# FINAL TRANSCRIPT

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## CSE - Q4 2005 CapitalSource Inc Earnings Conference Call

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## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the fourth quarter CapitalSource earnings conference call. At this time, all participants are in listen-only mode. We will conduct a question-and-answer session towards the end of this conference. (OPERATOR INSTRUCTIONS) I would now like to turn the presentation over to your host for today's call, Mr. Tony Skarupa, Finance Director.

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

Thank you and good morning. Joining us today are John Delaney, Chairman and Chief Executive Officer of CapitalSource, Jason Fish, our Vice Chairman and Chief Investment Officer, and Tom Fink, our Chief Financial Officer. Before I turn the call over to John I want to remind you that we posted a presentation on the investor relations page of our website, www.CapitalSource.com. This presentation contains additional materials related to this conference call and we may refer to certain slides during our

remarks today. Furthermore, this call is being webcast simultaneously on our website and a recording of the call will be available beginning at approximately 12 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.

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

Thank you, Tony, and good morning everyone. I will be referring briefly to two pages in the investor presentation that Tony referenced, so if you wouldn't mind having that handy that would probably be helpful. We're pleased to report our fourth quarter and full year 2005 results this morning. Results that we view to be very strong. As you can see from looking at our earnings release we earned $0.37 for the fourth quarter, 2005, and $1.33 for the full year 2005.

These results were affected by our inclusion of certain shares issued as part of our ENT dividend. We're required under GAAP to include these shares from the date of the record date of the dividend. Even though the shares were in fact not issued until January. The record date of the dividend was November 23, 2005, so for calculating both the quarterly EPS numbers in the full year EPS numbers we were including 12.3 million shares in the calculation from November 23 until the end of the year. Adjusting for this, our quarterly earnings would have been $0.38 per share, and our full year earnings would have been $1.35 per share.

As you can see, growth was very strong in the quarter with 500 million of net loan growth for the quarter; we had about a 10% increase in both number of loans and number of clients. And this growth has continued into the first quarter of this year. As of today we have a funded loan balance of slightly in excess of $6.5 billion. This strong portfolio growth is really driven by two things to my mind; first, our origination platform is performing at a very high-level. As most of you know we have three very robust lending groups, and about nine lending platforms beneath these three larger lending groups. These platforms represent in my opinion, the finest middle market lending platform in the country. And our ability to originate loans and maintain our high credit standards is unmatched in the industry.

Second, the REIT election that we made has enhanced our competitive positions with respect to those loans that are tied to real estate which include our health care and commercial real estate lending businesses. For example, we announced recently that we closed on a $211 million sale leaseback transaction in the health care industry. This transaction involved us acquiring 38 health care properties, and leasing them back to an operator that is well known to CapitalSource. This transaction we would never have been able to complete prior to our REIT election because why we view this as a very stable asset and a long-term asset, the returns were not attractive as a taxpayer. With the tax benefits associated with the REIT, this transaction meets our return thresholds.

The overall market for middle market lending remains competitive but stable. Most of our growth continues to be driven by our health care, and some of our specialty asset based lending and real estate lending products. With less growth coming from our more highly liquid cash flow lending sector. Our cash flow team however continues to perform at a very high-level but they have changed the orientation of their business, increasingly they are originating loans and selling down to much smaller exposures and earning fee income as part of those syndication efforts. This is steering that portfolio towards a more granular

portfolio and to some extent a more agency based portfolio, which we think is the appropriate strategic move in a market that I would characterize as big highly liquid.

Overall, the portfolio continues to steer itself towards a more asset-based orientation, which should only improve over time what we believe to be very strong credit performance in the business. The last word on originations can be found on page 8 of the presentation, if you would not mind turning to that. This shows the quarterly pipeline and closing rate for the business. As you can see in the fourth quarter, our pipeline stood at an all-time high of about $35 billion and our closing rate or our deal selectivity rate was 5.1%. Which is the lowest or tightest it has been since the second quarter of 2004.

So CapitalSource continues to build a larger and larger pipeline and we continue to be very selective with respect to the deals we close. Regarding credit, we continue to see good trends in the business; again, I direct you to page 22 of the presentation. Which is an update of the various credit metrics of the business. As you can see, 60-day delinquencies were down from the prior quarter, loans on nonaccrual status were up slightly, impaired loans were down, charge-offs whether they are measured on a year-to-date or a trailing twelve-months basis were also down, and the allowance was down slightly due entirely to the mix of business. As you can see, we've seen stabilization of these credit metrics, and to some extent improvement.

We would like to remind everyone however, that CapitalSource makes money by taking some measure of credit risk. Risk that we believe we understand very well and can manage in a very effective and highly profitable manner. And despite stabilizing and improving credit trends, and what I would call a very positive credit pipeline, you should expect these statistics to move around from time to time both up-and-down. Including the charge-off line. Which will be lumpy but which should have minimal P&L impact as charge-offs should in general, be absorbed by the allocated reserves we take within our general reserve allocation.

And finally, we announced our first quarter dividend of $0.49 per share, which puts us in line with our dividend guidance for 2006 of $1.96. Let me close by saying that we believe we are on track with all of the elements of our REIT election plan, and that the business is performing at or above our expectations in all material ways. With that, I will turn the call over to Tom Fink.

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**Tom Fink** - *CapitalSource, Inc. - CFO*

Thanks, John, good morning everyone. The fourth quarter was indeed a strong quarter for CapitalSource, and above our expectations for both the quarter and the year. As highlighted in our press release and in Johns' remarks continued strong growth across our commercial lending business, strong yield performance, improved borrowing spreads and stable credit performance combined to produce solid earnings for the quarter. Our net income for the quarter was us up 34% compared to the fourth quarter of 2004, and our full year net income was 32% higher than 2004's full year net income. Both underscoring the strong fundamentals in the business.

Back in September, at our annual investor presentation, we refined our guidance for 2005 on an apples-to-apples basis, adjusting for the size of our October common stock offering and accounting for the stock portion of our E&P dividend paid in January we exceeded the guidance we set out making effectively $1.35 for the year compared to $1.32 to $1.33 that we guided to.

In addition, we are encouraged by the strong momentum that we carried into 2006 and continue to execute well across the business and are continuing to tick off the milestones on our path to elect REIT status this year just as we outlined them. I think our results in the press release speak for themselves very well so I will keep my remarks short today. But let me summarize the high points.

We saw strong balance growth this quarter as John mentioned, with growth coming from all of the lending groups and in particular, in first mortgage loans. We've maintained and actually increased our focus of providing senior secured debt which at December 31st accounted for 96% of our commercial portfolio, yield was strong this quarter down just 12 basis points from last quarter, but remaining a solid 12.23%. This modest decrease was largely the result of a decrease in prepayment related fee income this quarter from last quarter. Prepayment fees are a lumpy item, contributing 36 basis points to yield this quarter

compared to last quarter's relatively strong level of 81 basis points. For the full year, prepayment fees contributed 65 basis points to yield so we were pretty close to the 50 basis points we typically model. Our yield has been very strong all year long, in what has been a very competitive market and I think this ability to grow the business while still generating strong risk-adjusted returns underscores the strength of CapitalSource's origination capability.

Our cost of funds was up this quarter with short-term rates also going up, but our borrowing spread improved in the quarter to 88 basis points over LIBOR compared to 101 basis points last quarter. For the year, our borrowing spread to LIBOR was 106 basis points, down from 155 basis points for the full-year 2004, and we're very pleased with how our funding program has evolved. This year-over-year improvement in our borrowing spread of approximately 50 basis points came at the same time we increased our average borrowings by over $1.6 billion.

Leverage this quarter decreased as expected, after the completion of our common stock offering in October. However, this statistic is somewhat distorted by the accounting for the E&P dividend. As outlined in our press release, GAAP requires us to accrue the entire E&P dividend as a liability, even though 80% of it was paid in stock or approximately $281 million. The dividend was paid on January 25; and 12.3 million shares were issued on that date.

Adjusting for our shareholders equity to include the stock portion of the dividend results in our pro forma leverage being 3.4 times as of December 31. This shows that we had headed into 2006 in a very well-capitalized position.

My final point before turning the call back to John is on dividends. As previously discussed, we expected this year to begin paying regular cash dividends each quarter. Yesterday we issued a release announcing that our Board has declared our first quarterly cash dividend of $0.49 per share. This dividend is payable to shareholders of record as of March 3, and we expect to pay the dividend on or about March 31.

Going forward it is our plan to target paying dividends on the last day of each fiscal quarter. Also, while future dividends are subject to the approval of our Board, this dividend reflects our intent during 2006 to target a level dividend payment each quarter and our expectation that we will pay $1.96 per share in dividends this year.

We also will be implementing a dividend reinvestment plan which we expect to have in place prior to the payment of the first quarterly dividend. With that, I will turn the call back to John for closing comments.

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

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

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## QUESTIONS AND ANSWERS

**Operator**

(OPERATOR INSTRUCTIONS) Don Destino from JMP Securities.

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

Congratulations on a very nice quarter. Two questions. First, John, you guys significantly exceeded your credit guidance for the year, can you talk about the nature of that outperformance? Are you seeing better-than-expected portfolio kind of broadly or were there a couple of situations that you expected to be problems that didn't turn out to be, or what was it just kind of the volatility in this quarter and the volatility worked in your favor?

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

I think you summarized most of the points I would make in your question there Don. I would say that as I said in my remarks, we view the credit performance of the business as very good. I use the term a positive credit pipeline which means that kind of new situations on the horizon, I would say as a percentage of the portfolio are decreasing and some of the problem loans that we have are exceeding our expectations with respect to their performance. Which I don't want you to take that to mean that we don't still have problem loans, we do, we have some problem loans that are still not doing well and we expect to have charge-offs related to those.

There is some lumpiness in when these things hit. Which we talked about in the past. Sometimes they hit in a way that is kind of negative lumpy and sometimes they hit in a way that is positive lumpy. I think the larger point is that we believe within our general reserve, we have allocated reserves towards the situations we are concerned about, so when some of these charge-offs materialize it won't have a negative P&L impact. We still stand by our charge-off guidance for '06, and that is probably all I can say on that at this point.

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

Got it, and then second question is, a little bit of housekeeping probably for Tom, just to be clear, with the accounting for the kind of compliance assets, I understand you are recording them on a net basis, does that mean that through the P&L, effectively, you're going to record a what amounts to an ROE on the net investment? So it will be there is not going to be the growth interest revenue and interest expense items there? And then secondly, can I assume that when you are reporting all of your particularly your credit statistics, are those as a percentage of commercial loans, or I don't think you are including the growth stuff, residential mortgages in there as well?

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**Tom Fink** - *CapitalSource, Inc. - CFO*

You are right, we have included some disclosure about the accounting for the residential mortgage assets in the press release. And we are recording them on a net basis. Based on this rather technical interpretation of certain GAAP rules, mostly FASB 140, as long as the recorded net on that basis, all of the income loss will be running through basically our other income line. So you are correct, before the year ended 12/31, there is nothing flowing through interest income or interest expense for the residential mortgage assets, it's all in other income.

And also, you're similarly correct that those assets or those investments are not included in the denominator for any of those credit statistics. Or yield, for that matter.

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

Got it, thank you very much.

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**Operator**

Carl Drake from SunTrust Robinson Humphrey.

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**Carl Drake** - *SunTrust Robinson Humphrey - Analyst*

Thank you and good morning. Is there any update on the efforts in the ILC from a regulatory standpoint?

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

No updates that differ than what we have said in the past, we believe based on what we know we are on track to receive the charter. It's been approved by certain aspects of the regulatory chain and its waiting final approval, so there is nothing new to report there.

**Carl Drake** - *SunTrust Robinson Humphrey - Analyst*

Okay, and then in terms of yield, potential yield compression as you move into lower risk, high-quality assets, more asset based, more real estate assets, do you -- is there any change in your outlook on spread compression going forward? As you compete with some other new competitors? Probably larger competitors?

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

Where we will see unlevered yields compressed significantly is in products that are tied to real estate and that is by design. With our REIT status any loan that we make that is tied to real estate provided it's structured appropriately, will benefit from the tax advantage status of being a REIT. So in other words we don't pay tax on those. And so we can achieve our targeted ROE which depending upon the business is kind of high teens to low 20s. By having a much tighter spread or a much lower unlevered yield and get to the same point. To put it another way, if we're paying tax on an asset, the unleveraged yield has to be higher assuming constant leverage and if we are not paying tax on the asset.

So in certain of these new initiatives, around our real estate business, which I would define as CapitalSource going after some larger situations and some stronger sponsors, some lower leverage situations, sale leaseback situations which are effectively a long-term fixed-rate loan, the unlevered yields are lower, but the return to the business is the same. And probably on the margin the credit is better. So depending upon the amount of those assets coming to the balance sheet, which they are just starting to, that will steer the unlevered yield to the portfolio down, without a negative effect on the return on equity. And that is kind of summarizes why we think this REIT election is really smart for the business. So as that happens which, will happen across time, you will see compression on levered yields but not likely to see significant compression on return on equity.

**Carl Drake** - *SunTrust Robinson Humphrey - Analyst*

Right, okay. And last question about the allowance it's continued to decline due to this mix shift, should we expect that to tick down over time? Sequentially?

**Tom Fink** - *CapitalSource, Inc. - CFO*

Yes, I think so. We are still working with basically the same reserve factors that we talked about in our September investor conference and so what you see in third quarter, fourth quarter is literally the shift in mix of the business so as we -- as real estate grows, for example, as first mortgages grow as a percentage of the overall commercial portfolio, you would see that allowance blend down.

**Carl Drake** - *SunTrust Robinson Humphrey - Analyst*

Great, thank you. Nice job.

**Operator**

Joel Houck from Wachovia Securities.

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

By question has to do with kind of a follow-on to the compliance assets and your press release you talked about the whole loan prospective, whole loan that you're going to buy, it looks like those are going to be put on balance sheet and will have a spread component to them. A, is that correct? And the second part of the question is, assuming that is correct, if there is a runoff component the whole loans as you originate more traditional real estate loans, how should we think about that runoff over the next 4 to 6 quarters for modeling purposes?

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**Tom Fink** - *CapitalSource, Inc. - CFO*

Joel, let me say one thing first, we are planning and intend to in 2006 really start talking about the business in two segments, the commercial finance portfolio and then the residential mortgage finance so we will be able to more discreetly break out for you the result so you can see exactly the kinds of questions you are asking. We have not closed the owner trust securitizations yet but it is our expectation that they will be accounted for on balance sheet so we will have yield and interest expense in all of those normal items.

The way I would I think maybe most simply expect you to model those businesses for now at least, would be better done based on just a net return basis. So you know that we are closing on 2.6 billion and we have targeted sort of mid to high single digits in terms of return on equity in that business. The amount of equity allocated to that part of the business is very small, roughly 6 to 7% of the equity, of total equity of the company. And as we do our segment reporting, on those two different parts of the business, you'll see the different portfolio metrics at work for those.

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

You mean mid to high single ROA time? I think you said ROE.

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**Tom Fink** - *CapitalSource, Inc. - CFO*

No, I said ROE.

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

Okay, I thought with the leverage you're still going to get back to kind of below 20 ROE?

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**Tom Fink** - *CapitalSource, Inc. - CFO*

No, I think for the 19 plus percent ROE that we have guided to for deal is for the business overall, okay?

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

Okay.

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

The returns on these compliance assets from an ROE prospective are obviously very low. And the reason they are low is because we are doing our best to take virtually no risk in that business, and it's a fairly inconsequential matter of equity. So it has, I wouldn't call it an inconsequential effect on the overall performance of the business but it is certainly not a material -- we think over time the equity in that business as Tom indicated will be close to 5%. 6, 7% of the total firm's equity will be allocated towards that business. So even if it has, we would rather have as little volatility as possible and a lower ROE considering its only 6% of our equity say over time. Than to try to make money in the business and have some volatility which --.

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

No, I understand. But directionally, should we expect that whole loan portfolio to kind of be in a runoff mode? Is that kind of a directional way to think about it as you originate more of the traditional real estate loans?

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

Directionally that is right but you have to remember that we continue to see very good opportunities in the corporate lending business of the company. And other kind of ancillary related fee businesses that we are building and creating in those businesses. So as we grow those businesses, I think two things are going to happen, one, the core real estate business is going to grow which is both healthcare real estate and commercial real estate, and also the core corporate lending business is going to grow.

If the ratio of the growth of the real estate business is faster than the growth of the corporate business, then you'll see a decline in these compliance assets. It is the same -- it will be about the same and if the corporate stuff grows faster you would actually see the compliance assets go up. We don't think the latter is going to happen. I would say we're going to see good growth in both real estate and corporate, we think based on what we see today real estate will grow faster in part because some of the stuff we are doing in real estate like sale leaseback they don't roll off those assets. So as part of that real estate business we will stop having the runoff we see in the other parts of the portfolio so that will allow it to grow at a faster rate as well. So that would lead me to conclude the compliance assets will decrease, but I just want to make you sensitive to the relationship there. So I think you're right but I don't think at this point we're willing to forecast how fast it will go down, because we continue to see lots of good opportunities in our corporate lending business and we want to continue to build them.

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

All right, that's good color. Just lastly, could you remind us, John, of the forecast for equity raises for '06 and how, if it all, the ILC might play into some relief around those equity raises this year?

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

Well the ILC, we have given specific guidance for equity raises as you know. And I think that the number and I want to make sure I quote it exactly in our investor conference was, the number was exactly like 500 million -- 5 to 600 million?

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**Tom Fink** - *CapitalSource, Inc. - CFO*

Yes.

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

Which is based on our view of how the business was going to grow et cetera, so that is the guidance we have given for equity raises. The ILC, one would argue, would allow us to leverage the business more which we agree with because it not only gives us access to a pool of capital that will allow us to leverage part of our business at a higher rate, but it also creates greater stabilization across the whole funding platform. Because in addition to having our secured funding programs we will have the bank funding program and we think both of those things will lead to better execution on the unsecured side. So you could argue that our leverage can go up over time which we would agree with, because we don't have the ILC yet at this point we're not forecasting any changes based on that. So that is probably our answer to that question.

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

Okay, thanks. Outstanding quarter, guys.

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**Operator**

Stephen Schulz from KBW.

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**Stephen Schulz** - *KBW - Analyst*

Hi, thanks guys. Just one more question follow-up on the MBF portfolio. Am I looking at the accounting right that the 2.3 billion portfolio is showing up as the 49 or 50 million net investment on the balance sheet?

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**Tom Fink** - *CapitalSource, Inc. - CFO*

Right, that is our net investment in those securities and then we also have as we disclosed in the press release recorded a derivative which is part of other assets.

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**Stephen Schulz** - *KBW - Analyst*

Okay, so the portfolio is being funded with about 2% equity or over kind of 40 times net to equity?

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**Tom Fink** - *CapitalSource, Inc. - CFO*

I think it's a little bit more than that. I mean these are very -- these are agency pools guaranteed by Freddie; guaranteed by Fannie, they are highly liquid securities.

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

Durations down to a week and a half in that portfolio?

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**Tom Fink** - *CapitalSource, Inc. - CFO*

Or less, yes.

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**Stephen Schulz** - *KBW - Analyst*

Can you comment just broadly on how -- what kind of potential volatility there could be from this portfolio?

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**Tom Fink** - *CapitalSource, Inc. - CFO*

Well, I don't -- directionally, we don't think there is -- there will be volatility plus or minus because we are investing in mortgage assets and those come with certain risks and benefits. We expect that volatility to be small, we don't expect it to be directional in nature otherwise we would have -- John mentioned we have taken a very risk averse strategy with respect to these residential mortgage investments. So if there was some directional bias there we would have hedged it. But there will be some volatility and it's very difficult to forecast. You'll see in our press release in the income statement there is a loss in derivative of about $2 million. That is the sum total of the results for the residential mortgage portfolio for the quarter. Most of which is made up with some loss due to some basis risk there but we don't think it's going to be a material amounts over time.

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

Just one thing to add if you think about the risk in that business which we do, it comes down into four kind of categories. There is credit risk, there is duration risk, there is convexity risk, and then there is basis risk. The credit risk we do not think is significant not only because the quality of the loans but because they are guaranteed by either Fannie or Freddie. We have hedged out the duration risk as aggressively as we can. As I said it is probably weaker in that range which is incredibly aggressive for hedging that. We have hedged out the convexity risk as much as is practical, and the basis risk you can't really hedge because that is really how the market values mortgage assets relative to other investments they have. And that is what causes the change in the mark-to-market.

It is our view that the cash flows from this business is fairly locked in and we should have almost no volatility with respect to the cash flows. We could have some relatively minor mark-to-market issues, largely related to basis risk, but if you go through those kind of four areas of risk whether it be credit, duration, convexity or basis, we have taken as aggressive a stance as you can to eliminate the risk from that business.

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**Stephen Schulz** - *KBW - Analyst*

Okay, thank you very much.

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**Operator**

Henry Coffey from Ferris, Baker Watts.

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**Henry Coffey** - *Ferris, Baker Watts - Analyst*

Yes, good morning. Great quarter but I apologize for talking about the hedge assets again. Listening to you talk about it, should we view them completely as compliance assets or is there any notion of a business here? I know at one point you talked about breaking it out and making maybe a small ROE on this. But in terms of modeling, should we simply view it as a breakeven business?

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

I think that is a fair way to look at it.

**Henry Coffey** - *Ferris, Baker Watts - Analyst*

And it is a "compliance" trade not an income trade?

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

That's right. We do make some money doing it, but relative to the -- I mean, we have a few loans -- single loans in CapitalSource that will make us more than a compliance asset.

**Henry Coffey** - *Ferris, Baker Watts - Analyst*

And the whole loan program is just another way of competing compliance issues, you're not -- there is not a business here even on the whole loan side?

**Tom Fink** - *CapitalSource, Inc. - CFO*

That's right, it represents a little bit of diversification in our asset strategy if you will on the residential mortgage investments with the compliance assets.

**Henry Coffey** - *Ferris, Baker Watts - Analyst*

Great, thank you. The other issue your triple net lease transaction that you announced, can you give us some sense of the yield on the assets? To CapitalSource?

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

We didn't disclose the specific yield on that but depending upon the asset, I will give you the range that we're seeing in the market. Depending upon the quality of the asset which is both the underlying real estate and the quality of the credit or the obligor, we're seeing unlevered yields on that business ranging from about say 8.5 to 10.5.

**Henry Coffey** - *Ferris, Baker Watts - Analyst*

Okay, and you have what you called a down REIT structure with some equity issuance component to it?

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

Yes, that's right.

**Henry Coffey** - *Ferris, Baker Watts - Analyst*

Can you quantify that for us, how that works, how does that get accounted for? What real share issuance results?

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

I will let Tom deal with the second part of the question and I will just comment as to why people like that in the market and why we think it is the competitive advantage. What we're really doing there is exchanging capital as far as equity. Or the equity that the borrower has in the project and they receive that equity in the form of a kind of a subsidiary where they receive interest -- limited partnership interests -- and those interests are exchangeable for CapitalSource stock, it is kind of a form of a 1031 exchange is the simplest way of thinking about it. And what was interesting about the first deal that we did was the operator of that -- those nursing homes was well known to the company. We financed them at CapitalSource and we had known them or some of us had known from my prior business. And he followed us fairly closely and we believe he had a better opportunity in the market to sell the assets at a better price. But he was both attracted by the tax deferral nature of the down REIT structure and also thought that the company was well-positioned and that he was making a good investment decision by trading his equity in this pool of assets for equity in CapitalSource. So we actually think the down REIT structure gives us a nice competitive advantage in the market. I will let Tom talk about the accounting.

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**Tom Fink** - *CapitalSource, Inc. - CFO*

Basically, this transaction closed in January so we will see it the effects of it in our first quarter release, but we will record all of the normal things you would expect with having operating leases. We will have rent income, we will have some interest expense, based on how we are going to finance those assets; we will have depreciation that will also be running through the P&L. And then with respect to the down REIT portion of it we have basically in our minds, issued equity for that portion of the acquisition. Which will be accounted for as a minority interest, and that we expect to reduce over time as our partners there in accordance with their own schedules convert their LLC interest into the CapitalSource stock.

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**Henry Coffey** - *Ferris, Baker Watts - Analyst*

What kind of number can we put on the expected shares that could be issued?

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**Tom Fink** - *CapitalSource, Inc. - CFO*

Approximately 4 million. And probably 1.2 million of that has been issued already.

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**Henry Coffey** - *Ferris, Baker Watts - Analyst*

Listen, great quarter and thank you very much for your comments.

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**Operator**

Sameer Gokhale from Bear Stearns.

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**Sameer Gokhale** - *Bear Stearns - Analyst*

I just want to flush out something on your net interest margin, again, it was down compared to last quarter and you guys provided some detail in your release but I adjusting for the decrease in prepayment related income, and also adjusting for the tightening in your debt spread, it still looks like the net interest margin actually expanded slightly compared to last quarter. And I was wondering if that was due to the syndication fees that might be incurred in that margin calculation, or if pricing somehow improved on the asset side of the piece?

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

Jason why don't you start off on this one?

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**Jason Fish** - *CapitalSource, Inc. - Vice Chairman, CIO*

Yes, the syndication fees which John referred to earlier, are accounted for as if the -- because we continue to hold the loans over the life of the loans so those are not going to have a meaningful impact on the net interest margin of the business as a whole. But they do have some positive impact, obviously. I would say that the environment for lending generally was pretty robust, we had a lot of originations which means we saw a lot of good opportunity and I think that will move up and down a little bit. I think the meaningful impact that we have seen of competition that we have referred to in the earlier quarters of 2005, is more or less stabilized. So I don't think you're having as much pressure from that, and then I also think that because we are having -- we continue to have fairly steady leverage and in fact the leverage went down a little bit in the quarter, you get some improvement to your net interest margin as a result of funding more of your business with equity in the quarter.

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**Sameer Gokhale** - *Bear Stearns - Analyst*

Okay, that's helpful. And the other thing I was curious about was the I think your press release mentioned that incentive comp decreased from last quarter and I would have thought with the strong performance of your business, and with bonus accruals and the like that incentive comp would probably be up from last quarter. Can you comment on that a little bit?

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**Tom Fink** - *CapitalSource, Inc. - CFO*

The number moves around from quarter-to-quarter, I think a fair amount of our bonus compensation and restricted stock and other things float in earlier in the year. So that really accounts for most of the difference third quarter to the fourth quarter.

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**Sameer Gokhale** - *Bear Stearns - Analyst*

Okay, and then the last question I had was can you talk about your acquisitions like your down REIT transaction and then there was another transaction where you actually (indiscernible) acquired the properties but you provided funding to Formation Capital. How should we think about those types of acquisition scenarios? Should we think of them from a pricing perspective? Is it a price per bed or we don't have any insight into PE so could you share with us what you say the price per bed was on the down REIT purchase that you did? And the same thing for the Formation Capital acquisition of Laurel Healthcare's assets?

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

The Formation transaction you're referring to was a loan -- it was not an acquisition, the only acquisition we made was the Senior Health portfolio.

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**Sameer Gokhale** - *Bear Stearns - Analyst*

No I was just curious on the Formation (indiscernible) how much they may have paid for their acquisition and how that compares to your acquisition of the down REIT transaction from a price perspective?

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

It would not be appropriate for us to disclose what Formation paid for a business; they are a private company and they acquired a private business, so but suffice to say that when we look at the long-term care sector which is an area or an industry I have a fair amount of experience in, we look at a variety of factors when we determine valuation. And whether our headset is as a lender or whether our headset is now increasingly as someone looking to sell leaseback opportunities, we factor things like most importantly the cash flow of the business, secondly the per bed pricing. And the per bed pricing can vary dramatically state by state.

In other words your per bed pricing in Florida may be up to 60,000 a bed these days because of what's going on in the reimbursement business. Yet your per bed price in other states may be down to 20 or 25,000 a bed based on the reimbursement system that exists in those states. We tend to focus on Medicaid operators which tend to be more dependent obviously on the Medicaid program and on that pricing scheme that is delivered in that individual state. So some states have a more robust Medicaid program, which translates into kind of higher cash flow per bed which translates into a higher per bed kind of common metric if you will. And other states have tighter Medicaid programs, and it translates to lower cash flow per bed and therefore lower per bed metric.

So we look at a variety of things we look at the cash flow of the facility, obviously. We have kind of standard metrics that we look at for making loans which can range from kind of five times to 6.5 times adjusted cash flow, adjusted for some management fee, that can translate into a per bed price as low as 20 and as high as 60. And in fact, in some assets like kind of some assisted living properties or independent living properties or in the State of New York for example, where they have a very good Medicaid program, you will see per bed prices be 80, 90, $100,000 a bed.

The other thing we look at is asset quality. Because just because a nursing home is producing good cash flow right now, and that nursing home is being sold at a price that reflects kind of the average per bed prices for that state, we have spent a lot of time looking at the underlying asset quality which is both a physical examination and a clinical examination to make sure both the clinical performance of the business is good so there won't be any material effects of the cash flow going forward and we look at the physical quality assets. Now most nursing homes aren't the best looking things you've ever seen, but there are certain things we do care about as it relates to the physical asset that we look at. So in terms of what goes into our evaluation we do look at per bed prices and its kind of a guidepost or a smell test if you will.

So when our team sees a deal in Illinois they kind of know what the per bed prices should be. But that is only one level of analysis; there are a lot of other things to take into consideration. I think it is our policy not to disclose per bed prices that we pay when we acquire assets and sell leaseback transactions. For no other reason than its somewhat misleading because again if we buy a nursing home in Brooklyn which probably have some of the highest per bed prices and the reason they have very high per bed prices because nursing homes in Brooklyn tend to be very big so they can leverage their operating expenses very well and they actually produce more cash flow then a nursing home in Syracuse. So the per bed pricing can be a little misleading and I don't think it would be that material to disclose that at this point.

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**Sameer Gokhale** - *Bear Stearns - Analyst*

Okay, fair enough. Thank you, very much, guys and again, strong quarter. Thanks.

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**Operator**

Erin Archer from Piper Jaffray.

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**Erin Archer** - *Piper Jaffray - Analyst*

Good morning and congratulations on the quarter. I'm filling in for Bob Napoli this morning. John, I was hoping you could talk a little bit more about your credit pipeline and what you are seeing both in terms of CapitalSource and overall economy? And as well, could you give us a sense of how much growth is coming from products that you would not have been able to fund without the REIT structure? Thanks very much.

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

So the two questions were just you want some kind of commentary on the credit pipeline, and also some commentary on things we been able to do because of the REIT election?

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**Erin Archer** - *Piper Jaffray - Analyst*

Yes, please.

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

I will answer the second part first because I have actually spent some time on that in the call, its really things like these sale leasebacks or some of these larger real estate transactions both in the health care and nonhealth care. Because we have spoken a lot about health care I want to make the point that our commercial lending business has benefited from the REIT election significantly. They are still doing the same type of deals, in other words, financing with the first mortgage a property that is generally being repositioned or some value added investment opportunity by an investor where they think they're buying commercial real estate. And improving it and they will look to sell it or refinance it. But what we're able to do is start working with some larger sponsors who are looking to put more equity into the deals and therefore want a tighter spread on the loan. That has been very positive for that business.

It has also helped our REIT discount finance business, which is a business where we finance other finance companies and a good percentage of those other finance companies are real estate lenders. So when we act as an asset based lender to another real estate lender that becomes if structured appropriately, a good REIT asset. So again, they have been able to kind of start steering their business toward some larger situations. So I think in general, whether it be health care real estate, commercial real estate, or our REIT discount business, the REIT election has allowed us to offer a tighter spread product which is typically more appealing to someone who is putting more equity into a transaction. And is looking for lower leverage at a tighter spread and I think that is all good for CapitalSource.

The credit pipeline I think when I say positive credit pipeline I think we are kind of talking about two things, number one, just the sheer number of deals that are hitting these negative credit buckets as you can see they are down. And that is good. And secondly, kind of the potential data on some of these deals meaning when we assess the likelihood of loss, the severity of the loss varies depending upon the type of situation. As the portfolio is steered more towards asset-based loans, as asset-based loans go into the credit buckets, you are a little less concerned about them because you have some better visibility is what the outcome could be in a worst-case scenario. When a cash flow loan steers to one of the negative credit buckets, you have less visibility as to that because you're really depending upon the operations of the business.

So I think the reason I use the term positive credit pipeline is because A, the credit statistics have in fact improved; and B, as the business steers a little more toward asset-based lending we expect more of the problem loans to have that orientation. Which I don't want you to take away from this answer, the fact that CapitalSource no longer has problem deals. We do have problem deals. We have some problem loans that we have fairly material allocated reserves against and at some point we will be charging those off and getting those allocated reserves. But in general I think our view on credit as I said is good at this point.

**Erin Archer** - *Piper Jaffray - Analyst*

Okay, thank you very much.

**Operator**

(OPERATOR INSTRUCTIONS) Joel Houck from Wachovia Securities.

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

Just a quick follow-up, I am not sure if this matters but I was just asking you, what is the thought process behind the whole loan or I know you haven't closed on it yet versus the NBS? Are you just trying to diversify away from one product or what is the thought process behind doing it differently?

**Tom Fink** - *CapitalSource, Inc. - CFO*

It is a bit of diversification. What is different about it, largely, one way is the funding for it which through the owner trust you will achieve basically permanent financing for the vast, vast majority almost all of the asset. It diversifies our risk a little bit, in the transaction, away from interest rate risk going into things back to more things that CapitalSource is more oriented towards which is more credit orientation. It's disclosed in the release with the 8-K announcing our commitment to enter those transactions we have focused on very high-quality whole loan pools. So we feel good about those transactions.

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

Okay, thanks Tom.

**Operator**

Craig Maurer from Soleil Securities.

**Craig Maurer** - *Fulcrum Global Partners - Analyst*

Good morning, just a quick question; I hope this wasn't already answered. Have you discussed going forward guidance for the leverage ratio?

**Tom Fink** - *CapitalSource, Inc. - CFO*

We have not talked about that today, but our sense, Craig, is really no different than when we talked about it before. Which is for our commercial finance business we are targeting leverage in the four to five times range, that sort of being the appropriate we think prudent level for CapitalSource. That is far below what we actually could achieve in the marketplace with all of the securitization transactions etc., but it's our intent to run the business conservatively from a capital point of view.

**Craig Maurer** - *Fulcrum Global Partners - Analyst*

So not a dramatic change from where you were --?

**Tom Fink** - *CapitalSource, Inc. - CFO*

No, not at all.

**Craig Maurer** - *Fulcrum Global Partners - Analyst*

Thank you.

**Operator**

Laura Kaster from Sandler O'Neill.

**Laura Kaster** - *Sandler O'Neill & Partners - Analyst*

Thank you, great quarter. Just a follow-up on Craig's question. I know that you're not modeling to have the bank in '06 but if you were, how would that change your outlook for your leverage ratio? Also, I was expecting your Corporate Finance loans to be flat sequential quarter basis; they were done a little bit. Could you give us an update what you're seeing there as far as competitive pressures and how that business line is relative to your expectations?

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

Tom, why don't you answer the first part of the question?

**Tom Fink** - *CapitalSource, Inc. - CFO*

With the bank, I think the biggest or the largest benefits for the CapitalSource with an industrial loan bank would be in our cost of funds and also just a further broadening and diversifying our sources of funds, that is what is really most attractive about it. It is really premature to talk about or consider what kind of leverage could be achieved, based on that, but again, we are not guiding to higher levels of leverage in the commercial finance business because of the bank.

**Laura Kaster** - *Sandler O'Neill & Partners - Analyst*

And you could put on cost of funds would be LIBOR flat with the bank versus the C&L market of about 70, 80 bips?

**Tom Fink** - *CapitalSource, Inc. - CFO*

It depends on where along the maturity curve you are raising those funds; right now they are very cost competitive, at or below LIBOR flat levels. I don't believe our securitizations would be as high as you quoted, they are probably in the LIBOR 30-ish range, so there is some savings in interest expense for the company with the bank. But it's also important or attractive to us from a funding diversity or funding diversification point of view.

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

Laura, as it relates to the second part of your question, or maybe the first part, I forgot, about the core finance group, that is we believe, people have different views of this, but we believe it is a fairly frothy market right now. There is a lot of buyout activities, there's a lot of liquidity in the market which doesn't mean there isn't good opportunities; its just more competitive than it's

been. And that business we have said is we think more cyclical than our other businesses because of the capital flows. And so our approach to that business has been and I really have to commend our Corporate Finance group for doing a really nice job in this regard is they started to steer a part of the business a little more upmarket and leveraged what we think is becoming a very good syndication team that we're building out of our Chicago office.

And so what they are doing is part of their business they're going after some larger deals and they are aggressively selling down our exposure to $15 million typically or sometimes even less than that. And they're taking the skim income which as Jason indicated we've kind of earn over time and they are applying that to the unlevered yield on the piece that we retain and it gets us to an unlevered yield, the combination of those two things that meet our standards. And so what's happening in that business is a fair amount of runoff because we do have a good portfolio, and if you were in the OBO business and you bought a company a few years ago you would be trying to sell it now probably because multiples are high. So we're seeing a fair amount of runoff from that business and they're largely staying in place by doing more deals to some extent because our hold sizes are starting to go down. And so that is the path they have chosen to compete in this more liquid competitive market which I think is the right answer.

The business as I said is becoming a little more granular, a little more diverse, they're still making good returns, they have the agency business that is facilitating it as part of our syndication business. And they have a lot of things on the white board in terms of ways they can kind of continue to reposition their business, and then start growing it again. Largely around leveraging some of the syndication capabilities that we have. So that is kind of our view on Corporate Finance, again I said there are different views people have in the market, there are certainly a lot of LBO's being done. And since that business finances LBO's we could clearly be growing that business.

We have decided to take what's a somewhat considered to be a more prudent path, manage our exposures down more than we have in the past, leverage more syndication to get more fee income and that has resulted in the portfolio being largely flat. It goes up and down a little bit in any quarter. I would not consider the move down material just like I think it went up second quarter to third quarter which it did not go up materially. It was largely a flat business for us this year.

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**Laura Kaster** - *Sandler O'Neill & Partners - Analyst*

Okay, great. Thank you.

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**Operator**

Don Destino from JMP Securities.

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

Hi guys, actually, John, I think you just answered my first question which was a clarification on Jason's answer. So when you syndicate a loan there is no income in the current quarter, it basically affects your cost basis and increases the yield on that asset? Is that right?

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**Jason Fish** - *CapitalSource, Inc. - Vice Chairman, CIO*

It is fee income over the life of the loan, Don.

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

Fee income over the life of the loan? Got it, perfect. Second question, John, back in the health care financial partners days, health care financial partners days, you received and deserved a lot of credit for staying ahead of the curve on some pretty volatile reimbursement policies at the government level. That certainly stunned a lot of other lenders and some providers. Can you talk a little bit about what you do today, what you're current efforts are to kind of stay ahead of that curve and understand what is going on at the federal level and at the various state levels in terms of reimbursement policies? And how you can kind of feel comfortable that you are underwriting to what not only what the policies are but what they are going to be?

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

Sure, what you're referring to, Don, there was a specific reimbursement change back in the late '90s. As part of the balanced budget act of '97, it changed fairly dramatically how nursing homes were reimbursed. And it caused a lot of havoc in the market and we were successful in staying ahead of that curve. And there is nothing right now that is similar to that. That does that mean either at state or federal levels there aren't some initiatives from time to time. We have been looking at transactions with physician owned hospitals for example, and that has been a sector that has been focused on increasingly about rules they are trying to implement to limit physicians ownership of hospitals so if you are underwriting deals like that what effect that has et cetera.

So there are definitely things that we're looking at and the way we do that is not only by having a team that focuses on this day in and day out, but we also have an accounting policy, if you will or reimbursement policy oriented group within capital analytics that spends a lot of time tracking all this stuff. And on a regular basis they are issuing kind of alerts or warnings or kind of advisories to members of the team about things that are happening. That both affect our underwriting and specific situations but also in general will steer the direction we're going in. I would say in general we become somewhat suspicious of health care companies that post very high profit margins and depend on reimbursement because the health care system to some extent yearns to be nonprofit and regulators think of it that way.

And so when you see high margins like from time to time you'll see high margins in businesses like hospices and stuff like that, it puts up kind of a flashing yellow light to us that we need to be particularly mindful. And that has always led us towards a lot of Medicaid business actually on the nursing home side, et cetera, because the margins are low, the businesses provide fundamental value and while there can be reimbursement cuts, the severity of those reimbursement cuts tends not to be as dramatic as when regulators see a 30% profit margin business they feel like they can really take out the ax and start chopping. So at the end of the day it is just a lot of work and a lot of experience which I think -- I don't think, I know the team does a lot of work and they have a tremendous amount of experience.

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

Got it, thank you very much.

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**Operator**

(OPERATOR INSTRUCTIONS) Gentlemen, we have no further questions. I will turn it back to you for closing remarks.

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

We have no closing remarks other than to thank people for joining the call this morning. And we look forward to talking to you all at various events in the future. Thank you.

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**Operator**

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Everyone have a wonderful day.