# FINAL TRANSCRIPT

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## CSE - Q1 2005 CapitalSource Inc Earnings Conference Call

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## CORPORATE PARTICIPANTS

**Tony Skarupa**
*CapitalSource Inc - Director of Finance*

**John Delaney**
*CapitalSource Inc - Chairman, CEO*

**Jason Fish**
*CapitalSource Inc - President, Director*

**Tom Fink**
*CapitalSource Inc - CFO*

## CONFERENCE CALL PARTICIPANTS

**Don Destino**
*JMP Securities - Analyst*

**Josh Steiner**
*Lehman Brothers - Analyst*

**Bob Napoli**
*Piper Jaffray - Analyst*

**Joel Houck**
*Wachovia - Analyst*

**Moshe Orenbuch**
*Credit Suisse First Boston - Analyst*

**Tom Purcell**
*Viking Global - Analyst*

**Michael Cohen**
*- Analyst*

## PRESENTATION

**Operator**

Good day ladies and gentlemen. Welcome to the first quarter 2005 CapitalSource earnings conference call. [OPERATOR INSTRUCTIONS] I would now like to turn the presentation over to your host for today's call Mr. Tony Skarupa, Finance Director. Please proceed, sir.

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**Tony Skarupa** - *CapitalSource Inc - Director of Finance*

Thank you, and good afternoon. Joining us today are John Delaney, Chairman and Chief Executive Officer of CapitalSource, Jason Fish, our President, and Tom Fink our Chief Financial Officer. Before I turn the call over to John, I want to inform you that this call is being Webcast simultaneously on the Investor Relations section of our website at www.CapitalSource.com. Furthermore a recording of the call will be available on the website beginning at approximately 7:30 p.m. eastern time and our press release and website provide details on accessing the archived call.

Also before we begin, I need to inform you that statements in this earnings call which are not historical facts may be deemed forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All forward-looking statements, including statements regarding future financial and operating results involve risks, uncertainties, and contingencies many of which are beyond CapitalSource's control and which may cause actual results to differ materially from anticipated

results. More detailed information about these risk factors can be found in our annual report as filed with the Securities and Exchange Commission on form 10-K. CapitalSource is under no obligation to and we expressly disclaim any such obligation to update or alter our forward-looking statements whether as a result of new information, future events, or otherwise. Now, I would like to turn the call over to CapitalSource's Chairman and Chief Executive Officer, John Delaney.

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

Thanks, Tony. I will start with the highlights. We earned $0.33 per share for the quarter. And we grew our loan portfolio by $443 million. Which is our net portfolio growth. The asset growth for the quarter was particularly strong in our health care and specialty financial business. Our health care and specialty finance business which was formally our health care finance business now has a broader mandate and includes five businesses. Three of those businesses are health care business, our health care real estate business, our health care working capital business, our FHA/HUD fee related business and then two nonhealth care businesses our business credit services group and our security alarm finance business.

And the four lending groups that really exist within this broader health care and specialty finance business all experienced very strong growth in the quarter and really drove a significant amount of the growth in the quarter. Our structured finance business had growth that was essentially on our plan. And our corporate finance business continues to face a strong what I will call head wind of competition which is something we have been predicting for some time and this competition is coming from a range of sources, banks, hedge funds, specialty finance companies. As we have discussed with you in the past, we expect the business to continue to migrate to more of an asset-based platform. As our businesses that originate, the more structured specialty asset-based products are experiencing strong growth, and our corporate finance business and more specifically the cash flow lending activity within the corporate finance business, because some of the corporate finance business is asset-based as well, remains disciplined in this more competitive environment.

And this migration is really by design in that we have emphasized the specialty asset-based businesses that are less competitive right now and therefore present better opportunities. And the success of these businesses to our minds reinforces the decisions we made starting in 2004, to invest in these businesses and build these teams, so that our business would be balanced and be in a position to grow in all market conditions. Yields remain strong, despite the slight decrease in fee income that you will notice which is due to the lumpiness and the prepayment fees that we've spoken about in the past and also due to the deferral of income from certain residential mezzanine financings that are now accounted for as joint ventures that caused the earnings on a portion of our portfolio to be deferred. And we spoke about this at some length last quarter.

And the lumpiness we frequently talk about across many aspects of our platforms also emerged on the credit side this quarter. Not with respect to charge-offs, which were practically zero, but we did have a few new loans enter the specific reserve bucket causing our specific reserves to be 8.7 million for the quarter. Our allowance for loan losses now stands at 96 basis points of which 29 basis points is in specific reserves. The general reserve component of our allowance was 66 basis points which actually decreased from 70 basis points last quarter. As most of you know, our general reserves are tied to the mix of business, since the businesses I discussed is now migrating or we're steering it more towards asset-based, the general reserve will decrease as a percentage of the portfolio reflecting this change in the portfolio mix, reflecting the fact that the portfolio is moving towards a more secured asset based orientation.

We also had an uptick this quarter in the percentage of loans that fall into other credit quality ratio buckets, including impaired loans, which we will -- which we will disclose in our Q. Part of this is a result of new loans that are subject to new specific reserves, but the rest is simply loans that we believe do not merit a specific reserve, but fall into these various categories, including loans that accounting rules require us to disclose as definitionally impaired, even if we don't think that we have a risk of loss or a risk of economic loss.

It is our judgment that loans not subject to specific reserves, even if they fall into other categories, such as delinquent or impaired, are fully collectible. A good example of this is some of our asset based loans that may go delinquent or go on nonaccrual status

but that we believe have more than adequate asset coverage and are fully collectible. As we've discussed in the past, we expect all these ratios to both move around from quarter to quarter, and to grow in fact as the portfolio continues to mature. So this is not a surprise to us.

Finally, we continue to make progress on our funding plans. Tom will touch on this further in a few minutes, but we achieved two significant milestones this year. First, we priced and closed another term debt securitization, we had a press release out about this, which was in every respect our best to date, and continues the terrific progress Tom and his team have made in this area. And second, we received an investment grade rating of BBB minus from Fitch this quarter. This rating will open up new opportunities for us on the unsecured side. We are very pleased with this development, which we clearly view as an endorsement of our credit culture and our process and I can assure you that Fitch spent a tremendous amount of time in these offices really understanding how we do our business. And again, Tom will touch on that in more detail in a few minutes.

Despite the fact that we continue to see strong organic growth, we still continue to pursue new initiatives to broaden this platform. Some of these include building two discrete distress teams within the business, which are just starting to get traction, and we think will create good opportunities for us in the future, and looking at some new fee businesses to leverage our platform. You should expect to hear more from us in the coming quarters on some of these activities.

In sum, we feel very good about the progress of the business this quarter. We feel very good about the business as we move into the second quarter. And we feel very good about our ability to deliver in a manner and fashion that we have discussed for the business in the past. So with, that I will first turn it over to Jason who will drill down a little deeper into some of the financial metrics of the business. And then Tom will finish up. Jason?

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**Jason Fish** - *CapitalSource Inc - President, Director*

Thank you, John. I'm going to try to provide some more insight on some of the drivers of the performance for this quarter compared to the last quarter. On growth, overall growth was very strong on the quarter. The portfolio balance as of March 31, of 4.7 billion is up 443 million from our portfolio balance at the end of 2004. But in addition to the period end comparisons let me point you to the growth in the average balance over the quarter which was even stronger. The average balance for the first quarter of 2005 was $637 million, larger than the average balance, during the fourth quarter of 2004. This favorable ramp rate was caused by originations occurring earlier in this quarter than they did in the fourth quarter of 2004.

Our net interest margin for the quarter was ahead of our expectations at 8.52%. While down marginally compared to last quarter, directionally, this was expected due to anticipated declines in yields on new originations and increased leverage. While leverage at quarter end was effectively the same as in the fourth quarter, the average leverage for the quarter was higher with average borrowings of $3.7 billion for the quarter, versus $3.2 billion last quarter. I would also like to point out that increases in short-term rates which affected both yields and cost of funds helped us this quarter. As rising rates should do.

However, on the yield side and in particular on the interest income component that effect was somewhat muted by two factors. Lower prepayment rates or prepayment fees of 41 basis points this quarter versus 62 basis points last quarter, and the effect that John mentioned of deferring income on certain mezzanine mortgage financings that we now treat as joint ventures for GAAP purposes. The negative impact of this accounting change was approximately 13 basis points for the quarter. As expected, we also saw some continued downward movement in yields on incremental loans. This -- that is loans made this quarter relative to yields on the existing portfolio. This is as expected due to the more competitive lending environment and we expect yields to continue to decline going forward. But since we are a consumer of capital as well as a provider spread compression on the lending side can be offset by improvements in our borrowing spread.

Our cost of funds for the quarter increased by 25 basis points while one month LIBOR which is the proxy we use for short-term rates was up 48 basis points. This means our average borrowing spread decreased during the quarter by 23 basis points to 107 basis points versus 130 basis points over LIBOR last quarter. Which we are very pleased with. Tom will expand upon this later

and the reasons for that. In all, net interest margin was very solid for the quarter, and was better than our expectation when we gave guidance for 2005. I would also reinforce the point that rising short-term rates are favorable for the Company. We expect short-term rates to continue to rise based on the forward LIBOR curve, and we have modeled that into our forecast, and plans for the business.

Let me make a few other quick points and then turn the meeting over to Tom. First, on operating expenses, our operating expenses decreased this quarter to 2.6%, as a percentage of assets from 2.8% in the fourth quarter. This was slightly better than we expected. While we continue to add head count, and appropriately invest in the business, we are continuing to realize operating leverage in the business on a quarter to quarter basis. Which we did anticipate and which we have given guidance to in the past. We will see some fluctuations in operating expenses due to our varying -- variable bonus model and timing of certain expenses but generally expect to see continuing improvement in this metric over the course of the year.

In terms of other income, our other income was $4.3 million this quarter compared to 6.5 million in the fourth quarter. We saw a pickup of dead deal fees this quarter and had about $2 million in gains on our equity investments. Both of these numbers are in line with our expectations. The main reason for the decrease quarter over quarter is due to the timing of the activity in our HUD mortgage processing business. This fee-based business continues to see strong deal flow and should continue to grow in 2005. However, its revenues -- its revenues are recognized when deals close, which can fluctuate from period to period, and we had few first quarter closings in this area. More importantly, we view other income in total as a recurring revenue stream that is directly linked to our portfolio. And while uneven quarter to quarter should continue to grow, as the portfolio grows. And we remain comfortable with our guidance of approximately $20 million in other income for the Company for the year.

Finally, on the balance sheet, let me point out the decrease in cash and restricted cash. As we explained last quarter, we had an unusual blip in cash and restricted cash right at the end of the year. That came from delayed loan closings which we had taken down cash for, some large loan repayments at the end of the year, and other large collections. This was a moment in time phenomena and it worked itself out quickly in the new year. What you see at the end of the first quarter is a more normal cash and restricted cash position and one you can expect in the future. Other assets was down $15.8 million reflecting the sale of the REO asset we discussed on the fourth quarter earnings call last quarter and other liabilities was down by approximately $14 million reflecting the payment of 2004 bonuses in February, and other decreases in accounts payable offset by an increase in income tax payable. With that, let me turn the mic over to Tom Fink to discuss progress in our financing plan.

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**Tom Fink** - *CapitalSource Inc - CFO*

Thank you, Jason. We continue to make progress on the funding side of our business. I'm very pleased with both where we are today and also the potential I see for us in the future. We continue to make improvements to our borrowing spread. We made some this quarter as a function of reducing some of the margins on our credit facility and as Jason mentioned we saw our improvement in our borrowing spread of about 23 basis points this quarter. And these improvements have been helping offset the cost of rising short-term rates on interest expense.

Our funding plans for this year center really around two basic objectives. First, is to continue our secured funding program, that is to say to continue the successes we've had in our secured funding program, and second, to continue diversifying our funding sources. We've made significant progress on both those fronts already this year. With respect to our securitization program, in April, we closed and completed our seventh term securitization. This was just an absolute success for CapitalSource, as our largest transaction with our largest and most diverse pool of loans. It's also allowed us to structure and sell notes secured by that pool equal to just over 91% of the pool which was our highest advance rate to date, and we saw terrific execution on the notes structured against those loan assets.

As a result of this transaction, we raised $1.1 billion of debt at a weighted average LIBOR spread of 32 basis points. That is the same weighted average spread as our last deal which we completed about six months ago in October. But with an advanced rate on this deal that was higher than on our last transaction. So on an apples-to-apples basis our execution was about 6 basis

points better on this transaction than the last. And this was ahead of our expectations and I said -- as I said, we were very, very pleased with it.

The second point and really this is a very significant milestone for CapitalSource, was our receiving this month an investment grade rating from Fitch. Specifically Fitch has rated our senior unsecured debt BBB minus and the rating outlook is described as stable. In particular this rating applies to our existing convertible bonds. We are truly very pleased with this development as it opens up the possibility of doing more corporate unsecured funding to us on an economically attractive basis. Having access to another deep market like the corporate debt market secures for us another means of financing the business that will complement the already deep access we have to the secure markets. To be clear some forms of unsecured debt will be more expensive for us than the secured debt and this may offset in the future some of the improvements we hope to keep eking out in our cost of funding but we think pursuing a diversified funding strategy is absolutely the right direction for us to take at the Company.

I think the take away here for investors is that in addition to the success that our term securitization has brought to us in terms of helping increase the efficiencies in our borrowing spreads and the investment grade rating increasing and diversifying our funding sources both of these events are really the result of a lot of hard work and a very intensive process with the rating agencies. With the investment grade rating from Fitch we first started working with them about a year ago and held several meetings with them over the course of the last several months. In addition to all of our public information, we spent significant time reviewing with them our internal processes, our plans, and other information, and in its release, announcing the rating, Fitch made note of "the Company's highly structured credit approval and monitoring processes." As well as our solid capitalization both on an absolute and a risk adjusted basis.

Also on our term securitizations, I think there is a similar take away. The term securitizations are a very intensive process for the rating agencies as well. These deals really start with each of the three rating agencies, Fitch, Moody's, and S&P, performing shadow credit assessments or developing a credit estimate on every loan that goes into those pools. So in addition to our own underwriting and loan monitoring there is another filter that our loan collateral go through in those deals. On the last two transactions we were able to structure investment grade debt, that is debt rated BBB and better, at approximately 90% advance rate against the collateral pool. To some extent I think that is a a proxy that can be applied to our entire portfolio.

The agencies also do surveillance on the term debt securitizations as well as the underlying loan collateral pools on an ongoing basis and earlier this month we also put out a press release pointing to the recent rating agency upgrades and affirmations of some of our earlier transactions that we have received from Fitch and S&P. These releases typically cite the performance of the transaction as well as the state of the underlying collateral pool. So I think clearly there is a lot for us to be proud of here. With, that I will turn the call back to John for any comments or questions.

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

No more comments. I think we'll just open it up to questions.

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## QUESTIONS AND ANSWERS

**Operator**

[OPERATOR INSTRUCTIONS] And your first question comes from the line of Don Destino of JMP Securities. Please go ahead sir.

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**Don Destino** - *JMP Securities - Analyst*

Hi, guys. Considering that at least in the short term corporate finance is going to be a smaller portion of originations, can you talk a little bit about the spreads on the other two major lines of business, the leverage ability of those, or just basically get to the differences and returns on capital between the three businesses?

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

Sure. The business with the highest returns on capital is our health care specialty finance business. And they have -- that business has very high yields. It tends to have high operating expenses but it has had a very good credit performance so that business, I think has consistently been our highest return on capital, probably for the last two years. And so -- and that's the business that's growing right now. So I don't think these changes in mix of business will have any negative effect on spreads in the business.

It doesn't actually change the leverage ability of the business, either. I mean in our current funding structure, we don't actually receive higher leverage on the asset based business than we do on the corporate finance business, even though some would think you should, because of the underlying profile of the asset-based business being a more secure business, but the nature of asset based lending revolvers things like that make them a little more complicated to finance so that tends to take away some of the efficiency. So the health care specialty finance business has the highest returns on capital. The corporate finance business has historically probably had the second highest compared to the structured finance business. So I don't think any of this change of mix of business will have any effect on the kind of returns on the business, certainly that we're projecting. If that was kind of where you were going.

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**Don Destino** - *JMP Securities - Analyst*

That's exactly where I was going. And then the other quick one is are you actively pursuing Moody's and S&P for an investment-grade unsecured rating? Or are you going to let that go for a while and let them kind of get up to speed?

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**Tom Fink** - *CapitalSource Inc - CFO*

Don, I mean we obviously know them and have had conversations with them. There is really nothing for us to report here to you in terms of any timing we expect. But I would simply say I certainly expect to see a rating from either or both of those agencies at some point in our future, but I don't really have an update on timing for you.

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**Don Destino** - *JMP Securities - Analyst*

Got it. Thank you very much.

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**Operator**

And your next question comes from the line of Josh Steiner of Lehman Brothers. Please go ahead, sir.

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**Josh Steiner** - *Lehman Brothers - Analyst*

Hi, guys. Congratulations on a good quarter.

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

Thanks, Josh.

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**Josh Steiner** - *Lehman Brothers - Analyst*

Two quick questions. One, there's been a fair amount of talk on Capitol Hill about cuts to Medicaid, and things like Congress looking into hospital billing practices, and so forth. Just wondering if you can give us a sense of where you guys stand there, and what kind of safeguards you have in place in your health care practice to guard you against changes there? And then secondly, I had read somewhere that you guys were a bidder on the Allied B piece which is a good bit larger I think than anything you guys had acquired in the past, and I was just wondering if you could talk a little about your philosophy on acquisitions going forward, just curious there if your strategy in this regard has changed at all?

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

Sure, Josh. Let me deal with your first part of your question, which is the health care part first. You mentioned the rumblings on Capitol Hill regarding Medicaid and where that comes from is the federal government really provides matching for the states. The states run the Medicaid program, it is designed to fund the poor and certain disabled members of the population, and the federal government provides matching. So that's why the federal government cares about what states spend on Medicaid and the government has alleged several things, number one, -- not alleged but they've questioned several things number one are they using the money as efficiently as they should are they managing the Medicaid program as efficiently as they should and secondly are they allowing people to qualify for Medicaid that really shouldn't qualify for Medicaid. There has been a practice particularly in the long term care industry where people kind of spend down their savings by potentially moving it to other family members et cetera so that they qualify at a poverty level that allows them to go into a nursing home and get taken care of for the rest of their life by Medicaid and the government, obviously, and the states and the federal government wants people who get Medicaid benefits to truly be eligible Medicaid beneficiaries.

So they're definitely looking into it and we think it will result in a lot of scrutiny and we follow it pretty closely because we do finance the nursing home industry and it's a big business for us and we've been financing that business, the team here has been financing it for 10 years through a lot of changes on the reimbursement side both in the Balanced Budget Act of 1997 which had a very dramatic change to the Medicare payment system for nursing homes and now some of these rumblings on the Medicaid side. We do follow it. We're not concerned about anything in particular because there is nothing really happening right now. The nice thing about the Medicaid, financing Medicaid nursing homes is that they generally tend to be very low margin businesses. In some states in this country, for $70 a day they give you a bed and three meals, and a basic level of medical care.

So there is not a lot of cuts that can go to these -- to that part of the budget, and so I think there has been really a lot of questions about the number of beneficiaries who are actually receiving the benefits or following that and on the Medicare side, too, and on hospitals. We have within our capital analytics business a dedicated reimbursement team that is constantly following all the changes that are proposed whether they be Medicare changes or Medicaid change, as it affects the target markets that we have in that business, with the long-term care being the largest sub industry of health care that we finance. But we also have exposure to hospitals, to home health care providers, to hospices, and things like that, and so we're really focusing on three things, we're focusing on any Medicaid changes which is a state by state analysis, any Medicare changes which affects all providers and clinical changes, or kind of clinical crack downs that may occur. And so we try to stay ahead of these things. It is hard to kind of answer it anecdotally about it, unless you're talking about anything in particular but that is our normal practice.

As it relates to your second question, we don't -- we won't comment on anything we've looked at, particularly as it relates to another publicly-traded company. And I wouldn't read anything into that one way or the other. It is just not appropriate for us to comment yes or no. In terms of our acquisition strategy, it remains very focused on businesses that we think tuck into our

core competency. We define our core competency here as a credit competency which is both general credit and then kind of focused credit in things like health care, et cetera. And then we also have kind of a middle market competency where we think we have unique abilities to originate transactions in the middle market. So anything we do on an acquisition front, or on a new business initiative would lever one of those competencies. Either a middle market focus or a credit focus.

But in general as we look at acquisitions we're not looking at -- we're looking at things that tuck in, that is probably the best way I can describe it, we're not looking at things that would be dramatic changes to the platform and there is an obvious reason for that. The core platform is doing terrific. We have very good organic growth. We're very focused on managing the growth of this business. And so we're not really looking at things of what I would consider big scale that would really change the business. So I don't know if that helps gives you a sense as to what we're thinking about.

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**Josh Steiner** - *Lehman Brothers - Analyst*

Definitely, thank you.

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

Sure.

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**Operator**

And your next question comes from the line of Bob Napoli of Piper Jaffray. Please go ahead sir.

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**Bob Napoli** - *Piper Jaffray - Analyst*

Good afternoon. Two questions. One on credit on the move-up in some of the delinquency and nonaccrual statistics, wondering if you could give a little more color on where that is coming from and what your outlook is on the credit side, and then I do have one follow-up question.

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

Our outlook on the credit side is consistent with the guidance we've given in the past. Nothing has changed. And as we've said in the past our annual guidance on credit will never turn out to be that number divided by four each quarter. We will move around. So we're not -- we have no different view or insight into the credit performance of the business. We still consider it to be good and in line with our expectations for the business. And what we talked about in the past, that as the business grows and matures, you will see some movement on these kind of credit-related buckets whether they be delinquencies, nonaccruals, impaired loans, et cetera. So it's not surprising to us that those are going up because that's what you'd expect, because we went for a long time with those things close to zero which we didn't expect to be the normal kind of course of the business, which is why we're reserving.

So you know, I think our credit outlook is the same as it's been, and you tend to find these credit issues more in the cash flow lending and the real estate lending business, than do you in our kind of asset-based lending and the real-estate lending business than you do in our kind of asset based lending business where we're lending on receivables or inventory, or underlying finance companies and their notes because there's simply more volatility in those businesses. You're making a bit more -- you're making obviously an enterprise value bet when you underwrite a business and to some extent you are making an enterprise value bet when you underwrite a piece of real estate. And so that's where tend to find both -- that's where historically we've had our charge-offs. And that's where historically we've had our specific reserves. And I would expect that to continue.

And in terms of the transactions that are triggering the different percentages in the buckets, those can come from any part of the business quite frankly. But the specific reserves tend to be focused on the real-estate and the corporate finance side.

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**Bob Napoli** - *Piper Jaffray - Analyst*

And then the follow-up question is on growth and pipeline for growth, I mean you had very strong growth that is coming out of different sectors than it had as you had outlined in prior quarter, I just wondered do you still see the same type of growth trends that we've seen in the last couple of quarters continuing through this year and do you see it again being concentrated primarily within your health care specialty segment? And maybe even dig deeper into which areas within health care specialty.

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

Well, we do see growth continuing. As we sit here today, the pipeline is strong and we have no insight that would make us think that the growth trajectory of the business is changing. We feel very good about the business. We have three businesses. One of them on a relative basis is not growing as fast as it did in the past which is the corporate finance business. The other two businesses is health care and specialty and structured finance, are having very nice growth. There is really seven businesses beneath those two other businesses. Beneath the corporate finance business, there is one basic business which is providing senior debt to finance these leverage buyouts. We do a few other things in there but it is principally financing these leverage buyouts and that's where it is slower.

Not that the buyout activity is slow. There is a lot of buyout activity. But we view ourselves as disciplined. And right now, people are paying a lot for businesses and they want lenders to lend at high multiples and at low prices and it makes it tougher to make loans and maintain your standards. We will still do business in that area but as we said in the past on a relative basis it won't grow like it has. Health care and specialty finance has five businesses of which four are balance sheet businesses, we have a fee business which is doing well. But the four balance sheet businesses are health care real-estate lending, doing well, health care account receivable lending doing well, business credit services which is off to a terrific start and is probably growing the fastest, and then the security alarm finance business. So all four of those are doing -- having good solid growth.

And then structured finance I would say both of those businesses, real estate lender finance are growing nicely, probably not at the relative rate that health care is growing so health care and specialty finance, I still like you refer to it it as health care but I think all of those things are experiencing nice growth and this is really what we've tried to do, we've tried to have a balanced portfolio so that we can grow in all market conditions, because we've always had a view that credit certainly cycles at 5,000 feet but kind of down when you -- at the level where you're making loans you do see different kind of areas of pressure. And we're seeing that now in our cash flow lending business and we're not seeing the asset-based businesses so we're doing as you would expect, which is to steer and run towards those. And that's where we're seeing our growth.

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**Bob Napoli** - *Piper Jaffray - Analyst*

Thank you.

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**Operator**

And your next question comes from the line of Joel Houck of Wachovia. Please go ahead sir.

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**Joel Houck** - *Wachovia - Analyst*

Thanks. Good evening, guys. In the corporate finance business, I mean you guys have been talking about this for a while, in terms of the competitive landscape. Can you give us a sense, have things gotten incrementally worse during the quarter in

terms of the competitive landscape or is it just multiples kind of creeping up late last year and then kind of remained high? Can you give us a sense for kind of where you see it directionally?

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

I will start and then I will let Jason share some of the talking here. Why don't you chime in also Jason when I'm done. What has happened in corporate finance is that multiples have moved up in terms of what people are paying for businesses and so that's -- they want to maintain some percentage of debt in the capital structure and so they force -- they've pushed the lenders to move up. I would say that the three kind of potential competitors, someone like us could have for debt would be specialty lending platforms that are focused on this business, hedge funds that have entered the business, and then regional banks. I would say that we see all three of those people in the business now. And so on any given transaction, on any given day, we're competing with one of those or several of those sources, more than we have had in the past. And you're seeing deals done in high multiples, you're seeing deals done with very gentle amortization, you're seeing deals done at low rates. And that's not that we can't pick our spots and do deals because it is not a completely efficient market but you're just seeing more of that. So I don't know if that is a very specific answer to your question. Jason I don't know what you would add to that.

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**Jason Fish** - *CapitalSource Inc - President, Director*

I just think just to amplify, we are seeing competition today in more areas of a loan, whether it be the amount of due diligence that's done, the covenants that are being offered, the amount of leverage that's being given or the pricing by more people or more competitors than we have in the past. And this is really mostly focused in the corporate finance area, to a lesser degree, we are seeing it -- a tremendous amount of liquidity also flowing into the what I would call the traditional real estate areas, so normal cash flow type lending in that area has been more competitive. Mostly on a rate basis there. But a little bit on the leverage basis. So I think that's what we're seeing.

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**Joel Houck** - *Wachovia - Analyst*

Okay. And on the nonaccruals I don't know if you guys can give us a sense for in that bucket, how much are asset-based credits versus cash flow loans?

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

Joe, we have decided at this point not to break out those buckets like that. So I think we will probably -- A, I don't think we have that information here in front of us, I know we have the loans, we can look at them and we can guess what they are but I would want to give you a more accurate answer and which I can't do that offline so I think at this point we're not going to get into that detail.

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**Joel Houck** - *Wachovia - Analyst*

Maybe later --.

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

I can assure you that they are all represented in there.

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**Joel Houck** - *Wachovia - Analyst*

I'm sure they are. Maybe you can remind us again of the specific reserve in that, something goes on nonaccrual you're essentially estimating -- I guess you're estimating the future loss, so is that the number that's more indicative of what is coming as opposed to a nonaccrual number?

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

Yes, as I said in my remarks, the -- while we're not pleased to have loans go in nonaccrual status or have them go delinquent or have them be impaired, that doesn't -- when we look at those loans and do our analysis of the -- how collectible the loan is, that doesn't steer it towards being something that we think we can't collect the money at in my career I've had lots and lots and lots of loans in those categories that you fully collect. It is the nature of the business. To some extent.

The loans that we think we'll have credit loss on based on the information we have today are the loans we take specific reserves against. We do an analysis of what, assuming things go down a certain path, what's the likely amount we could lose, and then we handicap that based on different factors. We have a whole methodology for determining specific reserves that is essentially like approving a loan. It goes to the credit committee, we look at all the information and we sign off upon it. So the specific reserves are really the early indicators of charge off and historically we've been reasonably accurate with respect to that. Which is what we're trying to do.

So I tend to think that the more important -- what I look at is the loans -- what I worry about is the loans we're taking specific reserves on and those are the loans that I feel like we have exposure. I don't feel like we have exposure on the other loans or we would take specific reserves against them. Which doesn't mean we're not doing all kinds of things to resolve them and working them out and involved in different processes and back and forths with the borrowers, but you can have a problem loan and have a view that you're not going to lose money and that's what we -- that's what a lot of those loans in those buckets that don't have specific reserves associated with them really are.

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**Jason Fish** - *CapitalSource Inc - President, Director*

I would just like to add to, that Joel, that I don't think that you can either look at the nonaccruals, nor at the 60 days delinquent as leading indicators of what may happen in specific reserves. And also, that some of those that are in the specific reserve category are also already incorporated in those numbers.

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**Joel Houck** - *Wachovia - Analyst*

So that's helpful. Thanks, guys.

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**Operator**

And your next question comes from the line of Moshe Orenbuch of Credit Suisse First Boston. Please go ahead.

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**Moshe Orenbuch** - *Credit Suisse First Boston - Analyst*

Thanks. I hope this isn't repetitive. Maybe you could talk just a little bit about the workout process for both the loans that you've got specific reserves set up for and those that don't. Like how long does it take, what things have to happen for that?

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

It depends a lot on the deal and how it is structured and really what type of loan it is. If it is a corporate finance -- if it is a loan within our corporate finance group, and it is a cash flow loan which most of those loans are, the way you get out of the transaction is through the sale of the business, or a refinancing. So what the workout there is, is kind of steering the business as best you can, typically in negotiation with the equity sponsor, back to a point where you can get refinanced out or the business can get sold. And that's a negotiation with the equity sponsor. We try to get them to put money in, stabilize the business or pay our loan down. They obviously want to put in as little money as possible. We get involved with them in changing management teams, generally with them taking the lead but us insisting on turn-around firms and things like that going to these businesses.

So what happens is these business go on a path that is typically not a short-term resolution, unless it is an outright liquidation of the business, which is typically not what happens. The business is broken and it has to be fixed, so that you can get out of your loan, and I'm talking about loans that we take specific reserves on. And so what it involves is the CapitalSource asserting its rights, us coming to some a agreement with the equity investors as to how the business will be managed, typically we're insisting on a turn-around firm being installed to make sure things are being done. Sometimes equity is put in, sometimes it is not. And we work with them to stabilize the business.

If it is an asset-based deal, whether it be real estate or some other type of collateral receivables, et cetera, it tends to be a much more aggressive move to foreclosure, move to seizing the assets type approach. Which we have had to do. And so those tend to be a little shorter. In terms of their resolution. Because you really can take that aggressive approach because you're secured by an asset that there is usually a ready -- an available market for the asset. There is generally not an available market for a business at the price you or the equity sponsor wants it to be, if it is having problems. Often times you can -- you could probably sell the business to get your loan out but if you push the equity sponsor too hard they will put the business into bankruptcy so you sometimes have to work with them even if you could get them to sell the business and pay your loan out but selling the business in today's -- based on today's performance would involve them having a large equity loss.

So they will fight you and threaten to put the business into bankruptcy, so you end up working with them because you don't want to have the business in bankruptcy and be fighting it out in court so sometimes you're forced. Where as if it is an asset based deal, you don't really care if they put the business into bankruptcy, you don't really care if it has all kinds of operating problems associated with the bankruptcy because you're just going to take the asset. So unfortunately on the cash flow loans or the corporate finance loans it is a slower workout and on the asset based stuff it tends to be pretty quick you know exactly what you've got and you move against it. So I don't know if that helps you at all in terms of your question.

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**Moshe Orenbuch** - *Credit Suisse First Boston - Analyst*

Thanks.

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

Sure.

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**Operator**

Your next question comes from the line of Tom Purcell of Viking Global. Please go ahead, sir.

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**Tom Purcell** - *Viking Global - Analyst*

Hi, guys. Just a quick question on -- you did a good job in terms of maintaining your comp for the quarter. I noticed in the balance sheet there was a pretty significant rise in deferred compensation. Can you just talk about, how will that flow through the income statement over -- you know, it is it amortized over three years or how does that work?

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**Tom Fink** - *CapitalSource Inc - CFO*

Most of the rise in deferred compensation relates to our equity compensation that was given to the employees during the quarter. We typically, we sometimes give options, sometimes give restricted shares, restricted shares are expensed over their vesting schedule which depending on the individual is anywhere from three to five years. So it will get amortized over three to five years.

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

Yes, depending on the schedule.

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**Tom Purcell** - *Viking Global - Analyst*

Exactly. Understood. One last question, you mentioned earlier that -- and you have talked about the workout process, I guess, in terms of the increase in nonperformers this quarter, your coverage ratio now for the total nonperformers is 65%, and I know that depending on what type of loan it is that may or may not be appropriate. How do we get comfort in terms of -- without a specific breakdown I guess, of the NPAs that a coverage ratio of 65% is correct?

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

When you are just talking about coverage ratio, are you looking at our total reserves?

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**Tom Purcell** - *Viking Global - Analyst*

Total reserve divided by nonperformer, yes, just like banks do, basically.

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

Well, I mean our experience with nonperformers has been that you have very good recoveries on many of these situations. That's probably the best way I can answer the question. We're not expecting our nonperformers -- first of all, we're expecting many of our nonperformers not to have losses and even on the ones where we're taking specific reserves we feel like we have looked at the situation and addressed it and really it marked it to market. So then in the nonperforming category you have loans that we have taken specific reserves against which you would say that we've marked that to market by looking at the loan and taking a specific reserve against it. I think we have $13 million of specific -- $14 million of specific reserves on the balance sheet. So we have some loans that we think we'll lose money on and we've effectively marked those down to the order of $14 million and that is reflected obviously in the reserve and then the rest are loans that we think that we won't lose money on.

Now, they could turn around and we could get paid out right away, they could go back to performing status, or they could continue to deteriorate, and we could end up putting specific reserves on them and having losses but right now as we look at them, we don't think they deserve a specific reserve. So then the general reserves in some ways is standing against those loans, and the rest of the portfolio. I mean that's probably -- that's really the only answer I can give.

**Tom Purcell** - *Viking Global - Analyst*

Okay. And one other thing. One other thing that banks do is they break out restructured loans. Do you guys -- do you have any restructured loans in the portfolio?

**Tom Fink** - *CapitalSource Inc - CFO*

Yes, sure, we have restructured loans in the past and we do disclose trouble debt restructurings when we have them. And that's usually something you see in the Q. We also disclose the total dollar amount of impaired loans which John mentioned and you will see that in the Q as well.

**Tom Purcell** - *Viking Global - Analyst*

All right. Thanks a lot.

**John Delaney** - *CapitalSource Inc - Chairman, CEO*

Sure.

**Operator**

And your next question comes from the line of Michael Cohen. Please go ahead, sir.

**Michael Cohen** - - *Analyst*

Hi, guys. Wondering if you could sort of help me sort of think through this. I mean not to sort of beat a dead horse here but in thinking about sort of your leading credit metrics, and sort of nonaccruals are not really indicative and NPA, 60 days delinquent are not really indicative and I know you mentioned obviously that specific reserves are a pretty good leading indicator. What would you point to for us as outsiders to be able to analyze where credit is headed?

**John Delaney** - *CapitalSource Inc - Chairman, CEO*

I mean I think that impaired loans, nonaccruals, delinquencies, are not leading indicators, certainly dollar for dollar, I think the point we were making there is we expected these categories to begin to come in at these levels based on the business maturing. I think one of the things about a business like ours, it is very hard, just like we -- one of the loans that we took a specific reserve against just to put it into perspective, was a transaction that the sponsor was thinking of selling about a year ago, and we thought we would make a $5 million gain on our warrant in the transaction. And so a year ago, we were sitting there going through the portfolio thinking where we would have some gains, and now, it is a problem deal that we've taken a specific reserve against. So it is hard to really have good early indicators. I mean the way we run the business, we know all the loans, we rate them very carefully as they move down the rating schedule, we get deeper on them, and then when they get to a certain level, we take specific reserves against them. That is basically our mark-to-market on the portfolio.

And so the reason we have said the movement up in some of these categories is not an indicator was in part because we expected them to move up, as this business grew and mature, and as a relatively younger company, we didn't a lot of loans in these categories, we didn't have losses for a while, but we said we would have losses and we said we would need to take general reserves to appropriately reflect how we thought the business would perform. So that's really why they're not leading indicators.

**Jason Fish** - *CapitalSource Inc - President, Director*

Could I also mention a couple of other things, John. One of the large ones is that when a loan has has trouble or it either goes on nonaccrual or becomes 60 days delinquent, the entirety of the loan will go into that category, which in no way necessarily is going to reflect -- number one, whether we need to take a specific reserve on it, or the magnitude of the specific reserve. So we have two of actually our strongest loans today, ones where we will have no impairment at all, that are currently in the 60 day delinquent bucket. As yet another example.

So -- but even if you were to let's say have a larger loan in there the amount of loss associated with that is not going to be reflected by the balance, yet the entire balance goes to that bucket and I think that is in large part why we don't think that any of the categories, and while it is difficult for an outsider to hear that and get a lot of confidence from it, but that the buckets that are disclosed which are the 60 days delinquent, the loans on nonaccrual and the new one will which will be in the Q which is impaired loans really are not good indicators but the specific reserves will relate to -- it could be a $20 million loan with $1 million specific reserve against it or it could be a $5 million loan with a specific reserve about it. And -- $5 million loan with a specific reserve about it. And the specific reserve what is really going to matter and while they will have very different impacts on the categories on a percentage basis.

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**Michael Cohen** - - *Analyst*

Okay. So just just to a sort of quick question, the impaired loans you don't necessarily -- you will disclose in your Q or the impaired percentage, you kind of view this in the same bucket, that it is probably not a very good indicator if I thought I heard you correctly.

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**Jason Fish** - *CapitalSource Inc - President, Director*

Yes, that's correct.

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**Tom Fink** - *CapitalSource Inc - CFO*

And let me try to explain a little bit more on that. Jason also mentioned earlier they're also going to be a fair amount of overlap between these categories and one of the things we did in our K is provide a schedule that tried to show and illustrate some of that overlap amongst the categories so you can get a kind of the net balance. We will have that schedule again in our Q as well. But to the point of impairment, one of the the things we struggle with is there is accounting rules, a very specific accounting rule that require you to define certain roles -- certain loans as impaired loans. And so there's this concept of a loan being definitionally impaired.

And a good example might be there is a loan that maybe it was in trouble, you restructured it, you think you fixed it, you didn't give anything up, you don't think you are going to have a loss on this loan and we would not show it with a specific reserve because we don't think we are going to have a loss on it, but that loan, because it was restructured, and wasn't going to pay in connection with its original contract terms would be definitionally impaired. So you will see things like that that will come into that definition -- that impaired bucket. That I think, can make it a little challenging for people to figure out. So that's why we're trying to let you know how we think about the business, which is really to focus on the specific reserves.

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**Michael Cohen** - - *Analyst*

Sure. Okay. Might I suggest I mean just sort of as an outsider and having sort of studied your company and look at the sort of process that you go through and specifically on a lot of your asset-based lending, and a lot of the mortgage-based lending, where the sort of advanced rates are not that high and the probability of charge-off would seem to be significantly lower, to

the extent that you can provide some sort of segment-based delinquency or something that gives you an ability to be able to sort of look at it and say well, okay it may be an asset-based loan that is definitionally in -- definitionally delinquent or what have you, but knowing CapitalSource's process it is unlikely to charge-off kind of thing. Anything you guys can do to try to sort of amp up the disclosure around that would be enormously helpful.

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**Tom Fink** - *CapitalSource Inc - CFO*

Thank you. I don't think -- we will take that under advisement.

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**Operator**

Gentlemen. I turn it back to you for closing remarks.

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**John Delaney** - *CapitalSource Inc - Chairman, CEO*

I don't have any other remarks other than to say thank you for joining us this evening. And feel free to give us a call if you have any other questions.

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**Operator**

Ladies and gentlemen, this concludes your conference call for today. We thank you for your participation. You may now disconnect. Have a good day.

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