FINAL TRANSCRIPT

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CSE - Q3 2005 CapitalSource Inc Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the CapitalSource, Inc. earnings third-quarter 2005 conference call. At this time, all participants are in listen-only mode. We will be conducting a question-and-answer session towards the end of today's conference. (OPERATOR INSTRUCTIONS).

I would now like to turn the call over to Mr. Tony Skarupa, Finance Director.

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

Thank you and good morning. 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 wanted to remind you that we posted a presentation on the investor relations page of our website at www.CapitalSource.com. This presentation contains certain additional materials related to this conference call, and we encourage you to look at the presentation. Furthermore, this call is being webcast simultaneously on the website, and a recording of the call will be available beginning at approximately 12:00 PM Eastern time today. 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 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 press release issued this morning and in our annual report as filed with the SEC 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.

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

Thank you, Tony, and good morning, everyone. The third quarter was a strong quarter without many new developments, obviously, since we have had such lengthy communication with the market across the last 60 days. My comments will touch on the quarter, the environment for our business, review some of the major new developments we have announced and then discuss some things we want you to look for in the next few quarters, before I turn it over to Jason and Tom.

We earned $0.24 this quarter, as you can see from our release. These results were affected by the adjustment to the reserve levels which we have previously discussed in great detail. Loan growth was strong this quarter, with net loan growth of $418 million. And the loan growth was also balanced across all of our businesses, with the Healthcare and Specialty Finance business continuing to demonstrate the more significant net loan growth in the portfolio. And we are beginning to see traction in some of the new products that we will be able to offer as part of our REIT election, particularly healthcare sale leaseback transaction, which we've discussed in the past, and we are already seeing a good pipeline for this new product.

Moving on to credit, I would like to direct you to page nine of the presentation that we posted on our website this morning. Other than the changes in the reserve levels, all other credit metrics are stable. 60-day delinquencies are down slightly to 1% from 1.13%. Loans on nonaccrual also down slightly, 2.18%, down from 2.22%. Impaired loans are up slightly, up to 3.74% from 3.45%. You'll also note in the footnote that we disclosed that the current cash yield on troubled loans, or loans in the impaired loan category, is 6.6%. Some of you have asked for this disclosure in the past, so we elected to put it in this quarter. And what we are describing here is the cash interest that we are receiving on these loans. This doesn't include any PIK interest or any other fees that would be non-cash, so it's just the cash yield is 6.6%.

Moving on to charge-offs, we have also changed our disclosure there. There was apparently some confusion, perhaps, about how we had disclosed charge-offs in the past, so we decided to break it down into two categories. We have the year-to-date charge-offs annualized, which is 32 basis points, and then we have the trailing 12 months charge-offs, which were 31 basis points. You will note that these numbers are slightly different than what we had foreshadowed at our investor conference, where we were estimating what the charge-offs would be for the quarter. And when we closed the books and worked with our auditors, the charge-offs came in a little lower then we had estimated.

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And the reserves are up substantially, 1.49%, from 88 basis points. Again, we've discussed this in great detail. Our reserves are no longer a mathematical loan accrual plus a specific reserve. Now we are taking larger total reserves that take into consideration both qualitative and quantitative factors to reserve for both known and unknown situations. In general, we believe we are seeing a positive credit pipeline in the portfolio.

We want to remind people, however, that CapitalSource makes money by taking credit risk. And despite stabilizing credit trends and a positive credit pipeline, you should expect movement, both up and down, in all of these credit buckets.

The environment for our business, for the lending business, remains stable. That is to say it is competitive and fairly liquid, which is consistent with the guidance we have provided in the past. In this environment, we remain very careful, but benefit from the enormous origination processing platform we have and the diversity of our lending products. In a relatively credit-rich environment, a large, broad captive origination platform, which is what we have, allows us to grow while sticking to our uncompromising credit standards.

In terms of major developments, in addition to the reserve announcement, there were really three. First, the REIT election. As those of you who have been following the business know, we have announced our intention to be treated as a real estate investment trust effective January 1, 2006. Again, we believe this makes tremendous sense, since it makes the business more efficient and competitive, it results in significant tax savings and it should not limit the growth of the business in any way. We have also announced our E&P dividend, which Tom Fink will discuss in greater detail, and we recently completed a stock offering which is very successful, which Jason will discuss in detail.

And finally, things to look for in the coming quarters. We will be adding assets that we are calling compliance assets to our balance sheet beginning in the fourth quarter of this year, to ensure that we are in compliance and can optimize the REIT structure by next year. We expect several billion dollars in compliance assets by the end of the first quarter '06, to compensate in part for the fact that many otherwise good real estate assets or REIT assets have been comingled with corporate loans in prior financing vehicles. These assets will be a minority of our balance sheet and represent a fraction of the equity of the Company. Our goal with these assets is to have very low risk and, as a consequence, these assets will generate a very modest return.

The specific assets we acquire will depend on market conditions. One example will be ARMs fully guaranteed by Fannie Mae or Freddie Mac. These have modest interest rate risk and virtually no credit risk. Such low-risk assets, if hedged appropriately, do not offer particularly good returns, and these what I will call modest return expectations that we have for this part of the business have been fully reflected in our guidance.

And then, finally, you should expect very detailed guidance from us about how we expect the business to perform in 2006, when we announce our year-end results next year.

Before I turn it over to Jason, I want to reiterate our view that we believe the business is very well-positioned to deliver on the dividend guidance we have provided for both 2006 and 2007.

What that, I will turn the call over to Jason Fish.

Jason Fish - *CapitalSource Finance LLC - President, Director*

Thank you, John. We spent a significant amount of time discussing our financial performance last month during our investor conference in September. Our results this quarter were very much in line with our guidance set out at that conference, and the slides that were very detailed that we provided at that conference are still on our website, and we encourage you to access those if you would like to look at that guidance.

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We showed good, balanced growth this quarter, as John mentioned, with growth coming from all lending groups. And the proportion of loans per group stayed more or less constant. Yield was also strong this month, down approximately 24 basis points from last quarter but remaining a healthy 12.35%. This modest decrease was largely the result of a decrease in prepayment-related fee income this quarter from last quarter's exceptionally strong level of over 100 basis points. However, prepayment fees were still strong this quarter, contributing 81 basis points to yield compared to the 50 basis points of prepayment-related fees that we typically model.

And in contrast to last quarter, where prepayment volume drove high prepayment fees, this quarter was noted by much lower prepayment and runoff in the portfolio, but relatively high fees on the loans that did prepay. We will continue to model 50 basis points going forward as our prepayment fee assumption.

Our cost of funds was up, with higher short-term interest rate going up, but our borrowing spread improved to 101 basis points over one-month LIBOR. Leverage increased slightly to 4.3 times equity, which was consistent with the growth in the portfolio. Today, obviously, that leverage has come down substantially as a result of the equity offering we completed last month, where we raised in excess of $414 million in net proceeds and new common equity to the Company.

Our equity offering, which we closed in October, was by our view a very strong success. We saw significant demand for the stock, and our share price increased during the marketing period. As a result, we decided to upsize the offering from 15 million shares originally assumed to 17.5 million shares at the day of pricing. Subsequent to the pricing, the underwriters exercised the green shoe, which was a 10% shoe, bringing the total offering to 19.25 million shares. We take this strong demand from the market and insiders as validation of our decision to elect REIT status in 2006.

We saw significant interest from all quarters, which included new investors, current investors, as well as significant demand from insiders. In total, insiders ended up acquiring on the offering 4.3 million new shares, and from the SEC filings that we have monitored postclosing of the offering, we know they have purchased approximately an additional 0.5 million shares in the market after the offering. We were very pleased with the results of the offering and with our deep access to the capital markets.

Two last points to mention about the quarter's performance -- first, our operating expense was down this quarter, both in absolute dollars and as a percentage of assets for the quarter. Operating expenses were 2.4% of average assets. This is as we projected last quarter, since there were a couple of unusual items in last quarter's operating expense results. Second, our tax rate was down slightly, as we are now providing for income tax for the year at a 38.6% tax rate, compared to the 39% tax rate we had previously used in past quarters.

With that, let me turn it over to Tom Fink.

Tom Fink - *CapitalSource Finance LLC - CFO*

Thanks, Jason. The only update I have for you today is on our E&P dividend. As disclosed in the press release yesterday, our Board of Directors declared the special dividend of $2.50 per share or approximately $350 million in the aggregate. This dividend is the earnings and profits or E&P dividend that is a requirement of our electing REIT status. We have discussed this before, but in order to become a REIT, the Company must pay, prior to the end of 2006, a dividend representing our cumulative earnings and profits attributable to tax years ending prior to electing REIT status.

The announcement of the E&P dividend, the $350 million, is within the range that we forecasted last month when making our REIT announcement. The amount per share, $2.50 per share, is slightly less than the amount indicated last month. This is due simply to a higher share count, largely resulting from our decision to upsize the recent equity offering that Jason mentioned in light of the strong demand that we saw there.

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We are expecting to pay the E&P dividend prior to the end of January, also as previously forecast. Specifically, the E&P dividend will be payable to stockholders of record as of November 23, 2005, and we expect to pay this special dividend on or about January 25, 2006.

As previously discussed, we intend to pay the dividend in the combination of cash and stock. We will hold an election whereby stockholders of record for this dividend will be entitled to receive their portion of the dividend in either cash, shares of our common stock or a combination of 20% cash and 80% in shares of common stock, with not more than 20% of the total dividend amount being paid in cash. Election materials and forms will be mailed to all stockholders of record promptly after the record date. These forms will describe the election process in more detail, including the limitations on the amount of cash we will pay and other related logistical matters. Regardless of the form in which it is received, we expect this dividend to be a taxable dividend to stockholders, generally at the lower qualifying dividend rate.

In addition, as a REIT, we intend to pay regular quarterly dividends beginning in 2006. As John mentioned, we will provide updated guidance on those regular dividends when we release our full-year earnings in 2006. This is the usual time for us to provide guidance for the coming year.

With that, I'll turn the call back to John.

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

Thanks, Tom. And I think at this point, we will open the call to questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS). Bob Napoli, Piper Jaffray.

Bob Napoli - *Piper Jaffray - Analyst*

Good morning. Nice quarter. John, you mentioned that you're seeing a positive credit pipeline. I was just wondering if you could just comment a little bit more on that, if you can put some color around that and then maybe if you could just give the view of CapitalSource, and how you think the economy is hanging in there, as we go into the winter months here?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

Okay. My comment regarding our credit pipeline, what I was referring to -- it's an anecdotal comment, obviously. And we track the problem loans in this portfolio, obviously, to metrics which we disclosed. But then we also think about the situations very carefully; we track them, we have special view review processes, special workout plans. And when we say a positive credit pipeline, what we are referring to is the number -- and we've made these kind of comments before, particularly on this last roadshow -- the number of new loans that are kind of entering the problem loan buckets that we're concerned about, in other words, things that we view as truly problematic.

The absolute number of loans has not increased significantly. I think we saw a spike in problem loans entering the problem loan category about a year ago. A few problems emerged that we have been working through, but in terms of new situations, we don't see many new situations that we are overly concerned about percolating up. And so, while we certainly have problem

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loans, and we are working through some, and we will have losses on many of these loans, we haven't seen new situations that concern us significantly kind of enter our watchlist, if you will.

That's what I meant by that. And then, in terms of the economy, I don't think we have any specifically formulated views on how the economy is affecting our portfolio at this point. We clearly have many different lending businesses. We have a healthcare lending business. Our corporate finance business touches many industries. They don't tend to cycle the same. I don't think there's any specific comment we want to make. Obviously, interest rates have an effect on part of our portfolio from a credit perspective; our real estate portfolio is affected by rates, and we monitor that carefully. But we are not seeing any significant trends worth commenting on in the underlying performance of our portfolio companies.

Operator

Craig Maurer, Fulcrum.

Craig Maurer - *Fulcrum - Analyst*

In terms of the increased impaired loans, while I certainly understand this is a definitionally impaired loan category, which means a loan that falls into the impaired bucket might not necessarily be detrimental to the bottom line of the Company, I was just hoping you could provide a little bit more color on the increase there, if it was one loan that was driving it.

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

As I said in my comments, we view these credit statistics or these credit trends as stable. Two of them went down, one of them went up. I don't think they went up or down materially, and that would be my comment on the impaired loan bucket. Additional loans went into the impaired loan bucket. Most of them were, obviously, definitionally impaired since we didn't have an increase in the nonaccrual bucket. So that would probably be the only comment I'd make at this point.

Craig Maurer - *Fulcrum - Analyst*

Okay, thanks for the clarification.

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

(Multiple speakers) add anything to that, specifically.

Operator

Michael Hodes, Goldman Sachs.

Michael Hodes - *Goldman Sachs - Analyst*

John, I apologize if I missed this in your remarks. I just noticed on the balance sheet that the amounts of investment seemed to go up a decent bit in the quarter. Are those investments? What is that?

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Tom Fink - *CapitalSource Finance LLC - CFO*

Yes, investments did increase by approximately $40 million in the quarter. Some of that is new equity investments which we make every quarter. We also, this quarter, made investment in some debt securities, as well. One of the things to point out and things to look for in the future is John talked about the compliance assets. Depending on what we do there, you might see, actually, more activity in the investment column or in the investment line, as some of those securities might fall into that category.

Michael Hodes - *Goldman Sachs - Analyst*

And then, just secondly, in terms of the credit, the refinements to the estimates that you made back in September -- should we take that as a sign of just recoveries on certain loans, or just situations playing out a little bit better than you might think, or just an abundance of conservatism, you know, from back a few weeks ago?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

I think the way I would take that is for what it is, which is that we wanted to provide a fair amount of insight into how the business was doing. And since the quarter hadn't closed and a lot of these categories are addressed, as you would expect, really head-on at the end of the quarter, we made some estimates as to things that we thought might be charged off. And in working through the quarter close and consulting with our auditors, it was the view that some things we had estimated should be charged off should not be charged off, they should be counted for as part of our reserve calculation, and the charge-offs should occur upon resolution, if it were to occur.

So, I think it was just us trying to be prudent, with respect to estimating these categories. And when we refined it, they turned out to be less than we thought. I wouldn't necessarily read it as any recoveries, because loans that were making us think that there may be charge-offs, we are now considering those as part of the reserve numbers. So, in some ways, there's not a big difference, if you know what I mean. They weren't actually considered charge-offs this quarter, but we wanted to -- in coming up with our estimates, as you would expect, we wanted to be prudent and try to be as inclusive as possible. And then, when we ultimately refined it, they turned out not to be charge-offs.

Operator

Josh Steiner, Lehman Brothers.

Josh Steiner - *Lehman Brothers - Analyst*

Congratulations on a good quarter. When I think back to our conference, John, when you presented, I think you had indicated then that you expected recovery rates to improve marginally on first mortgages and get a little bit worse on cash flow loans. And I was kind of comparing the recovery analysis slide that you have got -- I think it's your slide seven -- for September 30 through March 31st. And it looks like first mortgage recoveries went up from 94 to 96 and cash flow recoveries went from 88 to 78, basically as you predicted.

So my question is, are we getting to a point in time where you feel like credit is really starting to flatten out, and these types of recovery rates are more or less what we can expect going forward?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

Yes. The one caveat I would make, and I don't recall my remarks exactly, but my sense is what probably I said was I expect recoveries on asset-based loans to increase and recoveries on cash flow loans to decrease. And I didn't necessarily express a

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view on real estate, other than the view I would have at this point is I expect them to decrease off 96%. So it was essentially kind of thematically or directionally what you were saying, specifically that cash flow recoveries would go down; I do think the asset-based recoveries will go up. And off 96% I wouldn't expect, actually, much increase of that off real estate.

But we do think that -- as I said in my opening remarks, we think credit is stabilizing. I want to caution people that we can see movements in these categories, both up and down, and I wouldn't want people to read too much into those, either way. But I think these kind of recovery statistics that you are seeing now are essentially where they will start settling in at. And I think these are very strong recovery statistics, and it reflects or supports our view that the nonaccrual levels that we are running should mathematically translate into the type of charge-off guidance we have provided.

Josh Steiner - *Lehman Brothers - Analyst*

I think, during your opening comments, you had indicated that there would be several billion in compliance assets coming on by the end of the first quarter '06. I didn't hear whether those were already fully incorporated in your guidance.

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

Yes, they are fully incorporated in our guidance. Tom, I don't know if you'd add anything to that.

Tom Fink - *CapitalSource Finance LLC - CFO*

Yes. No, there were fully baked into the dividend guidance.

Jason Fish - *CapitalSource Finance LLC - President, Director*

The one thing that I might add also is that when we gave guidance at the investor conference relative to asset growth, that was all asset growth from our core business, and did not include the compliance assets. So, while the dividends that we anticipate are reflective, in terms of the earnings that are going to be thrown off from the compliance assets, the asset numbers that we have talked about, in terms of growth in the portfolio, do not include those.

Operator

Joel Houck, Wachovia Securities.

Joel Houck - *Wachovia Securities - Analyst*

I thought it was a good quarter, as well. My question is, if you look at the reserve ratio at the end of September at 1.49%, that came in a little higher than what you guys had previewed. And if you look at kind of the -- for the first time in several quarters, the increase in Corporate Finance, which I assume is due to lower prepayment speeds, is that reserve a function of the mix? Or is there something, some other adjustments above and beyond kind of what you guys previewed at investor day?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

As we have said, Joel, in the past, the way we presented our reserves was we had a mathematical formula that took into consideration mix of business and rating of the underlying loans. And that, if you will, produced the general reserve. And then we had specific reserves on top of that, and together, those were our total reserves. Now, our total reserve factor certainly takes in kind of the quantitative calculation. We look at our ratings, we look at mix of business. The guidance we provided of 3/1/25

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isn't kind of hard guidance, but that's kind of what we were. When I say 3, 3% of cash loans, 1% of real estate loans, 25 basis points of asset-based loans.

But we also take into consideration kind of qualitative factors -- specific loans, other things that may be happening in the portfolio -- as well as looking at comparable companies. So more factors are playing into the calculation of our reserve at this point, going forward. And that's what caused us to make the adjustment. And, again, this work was done closely with our auditing firm. And every quarter, when we present reserves, we will make that same determination to use these qualitative and quantitative factors to reserve for known and unknown situations. And that's what produces the reserve, so it's a little less mathematically-driven than it was in the past. And I'm not sure that's a full answer to your question, but that's kind of the way we're addressing reserves at this point.

Tom, I don't know what you would add to that.

Tom Fink - *CapitalSource Finance LLC - CFO*

I would just add that John's also talked about our initial estimate of charge-offs and where we came in on charge-offs. The corollary of that, obviously, is the reserves in those situations would be fully reflected in our reserve balance, which also explains some of the slight difference between what we talked about in August and where we are in September.

Joel Houck - *Wachovia Securities - Analyst*

Okay, that makes sense. I was just trying to get a sense for directionally; I think that's helpful. Another question I had was, in the impaired bucket, if I'm not mistaken, the definitionally impaired loans have to stay on for 12 months. And I think that would mean that the first quarter we are eligible to see some of those removed would be in the December quarter, to the extent that they continue to perform. Is that thinking correct?

Tom Fink - *CapitalSource Finance LLC - CFO*

It's pretty close. Specifically, it's the impaired loans that are restructured through a troubled debt restructuring that can come out after a year. And we do have some of those loans that are performing well, and hopefully we'll see those come out in the future. But we'll make that determination at that time.

Joel Houck - *Wachovia Securities - Analyst*

And just one last one or maybe a follow-up as to maybe the size of the TDRs (ph) in that impaired bucket? Or if you don't know right offhand, maybe you can reach me off-line?

Tom Fink - *CapitalSource Finance LLC - CFO*

Yes, we can follow up with you on that.

Operator

Stephen Schulz, KBW.

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Stephen Schulz - *KBW - Analyst*

I had two questions -- the first on the compliance assets, the several billion that you had mentioned, John. I was curious what the kind of marginal return on investment or on equity, rather, for those assets were.

And then, if you could give us a sense for -- you say that you are going to lever those assets kind of comparable with industry norms. How much capital do you expect is going to be allocated toward that portfolio?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

We haven't disclosed the specific returns on the assets at this point, Steve, but I can say with certainty they will be significantly below the returns on the rest of the business, which, as you know, produces very high returns. And the amount of equity allocated to these assets is also significantly below the amount of equity we allocate to our other assets, kind of order of magnitude mid single digits.

Stephen Schulz - *KBW - Analyst*

Mid single digits in terms of equity as a percentage of assets?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

Yes, that's right.

Stephen Schulz - *KBW - Analyst*

And so, several billion -- it would be a bigger amount, say, of like the 400 million in equity raised in October? A decent amount of that we could kind of assume is going to fund the compliance assets?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

Yes, a third of it, maybe, you know.

Stephen Schulz - *KBW - Analyst*

And then, if you could, kind of going back to page seven in the slide deck, on the net recovery question, it looks like the cash flow loans -- there was one loan that was resolved in the quarter that led that net recovery to go to kind of 78% from 80%. It seems like kind of a big drop in the net recovery rate relative to the incremental increase in the dollar amount of loans that were resolved. Can you talk about -- was there a significantly lower recovery on that one cash flow loan that was resolved in the quarter?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

Yes. It was a situation that had multiple loans that was a problem. And we had reasonably good recoveries on some of the other loans associated with the situation. There was a small loan that was left that had very low recoveries (multiple speakers).

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Stephen Schulz - *KBW - Analyst*

But it's not an indication of expected magnitude of lower expected recoveries on the cash flow problem loans in the future?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

No. I think, as Josh pointed out earlier, the recoveries on cash flow loans, which were running close to 90% -- we were, I think, fairly clear with people that we did not expect those type of blended recovery rates on the cash flow portfolio. That's not -- that wouldn't be consistent with the experience that other lenders who provide similar type of lending have had, nor is it consistent with what the people who work at the CapitalSource have seen in the past in these types of businesses. And I think these recovery levels that we are starting to see now, in general -- and again, these will move around a bit -- will start reflecting more where the blended recovery rates in cash flows could be, recognizing that in any individual loan, as you'd expect, you could have 98% recoveries or you could have 20% recoveries.

Stephen Schulz - *KBW - Analyst*

Definitely. And then, just lastly, on the guidance, just to clarify, the guidance you gave at the conference -- I believe it was for 20% ROE. That's related to the core loan portfolio, not including the compliance assets, correct? (Multiple speakers).

Tom Fink - *CapitalSource Finance LLC - CFO*

That's for the entire business.

Stephen Schulz - *KBW - Analyst*

That is for the entire business?

Tom Fink - *CapitalSource Finance LLC - CFO*

Yes.

Operator

Moshe Orenbuch, Credit Suisse First Boston.

Moshe Orenbuch - *Credit Suisse First Boston - Analyst*

John, you had mentioned a little bit about beginning to see some traction on some of the new products. I was wondering if you could talk about that just in a little more detail as to what -- you mentioned kind of the healthcare sale leaseback. What other things kind of you're starting up? Now that we are a little more than a month since your meeting, what other things have happened in that vein?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

I would say the three things that we will be able to do in our new structure is, one, be more competitive in our floating-rate product; secondly, offer a fixed-rate product in both healthcare and non-healthcare; and then, third, offer sale leasebacks in

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healthcare and certain non-healthcare situations, probably relating to our corporate finance business where, as part of a buyout, oftentimes corporate real estate wants to be sold and leased back as a way of raising proceeds for the buyout.

The more competitive floating-rate product and the fixed-rate product -- the groups are rolling that out, and we are seeing some traction there. The reason I highlighted the sale leaseback is I would say that has been particularly well-received, I think, in the marketplace. I think it reflects the fact that our healthcare real estate team is really just really strong. The individual who runs that business has had significant experience in healthcare sale leasebacks, having run a healthcare REIT in the past. And I just think that our client base really wants that from us, and we have already built up a good-sized pipeline of deals that we are reviewing, in excess of $200 million, in a very short period of time.

So I don't want to detract from some of the other things I think we can do in the new structure; I just wanted to highlight that that, in particular, I think has been well-received by the market. And I think part of it is actually related to just specific timing. There's a very large and very well-attended healthcare, nursing home or long-term care conference that is designed to attract investors, lenders and operators. And we generally dominate that conference, one of the main sponsors, have dozens of people at it, et cetera. And the timing of that conference coincided with our announcement to be a REIT, coincidentally, which was fortuitous for us. And we really made a big splash and really were able to get a lot of traction in the market.

So, I think, kind of anecdotally, that has helped a little bit. But I think the real reason is it does make sense for us to be selling that to our long-term care customers, and we have a really good team doing it. So, there's just been a spike of deals that we're looking at in that area. And we are very, very excited about that.

Operator

Don Destino, JMP Securities.

Don Destino - *JMP Securities - Analyst*

Well, John, you just did a great job, providing lots of color with what I wanted to ask you about, which is the healthcare sale leasebacks.

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

I have nothing else to say about it.

Don Destino - *JMP Securities - Analyst*

I'm going to try to extract something out. What's the sale process there? Are you convincing kind of your core long-term care customers that this is a product that they should be interested in? Or do you think that, more often, somebody else would have done a sale leaseback, and you're just kind of taking share?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

Well, I think it's a little bit of both. The nursing home market, which is where we are focused initially, is a big business, and it's still dominated by small to midsized operators. And some of those operators have not used the sale leaseback product before. Others have had a fair amount of experience with it. There's several dedicated healthcare REITs that offer sale leasebacks, and many of them are very good at what they do.

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I would say we have a competitive advantage, because we can also do other things for the customers. And so, I think the customers view us as more of a one-stop shop. So when they look at their financing needs for building their business, what they will typically think about is a loan product is good for a turnaround, if they are buying a turnaround, and a sale leaseback product is a good way to finance a more stabilized asset. So, I think what you'll see is that CapitalSource will work with our customers and provide a lot of our traditional bridge financing as they are buying assets and trying to reposition them. And then, as those assets start stabilizing, it becomes more appropriate for a sale leaseback transaction, and someone like us can buy it, lease it back, free up some capital, and then they can reinvest that capital in building their business. So what they end up with is a portfolio of homes that they manage, some of which are subject to sale leaseback transactions, and they are really just getting management fees, and others they own and they are trying trying to improve and either sell or execute a sale leaseback.

So, I think it fits very nicely into our products, so that we can kind of offer a continuum of financing to the small to midsized operators, which will continue to be our focus for the sale leaseback product.

Don Destino - *JMP Securities - Analyst*

Three more quick minutia questions about that and then one unrelated question. First, ticket size on that? Is that a larger ticket size product than your normal debt investment?

Two, what the typical term of the lease is, in terms of years?

And then, three, do you need to or do you plan on -- you probably don't provision against sale leaseback assets?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

No, you don't provision against them. They are owned real estate. And to the extent they are impaired, you deal with them that way, but you don't take a provision against them.

The average ticket size is pretty similar, although there's a chance that you could do some pools. And so, there's a chance you could do some larger deals where people own 15 or 20 or 30 homes and they want to sell the whole portfolio. But in general, the ticket size will be very similar, because I think our focus will be more on one-off transactions.

The lease terms can be 10 to 20 years, with fixed escalators built into the leases. So, you will go in at a certain yield, and it will escalate in the fixed amount. You can't participate in the cash flow of the asset under the REIT rules, so you have to -- you can't negotiate increases in rent based on performance. That's why it's a better product for a stabilized asset. it's not a very good product for an asset that may improve because, quite frankly, as the sale leaseback financier, you will give up a lot of upside. So it's much better to have a stabilized asset and negotiate more of these fixed increases.

But what's nice about them is they are long-term. So, unlike a lot of our other -- as you can see from our portfolio, we have a fair amount of prepayment, which drives good fees and we like the business and we built the business to do that. Now, we will start aggregating a portfolio of stuff that won't run off as much, and we will have kind of internal growth in terms of the lease escalator.

So we think it will be a nice part of the business. And I think what excites us, like a lot of businesses, it's a good business if you run it well. And I think that the team that runs our healthcare real estate business runs it really well, so I expect them to run the healthcare sale leaseback business really well.

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Don Destino - *JMP Securities - Analyst*

Last housekeeping question -- can you put some perspective -- I just don't know how to interpret the statistic you gave on the cash yield on impaired loans. Put some perspective around that, or is there a trend to it, or how I should -- what I've learned by learning that there's a 6.6% cash yield on impaired loans.

Tom Fink - *CapitalSource Finance LLC - CFO*

We have not calculated that for prior periods, so I can't give you a comparison to it. But this is something that, actually, several people asked about recently, when we were on the road marketing our equity offering. And it's very simply the interest income on the loans in that impaired bucket. So, as John mentioned, we are not including fees. To the extent they are -- if there is any PIK -- we don't have a lot of PIK in the portfolio, but to the extent there was some, we wouldn't be including that.

And the point is just to make the point that we obviously are financing those assets, and with 6.6% cash-on-cash type return that we are obviously carrying the debt that's associated with funding those assets. So I think that's a very relevant and a very positive statistic for that part of the portfolio.

Operator

Laura Kaster, Sandler O'Neill.

Laura Kaster - *Sandler O'Neill - Analyst*

Just one clarification on Bob's question. Given the fact that charge-offs were beneath my estimates and are trending very well, you guys are staying with your '05 guidance for credit quality, correct?

Tom Fink - *CapitalSource Finance LLC - CFO*

Yes, we have not changed that.

Laura Kaster - *Sandler O'Neill - Analyst*

And relative to my expectations, Corporate Finance and cash flow loans were stronger than I would have thought in the quarter. Can you just speak to the overall competitive environment amongst the business segments in general? And how would you address the argument that you guys might be growing too quickly at the wrong stage of the business cycle, given the competitive environment?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

Well, the competitive environment -- it's a strong competitive environment across all of our businesses. There's a fair amount of liquidity in the markets, as everyone knows. And while that tends to trickle down less to some of these niche lending products, it certainly makes its way down there. And we see competition from other commercial finance companies. We see banks getting more active, and we see hedge funds increasingly playing in the market. All of that is very consistent with what we have been saying in the past, Laura. We haven't seen any uptick in the competition. In other words, it doesn't seem to be getting worse, and it's fairly stable at this point.

I would say, in terms of the answer to the question, how are we growing when it's competitive, the answer, I think, is very simple. CapitalSource is growing in large part because we continue to build a bigger business, and that's what's driving most of the

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growth. In other words, the reach of our business, in terms of the things we offer and the depth that we have been able to drill into the market, is much greater. And I believe that has just overcome simply us kind of growing with the market. And that's really -- when you look at statistic for the Company, in terms of employees, lines of businesses, number of development officers, number of investment officers, it's up as dramatic if not more than our portfolio growth.

So really, what's happening is we're building a bigger business. And we are doing that in a competitive market, and we are mindful of that. And we are careful, and we're trying to focus on where there is, on a relative basis, less competition. And the way we are competing is not by competing on credit but, from time to time, competing more on price, which has been built into our guidance and reflected into our model. But that's really the best way for me to answer it, because it's what I view as the truth, which is the business is growing because it's getting a lot bigger. It's not staying the same size and just we are pouring more on. We're building a bigger business, and that's what drives a lot of the asset growth. And in some of these businesses, you'll actually see growth has slowed quite a bit, businesses that we haven't built up and are just more just playing to their market.

And in light of the competition, Corporate Finance was a bit of an exception or a surprise, a positive surprise, this quarter. Their net asset growth hadn't been that strong, reflecting the competition. There is an example; the core Corporate Finance team, on a relative basis, has not grown because of the competitive environment, but a lot of the Company's asset growth has come from new things. We've made good progress and inroads in what I would call our broad umbrella of distressed lending products that continue to get built out. That includes our business credit services business and the special situations business we have as part of that, where we are providing GIP (ph) loans and turnarounds and things like that. That has driven a fair amount of our asset growth. So, we're trying to be smart in this liquid market.

Jason Fish - *CapitalSource Finance LLC - President, Director*

One other than to add on that is that, as I had mentioned in my remarks, repayments did slow this quarter from a volume standpoint. And so, some of the pickup in Corporate Finance growth that you saw is a reflection of what we had said earlier in our guidance and what we saw this quarter, which is that we have seen a slowdown in prepayments in Corporate Finance. So, the top line has been pretty consistent throughout the year.

And the other thing to note, as John said, is a lot of the incremental growth that we have seen this year on the top line has come from our asset-based businesses and the broader portfolio of offerings on the asset-based side.

Laura Kaster - *Sandler O'Neill - Analyst*

Did you give out a dollar amount of prepayment income?

Jason Fish - *CapitalSource Finance LLC - President, Director*

No, we gave out basis points of 81 basis points.

Laura Kaster - *Sandler O'Neill - Analyst*

And that was relative to what in the prior quarter?

Jason Fish - *CapitalSource Finance LLC - President, Director*

We were slightly over 100 basis points in the prior quarter. And, as we always forecast, 50 basis points -- or we use that as a plug into our model for what we expect to see from prepayments when we do our earnings modeling.

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Operator

Sameer Gokhale, Bear Stearns.

Sameer Gokhale - *Bear Stearns - Analyst*

I had a question on your net interest spread, if you were to just calculate your yield minus your interest cost. And it looks like that held up pretty nicely, something about 6.07% or so compared to 6.09% last quarter -- so, excluding any fees and other income and prepayment type of fees in there. And it was stable compared to last quarter, but over time it has kind of been trending down. And I was wondering if you could talk about the potential impact of, over time, your nonaccruals have increased. Can you quantify what impact the increase on nonaccruals over time has potentially had on that net interest spread? Because, if I understand it correctly, on assets there in nonaccrual, you don't accrue any interest income on those.

Tom Fink - *CapitalSource Finance LLC - CFO*

You are right. We do not, obviously, accrue any interest on the loans that are on nonaccrual. And as that balance goes up, that obviously eats into the yield and the portfolio. We have not quantified that nor talked about it before, but I think directionally, you are absolutely correct about that.

Sameer Gokhale - *Bear Stearns - Analyst*

It seems like that interest spread has come down. If I were to compare it from the first quarter of '04 to the current quarter, it's down about 100 basis points. Would you at least be able to say directionally, is most of that coming from what has happened in nonaccruals? Or is it what has happened to the yield from a pricing standpoint?

Tom Fink - *CapitalSource Finance LLC - CFO*

I would not say that most of it is due to nonaccruals. I think a minority of that is due to the nonaccruals. I think you touched on one of the other issues, which is just the competitiveness in the market. And we have certainly seen that. We've talked about that before, on the asset side of the business. The nice thing is we're seeing that on the liability side of the business as well, and our borrowing spread decreases.

The other than that had some effect on it is the mix of business. And as both John and Jason talked, about we have shifted -- the business has naturally steered itself more towards asset-based lending this quarter. And I think you could conclude that we are being a little bit more defensive this year, in light of this liquidity that you're seeing in these other parts of the market.

Jason Fish - *CapitalSource Finance LLC - President, Director*

I think you should also bear in mind that we really don't look at the business in terms of the coupon-to-coupon spread. It's really the return on the assets that are generated by a combination of ongoing fees plus coupon. As we have said in the past, the fee component of interest and fee income generally makes up in a range of about 18 to 24% of total interest and fee income. And so, when we look at the yields that we're underwriting loans at, we are looking at the yield on the portfolio, we are always taking into account fees. So I would not discount that to any degree.

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Sameer Gokhale - *Bear Stearns - Analyst*

And then, the other question I had was you posted pretty impressive loan growth numbers for the quarter, and I was wondering -- I just didn't seem to recall if you had any acquisitions during the quarter or if all that was organic. And it seems like some of these newer products that you've talked about are kind of in the pipeline, but have not really contributed to growth during this quarter. Maybe I'm mistaken about that. But can you also draw down a little further into the question of loan growth within each of your segments or, in particular, the Healthcare and Specialty Finance and the Structured Finance? Which subsectors within those businesses, which industry sectors, are looking the most attractive now, where you are seeing the most growth potential?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

Well, there were no acquisitions of any portfolios or businesses this quarter, nor did we have any effect this quarter from new products that we have outlined we would offer as a REIT. So, this quarter's growth really is just reflecting kind of the core capital source, pre-REIT announcement business. And as I said in my comments, it was reasonably balanced across all businesses, with Healthcare and Specialty Finance contributing more. And I tend to think, in terms of your question about where we're seeing more opportunities, we are and we have been seeing a lot of opportunities in healthcare. We have been seeing a lot of opportunities in our new business, Credit Services business, which is an asset-based lending business that tends to focus on turnarounds and restructurings. Those are the two areas that we see lots of opportunity. The teams, I think, have been performing at a very high-level. And if I were to single out any area, and I don't want to give it to the detriment of the other businesses, because I think the other businesses are doing very well. But if I were forced to single out an area, I would put those two as ones that deserve special mention.

I don't know, Jason, if you would add anything to that?

Jason Fish - *CapitalSource Finance LLC - President, Director*

No, except for to reiterate two things, which is, number one, the prepayments were down for the quarter. Generally, that helped us a fair amount. And we had noted that in the second quarter, we had had a significant number of prepayments. So I would say that was one of the major things.

The other is that just we had net loan growth of $418 million. And, while we consider that to be a very, very strong quarter, it's not completely out of line with what we told people what we were going to do for the year, in terms of annualizing that number against net loan growth for the year of 1.5 billion. That is about 1.65, and so I guess you could say that's a 10% increase on the rate of growth for the quarter over what you might have anticipated, but it's not huge.

Sameer Gokhale - *Bear Stearns - Analyst*

And I guess I just wanted to drill down just a little bit further into the healthcare and the growth that you mentioned. Specifically, are there any types of healthcare facilities or businesses which are experiencing a disproportionate amount of growth relative to other subsectors within healthcare in which you're specifically having an increased presence in? I mean, that's what I was going to get to, at a very detailed level.

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

No, and I don't think there's anything we could provide that would be useful. We cover the whole healthcare market very well. We are financing. On the real estate side, it tends to be more nursing homes, although we do look at assisted and independent living facilities, but it tends to be more nursing homes. And I expect that to continue.

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And then, on the non-real-estate side, it's a mix of all types of providers, ranging from home health to different types of ancillary providers to contract research organizations, hospices, all types of businesses we are financing in the healthcare. And I don't think there's anything in particular, other than I think in the last 18 months, we continue to see an increasing emphasis on healthcare, or focus on healthcare from private equity firms. And even though our healthcare business isn't built around private equity firms like our Corporate Finance business is -- because what we are financing in that business is leveraged buyouts, and those leveraged buyouts are backed by private equity investors -- our healthcare business does participate in a large percentage of their transactions with private equity firms. So we continue to see interest by investors in healthcare, and that drives the business. And those investors are attracted to all spaces right now, as best I can tell.

And I think that is reflective of a somewhat stable reimbursement environment in healthcare and a somewhat stable clinical environment in healthcare, where we're not seeing particular sectors being attacked from a reimbursement or clinical perspective. So it tends to be fairly broad in its distribution across the many subindustries in healthcare.

Sameer Gokhale - *Bear Stearns - Analyst*

Good quarter, guys.

Operator

Scott Valentin, Friedman Billings Ramsey.

Scott Valentin - *Friedman Billings Ramsey - Analyst*

Thanks for taking my question. It pertains to operating expense. I know you had given guidance that operating expenses would come down, due to some one-time events in the previous quarter. But it seemed to improve more than we thought. How do we think about expenses going forward? Obviously, with assets growing, they will probably come down as a percentage with the compliance assets. But on a core basis, is this quarter's results a good run rate going forward, with some growth for expansion of the business?

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

I think that's about right. That's consistent with what we said in September at the investor conference.

Operator

Carl Drake, SunTrust.

Alex Powell - *SunTrust - Analyst*

Just a quick question. This is Alex Powell (ph), actually, on for Carl. I was wondering -- forgive me if you have already answered this, too; we had some technical difficulties on our end. If you could give us a little more color on the ramp-up in the new low-yield, lower-risk products as a result of the REIT election?

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Tom Fink - *CapitalSource Finance LLC - CFO*

John talked about having several billion dollars on the balance sheet by the end of March, and I think we'll start adding that this quarter. And it could be in the range of 1 to $2 billion a month, as we refine our modeling and, as John mentioned, optimizing around the REIT structure, we will zero in on exactly what they will be.

Alex Powell - *SunTrust - Analyst*

Good quarter.

Operator

And there are no further questions at this time. I'd like to turn the conference back over to management for any closing comments.

John Delaney - *CapitalSource Finance LLC - Chairman, CEO*

Management has no further closing comments, other than to say thank you for joining us this morning and we look forward to speaking with everyone in the future. Feel free to call Tom, Jason or myself if you have further questions. Thank you.

Operator

Once again, ladies and gentlemen, thank you so much for your participation in today's conference. This does conclude the presentation, and you may now disconnect. Have a great day.

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