redeemed the remaining $26 million at maturity.
- In the fall, we amended and extended the maturity dates of our Residential Whole Loan and Commercial Whole Loan Credit Facilities to October 25, 2023, and November 3, 2023, respectively.
- Furthermore, in February 2023, we sold our one nonperforming Commercial Whole Loan to an unaffiliated third party for $8.8 million, which was equal to the fair value of the loan at December 31, 2022.

At the same time, 2022 was a challenging year for the mortgage REIT sector and for the Company. We faced a number of headwinds, including record high interest volatility, fluctuating asset values, wider credit spreads, and the underperformance of one of our larger commercial real estate investments. The financial results we share with you today reflect these difficulties.

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 make further progress, 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.

Against the backdrop of a challenging market, we have not seen our stock price reflect the progress we have made on our strategic plan. Last August, we therefore embarked upon a process to review strategic alternatives for the Company as the best path forward towards unlocking shareholder value. The market environment for mortgage REITs over the last several quarters has been remarkably challenging, with record levels of interest rate volatility and increasing risks to economic growth. This has added complexity to our exploration of strategic partners. We remain committed to concluding this process in a satisfactory manner and we will provide an update at the appropriate time. In the meantime, we will continue to run the Company in a manner that is consistent with our goal of optimizing the value of our assets and maintaining stable earnings.

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 on Form 10-K for the year ended December 31, 2022. In particular, please note the risk factors related to our business contained within the Annual Report.

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 strengthen our balance sheet and improve the earnings power of the portfolio. We believe that our progress on these steps should be reflected in our stock price over time. As always, we remain committed to generating consistent earnings that support an attractive dividend.

Sincerely,

Bonnie M. Wongtrakool
Chief Executive Officer
May 1, 2023

2023 Outlook

by Western Asset Management Company, LLC – May 1, 2023

Our view as we entered 2023 was that the Federal Reserve would continue its restrictive monetary policy and interest rate hikes until there was clear evidence that inflation was abating. We did believe that inflation would begin to ease in 2023 as supply-chain bottlenecks diminished, commodity prices declined from their peak levels and the labor market became more balanced. We anticipated that the U.S. economy would continue to grow, albeit at a slow pace, but were cognizant that the risks of a recession had increased, given the Federal Reserve's continued hawkish stance.

Added to this macroeconomic backdrop was that in the span of just two months, we've experienced three of the four largest bank failures in the history of the United States, which has created additional volatility in both the equity and fixed-income markets and has caused credit spreads to widen across nearly all major asset classes, with some sectors being impacted more than others. As such, while we believe that credit sectors remain attractive, both on a relative value and historical basis, the near-term outlook remains clouded by the macroeconomic uncertainty that exists in the minds of institutional and retail investors.

During the first quarter of 2023, WMC's residential investments experienced an increase in value versus the prior quarter. We believe this is a reflection of the quality of the residential whole-loan portfolio, which continues to perform well. Of the nearly 3,000 mortgages in the Company's portfolio, less than 1% are more than 30 days delinquent at quarter-end, an improvement from one year ago. This underscores the effectiveness of our credit underwriting standards which focus on high-quality borrowers who have meaningful equity in their homes.

Our view of the overall housing market is that after booming during the last couple of years, home prices have begun to stall and even decline in certain markets under the pressure of higher mortgage rates and the lack of affordability. The housing market surge during the 2020 and 2021 was primarily due to inadequate supply relative to increased demand. More recently, new supply has become available and demand has cooled in response to higher interest rates, creating a more balanced market. Given the potential for a recession, we believe that there will likely be continued downward pressure on home prices.

However, while housing is expected to cool, we do not see a significant risk of widespread defaults or home price correction, particularly as it relates to the Company's portfolio. This assessment is mainly due to our disciplined underwriting standards that have remained high during this cycle and our approach of targeting high quality borrowers. Additionally, we expect the volatility in interest rates and spreads to decline as we get more clarity on the conclusion of the Federal Reserve's tightening cycle. Therefore, we believe that spread normalization, combined with high carry, could provide upside value to the Company's residential holdings.

Meanwhile, the overall market sentiment for commercial real estate credit remains challenged. We see three primary reasons for this:

First, the Federal Reserve rate hikes have resulted in higher mortgage rates, negatively impacting cap rates and collateral valuations as equity investors adjust to the higher capital costs. Second, the recent banking industry stresses have impacted credit spreads broadly and over time are expected to drive further reductions in real estate credit availability and a tightening of underwriting standards. And lastly, concerns over office values have escalated as some notable high-profile defaults have occurred. While the multifamily housing, industrial, hospitality and retail sectors have all recovered and, in many cases, are now outperforming pre-COVID levels, the office market faces a highly uncertain future with significant questions about the long-term viability of lower-quality properties.

We believe that the Company's current commercial mortgage portfolio—while not immune to this negative market sentiment—is unique and well-positioned to withstand a deteriorating economic environment. During the first quarter of 2023, as spreads continued to widen across the commercial mortgage credit sector, the Company's commercial holdings were only modestly impacted.

The Company's commercial investments consist primarily of loans which are backed by class-A retail and hotel properties that cater to leisure travelers, and we continue to see positive operating momentum at a number of these properties. These are generally high-quality assets with strong equity sponsors, so we believe that their collateral values have not been materially or permanently impaired. In addition, the Company's exposure to office buildings is minimal within its total commercial mortgage holdings.

In conclusion, we believe that the Company is well-positioned to benefit from its residential holdings as well as a normalization of credit spreads in most sectors of the commercial real estate market. We remain focused on optimizing the recovery values in the Company's commercial portfolio and intend to use proceeds from exits and payoffs to reduce recourse debt levels, maintain sufficient liquidity and to opportunistically reinvest into new target assets that continue to offer attractive risk-adjusted returns.

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
Corproate Board Memeber and Advisor

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

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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

Robert W. Lehman
Chief Financial Officer of the Company

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