FINAL TRANSCRIPT

Thomson StreetEvents℠

CSE - Q1 2006 CapitalSource Inc Earnings Conference Call

Event Date/Time: May. 09. 2006 / 10:00AM ET

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the first-quarter 2006 CapitalSource Inc. earnings conference call. My name is Colby and I will be your coordinator for today. At this time, all participants are listen-only mode. We will be facilitating a question-and-answer session towards the end of this conference. (OPERATOR INSTRUCTIONS) As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the presentation over to your host for today's call, Ms. [Claire Rosebush], Investor Relations Associate. Please proceed, ma'am.

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Claire Rosebush - - *IR Associate*

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 that we may refer to 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 12:00 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 on 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 Financial - Chairman and CEO*

Thanks, Claire. Good morning everyone and thanks for joining us as we report what we view as strong results for the first quarter of 2006. During my remarks I will be referring briefly to two pages in the investor presentation that was posted this morning, which Claire referred to. So if you could have that handy, that would be helpful.

Our adjusted earnings for the quarter were $0.53 per share, which reflects a 21.6% return on equity for the quarter. Adjusted earnings is a new metric for us and in our press release this morning, we lay out a reconciliation of adjusted earnings to GAAP earnings for you to look at. Most of you know that some type of adjustment to earnings, whether it is called adjusted earnings or whether it is called adjusted funds from operations as equity REITs commonly refer to it as is a common definition or metric utilized by REITs. To our minds, adjusted earnings better reflects performance by backing out certain items that are commonly referred to as non-cash items.

For example, our adjusted earnings definition adjusts for things like depreciation of our sale leaseback portfolio, which we expect to be a larger part of the business across the year. It also adjusts for various items relating to our compliance portfolio of residential mortgages. We view the cash flow of this portfolio as locked in because of the aggressive hedging approach we have taken and the fact that we will hold these assets to maturity. The various marks and adjustments we are required to make such as bid [ask] adjustments which run through the GAAP income statement are adjusted in the adjusted earnings definition, as they do not reflect our view of the cash flow of this portfolio.

We built up our adjusted earnings definition by looking at comparables and we expect there to be a reasonable cushion between adjusted earnings and our dividend payment. And Tom will touch on that in a few minutes.

Core asset growth for the quarter was very strong, driven by both loan growth and growth in our real estate investments in the form of these sale leaseback transactions. In fact this quarter we had approximately $1 billion of gross originations as measured by fundings in both the core lending business and including the sale leaseback transactions. Core assets grew by about 11% from the end of the year or approximately $650 million.

While growth this quarter was more focused on our real estate businesses, we are experiencing a very strong pipeline across the Company with an uptick in activity in our corporate finance business. As most of you know, our corporate finance business

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had slowed across the past year. The pipeline for that business has in fact picked up significantly, largely enhanced by our efforts to move into slightly larger deals leveraging our syndication capabilities that we have been building.

Our REIT election continues to be what I call an enabling event for our real estate related businesses, enabling them to be both more competitive on price because of the tax savings and allowing them to pursue different transactions like these sale leaseback transactions we refer to.

And the last word originations can be found on page 8 of the presentation that we linked this morning, if you would turn to that please. This slide summarizes across the last nine quarters the pipeline for the Company and by pipeline what we mean is new transactions entered into the system in that particular quarter. You can see the pipeline has grown nicely across these last nine quarters. It is almost $35 billion in the first quarter of 2006 and this slide also shows our closing rate or what we call our deal selectivity rate. And you can see that continued to tighten, which I believe reflects an evolution of our credit platform.

Regarding credit, the credit trends continue to stabilize, which we view as a very positive development and we continue to see a credit pipeline that I would characterize as positive. If you would please turn to page 13 of the presentation, we will walk through some of the credit statistics for the Company.

This page reflects the core business, the core commercial lending business. As you can see, 60-day delinquencies were down slightly from the end of the year to 0.66%. Loans on nonaccrual status, this is essentially flat, down slightly but essentially flat from the end of the year. This we have said the past is the most important credit statistic for the Company and you can see across the last four quarters this has stabilized nicely in the 2.2% to 2.2% range.

Impaired loans essentially flat from last quarter at 3.34% and charge-offs on an annualized basis were unusually low this quarter, 0.02%. I say unusually low because we do expect charge-offs in the business and as we have said the past, they are lumpy.

Despite these credit trends, which again I would characterize them as stable to improving, we want to remind everyone that CapitalSource makes money by taking some measure of credit risk. We believe we manage that credit risk very well. We believe our results speak for themselves with respect to our ability to manage that credit risk, but that credit risk does appear from time to time in a lumpy fashion throughout these statistics and we just want to continue to keep that on people's radar screens.

I'll conclude with three points about the business. First, the business continues to perform at or above our expectations. Secondly, despite tremendous liquidity in the markets our inherent competitive advantages which I view is very significant coupled with the highly transactional marketplace that we target continues to lead us to increasing opportunities. And then finally, I remain of the view that CapitalSource is the finest middle market lending platform in the country and I expect us to continue to drive strong results like the results we reported today.

With that, I'd like to turn the call over to Tom Fink.

Tom Fink - *CapitalSorce Financial - CFO*

Thank you, John. Good morning everyone. The first quarter was a good quarter for CapitalSource and a busy one. We continued our momentum and the business performed well. We had strong topline revenue with particularly good growth in our real estate lending and investment activities. Adjusted earnings exceeded our expectations for the quarter and we continued our progress on our funding plans for the business.

As a result of various first-quarter actions including transactions representing some of the expanded opportunities we now have as a REIT, we saw significant growth in the balance sheet this quarter and have added several new line items to the balance sheet and income statement. We also adopted as John mentioned, adjusted earnings as a supplemental performance measure this quarter. Adjusted earnings is an additional and we think better way to evaluate the operating performance of the Company.

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Going forward, the guidance we gave will be focused on adjusted earnings and on dividends per share rather than GAAP net income.

Adjusted earnings follows the convention in the REIT industry to use supplemental performance measures that eliminate the effects of certain GAAP adjustments to income that may not necessarily reflect current operating performance. While not the only measure of performance, we believe adjusted earnings will assist in your evaluation of CapitalSource's performance. And please see our earnings release for the full definition of adjusted earnings and a reconciliation of adjusted earnings to GAAP net income.

This morning I would like to briefly review the new items on the balance sheet and income statement and then I'll touch on a few additional details of our performance this quarter and provide an update on our funding. One of the new items I'd like to point out is that we have begun reporting on the business's two segments, Commercial Lending & Investment, which is our historical commercial finance activity, and Residential Mortgage Investment, which comprises our Residential Mortgage Investment activities that we use to facilitate compliance with the REIT rules and help optimize the value of the REIT structure. The performance of our Commercial Lending & Investment segment is most analogous to CapitalSource's historical results. Our press release contains detail on the performance of these two segments, as well as of CapitalSource on a consolidated basis.

Turning to the balance sheet, consistent with our previously discussed plans we saw substantial balance sheet growth this quarter. At March 31 we had $12.8 billion in total assets, including $5.7 billion in Residential Mortgage Investment and the balance in our Commercial Lending & Investment activities. The Residential Mortgage Investments include approximately $2.5 billion in prime quality residential mortgage whole loans shown on the balance sheet as mortgage received related receivables net and $3.2 billion of residential mortgage-backed securities made up of Freddie Mac and Fannie Mae guaranteed securities.

Our commercial loans and investments continued to show strong growth this quarter. These totaled $6.6 billion at March 31 and included approximately $6.4 billion in commercial loans and approximately $200 million in direct real estate investments through sale leaseback transactions. The direct real estate investments are shown in property and equipment net.

Sale leasebacks are something that we are excited about for 2006. Healthcare real estate is an area where CapitalSource's deep expertise and is truly a leader in the field.

On the income statement, we are now including operating lease income above the line as part of our primary activity due to the income we earn from our sale leaseback financings. As a result, we similarly report net investment income, which includes operating lease income in addition to interest and fee income and we are now reporting net finance margin, which includes the sale leasebacks as profitability metric instead of net interest margin.

Now let me touch on the results for the quarter. John has already elaborated on some of the items that drove this quarter's performance. Also our press release provides additional details, however I would like to highlight a few notable items. Adjusted earnings per share was ahead of our expectations this quarter as a result of strong yield and other income in our Commercial Lending & Investment segment. Yield in our commercial lending investment segment was better than our expectations, up 54 basis points this quarter to 12.69%. This was due to a largely a 53 basis point increase in fee income driven by an increase in pre-payment related fees.

The interest income component of yield was relatively flat this quarter as increases in our short-term market rates were largely offset by decreases in our lending spread. But as part of our previously discussed plans, we had forecasted decrease in lending spread this quarter and throughout the year as we begin to use the pricing power of the REIT structure to be more competitive and at the same time maintain or improve overall returns. Also while lower quarter-over-quarter, other income in our commercial segment was better than our expectations in part due to receipt of a break-up fee related to a prospective loan.

Provision was up this quarter driven by growth in the loan portfolio as well as additional reserves provided for certain existing situations; however, charge-offs were virtually nil for the quarter. As John mentioned in his remarks, the credit metrics for the

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portfolio were stable this quarter and the built-in allowance is due to the limited charge-offs. One thing to note though is that when we do have charge-offs we expect our credit stats to improve as the charge-off balance would be removed from the calculation of the statistics.

Operating expense on a consolidated basis was down this quarter as a percentage of assets, but was up in dollar terms principally due to higher compensation expense. This includes higher compensation expense driven by our expanding employee base. However, most of the increase was due to higher incentive compensation expense compared to last quarter due to the relatively low incentive comp accrual in the fourth quarter last year. We consider the first-quarter run rate for compensation expense to be more indicative of what we expect to see in the business.

Other admin expenses were up this quarter too. We saw additional professional fees relating to the finalization of work on our reconversion and as a result, professional fees were higher than we expected but we expect those costs to abate in the second quarter and for the rest of the year. Also showing up in operating expense this quarter are expenses related to the new activities we have pursued as a REIT. These include depreciation for our direct real estate investments and management expenses related to our Residential Mortgage Investments. These expenses were fully anticipated in our plans.

Based on changes to the Company including the increase in the size of the balance sheet and the broadening of our sources of revenues, we no longer look to operating expense as a percent of assets as the primary measurement of our efficiency of our operations. Instead we now look to efficiency ratio as the better measure. Efficiency ratio is defined as operating expenses divided by the sum of net investment income and other income. Since we focused on our efforts more on generating income for the Company than simply growing the balance sheet, we think efficiency ratio has become the better measure of our effort. We currently expect efficiency ratio to improve during 2006 from the approximately 35% rate in the first quarter to an average of approximately 31% for the year.

The final income statement item I'd like to review this morning is income taxes. Due to our REIT conversion, we will see a lower tax rate this year. As indicated in our press release, we currently expect our annual effective tax rate to be 22.9% for the year. This is the blend of our REIT, which should generally not pay federal income tax, and our taxable REIT subsidiary, which we have an expectation of a 38.6% annual effective rate. The overall effective rate of 22.9% for the consolidated results reflects our current forecast for the business as well as the expected mix of income between the REIT and the taxable REIT subsidiary.

During the first quarter we wrote off $4.7 million of net deferred tax liabilities due to our change to REIT tax status. This write-off was expected and had the favorable effect of reducing our effective tax rate for the quarter to 16.8%. In the second quarter we will not have the benefit of this write-off and therefore expect our effective tax rate to increase to 22.9% for the quarter, second quarter and for the rest of the year.

In terms of guidance, on a consolidated basis, adjusted earnings for the quarter were $0.53 per share, up 35% from last quarter. This compares to our quarterly dividend of $0.49 per share. Our guidance for dividends this year currently remains at $1.96 per share. We expect to pay this annual dividend in level quarterly dividend payments. We would like to keep the focus on dividends. So while not specifically guiding to an adjusted EPS number, I can say that I expect our payout ratio of dividends to adjusted earnings would not be more than 90% on an annual basis.

Based on the tax rate increasing in the second quarter and on other things I have mentioned, we expect that the second quarter adjusted EPS may not exceed the adjusted EPS level this quarter; however, we do in general expect our quarterly adjusted EPS to be higher in the second half of 2006.

The last topic for me is financing and the execution of our funding plan for the Company. As mentioned in the release, we continue to make great progress on our plans. In addition to arranging financing for all the Residential Mortgage Investments, recently increasing and improving some of our credit facilities, and completing another successful commercial loan securitization, our eighth, we also took a big step forward this quarter with the completion of our unsecured revolving credit facility. This was a $545 million facility with 12 participating banks. As previously discussed, we are working this year to develop even more

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sources of funding for the Company including having a greater percentage of our debt be in the form of unsecured debt so the unsecured credit facility was a terrific start for us.

With that, I will turn it back to John.

John Delaney - *CapitalSource Financial - Chairman and CEO*

I think at this point we would like to open it up for questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) Bob Napoli, Piper Jaffray.

Bob Napoli - *Piper Jaffray - Analyst*

Nice quarter. Just a quick numbers question and then a broader question if I could. On the operating lease income of $4.6 million, the assets that are associated with that, is that -- what is the operating lease assets? Is it the 212 or some portion of the 212?

Tom Fink - *CapitalSorce Financial - CFO*

Yes, Bob, that's right. That operating lease income is coming from the sale leaseback investments, which is approximately $200 million transaction we talked about. That transaction closed towards the end of January. So what you see in the adjusted EPS calculation is basically two months worth of rent income there, so our quarterly run rate will be a little bit higher on that item.

Bob Napoli - *Piper Jaffray - Analyst*

On the $4.6 million? Okay.

John Delaney - *CapitalSource Financial - Chairman and CEO*

Bob, just so we're clear, we expect more those deals to come on. We have a very strong pipeline of healthcare sale leaseback transactions. So we expect that number which Tom is referring to. He is giving you the quarterly number for that particular transaction, but I would expect the quarterly numbers in the aggregate for this category to be growing across the year as we add more of these deals.

Bob Napoli - *Piper Jaffray - Analyst*

What are you leveraging those deals at over the long run, the sale leaseback transaction specifically?

Tom Fink - *CapitalSorce Financial - CFO*

I would think a reasonable amount of financing is in 80% area.

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Bob Napoli - *Piper Jaffray - Analyst*

My last question just a broader question, John. Where are you seeing the most opportunities within your business today? Where should we expect to see the highest growth? It seems like you've gotten a little more positive on the corporate finance business.

John Delaney - *CapitalSource Financial - Chairman and CEO*

Yes, I would say at this moment in time when I look at the businesses which I will put into three buckets, real estate, corporate lending, and asset-based lending. I think at this point in time and I would not have said this at any other point across the last year I think all businesses are showing good growth. I think the healthcare business across the last few quarters has shown very good growth and we expect that to continue. As I said, the pipeline for healthcare real estate transaction is particularly deep right now and we are expecting some rather big things out of that business for the rest of the year.

The healthcare [AR] business continues to be a solid grinded out business. The real estate business as I said, has been enabled quite a bit by the REIT election and that has given it some nice tailwind if you will and I expect good growth in a business. Our asset-based businesses mostly on the business credit service side continues to grow. It's growing off a small base so it's having fairly high percentage growth.

So what I just said I would have said a similar thing last quarter. I think what has changed this past quarter is I think the corporate finance business is now going to start growing again. I think our expectations for growth will be modest because it is still a fairly liquid market, but we have experienced a lot of payoffs in that business. We think that is going to slow down. We are actually very pleased that we had some payoffs and some deals that were somewhat on our watchlist. So from a credit perspective one of the reason I make these comments about positive credit pipelines is some deals that hadn't really become problems yet but were kind of sliding into a watch category were refinanced out in this past quarter. So we feel very good about that.

But really on origination side we've spent a lot of time and invested a fair amount of money in building a syndications capability which to my mind is doing a great job and leveraging that we have enabled the Corporate Finance business to go after a slightly larger customer. It is still a midmarket borrower from the perspective of the LBO universe if you will. But it is slightly larger and we're selling off and managing our whole sizes down to smaller levels which we've spoken about in the past.

We're really seeing a lot of good activity in that business. I think the team is energized. They understand our commitment to the business and we have done some things internally to try to make that business even more competitive. And I am expecting that business to get back on a fairly gentle glide path towards growth starting this quarter.

Bob Napoli - *Piper Jaffray - Analyst*

Thank you.

Operator

Joel Houck, Wachovia.

Joel Houck - *Wachovia - Analyst*

Thanks and nice quarter as well. Going back to Bob's question about the lease income, if I just do that math, it's about $7 million in rental income for the quarter and 10 to 12 million kind of implies a 13% annualized yield. Do you have subtract the depreciation to get the net yield of where you guys guided for for these products? Is that the right way to look at it?

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John Delaney - *CapitalSource Financial - Chairman and CEO*

I think I will chime in on one part of then Tom (inaudible). I think you can't completely annualize it because it did close toward the end of January. And when you start annualizing small periods, one additional week does change your number quite a bit there, Joel. That is just one, I think it was the third week of January. So I don't think -- the perfect calculation is not two-thirds of the quarter there. I think it is some larger percentage of the quarter, but then as it relates to the recognition of the income, Tom, I think you wanted to comment on that.

Tom Fink - *CapitalSorce Financial - CFO*

Just one thing with the way these sale leaseback transactions work, there's sort of a going in cash rental but what we actually have to recognize for GAAP purposes is more of a straight line rent, so the yield, if you will on that investment is sort of in the neighborhood that you talked about, which incorporates all of the expected escalators in the underlying lease payments.

John Delaney - *CapitalSource Financial - Chairman and CEO*

You see, the way that works just to drill it a little deeper, the way these leases are written they have a going in yield which depending upon the size of the portfolio -- if it's a one-off transaction it could be as high as 10%. If it is a portfolio, which gives you significant benefits because typically you're not only spreading your risk across multiple assets from an operating perspective but you may be spreading your risk across different states and one of the risks in the nursing home business for example is the state Medicaid programs. If you buy a portfolio that's in multiple states you inherently have a lower risk investment. But those will tighten down to even as potentially as low as 8.5 but probably closer to 9% going in yield.

But then what you do is across that 10-year period you negotiate escalators and those escalators are typically 2% per year, not 2% in absolute. You're going in rent times 1.02 per year if you will. And you're required to look at what that is across the 10-year period and average it and straight line it as Tom said. So that is really what happens there and that is a requirement by GAAP and it is the same thing all healthcare or other sale leaseback REITs do.

Joel Houck - *Wachovia - Analyst*

Okay. I think I've got it. That's great color. If I can kind of look at going back to your average yield guidance of 11 to 5, this kind of goes back to the guidance you guys set-- it's obviously running higher than that now. Does that guidance fully incorporate this new net investment income yield concept or is there something that has changed there?

Tom Fink - *CapitalSorce Financial - CFO*

I think yield is still yield. We calculate yield based on the loan portfolio and other interest-earning assets, so I would not include operating lease income in the yield calculation.

Joel Houck - *Wachovia - Analyst*

I've got you there. It's really a margin issue.

John Delaney - *CapitalSource Financial - Chairman and CEO*

You should model it as a separate category is I think what Tom is saying.

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Joel Houck - *Wachovia - Analyst*

Okay. Do you guys have in terms of the 1269 yield, the breakdown between the loan percentage prepayment fees and then the fees other than prepayment? Do you have that handy?

Tom Fink - *CapitalSorce Financial - CFO*

Sure, we can get that for you. Let me follow up on that.

Joel Houck - *Wachovia - Analyst*

Okay, lastly on the tax rate guidance, Tom, I think you said 22.9 for Q2, Q3, and Q4 and I understand why it goes back up from Q1 but shouldn't it start to go down sequentially from Q2 just based on the efficiencies of the REIT structure or am I missing something?

Tom Fink - *CapitalSorce Financial - CFO*

No. Actually it won't and the reason is it's a little bit tricky but indulge me for a second. All of the REIT's income is subject to tax and what happens is you get a deduction for the dividends you actually pay, so from a FAS 109 perspective, what we are required to do is project out the business for the full year and make our best guess if you will or forecast between the income between the REIT and the TRS and have a level tax rate for the full year. So it is not something that will float down every quarter, but it is more of an annual projection.

We do expect obviously continued tax efficiencies in the future, which you would see in a lower, even lower 2007 tax rate as the higher percentage of the earnings of the Company come from the REIT in '07 versus '06.

Joel Houck - *Wachovia - Analyst*

Okay, I'm with you. Great. Thanks a lot.

Operator

Moshe Orenbuch, Credit Suisse.

Moshe Orenbuch - *Credit Suisse First Boston - Analyst*

I was wondering if you could maybe just expand a little bit on the issues as to how you go from the 35% to 31% kind of efficiency ratio and maybe how much of the cost related to the specific one-time or professional type fees in the quarter and what other steps figure into that?

Tom Fink - *CapitalSorce Financial - CFO*

Basically, Moshe, the resi business is obviously less efficient for us than our commercial business, so the 35% I talked about is for a consolidated basis and very simply as the go through the year, we expect our commercial loan and investment portfolio to grow and a higher percentage of the earnings of the business come from that and that is really the principal driver of the improving efficiency ratio that we expect to see this year.

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Operating expenses were higher this quarter than we expected principally because of professional fees in the business, which as I mentioned we do expect to abate. The professional fees were just about $2 million this quarter. So we expect to see much lower levels there in the future. Does that help, Moshe?

Moshe Orenbuch - *Credit Suisse First Boston - Analyst*

Yes, thanks.

Operator

Stephen Schulz, Keefe, Bruyette, Woods.

Stephen Schulz - *Keefe, Bruyette & Woods - Analyst*

Just a question on the portfolio mix shift. It looked like in the quarter there is a pretty significant shift into mortgage assets and what you guys obviously have commented are lower risk. However the credit metrics have remained pretty stable, so I am just curious would you expect under normal circumstances to have the credit metrics at least look more favorable given the mix shift? And if so, are you seeing a deterioration elsewhere in the portfolio?

John Delaney - *CapitalSource Financial - Chairman and CEO*

No, I go back to the comments I made earlier which is our view of the credit profile of the business is certainly stable to improving. I use the term positive credit pipeline and what I'm really referring to there is we not only track the loans that appear in these various categories but we track loans as they migrate to a point where they could potentially appear in these various categories. Then the number of loans in that pipeline if you will is decreasing on a relative basis to our minds, which would lead to a conclusion at some point in the future these statistics will improve.

I think the other thing that's going on with the statistics and Tom mentioned this, the charge-offs were unusually low. Clearly we're projecting charge-offs for the business. We didn't have any this quarter of any significance. There is a timing issue there with when you recognize the charge-offs, recognizing further that we have reserves allocated against loans that are problematic. So what will happen when charge-offs occur is you should probably see these statistics actually improve because the loans -- we have some loans in these categories that are fairly fully reserved against that or kind of bloating the categories if you will. So it is our view that the credit picture of the Company is improving.

Stephen Schulz - *Keefe, Bruyette & Woods - Analyst*

Just one follow-up. Can you guys comment just on trends in Medicare or Medicaid reimbursements? I understand that the Center for Medicare and Medicaid services proposed some cuts to reimbursement levels and just curious how or what impact you may see and the outlook for growth or credit quality in the healthcare finance business particularly in the receivables, Medicare and Medicaid receivables finance business that you guys do?

John Delaney - *CapitalSource Financial - Chairman and CEO*

Yes, the receivables finance business you never want to say anything is immune from reimbursement changes, but the receivables finance business is largely immune from reimbursement changes because to the extent reimbursement changes occur they are not applied retroactively. So you are lending on receivables on a current basis based on the current reimbursement mechanism in place or regime in place. As changes are made, which they do all the time throughout all the different subindustries of

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healthcare which we track, we've got a very large staff of healthcare CPAs who are experts in reimbursement. We make adjustments to the borrowing basis as those changes go into affect and again there is generally a fairly lengthy provision or lengthy period of time before when you first learn about a reimbursement change and when it is applied that allows you to make adjustments to those borrowing basis.

You would argue that severe reimbursement changes could affect the financial viability of the companies, which in fact is the case and has historically occurred from time to time, but that is again one of the reasons you will end on the receivables because even if the business is no longer a viable enterprise, you should be able to get out of your loan whole through a liquidation and collection of the receivables, which unfortunately we have proven that to be a true statement in the past.

Where reimbursement can be more problematic is on the real estate side, because when you're landing healthcare real estate it is to some extent an enterprise value loan and the value of that enterprise is driven by the cash flow, which is driven by the reimbursement. It is our view that reimbursement in the long-term care sector is very stable right now, which is where all of our real estate activities are effectively focused. In the past we have financed impossible assets. We tend to finance those at very low multiples to cash flow, which reflects our view of the volatility of the reimbursement in hospital, and a lot of the noise that has come out of Washington recently around reimbursement has generally been more focused on hospitals and further on specialty hospitals, which is not where we have a lot of exposure right now.

Stephen Schulz - *Keefe, Bruyette & Woods - Analyst*

Great, thanks a lot for the color.

Operator

Don Fandetti, Citigroup.

Don Fandetti - *Citigroup - Analyst*

John, in the past you have talked about additional funds that could drive fee income. Can you comment on any progress there?

John Delaney - *CapitalSource Financial - Chairman and CEO*

There's nothing specifically we want to comment on. We are looking at several things in that area but I wouldn't put anything under the category of material and certainly not under the category of things we would want to be promoting prior to us knowing exactly what they are, but we do have several things in the works. And I am not trying to be evasive about the comment. I'd more put it in the category of I tend to think these could be some good-sized items for us in the future but I don't want to get people focused on it right now in terms of how they value the business because they are not here yet.

Don Fandetti - *Citigroup - Analyst*

Okay. I just joined so you may have commented on this but there are some large healthcare real estate deals in the marketplace. Are you looking at some of those and would you consider a joint venture transaction?

John Delaney - *CapitalSource Financial - Chairman and CEO*

Yes, we are looking. There has been a lot of private transactions in the nursing home sector. We have been involved in most of those to some extent, some to a meaningful extent, some to a smaller extent. There are other things going on in the healthcare

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REIT space for example that are in fact very interesting we think. And we talk to everyone and we are looking at a variety of things, but nothing specifically that we can comment on of course, but other than to say we think as it relates to long-term care assets, we I believe have the most significant set of competitive advantages in the business because not only do we have what I think is the best team at providing real estate financing to long-term care providers both in terms of mortgages and sale leasebacks, and that in and of itself is a competitive advantage because we do do both, but we have this kind of robust corporate lending practice that focuses on nursing homes.

So I think to a long-term care operator we offer more than other healthcare REITs. That coupled with some of the other advantages in the platform, cost of funding, etc., lead me to the conclusion that over time we should be the dominant player in that business. So it would not surprise me if we are involved in things going forward that occur in that industry. It's just got to be things that make a lot of sense for our shareholders.

So there's a lot of things going on and we have to look carefully at them both how they fit strategically and how they fit from a bottom-line perspective.

Don Fandetti - *Citigroup - Analyst*

Okay, thank you.

Operator

[Darren Peller], Lehman Brothers.

Darren Peller - *Lehman Brothers - Analyst*

In the past you guys have mentioned that for purposes of reserving for the corporate loans and I guess the cash flow base loans typically require higher reserve requirements. And I am curious to know given the fact that you're talking about a strategy going forward of more corporate finance type loan lending, will you be increasing the reserve levels and should provisions have an impact going forward?

John Delaney - *CapitalSource Financial - Chairman and CEO*

We do take more provisions when we make corporate finance loans because they are in fact riskier. That is kind of known to most people and we have seen that in our own portfolio. So it does affect our reserve levels. Mix of business does drive reserve levels and that is one of the reasons you have seen reserve levels move historically. I think that as it relates to our results, the corporate finance business, which has been a flat to declining business, will start increasing. And as I said, I don't think it will be explosive growth in that business because it is a very competitive marketplace and we also have paydowns, but I think it -- what I'm really saying is it will turn the tide from a shrinking business to turn it into a more growing business.

So I don't think that incremental growth across what is now becoming a reasonably large portfolio and the additional incremental reserves associated with those loans will really have any material effect of our results certainly, but it will cause there to be a slight change in the blended reserve levels, which are derived in part based on mix of business.

Darren Peller - *Lehman Brothers - Analyst*

Okay. Then you had also talked a little bit about going forward charge offs, being I think you mentioned around $42 million for the year. I think there was some sort of guidance given in the past. Is that still standing?

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John Delaney - *CapitalSource Financial - Chairman and CEO*

Yes, we're not changing any guidance at this point.

Darren Peller - *Lehman Brothers - Analyst*

Okay, thank you.

Operator

Donald Destino, JMP securities.

Don Destino - *JMP Securities - Analyst*

Most of my questions have been asked (technical difficulty) but there are few to remain. Tom, where are you (technical difficulty) in terms of the residential portfolio? Are you at a point where you would qualify, where you would pass the REIT test as of March 31? Or do you still have some work to do throughout the remainder of the year?

Tom Fink - *CapitalSorce Financial - CFO*

No, I think we did not say this explicitly on the call but clearly we complied with the REIT at the end of the quarter and I think we are in good shape. But the nice thing about the residential portfolio is that it is something that it is a great fine-tuning mechanism and we can really use it to balance what's going on in the rest of a business. As I said optimize the value of the REIT structure. We feel pretty good, but it is subject to change based on how we see the rest of the business performing.

John Delaney - *CapitalSource Financial - Chairman and CEO*

We probably should've been more clear about that, Don. We believe we have done everything we need to do.

Don Destino - *JMP Securities - Analyst*

Okay. A continued big ramp in that portfolio, but that is going to be more changing on the margin?

Tom Fink - *CapitalSorce Financial - CFO*

Exactly. I would definitely characterize it as that.

Don Destino - *JMP Securities - Analyst*

Okay, then I jumped on a little late as well, so you might have commented on this. I think I have it in my notes -- should we expect a bump up in stock based compensation in the second quarter? Is that the quarter that will annually get a little bump there?

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John Delaney - *CapitalSource Financial - Chairman and CEO*

That was unique last year.

Don Destino - *JMP Securities - Analyst*

For some reason I thought it was something that kind of annualized in every year something else vested and it jumped up every second quarter, but maybe I'm wrong?

Tom Fink - *CapitalSorce Financial - CFO*

No. Your recollection is correct, Don, on that. I think it would not be as noticeable this quarter. That was a particular dynamic last year I think.

Don Destino - *JMP Securities - Analyst*

Got you. The final housekeeping question, just a little more color to try to get me to understand a little better the tax rate issue, so next -- you'll basically hold a 23% or 22.9% for the remainder of this year as far as your expectations go and then next year you'll come up with another steady run rate dividend expectation that will drive what the effective tax rate will be in all four quarters of next year? Or is it -- will next year be more of a ramp depending on where the business is growing?

Tom Fink - *CapitalSorce Financial - CFO*

No, the former. It is going to be an annual projection if you will of the tax rate. But let me also make clear that the effective tax rate just as we have seen in the past is subject to changes in the business and updates in our forecasts. And when we have those updates, they get reflected as sort of a cumulative catch-up in the quarter, so we could see changes in our tax rate, our effective tax rate this year driven by just a respective opportunities we see in or have realized in the REIT versus the TRS. So it is a number that can move around this year, but the methodology that is behind it is an annual projection, as you mentioned.

Don Destino - *JMP Securities - Analyst*

I got it. Thanks very much. Nice quarter.

Tom Fink - *CapitalSorce Financial - CFO*

Let me also before too much time passes just follow up. Joel Houck asked a question about prepayment related fees and we had about $42 million worth of fee income in our commercial investment business this quarter. About $17.4 million of that was related to prepayment fees. Prepayment fees as we identified in the press release were 105, contributed 105 basis points to yield in the quarter, which is strong. As I think people know, we typically forecast about 50 basis points as a run rate and it is a lumpy number around that.

Operator

Carl Drake, SunTrust Robinson Humphrey.

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Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Thank you and good morning. I just had a question. The 158 allowance is unusually high because of the unusually low net charge-offs in the quarter, but should we think directionally that that is the highest level we should see and start to see a mix shift even with the slight increase in corporate finance loans still see that start to trend back down?

John Delaney - *CapitalSource Financial - Chairman and CEO*

I think that's probably right.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Would you say in the high 140s, maybe trend back down to the high 140s level?

John Delaney - *CapitalSource Financial - Chairman and CEO*

It is a little bit hard to predict. Our reserve policy as you know we take a general reserve and then we allocate part of that general reserve towards some known situations and the rest remains unallocated towards the rest of the portfolio. And what we have as I said, what we've seen in terms of problem situations we haven't seen a lot of new situations enter into the category. So you could assume that when some charge-offs occur that the reserve level will go down based on that. But it is hard to predict on a quarter-by-quarter basis where that will go. But I would expect, my own guess if you will would be that it will not increase off these levels certainly in any significant degree and I don't think, Tom, you'd probably --?

Tom Fink - *CapitalSorce Financial - CFO*

That's right.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Second question on the guidance you provided on average loan balances for '06 I think it was about $7.3 billion on the commercial loan side, do you still feel pretty good about that?

Tom Fink - *CapitalSorce Financial - CFO*

Yes, I would say the growth guidance we've talked about in the past is probably or it was a blend of both commercial loan assets as well as these direct real estate investments through sale leaseback transactions.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Sure, okay. But that 7.3 inclusive of those two still looks good?

John Delaney - *CapitalSource Financial - Chairman and CEO*

Yes, as I said, we're not changing any guidance at this point.

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Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Last question, is there any commentary on the ILC, potential ILC charter?

John Delaney - *CapitalSource Financial - Chairman and CEO*

I think it stands where we said, which is that we have done what we need to do. We continue to feel very good about the fact we will receive the charter. I suspect our friends at the FDIC are busy with a lot of things going on around this issue. We are just waiting to hear.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Thank you. Good quarter, guys.

Operator

Scott Scher, Clovis Capitol.

Scott Scher - *Clovis Capital - Analyst*

John, can you talk about the Capitol you raised in the first quarter, the equity obviously was somewhat front-loaded in terms of what you expected to do for the year. Can you just remind us how much equity you need to raise and whether or not you anticipate through some of the deals in the up-REIT structure that you'll be able to raise that through some of those deals?

John Delaney - *CapitalSource Financial - Chairman and CEO*

Yes, you are bringing up a good point, Scott, which is that the up-REIT structure which is the transaction or the down-REIT structure is more specifically what we refer to it as that we did in the first quarter is effectively issuing shares in a very efficient manner. We are gaining an asset as part of issuing the shares, so we don't have that drag that you were referring to and you don't pay any additional frictional costs associated with it as it relates to raising it through the market.

Since we do have as I said earlier a deep pipeline of transactions in that area which we are excited about, we expect some of them to be in that structure and so that will alleviate some of the demands on us raising capital in the market which I think net-net is just all positive.

Scott Scher - *Clovis Capital - Analyst*

Are the deals -- and I ask the question because you specifically called out your excitement with the backlog or the amount of deals you're looking at. If you were to close them all, I'm not asking for a guarantee but if you were to close them all would that fulfill your need to raise equity?

John Delaney - *CapitalSource Financial - Chairman and CEO*

Well they are not all -- some of them are cash deals. Do you see what I mean? I can't answer that specifically. Let's put it this way, there is a chance that if we were to do the deals in the pipeline we would not go back to the market this year to raise equity in the market.

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Scott Scher - *Clovis Capital - Analyst*

Thank you very much. Great job, guys.

Operator

Sameer Gokhale, Bear Stearns.

Sameer Gokhale - *Bear Stearns - Analyst*

I know you have talked about this a little bit, about the issues about the yield and the breakdown, but I didn't catch all of that. I just wanted to clarify this quarter you had the 12.69% yield and that included 105 basis point benefit from the prepayment income, but what was the offset to that compared to last quarter? Was it just a decline in the rates you charged on your loans? Is that it?

Tom Fink - *CapitalSorce Financial - CFO*

That's right, because the core if you will, fee income quarter-over-quarter in dollar terms is relatively the same. What you saw this quarter in deal versus last quarter was an increase of 54 basis points and 53 basis points of that is due to an increase in prepayment related fees. We did see short-term rates rise during the quarter. That implies that our lending spread reduced, which is true, but that is all what we expected would happen is we start using this pricing power as being a REIT, and there's obviously a lot of other things that go into it, but we did a nice improvement in our ROE in the business, in the commercial lending business quarter-over-quarter, which in part proves my point about using the pricing power of the REIT to lower topline spread if you will to drive the same or better returns on the bottom line.

Sameer Gokhale - *Bear Stearns - Analyst*

Okay, that's very helpful. If I take your yield for the quarter and I guess the 105 basis points and then I add back in 50 basis points, which is what I think you model in for prepayment income, you end up with something like 12.14% and then you back out your funding costs and you end up with a margin of about 6.59%. That was slightly lower than I think what you guided to in your investor presentation of about 6.7% net yield and I was wondering in your comments -- I thought I heard you say that this margin is expected to trend lower. Is it going to trend lower from the adjusted 6.59% or is a going to remain stable around those levels after you adjust for prepayment income?

Tom Fink - *CapitalSorce Financial - CFO*

Well, it really depends. It depends on the mix of business because we're driving real estate originations in our REIT, which can be done at lower spreads and make the same or better returns. John also mentioned we are sensing -- seeing a little uptick in the corporate finance business, which is done in our taxable REIT subsidiary where we expect spreads to be higher. In part it really depends on what is going on not just in business as a whole but within and among the various groups. That's why we are not really providing specific guidance on that, but really kin of talk in terms of our guidance more on what we expect for dividends per share and also now adjusted earnings.

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Sameer Gokhale - *Bear Stearns - Analyst*

Okay, thank you. The last question I have was on the corporate finance business. How are you guys approaching that from originations? Are you now syndicating a fixed percentage of all originations in that business and you lined up some partners there? Are you doing it more on a case by case basis?

John Delaney - *CapitalSource Financial - Chairman and CEO*

I will cover that. There's two things going on in corporate -- three things really going on in corporate finance now. First is the platform from the origination perspective, as I said earlier, is really starting to increase or build their pipeline. I think the team is doing very well. We have invested in the team across the last few months and provided more resources to them, so it is a large team performing at a pretty high level right now.

Secondly we have lowered our hold sizes in that business and I talked about that in the past. That was a decision we made based on our normal evaluation of the business and we said that we used to hold a certain level and we lowered those hold sizes pretty materially 30%, 40%, from what we were holding historically which by the way I believe will result over time to kind of a better credit profile from that business because you won't have some lumpy problems like we've had in the past.

But the other thing that's happened is by investing in the syndication resources which we have done, which is run out of Chicago and it's a good sized team and we continue to add to it including just bringing on a very strong senior person recently, we feel like pretty much any deal we can syndicate and get a very read from that team, so what that allows us to do is go after deals 50 to a 100 up to 150 million in size, have a very good read on the market and depending upon the piece of the capital structure because these deals are generally tranched into revolvers, Term loan As, they may have Term Bs, they may even have mezzanine, we can basically control the whole deal in syndicate it. And depending upon the piece of the deal, whether it be the revolver, the Term A, the Term B, or the mezzanine, the universe can be from 10 to 50 people that they talk to that they have a constant dialogue.

To enhance that business we have created kind of an asset management business also run by the team in Chicago where they are buying pieces of other lenders' deals and they are doing it in an off-balance sheet structure. So CapitalSource is not taking the credit risk on those situations so it makes us a more active buyer in the market. That is immaterial. I think it will result over time into a nice fee income for the Company but one of the main reasons to do it is to make us a better buyer in the market and not put those loans on our balance sheet, which will therefore makes us a better seller. Because it is kind of a two-way street in the syndicated loan business.

All those things kind of I think get to your question about how we are approaching that business.

Sameer Gokhale - *Bear Stearns - Analyst*

Thanks a lot, guys. Great quarter.

Operator

[Dave Chamberlain], (indiscernible).

Dave Chamberlain - - *Analyst*

My questions have been answered. Thanks.

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Operator

Joel Houck, Wachovia.

Joel Houck - *Wachovia - Analyst*

Just a follow-up. Can you tell us the dollar amount of funding that is supporting the two asset pieces in the compliance portfolio? I see the reverse repos but it looks like there's some other funding down there on the balance sheet on the term debt side that I can't quite break out.

Tom Fink - *CapitalSorce Financial - CFO*

Yes, in the liabilities you see the reverse -- not the reverse, but the repurchase agreements and then there is about -- $2.4 billion approximately of term debt that is shown there as well.

Joel Houck - *Wachovia - Analyst*

Okay, and then just in terms of your comments about the payout ratio not more than 90% on an annual basis, does that apply to '07 as well as '06?

John Delaney - *CapitalSource Financial - Chairman and CEO*

I think it is a little early to talk about the '07 payout ratio, Joel, with all due respect to your desire to get deep on some of this stuff. But I think what we want to do is have a very significant cushion between our adjusted earnings and our payout ratio. We think that is prudent. We think it will help people understand that the dividend is something that's solid and safe and I think what Tom said is we want it to be no more than 90% and it could over time be less than 90%. So I think that's an evolving discussion, but the point we're really trying to make is that there is cushion between our adjusted earnings and our dividend.

Joel Houck - *Wachovia - Analyst*

Fair enough. Thanks.

Operator

(OPERATOR INSTRUCTIONS) At this time there are no further questions appearing in queue.

John Delaney - *CapitalSource Financial - Chairman and CEO*

Thank you for your time, everyone, and feel free to if you have some follow-up information, feel free to call any of us. Thank you.

Operator

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

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