President's Letter

This is my fourteenth and last "President's Letter," as I plan to leave Dynex as an employee and its president on June 30th. Hopefully, my departure will provide Dynex with greater flexibility to continue forward in its recovery. From my perspective, there are three parts to the recovery -- restoring the Company to a sound financial footing, returning the Company to profitability, and restoring meaningful shareholder value. As explained below, the Company has made progress on all three fronts, but there is still much more to be achieved.

Sound Financial Footing

It has been a long tunnel since the fall of 1998. Some specialty finance companies recovered earlier; others declared bankruptcy and were liquidated, with shareholders getting wiped out. In our case, I believe the end of the tunnel is close at hand -- and there is light not darkness. The Company's remaining "recourse debt," which is currently $47 million, should be paid as agreed, assuming the successful call and resecuritization of certain of our securities, by its due date on July 15th -- just three months away. Since the fall of 1998, we will have repaid over $1 billion in recourse debt. By recourse debt, I mean obligations of the parent company (Dynex Capital, Inc.), and not the "non-recourse" debt of our securitization subsidiaries that we consolidate in our financial statements. The non-recourse debt is now approximately $2.2 billion, and is payable solely from the assets pledged as collateral for such debt.

Assuming the remaining recourse debt is paid as agreed by mid-year, the Company should have a substantial equity base (it was $173 million as of year-end 2001), a reasonable monthly cash flow and be free of any restrictions on its business and investment strategies going forward. Thus, I believe the first step in the recovery process -- a sound financial footing -- is close at hand.

Returning to Profitability

There are several ways of measuring profitability. For Dynex, two measures need to be focused upon. The first measure is the traditional net income (or loss) as reported on the "consolidated statement of operations." Last year, the Company basically broke even under this measure. Although that was a substantial improvement over the prior two years, "break-even" results are not very compelling.

The second measure is known as comprehensive income (or loss) as reported on the "consolidated statements of shareholders' equity." On that basis, Dynex reported $37.6 million of total comprehensive income in 2001. That result is obviously more compelling, representing a 24% return on beginning shareholders' equity.

Why the significant difference in these two measures? For 2001, the difference is primarily the result of the decline in the "unrealized loss on available-for-sale investments," a component of the total comprehensive income referenced above. The unrealized loss item reflects the difference in the current market value of certain of our assets versus our cost basis in those assets, a process known as "mark-to-market." At the beginning of 2001, the unrealized loss was $125 million; it ended the year at $84 million, or a favorable decline of $41 million. The largest portion of the unrealized loss is related to the valuation of the Company's securitized manufactured housing loan portfolio, which, due to a high level of projected credit losses, has a substantially lower market value than cost basis. A smaller, but still significant, component of the unrealized loss relates to mark-to-market on our commercial loan portfolio, as those loans carry large premiums incurred with their origination in 1997 and 1998. Approximately $36 million of unrealized losses related to these two factors were realized in the statement of operations last year and reduced net income by a like amount. The unrealized loss was also favorably reduced in 2001 by an improved mark-to-market valuation on our single family loan portfolio. This improvement was largely due to the decline in the level of short-term interest rates from the beginning of the year to the end of the year.

The level of profitability going forward is also going to be influenced by the income or return the Company achieves by reinvesting its cash flow. The Company has had substantial cash flow over the past several years, but that cash flow has been dedicated primarily to the repayment of recourse debt; thus, the Company did little in the way of reinvestment. Once the remaining recourse debt is paid off, the Company will still have (i) a reasonable level of unrestricted cash flow each month for reinvestment, (ii) shareholders' equity comparable to the $173 million as of December 31, 2001, and (iii) a tax loss carry-forward of over $180 million, $125 million of which is net operating losses which will not begin to expire until 2013. In the context of this outlook, the Board has recently reviewed various alternatives for the Company to reinvest its cash flow as a financial services business on a going-forward basis. Based on this review, the Company has taken the first step in exploring the formation or acquisition of a depository institution by engaging an advisor that specializes in that area.

In comparison to the other alternatives we reviewed, the depository institution appears to have the best risk-versus-return profile. In particular, the depository institution would reduce liquidity risk, as new assets would primarily be funded through the depository institution. We view the depository institution structure as the optimal vehicle for aggregating high-quality loans and securities in the future. Further, given the tax loss carry-forwards, the income of the depository institution would be sheltered from taxes for an extended period of time.

In terms of profitability, FDIC-insured institutions have recently earned on average a pre-tax return-on-equity of nearly 20%. While we would not expect a Dynex-owned depository institution to earn such returns immediately, it is indicative of the level of returns that can be earned in the future on the funds that Dynex would have available to reinvest.

Over the next several years, I would expect net income to continue to be about break-even, as losses on the manufactured housing loan portfolio and the amortization of the premium on the commercial loan portfolio will likely offset income from other areas, including income from the reinvestment of funds. However, I would expect that we would have positive comprehensive income over the next several years, as the unrealized losses on the manufactured housing loans and the premium on the commercial loan portfolio are largely realized.

Improving Shareholder Value

We made substantial progress last year in returning the Company to a sound financial footing and restoring profitability. That progress, coupled with certain actions we implemented, did have a considerable positive impact on shareholder value in 2001. The market price of each of the Company's equity securities more than *doubled* last year. Granted, the value of the Company's equity securities was depressed at the beginning of 2001. But progress is progress.

We did take specific actions last year to improve shareholder value. First, we negotiated in March 2001 an amendment to the indenture that sets forth the terms of the senior notes that are due this July. That amendment allowed for distributions to shareholders of up to $26 million while those notes were still outstanding. Based on that amendment, the Company made two tender offers during 2001 on its preferred stock, providing liquidity to those preferred shareholders desiring to sell their shares. These tender offers, which totaled $20 million in actual purchases, contributed to the improvement in the market prices of both the Company's preferred and common shares, and improved the book value per common share. Further, as a result of these two tender offers and the strong level of comprehensive income, the book value per common share increased last year from $0.37 per share to $4.71 per share.

The keys to improving shareholder value going forward are several: (i) maintaining a sound financial footing; (ii) improving profitability; (iii) increasing shareholders' equity both in the aggregate and on a per share basis; (iv) reversing the market value discount into a market value premium; and (v) patience. Let me explain from my perspective why the depository institution strategy, if implemented, is consistent with these five keys to improving shareholder value.

First, as future investments (*i.e.*, loans and/or securities) would be owned by the depository institution (which has access to deposits insured by the FDIC and to borrowings from the Federal Home Loan Bank System), there would be reduced liquidity risk to the Company in the future, a risk that has historically caused considerable losses to specialty finance companies including Dynex. Further, regulatory guidelines would likely require an investment strategy that would be of lower risk than the Company's historic investment strategies. Thus, a depository institution is likely to keep the Company on a sound financial footing going forward.

Second, the average FDIC-insured institution has recently had a pre-tax return on equity of nearly 20%. Assuming such a return, coupled with Dynex's tax loss carry-forwards, Dynex would achieve a favorable level of profitability on its reinvestment of funds for an extended period of time - most likely stretching over the next ten years.

Third, the profitability (or income) that the depository institution is expected to generate is consistent with increasing shareholders' equity both in the aggregate and on a per share basis. Shareholders' equity should increase in the future as a result of both the absorption of the unrealized losses, income from the existing portfolio, and income from the reinvestment of funds.

Fourth, depository institutions that are publicly owned generally trade at a market value premium versus a discount. For institutions with assets over $1 billion, the average premium to book value exceeds 50% for thrifts and 125% for banks. Dynex's stock is currently trading at an average discount of 34% to book value. If Dynex were to trade at premiums similar to thrifts and banks instead of its current discount, it would result in a doubling or a tripling in Dynex's stock price.

Fifth, and finally, Dynex is not going to achieve all these items overnight. The decision, approval, and implementation process for a depository institution could easily be 12 to 18 months. It may then take several more years for the profitability of the depository institution to have a material impact on Dynex's overall results.

The market seemed to concur with our thinking about the depository institution direction for Dynex. On the day the Company announced that it had engaged an adviser to assist the Company in that regard, the market responded favorably with the value of each of the equity securities increasing in the range of 5% to 8%. These higher valuations have since been maintained.

Although the Company is actively evaluating the feasibility of the depository institution, no decision has yet been made, and before Dynex could form or acquire a depository institution, it would need to receive regulatory approvals. Thus, it is possible that Dynex will choose a direction different from forming or acquiring a depository institution.

Certain holders of the Company's preferred stock have requested that the first action the Company takes once the recourse debt is paid off and funds are available is to bring current the dividend on the preferred stock. Let me share my perspective on that issue, and I appreciate that it is not shared by everyone. My perspective is that dividends are paid out of retained earnings; if there are no retained earnings, the dividend is not a dividend but a "return of capital." A return of capital is made when a company is in liquidation – and Dynex is not in liquidation. In fact, there was a shareholder proposal to that effect a year ago; shareholders voting on that issue rejected it by a margin of more than 5 to 1.

However, I would expect the Company going forward to continue to weigh the benefits and tradeoffs among (i) bringing current the dividend or resuming regular dividends on the preferred stock, (ii) future tender offers for the preferred stock, and (iii) reinvestment of funds in a depository institution or other avenue pursued by the Company. The goal will be the continued improvement in overall shareholder value.

Current Operations

Over the past three years, we have shrunk our operations from approximately 350 employees to approximately 73. Of these 73, approximately 60 are dedicated to servicing and collecting on $138 million of delinquent property tax receivables located primarily in Pennsylvania and Ohio. While we will keep our focus on collecting our remaining investment of approximately $60 million in these receivables, we will also be offering our collection capabilities to taxing jurisdictions in Pennsylvania and Ohio. Hopefully, this will allow us to grow our servicing capabilities, allow for greater efficiencies, and generate fee income going forward. This effort is consistent with our goal of improving profitability.

The remaining employees (including those in the corporate accounting and administration areas) are focused on the management of all the Company's other assets, nearly all of which are collateral for various securitizations. At December 31, 2001, these assets consisted of approximately $850 million of manufactured housing loans, $800 million of commercial mortgage loans, and $750 million of single-family loans. These employees monitor the performance of the primary servicers, advise or direct on the resolution of delinquent or defaulted loans, and manage the calls and reissuance of the related non-recourse debt securities. The Company anticipates the call and reissuance of approximately $600 million of its single-family loans this quarter.

As referenced above, we are experiencing a high level of credit losses on the manufactured housing loan portfolio. These losses are primarily related to the depressed market for repossessed manufactured homes, compounded by the exit from that market of several large lenders. We will continue to try to minimize these losses; however, shareholders' equity already reflects that these credit losses remain high. The remaining exposure of shareholders' equity to the performance of the manufactured housing loan portfolio is quite low.

A Reflection

It took considerable determination and dedication by many individuals at Dynex over the past three years to get Dynex back to where the results and trends are positive. The impact of the downgrading of our senior debt to "CCC" in September 1999, followed by our auditors stating in their opinion on our 1999 financial statements issued in April 2000 that there was "substantial doubt about our ability to continue as a going concern," was nearly self-fulfilling. It took a positive attitude, a plan, and admittedly some good fortune, to get Dynex back to where it is today.

I see it will take the same three ingredients going forward -- a positive attitude, a plan, and some good fortune. Given where we have been over the past three years, the attitude cannot be more positive. As set forth above, we have in motion a good plan. As to the good fortune, I am a believer that that is homemade.

In closing, I am also pleased that Steve Benedetti has agreed to extend his employment arrangement with Dynex through June 2004. Steve is currently our executive vice president and chief financial officer. He joined Dynex in 1994, and is knowledgeable of all aspects of the Company. He is fully capable of managing the Company until the Board selects my replacement. The process and timing of a replacement is dependent on the Board completing its evaluation of the feasibility of Dynex forming or acquiring a depository institution, or other alternatives for Dynex going forward. This will determine the particular skills and background for your next president.

Sincerely,

Thomas H. Potts
President

April 8, 2002

Certain statements in the above letter are not historical fact, but constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Please refer to the "Forward Looking Statements" section on page 26 in the accompanying Form 10-K.