Western Asset Mortgage Capital Corp
Form 10-Q
August 14, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended June 30, 2012

o **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: 001-35543

Western Asset Mortgage Capital Corporation

(Exact name of Registrant as specified in its charter)

Delaware	**27-0298092**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

Western Asset Mortgage Capital Corporation

385 East Colorado Boulevard

Pasadena, California 91101

(Address of Registrant s principal executive offices)

(626) 844-9400

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrant has submitted electronically 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 o No o

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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act (check one).

Large accelerated filer o	Accelerated filer o	Non-accelerated filer x (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 under the Securities Exchange Act of 1934). Yes o No x

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

As of August 13, 2012, there were 10,343,944 shares, par value $0.01, of the registrant s common stock issued and outstanding.

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Western Asset Mortgage Capital Corporation

Balance Sheets (Unaudited)

(in thousands except share and per share data)

		June 30, 2012		December 31, 2011
Assets:				
Cash and cash equivalents	$	26,781	$	1
Residential mortgage-backed securities, at fair value ($1,819,089 pledged as collateral, at fair value)		1,918,832		-
Investment related receivables		102,336		-
Accrued interest receivable		7,076		-
Due from counterparties		8,000		-
Derivative assets, at fair value		1,283		-
Other assets		552		-
Total Assets		2,064,860		1
Liabilities and Stockholders Equity:				
Liabilities:				
Borrowings under repurchase agreements	$	1,736,493	$	-
Investment related payables		106,019		-
Accrued interest payable		1,000		-
Due to counterparties		4,309		-
Derivative liability, at fair value		6,327		-
Accounts payable and accrued expenses		433		-
Payable to related party		1,607		-
Total Liabilities		1,856,188		-
Commitments and contingencies				
Stockholders Equity:				
Common stock, $0.01 par value, 500,000,000 and 100,000 shares authorized, 10,343,944 and 100 shares issued and outstanding, respectively		103		-
Preferred stock, $0.01 par value, 100,000,000 shares authorized and no shares outstanding		-		-
Additional paid-in capital		204,308		1
Retained earnings		4,261		-
Total Stockholders Equity		208,672		1
Total Liabilities and Stockholders Equity	$	2,064,860	$	1

See notes to unaudited financial statements.

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Western Asset Mortgage Capital Corporation

Statement of Operations (Unaudited)

(in thousands except share and per share data)

		For the period from May 15, 2012 (commencement of operations) through June 30, 2012
Net Interest Income:		
Interest income	$	6,850
Interest expense		725
Net Interest Income		6,125
Other Income (Loss):		
Realized gain on sale of Residential mortgage-backed securities and other securities, net		1,120
Other loss on Residential mortgage-backed securities		(605)
Unrealized gain on Residential mortgage-backed securities and other securities, net		3,925
Loss on derivative instruments (includes ($5,408) mark-to-market adjustments on derivative instruments), net		(5,313)
Other Income (Loss), net		(873)
Operating Expenses:		
General and administrative (includes $54 non-cash stock based compensation)		584
Management fee related party		407
Total Operating Expenses		991
Net income available to Common Stock and participating securities	$	4,261
Earnings per Common Share Basic and Diluted	$	0.41
Basic and diluted weighted average number of common shares outstanding		10,334,824
Dividends Declared per Share of Common Stock	$	-

See notes to unaudited financial statements.

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Western Asset Mortgage Capital Corporation

Statement of Changes in Stockholders Equity (Unaudited)

(in thousands except shares and share data)

	Common Stock								
	Shares		Par		Additional Paid-In Capital		Retained Earnings		Total
Balance at May 15, 2012 (commencement of operations)	100	$	-	$	1	$	-	$	1
Redemption of common stock	(100)		-		(1)		-		(1)
Proceeds from public offering of common stock	8,000,000		80		159,920		-		160,000
Offering costs	-		-		(1,200)		-		(1,200)
Proceeds from private placement of common stock	2,277,830		23		42,588		-		42,611
Warrants	-		-		2,946		-		2,946
Grants of restricted stock	66,114		-		-		-		-
Vesting of restricted stock	-		-		54		-		54
Net income	-		-		-		4,261		4,261
Dividends on common stock	-		-		-		-		-
Balance at June 30, 2012	10,343,944	$	103	$	204,308	$	4,261	$	208,672

See notes to unaudited financial statements.

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Western Asset Mortgage Capital Corporation

Statement of Cash Flows (Unaudited)

(in thousands)

		For the period from May 15, 2012 (commencement of operations) through June 30, 2012
Cash flows from operating activities:		
Net income	$	4,261
Adjustments to reconcile net income to net cash provided by operating activities:		
Premium amortization and (discount accretion), net		2,198
Restricted stock amortization expense		54
Unrealized (gain) loss on Residential mortgage-backed securities and other securities, net		(3,925)
Mark-to-market adjustments on derivative instruments		5,408
Other loss on Residential mortgage-backed securities		605
Realized (gain) loss on sale of Residential mortgage-backed securities and other securities, net		(1,120)
Changes in operating assets and liabilities:		
Increase in accrued interest receivable		(7,076)
Increase in other assets		(552)
Increase in accrued interest payable		1,000
Increase in accounts payable and accrued expenses		433
Increase in payable to related party		407
Net cash provided by operating activities		1,693
Cash flows from investing activities:		
Purchase of Residential mortgage-backed securities and other securities		(2,158,676)
Proceeds from sale of Residential mortgage-backed securities and other securities		237,390
Principal payments received on Residential mortgage-backed securities and other securities		8,015
Net cash used in investing activities		(1,913,271)
Cash flows from financing activities:		
Proceeds from issuance of common stock		160,000
Proceeds from private placements of units and common stock (concurrent with initial public offering)		45,557
Redemption of common stock		(1)
Proceeds from repurchase agreement borrowings		3,192,929
Repayments of repurchase agreement borrowings		(1,456,436)
Due from counterparties		(8,000)
Due to counterparties		4,309
Net cash provided by financing activities		1,938,358
Net increase in cash and cash equivalents		26,780
Cash and cash equivalents beginning of period		1
Cash and cash equivalents end of period	$	26,781
Supplemental disclosure of operating cash flow information:		
Interest paid	$	446
Supplemental disclosure of non-cash financing/investing activities:		
Offering costs to be settled with related party	$	1,200
Mortgage-backed securities sold, not settled	$	102,336
Mortgage-backed securities purchased, not settled	$	(106,019)

See notes to unaudited financial statements.

Western Asset Mortgage Capital Corporation

Notes to Financial Statements (Unaudited)

(in thousands- except share and per share data)

The following defines certain of the commonly used terms in these Notes to Financial Statements: Agency or Agencies refer to a federally chartered corporation, such as the Federal National Mortgage Association (Fannie Mae or FNMA) or the Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC), or an agency of the U.S. Government, such as the Government National Mortgage Association (Ginnie Mae or GNMA); references to RMBS refer to residential mortgage-backed securities, Agency RMBS refer to RMBS issued or guaranteed by the Agencies while non-Agency RMBS refer to RMBS that are not issued or guaranteed by the Agencies; references to ARMs refers to adjustable rate mortgages; and references to Agency Derivatives or Agency Interest-Only Strips refer to interest-only(IO) and inverse interest-only (IIO) securities issued as part of or collateralized with Agency RMBS.

Note 1 Organization

Western Asset Mortgage Capital Corporation (is referred to throughout this report as the Company) is a residential real estate finance company that invests in residential mortgage assets in the United States. The Company has selectively constructed a portfolio of assets that currently consists of Agency RMBS and that over time may be diversified to cover a broader range of other residential mortgage assets, including non-Agency RMBS, as well as asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS).

The Company was organized in the state of Delaware on June 3, 2009. The Company filed a Certificate of Dissolution in Delaware on May 5, 2010 and revoked such dissolution by filing a Certificate of Revocation of Dissolution on March 24, 2011. On March 24, 2011, Western Asset Management Company (WAM , or the Manager), an investment advisor registered with the Securities and Exchange Commission, made a $1,000 initial capital contribution to the Company. WAM is a wholly-owned subsidiary of Legg Mason, Inc and is the external manager of the Company. The Company intends to elect and qualify to be taxed as a real estate investment trust or REIT commencing with its taxable year ending December 31, 2012.

Through May 14, 2012, the Company complied with the reporting requirements for development stage enterprises. The Company incurred organizational, accounting and offering costs in connection with the Company s initial public offering (the IPO) of its common stock and concurrent private placements. In accordance with the Management Agreement (as defined herein in Note 8) between the Company and the Manager, the Company will reimburse the Manager for up to $1.2 million of offering and other related organization costs, which have been paid by the Manager, from the proceeds of the IPO and concurrent private placements on May 15, 2012. The Manager has agreed to pay for all costs in excess of $1.2 million. The Company ceased reporting as a development stage company on May 15, 2012.

Note 2 Summary of Significant Accounting Policies

Basis of Presentation

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary have been made to present fairly the Company s financial position, results of operations and cash flows. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted in accordance with Article 10 of Regulation S-X and the instructions to Form 10-Q. These financial statements should be read in conjunction with the Company s Registration Statement on Form S-11, as originally filed on and declared effective on May 9, 2012 with the Securities and Exchange Commission (SEC). The results of operations for the period ended June 30, 2012 are not necessarily indicative of the results to be expected for the full year or any other future period.

Western Asset Mortgage Capital Corporation

Notes to Financial Statements (Unaudited)

(in thousands- except share and per share data)

The Company currently operates as one business segment.

Cash and Cash Equivalents

The Company considers all highly-liquid short term investments with original maturities of 90 days or less when purchased to be cash equivalents. Cash and cash equivalents are exposed to concentrations of credit risk. The Company places its cash and cash equivalents with what it believes to be high credit quality institutions. At times such investments may be in excess of the Federal Deposit Insurance Corporation insurance limit.

Classification of mortgage-backed securities and valuations of financial instruments

Mortgage-backed and US Treasury securities - Fair value election

The Company has elected the fair value option for all of its RMBS and US Treasury securities at the date of purchase, which permits the Company to measure these securities at estimated fair value with the change in estimated fair value included as a component of earnings. In the Manager s view, this election more appropriately reflects the results of the Company s operations for a particular reporting period, as financial asset fair value changes are presented in a manner consistent with the presentation and timing of the fair value changes of economic hedging instruments.

Balance Sheet Presentation

The Company s mortgage-backed securities purchases and sales are recorded on the trade date, which results in an investment related payable (receivable) for RMBS purchased (sold) for which settlement has not taken place as of the balance sheet date. The Company s RMBS pledged as collateral against borrowings under repurchase agreements are included in residential mortgage-backed securities on the balance sheet, with the fair value of such securities pledged disclosed parenthetically.

Valuation of financial instruments

The Company discloses the estimated fair value of its financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below). In accordance with GAAP, the Company is required to provide enhanced disclosures regarding instruments in the Level III category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities. GAAP establishes a framework for measuring estimated fair value and expands financial statement disclosure requirements for fair value measurements. GAAP further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

Level I Quoted prices in active markets for identical assets or liabilities.

Level II Quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level III Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period), unobservable inputs may be used.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

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Western Asset Mortgage Capital Corporation

Notes to Financial Statements (Unaudited)

(in thousands- except share and per share data)

When available, the Company uses quoted market prices to determine the estimated fair value of an asset or liability. If quoted market prices are not available, the Company consults with independent pricing services or third party broker quotes, provided that there is no ongoing material event that affects the issuer of the securities being valued or the market thereof. If there is such an ongoing event, or if quoted market prices are not available, the Company will determine the estimated fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates. In the event pricing is based on broker quotes, the Company performs additional analysis on prices received based on broker quotes to validate the prices and adjustments are made as deemed necessary by management to capture current market information.

Valuation techniques for RMBS may be based on models that consider the estimated cash flows of each debt tranche of the issuer, establish a benchmark yield, and develop an estimated tranche-specific spread to the benchmark yield based on the unique attributes of the tranche including, but not limited to, assumptions related to prepayment speed, the frequency of defaults and, for non-Agency RMBS, severity of defaults, and attributes of the collateral underlying such securities. To the extent the inputs are observable and timely, the values would be categorized in Level II of the fair value hierarchy; otherwise they would be categorized as Level III.

The Company will determine the estimated fair value of derivative financial instruments and obtain quotations from a third party to facilitate the process of determining these fair values.

In May 2011, the Board issued amendments, which were adopted by the Company, to achieve common fair value measurement and disclosure requirements in GAAP and International Financial Reporting Standards. New disclosures, with a particular focus on Level III measurement were required. All transfers between Level I and Level II were required to be disclosed. Information about when the current use of a non-financial asset measured at fair value differs from its highest and best use is to be disclosed. The Company does not hold any Level III assets and therefore, this update has no significant effect on the Company s financial statements.

Fair value under GAAP represents an exit price in the normal course of business, not a forced liquidation price. If the Company were forced to sell assets in a short period to meet liquidity needs, the prices it receives could be substantially less than their recorded fair values. Furthermore, the analysis of whether it is more likely than not that the Company will be required to sell securities in an unrealized loss position prior to an expected recovery in value (if any), the amount of such expected required sales, and the projected identification of which securities would be sold is also subject to significant judgment, particularly in times of market illiquidity.

Any changes to the valuation methodology will be reviewed by the Company to ensure the changes are appropriate. As markets and products develop and the pricing for certain products becomes more transparent, the Company will continue to refine its valuation methodologies. The methods used by the Company may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Company anticipates that its valuation methods will be appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the estimated fair value of certain financial instruments could result in a different estimate of estimated fair value at the reporting date. The Company uses inputs that are current as of the measurement date, which may include periods of market dislocation, during which price transparency may be reduced.

Interest income recognition

Interest income on mortgage-backed securities is accrued based on the outstanding principal balance and their contractual terms. Premiums and discounts associated with Agency RMBS and, to the extent the Company invests in such assets, non-Agency RMBS rated AA and higher at the time of purchase, are amortized into interest income over the estimated life of such securities using the effective yield method. Adjustments to premium and discount amortization are made for actual prepayment activity. The Company estimates prepayments for its securities and as a result, if prepayments increase (or are expected to increase), the Company will accelerate the rate of amortization on premiums or discounts and make a retrospective adjustment to historical amortization. Alternatively, if prepayments decrease (or are expected to decrease) the Company will reduce the rate of amortization on the premiums or discounts and make a retrospective adjustment to historical amortization.

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Notes to Financial Statements (Unaudited)

(in thousands- except share and per share data)

To the extent the Company invests in non-Agency RMBS that are purchased at a discount to par value and/or are rated below AA at the time of purchase and Agency Interest-Only Strips that are not classified as a derivative, interest income will be recognized based on the effective yield method. The effective yield on these securities will be based on the projected cash flows from each security, which will be estimated based on the Company s observation of the then current information and events and will include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses. On at least a quarterly basis, the Company will review and, if appropriate, make adjustments to its cash flow projections based on input and analysis received from external sources, internal models, and its judgment about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. Actual maturities of the securities will be affected by the contractual lives of the associated mortgage collateral, periodic payments of principal, and prepayments of principal. Therefore, actual maturities of the securities will generally be shorter than stated contractual maturities.

Based on the projected cash flow of any non-Agency RMBS purchased at a discount to par value, the Company may designate a portion of such purchase discount as credit protection against future credit losses and, therefore, not accrete such amount into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

Earnings per share

GAAP requires use of the two-class method of computing earnings per share for all periods presented for each class of common stock and participating securities as if all earnings for the period had been distributed. Under the two-class method, during periods of net income, the net income is first reduced for dividends declared on all classes of securities to arrive at undistributed earnings. During periods of net losses, the net loss is reduced for dividends declared on participating securities only if the security has the right to participate in the earnings of the entity and an objectively determinable contractual obligation to share in net losses of the entity.

The remaining earnings are allocated to common stockholders and participating securities, to the extent that each security shares in earnings, as if all of the earnings for the period had been distributed. Each total is then divided by the applicable number of shares to arrive at basic earnings per share. For the diluted earnings, the denominator includes all outstanding common shares and all potential common shares assumed issued if they are dilutive. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of these potential common shares.

Due from counterparties/Due to counterparties

Due from counterparties represents cash posted with its counterparties as collateral for the Company s interest rate swaps and repurchase agreements. Due to counterparties represents cash posted with the Company by its counterparties as collateral under the Company s interest rate swaps and repurchase agreements. Due from counterparties and Due to counterparties is carried at cost, which approximates fair value.

Hedging instruments and hedging activities

Subject to maintaining its qualification as a REIT for U.S. federal income tax purposes, the Company utilizes derivative financial instruments, including interest rate swaps, U.S. treasuries and Agency Interest-Only Strips to hedge the interest rate risk associated with its portfolio and related borrowings. Derivatives will be used for hedging purposes rather than speculation. The Company will determine the estimated fair value of its derivative positions and obtain quotations from a third party to facilitate the process of determining these estimated fair values. If the Company s hedging activities do not achieve the desired results, reported earnings may be adversely affected.

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Notes to Financial Statements (Unaudited)

(in thousands- except share and per share data)

GAAP requires an entity to recognize all derivatives as either assets or liabilities and to measure those instruments at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives are classified as either hedges of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge) or hedges of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge). Fair value adjustments are recorded in earnings immediately, if the Company does not elect hedge accounting for a derivative instrument.

The Company elected not to apply hedge accounting for its derivative instruments and records the change in estimated fair value and net interest rate swap payments (including accrued amounts) related to interest rate swaps in earnings.

The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. For stock-based derivative financial instruments, the Company uses a variation of the adjusted Black-Scholes option valuation model to value the derivative instruments at inception. In addition, certain of the Company s Agency Interest-Only Strips may be considered derivatives for GAAP purposes.

Repurchase agreements

Mortgage-backed securities sold under repurchase agreements are treated as collateralized financing transactions, unless they meet sales treatment. Securities financed through a repurchase agreement remain on the Company s balance sheet as an asset and cash received from the lender is recorded in the Company s balance sheet as a liability. Interest paid in accordance with repurchase agreements is recorded as interest expense.

In instances where the Company acquires securities through repurchase agreements with the same counterparty from which the securities were purchased, the Company will account for the purchase commitment and repurchase agreement on a net basis and record a forward commitment to purchase securities as a derivative instrument if the transaction does not comply with the criteria for gross presentation. Such forward commitments will be recorded at fair value with subsequent changes in fair value recognized in income. Additionally, the Company will record the cash portion of its investment in securities as a mortgage-related receivable from the counterparty on its balance sheet. If the transaction complies with the criteria for gross presentation, the Company will record the assets and the related financing on a gross basis in its balance sheet and the corresponding interest income and interest expense in its statement of operations.

Share-based compensation

The Company accounts for share-based compensation to its independent directors, to its employees, to its Manager and to employees of its Manager and its affiliates using the fair value based methodology prescribed by GAAP. Compensation cost related to restricted common stock issued to the Company s independent directors and employees of the Company is measured at its estimated fair value at the grant date, and amortized into expense over the vesting period on a straight-line basis. Compensation costs related to restricted common stock issued to the Manager and to employees of the Manager and its affiliates will initially be measured at estimated fair value at the grant date, and amortized into expense over the vesting period on a straight-line basis and remeasured on subsequent dates to the extent the awards are unvested.

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Western Asset Mortgage Capital Corporation

Notes to Financial Statements (Unaudited)

(in thousands- except share and per share data)

Warrants

The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at its fair value and is then re-valued at each reporting date, with changes in the fair value reported in the statements of operations. Financial instruments without these features are recorded as a component of equity. For the Company s warrants, the Company uses a variation of the adjusted Black-Scholes option valuation model to record the financial instruments at their relative fair values at issuance. The warrants issued with the Company s common stock in the private placement to certain accredited institutional investors have been evaluated by the Company and have been recorded at their relative fair value as a component of equity.

Income taxes

The Company intends to elect and qualify to be taxed as a REIT commencing with its taxable year ending December 31, 2012. Accordingly, the Company will generally not be subject to corporate U.S. federal or state income tax to the extent that the Company makes qualifying distributions to stockholders, and provided that the Company satisfies, on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If the Company fails to qualify as a REIT, and does not qualify for certain statutory relief provisions, the Company will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which the Company lost its REIT qualification. Accordingly, the failure to qualify as a REIT could have a material adverse impact on the Company s results of operations and amounts available for distribution to stockholders.

The dividends paid deduction for qualifying dividends paid to stockholders is computed using the Company s taxable income as opposed to net income reported on the financial statements. Taxable income, generally, will differ from net income reported on the financial statements because the determination of taxable income is based on tax provisions and not GAAP.

The Company may create and elect to treat certain subsidiaries as Taxable REIT Subsidiaries (TRS). In general, a TRS may hold assets and engage in activities that the Company cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes and its value may not exceed 25% of the value of the Company. As of June 30, 2012, the Company does not have a TRS.

While a TRS will generate net income, a TRS can declare dividends to the Company, which will be included in the Company s taxable income and necessitate a distribution to the Company s stockholders. Conversely, if the earnings are retained at a TRS level, no distribution is required, thereby increasing the book equity of the Company.

The Company evaluates uncertain tax positions, if any, and classifies interest and penalties, if any, related to unrecognized tax benefits as a component of provision for income taxes.

Offering costs

Offering costs incurred by the Company in connection with the IPO and concurrent private placements are reflected as a reduction of additional paid-in-capital.

Accounting standards applicable to emerging growth companies

The JOBS Act contains provisions that relax certain requirements for emerging growth companies , which includes us. For as long as the Company is an emerging growth company, which may be up to five full fiscal years, unlike other public companies, the Company will not be required to: (i) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies under Section 102(b)(1) of the JOBS Act; (ii) provide an auditor s attestation report on management s assessment of the effectiveness of the Company s system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act; (iii) comply with any new requirements adopted by the PCAOB requiring mandatory audit firm rotation or a supplement to the auditor s report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer; or (iv) comply with any new audit rules adopted by the PCAOB after April 5, 2012, unless the SEC determines otherwise.

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Western Asset Mortgage Capital Corporation

Notes to Financial Statements (Unaudited)

(in thousands- except share and per share data)

As noted above, under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards that have different effective dates for public and private companies until such time as those standards apply to private companies. The Company intends to take advantage of such extended transition period. Since the Company will not be required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, its financial statements may not be comparable to the financial statements of companies that comply with public company effective dates. If the Company were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

Recent accounting pronouncements

Accounting Standards to be Adopted in Future Periods

In May 2011, the FASB issued guidance that clarifies its intent regarding the application of existing fair value measurement requirements including: 1) prohibiting the inclusion of block discounts in all fair value measurements, not just Level I measurements; 2) adding guidance on when to include other premiums and discounts in fair value measurements; 3) clarifying that the concepts of highest and best use and valuation premise apply only when measuring the fair value of non-financial assets and 4) adding an exception that allows the measurement of a group of financial assets and liabilities with offsetting risks (e.g., a portfolio of derivative contracts) at their net exposure to a particular risk if certain criteria are met. For non-public entities, this guidance is effective for fiscal years beginning after December 15, 2011. The Company does not hold any Level III assets and therefore, this update will have no significant effect on the Company s financial statements.