FINAL TRANSCRIPT

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the third-quarter 2006 CapitalSource earnings conference call. My name is Minotia and I will be your coordinator for today. At this time, all participants are in a listen-only mode. We will conduct a question-and-answer session towards the end of today's presentation. (OPERATOR INSTRUCTIONS)

I would now like to turn the presentation over to your host for today's call, Ms. Claire Rosebush, Investor Relations associate.

Claire Rosebush - *CapitalSource Inc. - IR*

Thank you, Minotia, and thank you, everyone, for joining us for our third-quarter 2006 earnings conference call. With me today I have 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've 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 1 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'd like to turn the call over to CapitalSource's Chairman and Chief Executive Officer, John Delaney.

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

Thanks, Claire. Let me start by reviewing the larger themes for the quarter, and then I'll turn it over to Tom, who will provide a more detailed overview.

We had an exceptional bottom-line performance this quarter, driven in part by strong prepayment fees. Adjusted earnings per share for the quarter were $0.71 compared to $0.57 per share last quarter, which is a 24% increase. Prepayment fees are an essential and recurring part of our business, and they flow from the style of high-touch lending we provide.

Equity gains from our diverse and growing portfolio of equity coinvestments were also strong this quarter. Again prepayment fees and equity gains may be lumpy at times, but they are core and recurring to our business. This quarter's performance, or return on equity, on an adjusted earnings basis was 24% after-tax, shows what this diverse franchise of high value-add market-leading businesses is capable of delivering.

Net asset growth was lighter than average, in part driven by these prepayments, which drove the high prepayment fees. In addition, many closings off our pipeline slid into the third quarter, effectively moving our asset growth assumptions back. Average assets were actually $8.1 billion for the quarter, which is above the quarter-end core assets of $7.6 billion, and which would be opposite dynamic that we observed last quarter. As we predicted last quarter, we experienced an uptick in business from our corporate finance business, which is benefiting from its repositioning as more of an up-market strategy.

I'd like to refer you to slide 7 in the investor presentation that Claire referred to to discuss our pipeline. This page details the pipeline across the last 11 quarters, and it also details our closing rate, or our deal selectivity ratio. As you can see, the pipeline grew nicely to $42.5 billion of new transactions entered into our systems for review in the third quarter; and our closing rate tightened to 3.6%, again reflecting an evolution of the credit platform of the Company.

One of the reasons that the pipeline is growing is in part based on what I referred to in the corporate finance business, how it is pursuing a more up-market strategy and going after larger deals and syndicating down our exposure. Even though the hold sizes in these transactions are similar to what we've been holding historically, the face amount of the transactions that are actually entered into the system are actually higher, and that is one explanation as to why the pipeline is growing.

The REIT election continues to drive very attractive opportunities in our real estate related businesses. Today, we announced that we have entered into definitive agreements to acquire 106 long-term care facilities from three sellers in three unrelated transactions. Transaction size is about $660 million, and we expect these transactions to close in the fourth quarter and into January of next year.

These transactions are all in the long-term care sector, which is a core competency and strength of the Company. And these transactions, when combined with our current portfolio of real estate related health care investments and loans, indicates that

CapitalSource as one of the largest health care REITs within our diversified franchise. You should expect more transactions along these lines in the future.

Credit trends and the credit pipeline remain stable. Delinquencies were down this quarter and nonaccruals were up, but the overall credit picture is solid. As I've said in our last several calls, credit metrics will be lumpy. One loan, for example, can move these stats up and down 50 basis points, and we certainly don't read anything into movements of these magnitudes, either up or down. More importantly, as we have said in the past, we feel very good about our credit pipeline.

We continue to see good opportunities in the highly transactional middle market, while also observing a competitive marketplace. The benefits of a diversified franchise. where we can leverage our credit expertise, market insight and funding advantages across multiple best-in-class origination platforms is never more important than in the kind of market we find ourselves in today, and continues to be the greatest strength, and I would say perhaps the most undervalued component of this franchise.

Let me close by confirming our dividend guidance for 2006 and 2007, which we just provided a little over a month ago at our investor conference, of at $2 per share for 2006 and $2.40 a share for 2007.

So with that, I'll turn the call over to Tom, who will provide a more detailed overview of the quarter.

Tom Fink - *CapitalSource Inc. - CFO*

Good morning, everyone. Thank you, John. Our bottom-line results this quarter, as John outlined, were indeed very, very strong. We've provided a fair amount of detail about our results in the press release, so my focus this morning is to put a little more color behind this quarter's results.

We anticipated a strong performance in the second half of 2006, which was factored into the guidance we provided at our investor conference in September. Our adjusted earnings performance this quarter was better than our expectation.

The first of my comments is that, similar to many quarters in the past, some relatively lumpy aspects of the business came into play this quarter. Specifically leading the highlights of this quarter's performance was prepayment. Prepayments were way up in dollar terms this quarter; however, so was the amount of prepayment-related fee income.

As we have seen in quarters past, our business model regularly produces strong fee income, in part driven by prepayment-related fee income. It is a significant contributor to bottom-line performance, albeit sometimes a lumpy one. During the quarter, we earned $26.4 million in prepayment-related fee income in our Commercial Lending and investment segment, up from $10.9 million in the second quarter. This equated to 137 basis points of yield in the Commercial Lending and investment segment, up from 63 basis points last quarter.

In part due to the heavy, lumpy volume of prepayment activity, net growth in the Commercial Lending portfolio was a little light this quarter, and was less than the average quarterly growth rate we saw in the first half. However, we entered the fourth quarter with a strong pipeline.

With respect to sale leasebacks, specifically during the third quarter, we closed on an additional $29 million of investments. Net growth there was $26.7 million, reflecting some depreciation on the direct real estate portfolio during the quarter. We have a very strong pipeline in the sale leasebacks. As mentioned in our press release, we have signed definitive agreements on three large transactions totaling over $660 million and 106 properties. We expect these transactions to close in the next 60 to 120 days.

The second thing I'd like to comment on is that in addition to strong prepayment-related fee income, core lending spreads in the Commercial segment, that is, the basic coupon component of yields less the weighted average 30-day LIBOR, was in excess

of our expectations. For the quarter, core lending spread was 4.93%, down 44 basis points from the second quarter. As discussed during our investor conference in September, we are expecting to see lower pretax spreads due to a number of factors, including using the pricing power advantage as a result of our REIT structure. So quarter-over-quarter, lending spread performance is directionally in line with what we expect, but better than we had forecasted.

A third element of our performance this quarter was the significant returns we saw in our equity investment portfolio, which John alluded to. During the quarter we saw a $7.2 million net gain on investments, of which $7 million were realized gains and dividends received. As you know, we frequently make small equity coinvestments in connection with our corporate finance business's lending activities, and this portfolio provides a recurring, but again, somewhat lumpy source of income.

(Technical difficulty) amortization of deferred financing fees. During the quarter, we completed our second term securitization of the year, including about $1.5 billion of assets. This transaction closed right at the end of the quarter and provided approximately $1.3 billion of term financing debt and included a three-year replenishment period, which effectively will serve to extend the life of these liabilities. The should contribute to lower borrowing spread in the future in terms of both lower cash coupon and lower amortization of deferred financing --.

With respect to credit, as predicted last quarter, delinquencies decreased. They decreased to 84 basis points from 131 basis points. Nonaccruals were up slightly from 2.01% to 2.39%, but within the range that we provided guidance to.

During the quarter, we charged off $22.8 million of loans, bringing our trailing 12-month charge-off rate in the Commercial segment to 57 basis points. We have been guiding to the full-year charge-offs of around $40 million, and at this point I think we should be close to our guidance for the full year.

The final comment is on tax rate. The main item we have focused on here in our discussion in these calls and other updates is the overall effective tax rate, excluding the impact of a onetime writeoff of net deferred tax liabilities in the first quarter. Our estimate of this overall annual rate was 21% in the second quarter, and it decreased slightly to 20.8% this quarter. The actual tax rate booked this quarter was slightly higher at 21.6% because we ran through a true-up of 2005 actual taxes paid to what was provided for in 2005. This is also bumped up the effective tax rate in the TRF to 39.2% from last quarter's 38.6%.

And with that update on the third quarter, I will turn the call back to John.

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

Thanks, Tom. We will probably open it up to questions at this point. It's just been brought to our attention that there might have been a bit of a blackout on the call for 30 seconds. So I hope we didn't lose too many people. We are not sure if that is true or not, but someone sent us an e-mail to that effect.

So assuming everyone is still with us, we would like to open it up to questions.

QUESTIONS AND ANSWERS

Operator

(OPERATOR INSTRUCTIONS) Bob Napoli of Jeffrey.

Bob Napoli - *Piper Jaffray - Analyst*

Thank you. Good morning. I guess I'd like a little better understanding. You did have one loan, you pointed out, that you were not aware of was a problem loan at the end of last quarter that charged off. Just to get an idea of the type of loan and the kinds of things that could happen, and if you can give some color on that, I'd appreciate it.

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

Sure. From time to time, Bob, we identify a situation that emerges quickly, and based on the facts, it is a more prudent position to go right to charge-off than the normal process. The normal process is we identify a problem, we excess it, we put up a specific reserve, we pursue the workout strategy and we resolve the loan, either at par or at the specific reserve amount or at some different amount.

But sometimes a loan present itself, and the facts appear particularly bad based on the event. It wasn't a real estate loan; it was a corporate loan. And we thought the more prudent tack was to go right to charge-off, which is what we did with that credit.

Bob Napoli - *Piper Jaffray - Analyst*

Do you have what was the recovery rate, I guess, on that --?

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

We are still resolving the situation. But rather than doing the normal specific reserving, we just went right to charge-off on that credit. So it is still in workout, and so the final resolution is not clear at this point. But we thought a more tack was to go right to charge-off.

Bob Napoli - *Piper Jaffray - Analyst*

Okay. And then, your loan growth was lower because of prepayments. You talked about a higher pipeline. I don't know if it was on the blackout period, but did you quantify -- give any feel for what that pipeline looks like and do you expect those sale leaseback transactions to close in the fourth quarter?

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

The net loan growth was lighter than average for a couple of reasons. One is, as we talked about, there were very strong prepayments this quarter, which drove prepayment fees.

The second thing that happened is the pipeline, as you can see, as I indicated on page 7 of the presentation, the pipeline is actually very large. But the closing off that pipeline, if you will, slid from things that we thought would close in the third quarter to the fourth quarter. Which is not an uncommon activity, particularly when you have a lot of prepayments at the end of quarter, which we did. That really resulted in the light net loan growth.

As far as the sale leaseback transactions, which we had been working on for some time, the three transactions that we signed up, we expect most of those to close in the fourth quarter, but some may slide into 2007.

Bob Napoli - *Piper Jaffray - Analyst*

And what type of an ROE do you expect on those transactions from the sale of leasebacks?

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

We are not talking specifically about the individual deals. What we've said in the past is that the unlevered yield on these transactions is typically in the 8.5% to 10% range. And it varies by portfolio size, portfolio quality, coverage ratio, etc. And when you run those through a leverage model, you end up with the targeted ROE we have for the Company.

Bob Napoli - *Piper Jaffray - Analyst*

What leverage do you use on those? Your targeted leverage for the sale leasebacks?

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

We don't necessarily have an individual leverage ratio for the sale leaseback portfolio. It's all part of the health care real estate portfolio. Tom, I don't know what detail you want to provide on that.

Tom Fink - *CapitalSource Inc. - CFO*

I don't think we'd provide any more specific detail there. The actual financing that we will achieve on those, some of that we're still working on for some of the future deals that will close. So it would be premature for me to comment precisely.

Bob Napoli - *Piper Jaffray - Analyst*

Thank you.

Operator

Laura Kaster of Sandler O'Neill.

Laura Kaster - *Sandler O'Neill - Analyst*

Good morning. Tom, just a little bit of clarification to follow up on Bob's question. The net charge-offs that you had this quarter, that $10 million which was -- the gestation period, which happened pretty quickly -- is that also inclusive of your $40 million net charge-off guidance for the year?

Tom Fink - *CapitalSource Inc. - CFO*

Our charge-off guidance for the year would include all charge-offs. So, yes, it would be included in that number.

Laura Kaster - *Sandler O'Neill - Analyst*

Okay. And just so I have all my ducks in a row, has there been any substantial change to any of the guidance that you gave us on the investor day?

Tom Fink - *CapitalSource Inc. - CFO*

I think the one thing -- obviously, the growth rate was a little bit -- the ending balance, I should say, was a little bit less than what we had forecasted, in part driven by the prepayments and in part driven by the slide of things out into the fourth quarter. We will see how that carries through in the fourth quarter, how much of that we can catch up on and how much of that is just things just pushed back a little bit in time.

So we are not today really updating any of the guidance we've given, other than to reaffirm our dividends for 2006 and also 2007. And in case -- I don't know at what point the call was blacked out, but John did confirm the dividend guidance of at least $2 dollars a share in 2006 for the full year, and $2.40 for 2007.

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

And while Tom said we're not going through a detailed guidance, I mean, in all material respects, the business is performing as we expected. Because we just provided a fair amount of specific detail to that business not that long ago.

Laura Kaster - *Sandler O'Neill - Analyst*

Okay, perfect. And just so you know, where it cut off on my phone was after you spoke about the equity investment income, $7 million of which was realized. That is where my phone blacked out. And then it came back in when you were discussing the tax rate.

And then I guess, John, if you could give us any type of update on the bank or any type of alternative deposit funding that you could see in the future.

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

Sure. We've made, I think, pretty clear to most people that we view deposit-based funding as part of our future. Our initial attempt at that was through the Utah Industrial Loan Corporation application that that we filed in -- I guess it has now been over a year. As you know, that application is caught up in a moratorium that has been opposed upon all industrial loan corporation applications, whether they be new charters or change of control situations.

And that moratorium is expected to last until the end of January. They haven't advised whether they will extend it or actually end it at that point. We hope it ends at the end of January and we would expect our application to be processed and approved. Obviously, we are being more cautious because we thought we would have it by now, and we didn't see this moratorium coming.

So we expect that to work. And if, for some reason, that doesn't work, we will pursue another strategy. But we think it's important for the business. We see lost of growth into the future. We see lots of way we can leverage this platform into other products and other businesses where deposit base-funding would be ideal. And it's a very high priority for us as a Company to obtain it. We hope in a few months we will be talking about how we expect our Utah Industrial Loan application to be approved. But if not, we will pursue some other strategy.

Laura Kaster - *Sandler O'Neill - Analyst*

Great, good luck. Thank you.

Tom Fink - *CapitalSource Inc. - CFO*

Why don't I just take a minute and just -- since Laura identified the part of the call that was missing -- the things I touched on very briefly were operating expenses, which were down slightly in total dollar terms, but on a percentage of average assets were 2.51% this quarter compared to 2.87% last quarter. Cost of funds was up due to higher short-term interest rates, but was lower in terms of our borrowings spread. Our borrowing spread was 91 basis points over LIBOR, about 9 basis points less than the prior quarter.

We did complete our second term securitization in the third quarter. It closed right at the end of the quarter, and this should contribute to lower cost of funds of the future, both on a cash coupon basis and also lower amortization of deferred financing fees.

With respect to credit, delinquencies decreased to 84 basis points; we had predicted that for people, from 131 basis points last quarter. Nonaccruals were up slightly, but within our range. And during the quarter, we did charge off $22.8 million of loans, bringing our 12-month charge-off rate to 57 basis points.

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

Go back to questions now.

Operator

Carl Drake, SunTrust Robinson Humphrey.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Good morning. I was wondering if you could comment on -- it looks like if I'm reading page 23 correctly, there were six new loans dropping into the delinquent nonaccrual bucket. It looks like your recovery improved in the three categories and at the mix of new loans coming into the unresolved category is favorable, in that the increase was in the asset-based area and the mortgage area primarily, and the cash flow came down.

Maybe you could provide a little color behind kind of updating us on page 23.

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

I think in terms of color, I mean, I think the numbers to some extent speak for themselves. Tom, I'm not sure what you would want to add.

Tom Fink - *CapitalSource Inc. - CFO*

I think you are right, Carl. There were two new -- just if you were to compare those two slides quarter over quarter, there were two new asset-based loans. We did have a couple of cash flow loans move up to the resolved category, with one new loan appearing there. And one real estate loan was resolved, and we had a net increase of four in the real estate loans, but mostly much smaller transactions.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Okay.

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

Let me add one thing, Carl. The one thing that isn't necessarily reflected on these statistics because we don't track it that far into the portfolio is that across the last, I'd say, nine months at this point, we've done a very good job of outplacing credits, but have not quite gotten to these categories but were things we might have been concerned about in the future. And I think we took a much more proactive approach to outplacing certain credits.

Again, it is not actually picked up in these statistics, but is one of the reasons when we look into the future, we feel good about the credit pipeline.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Yes, I was going to comment, it seems like the mix could be favorable from the fact that your recovery -- your growth in your unresolved category is in the higher recovery rate areas.

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

Yes. The other observation to make about credit that we do make from time to time is that our nonaccruals run much higher than our delinquencies, which is quite unusual in financial services, meaning many of our loans on nonaccrual are paying current. But we think it's prudent to put certain situations on nonaccrual, so that to the extent things were to continue to deteriorate, we don't increase our exposure in the credit.

Again, as I've said in the past, we provides high- touch lending in our businesses taking credit risk, and we do it very well, but from time to time loans appear in these categories. And even though our portfolio is getting more granular and more diverse as we grow the business, one loan could move these things one way or the other.

We saw that last quarter as one relatively large real estate loan, that we were fully aware of it being refinanced out, became a delinquent loan. And it didn't actually become a delinquent loan, if my recollection is correct, because interest was past due. It became a delinquent loan because the loan's term was up.

The other thing that is unusual based on our research is we actually include in our delinquent loans, loans that are both delinquent on interest and delinquent on principal, meaning they are past the term, which is not necessarily common practice. Many lenders just disclose loans that are delinquent on interest. And as we said that quarter that that was a meaningful move in the statistic, kind of the law of small numbers, if you will, working against us and that it would be resolved, which it was.

And so that kind of thing happens both positively and negatively. In other words, the fact that that loan existed and caused the delinquencies to go up and now caused the delinquencies to go down was essentially an irrelevant event for us. We tend to look deeper into the individual credits.

I don't know what other color you might be looking for on this page.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Well, that is helpful. I think it seems that recovery rates still appear to be pretty favorable. You don't see anything significantly changing there that would cause you to need to revise '07 charge-off guidance or anything like that?

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

That is right.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Okay. Last question is, do you expect this better-than-expected yield performance in the near-term to continue in the corporate area? And is that potentially driven by higher mix of corporate finance loans?

Tom Fink - *CapitalSource Inc. - CFO*

Well, it's really a mix of a lot of things, including changes in short-term rates and all that. Mix of loans is definitely part of it. I would say that the growth in the corporate portfolio net-net helped that versus what we had forecasted perhaps. I think we -- our guidance is based on our forecast which we build up from the bottom, if you will. I'd like to say we've hopefully been conservative with respect to our spread estimates, and that proved correct so far this quarter.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

And on prepayment fee income, and it's difficult to predict, last quarter you said you thought it might cut your way. Do you see anything into the fourth quarter that would help us, I guess, understand the volatility and the prepayment fees, jumping from 67 to 130 or so?

Tom Fink - *CapitalSource Inc. - CFO*

I don't see anything this quarter that would be -- the fourth quarter that would be as significant as the third quarter. We definitely don't see that. Just to kind of go back to our conventional modeling here is we typically model 50 basis points of prepayment related to fee income. The second quarter actually was ahead of that, and this third quarter obviously very, very strong, driven both by volume and also the amount of fees with respect to those loans that did prepay.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

So you would expect it to trend down back to more normal levels in the fourth quarter and beyond?

Tom Fink - *CapitalSource Inc. - CFO*

Yes.

Carl Drake - *SunTrust Robinson Humphrey - Analyst*

Okay, thank you.

Operator

Don Fandetti of Citigroup.

Don Fandetti - *Citigroup - Analyst*

Good morning. A couple quick questions. John, what type of IRR did you earn on that equity investment? Can you provide a range or some color there?

Tom Fink - *CapitalSource Inc. - CFO*

Don, this is Tom. There were several different investments; it wasn't just one investment. I mean, there was some realized gains, some dividends received. I think the thing that I would point out is we have about $107 million of investments on the balance sheet, and about $78 million of that is -- or about $80 million of it, I should say, is our coinvestment portfolio, what we call. So if you take that $7 million of realized gains divided by the [agency], it was a pretty nice return.

Don Fandetti - *Citigroup - Analyst*

Okay, that is very helpful. And just also, on your health care property acquisitions, two questions. One, were those competitively bid deals? And also, did the seller take your REIT units or was it all-cash type deal?

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

These are all-cash transactions, which was our preferred way of applying the assets. I would say that one situation was an existing client of the firm's, which was not a competitive situation; it was negotiated transactions between us and the seller based on our relationship with the company.

The second seller was not an existing client of the firm's right now, but we have done business with them several times in the past. And the third situation -- and that was probably the competitive situation. And the third situation and the larger situation was someone that we had not done business with in the past and it was not really a competitive situation.

We had known them and we had discussed this about a year ago, and it didn't move forward, based on some timing on their part really. And we relaunched discussion probably four months ago and consummated the transaction.

Don Fandetti - *Citigroup - Analyst*

Okay, thanks. That's all.

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

They weren't auctions, if that's what you were getting at. I think one of the situations, they talked to maybe three or four people. But one's existing client and we generated the opportunity by suggesting it to them. The other one was someone we had done some business with or tried to do some business with in the past.

Don Fandetti - *Citigroup - Analyst*

And there were no existing loans that are being replaced with properties? It's sort of a net add to the portfolio?

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

That's right, that's right.

Don Fandetti - *Citigroup - Analyst*

Okay, thank you.

Operator

Henry Coffey of Ferris, Baker.

Henry Coffey - *Ferris, Baker Watts - Analyst*

Good morning, everyone. You made some comments when Bob asked a question and I didn't catch all the details on a specific loan that you pushed right to charge-off.

And then secondly, I was wondering if you could give us some sense of -- I guess you'd call it the equivalent of a static pool loss ratio. When you look at your older, seasoned loans, what sort of losses are we trending towards?

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

I would say on the second part of your question, we don't have any updated static pool information that we're disclosing at this point. But as I said earlier, nothing has really changed in terms of how we look at the credit performance of the business going forward.

Now, to the first part of your question, it was a situation that based on the facts we thought justified an immediate charge-off, even though it's not fully resolved. As opposed to the normal process of putting up a specific reserve and launching the workout process.

Henry Coffey - *Ferris, Baker Watts - Analyst*

And the size of that loan was?

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

What we indicated was that it was -- the charge-off was about half of the charge-offs this quarter, and that was a majority of the loan.

Henry Coffey - *Ferris, Baker Watts - Analyst*

So about half of the charge-offs in the quarter were new and the other half were sort of pre-'05 or pre-December '05 losses.

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

That is right.

Henry Coffey - *Ferris, Baker Watts - Analyst*

Great, thank you.

Operator

Sameer Gokhale at Bear Stearns.

Sameer Gokhale - *Bear Stearns - Analyst*

Thanks. I hate to harp on this point, but in terms of the charge-off that you took, the excess and the corporate finance charge of about $12 million, skeptics may say, well, you took the charge-off this quarter because you had such strong yield income and you were able to offset it for purposes of providing your adjusted EPS number with this -- you were able to more than offset the increased charge-off number this quarter.

And I think you mentioned in your comments that in other cases, you typically don't charge off immediately; this situation, you thought you would charge it off immediately. So how do you address the skeptics, when we think, well this quarter you had such strong yield income and you just accelerated the charge-offs so you wouldn't have to take it next quarter? Historically, what have you done in these types of situations?

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

I understand where the question would come from. Obviously, that's not what we did, and it would actually be -- to do that would be kind of manipulating our policies, which we would never do. I think the normal process is what happens in a problem loan typically is that the facts of the case indicate to us that there's a potential loss in the future. But we don't know what that loss is because the workout could take a number of different paths.

In situations we've seen historically, we've taken specific reserves against loans and we've resolved them at par. Other times, we've taken specific reserves against loans and then we've learned more about them and we've taken greater specific loans against it. And so what happens is the workout strategy begins, a team is assigned, and depending upon the situation, they do different things. And sometimes that includes working with the sponsor or the owner of the business or other stakeholders, and putting turnaround firms in and fixing the business, etc.

But sometimes loans present themselves and, based on the facts of the case, the best course of action is an immediate liquidation. And then you look right through the situation and say, okay, since we know the path that this is going down -- because most workouts don't go to immediate liquidation, right? Most businesses can be fixed and turned around or resolved or greater value reaped from them through some more organized process.

But sometimes they go direct to liquidation. And you sit back and you say, this is going direct to liquidation which makes us think that the loss is knowable and more certain, if that is right phrase. And so you go right to charge-off. And that is the case here.

And so, I mean if people were to say that, if we were to be able to walk them through the situation in great detail, I think they will see that this loan will resolve itself very quickly because of the path it's going down, which is why we think the charge-off is appropriate. I don't know, Tom, if you would add anything to that.

Tom Fink - *CapitalSource Inc. - CFO*

That's right.

Sameer Gokhale - *Bear Stearns - Analyst*

That's very helpful. And then the other thing I wanted to just get some perspective on was the dividend guidance for 2007. And I think when you had initially given that guidance, you had basically said you'd be retaining more capital; hence you were kind of toning down your dividend guidance.

I'm sorry -- would it be accurate to say that that was in fact just because of you wanted to rely less on the equity markets in order to raise capital? Or is it something about the macro credit environment that you are retaining that cushion for in '07?

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

No, it has much more to do with getting the platform less dependent upon the equity capital markets. What we talked about when we guided towards at least $2 and at least $2.40 was lowering also the payout ratio. Because in prior guidance, we had talked about 100% payout ratio, and we guided towards, I believe, in '07 an 80% to 90% payout ratio. And you can see based on our adjusted earnings year-to-date and how the business is performing already, and based on the at least $2 guidance we provided this year, we're certainly going to come in within that ratio.

So it was more about getting the platform, once it becomes more stabilized from a top-line growth perspective. In other words, we are experiencing a lot of top-line growth going into next year. But at some point we expect the top-line asset growth to be slower than it has been across the last few years. And if you do the model and we can increase leverage through getting deposit-based funding, you see that a certain percentage of our earnings being retained can actually make us independent of the capital markets. And that is clearly where we are steering this platform towards.

And that is the reason for the lower payout ratio. It has nothing to do with our view on credit in the business.

Sameer Gokhale - *Bear Stearns - Analyst*

Okay, that is very helpful. Thank you.

Operator

(OPERATOR INSTRUCTIONS) Bob Napoli.

Bob Napoli - *Piper Jaffray - Analyst*

Thanks. Just wondered on the fee income line, the $54 million, is there anything besides the prepays or other that drove that line this quarter that -- some of your syndications businesses or anything in that regard?

Tom Fink - *CapitalSource Inc. - CFO*

No, I think we typically have a good amount of fee income just associated with our lending amortization of upfront fees, etc., on deals. So really the biggest change there is due to the increase in the prepayment-related fee income. The rest of the fee income, excluding the prepayment fees, if you take a look at it on sort of a yield basis, is not remarkable.

Bob Napoli - *Piper Jaffray - Analyst*

And then it's only been a few weeks since your investor day, and I know we discussed this in-depth. But have noticed any adjustments in competitive trends or economic trends over the past month that are worth mentioning?

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

No. No. I mean nothing new has happened. And as you said, we did have a fairly extensive conversation around it. The business is competitive. I think most people know that the lending business right now, there's a fair amount of liquidity. One of the benefits we think of the way the platform is positioned is we have multiple businesses and we can be disciplined in terms of which businesses grow based on the opportunities. And we think based on the collection of businesses we have, we can grow this platform along the lines that we discussed. But I think it can be more disciplined growth than if we were just in one business.

I will also add to your follow-up question about fee income, just a reminder, Bob, on our corporate finance -- and I don't think Tom mentioned this -- on our corporate finance business, when we do do a syndication, we don't do what most lenders do, which is to accelerate the fee income. It essentially enhances the yield over time of the piece that we are left with, which I believe -- I'm actually quite certain -- puts us in the minority of how these kind of fees are recognized. So there is actually an earnings quality, a positive earnings quality comment to be made there about how we deal with syndications.

Because if we were to recognize syndication fees upfront, we would be driving very high fee income into the business right now, and then numbers would be much better than they actually are. But we've chosen to continue to steer the business towards a more portfolio income approach and defer those fees over the life (multiple speakers).

Bob Napoli - *Piper Jaffray - Analyst*

Generally what fees do you earn when you syndicate?

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

You earn skim income, which means you originate -- it depends -- I mean, there's a couple of things. You can originate a loan and earn a 2% commitment fee and sell a piece of that loan with no commitment fee. So you have effectively earned 2% on the piece you've sold. And that is one way. Or you can actually sell a piece at a lower spread.

But if you were to do the math, if CapitalSource originates $120 million loan and earns a 2% commitment fee and sells $100 million of that loan, if we were to accelerate those fees, we would make $2 million this quarter. What we choose to do is take that $2 million and spread it over the life of the $20 million piece we are left with. Do you see what I mean?

Bob Napoli - *Piper Jaffray - Analyst*

Yes. Can you give me any idea of how much you syndicated this quarter, kind of the trend in syndications?

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

You know, we haven't really been disclosing that, Bob, so I think we will -- I think at some point we will do a whole discussion on our syndication activities and update everyone on that with a fair amount of detail.

Bob Napoli - *Piper Jaffray - Analyst*

Okay. Is it fair to say that it continues to ramp up --?

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

Yes, it definitely continues to ramp up.

Bob Napoli - *Piper Jaffray - Analyst*

Thank you.

Operator

Scott Valentin of Friedman, Billings, Ramsey.

Scott Valentin - *Friedman, Billings, Ramsey - Analyst*

Thanks for taking my question. On the compensation and benefits line, it looked like it declined a little bit linked quarter. But more importantly, I was wondering about the fourth quarter. It's been a pretty strong year in originations and profitability. I was curious -- any true-up or any type of onetime quarterly expenses in the fourth quarter?

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

I think we do a pretty good job of estimating our accruals as we go along, and we haven't experienced the kind of volatility in the fourth quarter historically, and I wouldn't expect it to occur this quarter. I don't know, Tom, if you would add anything to that.

Tom Fink - *CapitalSource Inc. - CFO*

I think we had a lumpy bit of compensation expense in the second quarter, which was due to the options, which was not -- and the granting of new options with some accelerated vesting, if you will. That was not repeated in second quarter, so that explains most of the change there. And then we just had normal -- added to the employee base a little bit, so a little bit higher salary, a little bit higher bonus. But John is right, we think we're doing a good job of accruing that bonus expense ratably throughout the year.

Scott Valentin - *Friedman, Billings, Ramsey - Analyst*

Okay, thank you.

Operator

Laura Kaster.

Laura Kaster - *Sandler O'Neill - Analyst*

Thank you. Tom or John, can you please tell me -- I think at the end of the year we had about $32 million in specific reserves. Am I doing the math right, that there is maybe $8 million or $9 million left of that that would affect what you would reverse out of the adjusted EPS?

Tom Fink - *CapitalSource Inc. - CFO*

Yes, that is about right.

Laura Kaster - *Sandler O'Neill - Analyst*

Okay, great. Thank you. I guess just one more question. Given the article we saw in the Journal today about that company out of Pittsburgh, what percentage of the loans that you charge off or would charge off this quickly would be due to fraud, and how often would you see something like that?

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

Maybe you could refresh us on what you are talking about specifically, Laura.

Laura Kaster - *Sandler O'Neill - Analyst*

Well, there is a company out of Pittsburgh that was forced into bankruptcy because of fraudulent activities that was cited in the Journal today -- it's called LeNature. I was just wondering what percentage of the loans that you look at that you've had to charge off have been correlated with fraudulent bookkeeping or activities?

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

We are not familiar or exposed to whatever company you are referring to, so I will start with that. Fraud is a risk of the business, and it does occur and we do have charge-offs based on fraud. You tend to see fraud in more of our asset-based businesses and less in the corporate finance business, for example. The standards in corporate finance are generally quite a bit higher because of the nature of the transaction, you are financing a leveraged buyout, there's a deep pocketed equity investor as your partner, and they are not generally interested in defrauding lenders.

So, that is not really where you find the fraud. You find the fraud more in the asset-based stuff, when you are lending on people's assets. And we've certainly had that. We have both had that real, actual fraud, but we've also alleged it in lots of situations. Because if you have an asset-based loan and you have a problem, there is generally a lot of representations that people make to you about the quality of their assets that we alleged weren't accurate at the time of the workout, even if they are not what most people think of as classic fraud.

So it wouldn't be uncommon to see CapitalSource involved in a workout and hear us alleging fraud. That is kind of part of the workout playbook, if you will, of an asset-based loan.

Laura Kaster - *Sandler O'Neill - Analyst*

Okay, thank you.

Operator

We have no further questions at this time. I would like to turn the call over to management for closing comments.

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

We have no other comments. We appreciate everyone calling in, and always, feel free to give us a call if you have further questions. Thank you.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Have a wonderful day.
