

ANTHRACITE CAPITAL INC

Form 10-Q

November 09, 2006

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**SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2006**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from: \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 001-13937**

**ANTHRACITE CAPITAL, INC.**

(Exact name of registrant as specified in its charter)

Maryland

13-3978906

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

40 East 52<sup>nd</sup> Street, New York, New York

10022

(Address of principal executive offices)

(Zip Code)

(Registrant's telephone number including area code): (212) 810-3333

**NOT APPLICABLE**

(Former name, former address, and for new fiscal year; if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

(1) Yes  No

(2) Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

(1) Yes  No

At November 9, 2006, 57,818,331 shares of common stock (\$.001 par value per share) were outstanding.

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**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

Anthracite Capital, Inc. ( Anthracite or the Company ) is a specialty finance company that invests in commercial real estate assets on a global basis. Anthracite is externally managed by BlackRock Financial Management, Inc., which is a subsidiary of BlackRock, Inc. ( BlackRock ) (NYSE:BLK), one of the largest publicly traded investment management firms in the United States with approximately \$1.075 trillion in global assets under management at September 30, 2006. BlackRock Realty Advisors, Inc., another subsidiary of BlackRock, provides real estate equity and other real estate-related products and services in a variety of strategies to meet the needs of institutional investors. The PNC Financial Services Group, Inc. ( PNC ), a diversified financial services organization, is a significant shareholder of BlackRock. Through its affiliates, PNC originates commercial, multifamily and residential real estate loans, and services \$173.7 billion in commercial mortgage loans for third parties through its Midland Loan Services, Inc. subsidiary at September 30, 2006.

**Forward-Looking Statements**

Certain statements contained herein constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to future financial or business performance, strategies or expectations.

Forward-looking statements are typically identified by words or phrases such as trend, potential, opportunity, pipeline, believe, comfortable, expect, anticipate, current, intention, estimate, position, assume, outlook, maintain, sustain, seek, achieve, and similar expressions, or future or conditional verbs such as will, would, could, may or similar expressions. Anthracite cautions that forward-looking statements are subject to numerous assumptions, risks and uncertainties, which change over time. Forward-looking statements speak only as of the date they are made, and Anthracite assumes no duty to and does not undertake to update forward-looking statements. Actual results could differ materially from those anticipated in forward-looking statements and future results could differ materially from historical performance.

In addition to factors previously disclosed in the Company's Securities and Exchange Commission (the SEC) reports and those identified elsewhere in this report, the following factors, among others, could cause actual results to differ materially from forward-looking statements or historical performance:

- (1) the introduction, withdrawal, success and timing of business initiatives and strategies;
- (2) changes in political, economic or industry conditions, the interest rate environment or financial and capital markets, which could result in changes in the value of Anthracite's assets;
- (3) the relative and absolute investment performance and operations of Anthracite's Manager;
- (4) the impact of increased competition;
- (5) the impact of capital improvement projects;
- (6) the impact of future acquisitions or divestitures;
- (7) the unfavorable resolution of legal proceedings;
- (8) the extent and timing of any share repurchases;
- (9) the impact, extent and timing of technological changes and the adequacy of intellectual property protection;
- (10) the impact of legislative and regulatory actions and reforms and regulatory, supervisory or enforcement actions of government agencies relating to Anthracite, BlackRock, Merrill Lynch & Co., Inc. or PNC;
- (11) terrorist activities and international hostilities, which may adversely affect the general economy, domestic and global financial and capital markets, specific industries, and Anthracite;



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- (12) the ability of BlackRock to attract and retain highly talented professionals;
- (13) fluctuations in foreign currency exchange rates;
- (14) the impact of changes to tax legislation and, generally, the tax position of the Company;
- (15) BlackRock's ability to successfully integrate the Merrill Lynch Investment Managers ( MLIM ) business with its existing business; and
- (16) the ability of BlackRock to effectively manage the former MLIM assets along with its historical assets under management.

Anthracite's Annual Report on Form 10-K for the year ended December 31, 2005 and Anthracite's subsequent reports filed with the SEC, accessible on the SEC's website at [www.sec.gov](http://www.sec.gov), identify additional factors that can affect forward-looking statements.

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## Part I FINANCIAL INFORMATION

## Item 1. Financial Statements

**Anthracite Capital, Inc. and Subsidiaries**  
**Consolidated Statements of Financial Condition**  
(in thousands)  
(unaudited)

	September 30, 2006	December 31, 2005
<b>ASSETS</b>		
Cash and cash equivalents	\$ 31,646	\$ 40,556
Restricted cash equivalents	20,501	1,246
Securities available-for-sale, at fair value:		
Subordinated commercial mortgage-backed securities ( CMBS )	\$ 874,792	\$ 826,955
Investment grade CMBS	1,623,583	1,157,164
Residential mortgage-backed securities ( RMBS )	150,809	92,817
Total securities available-for-sale	2,649,184	2,076,936
Commercial mortgage loan pools, at amortized cost	1,276,471	1,292,407
Securities held-for-trading, at estimated fair value		
CMBS	22,067	21,264
RMBS	139,217	166,209
Total securities held-for-trading	161,284	187,473
Commercial mortgage loans, net	507,743	365,806
Equity investments	183,227	110,650
Interest rate swap agreements, at fair value	33,401	31,172
Other assets	62,530	58,013
Total Assets	\$ 4,925,987	\$ 4,164,259

**LIABILITIES AND STOCKHOLDERS****EQUITY**

## Liabilities:

## Borrowings:

Collateralized debt obligations ( CDOs )	\$ 1,480,632	\$ 1,066,930
Secured by pledge of subordinated CMBS	127,059	83,213
Secured by pledge of other securities available-for-sale	799,385	606,209
Secured by pledge of commercial mortgage loan pools	1,257,004	1,278,908
Secured by pledge of securities held-for-trading	133,266	176,361
Secured by pledge of commercial mortgage loans	193,183	229,556



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Junior subordinated notes to subsidiary trust issuing preferred securities	180,477	77,380
Total borrowings	\$ 4,171,006	\$ 3,518,557
Payable for investments purchased	42,519	
Distributions payable	17,613	16,673
Interest rate swap agreements, at fair value	18,222	8,907
Other liabilities	24,461	22,104
Total Liabilities	\$ 4,273,821	\$ 3,566,241

Commitments and Contingencies

Stockholders' Equity:

Common Stock, par value \$0.001 per share; 400,000 shares authorized; 57,638 shares issued and outstanding in 2006;		
56,339 shares issued and outstanding in 2005	58	56
9.375% Series C Preferred stock, liquidation preference \$57,500	55,435	55,435
Additional paid-in capital	627,403	612,368
Distributions in excess of earnings	(131,566)	(130,038)
Accumulated other comprehensive income	100,836	60,197
Total Stockholders' Equity	652,166	598,018
Total Liabilities and Stockholders' Equity	\$ 4,925,987	\$ 4,164,259

The accompanying notes are an integral part of these consolidated financial statements.

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**Anthracite Capital, Inc. and Subsidiaries**  
**Consolidated Statements of Operations (Unaudited)**  
(in thousands, except per share data)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
<b>Income:</b>				
Interest from securities available-for-sale	\$ 44,707	\$ 35,480	\$ 126,684	\$ 103,024
Interest from commercial mortgage loans	11,052	5,362	28,041	15,643
Interest from commercial mortgage loan pools	13,230	13,460	39,743	40,617
Interest from securities held-for-trading	1,750	3,797	5,522	8,057
Earnings from equity investments	2,986	2,870	22,001	8,499
Earnings from real estate joint ventures				59
Interest from cash and cash equivalents	828	969	1,746	1,471
<b>Total income</b>	<b>74,553</b>	<b>61,938</b>	<b>223,737</b>	<b>177,370</b>
<b>Expenses:</b>				
Interest	54,185	40,940	148,345	113,501
Interest securities held-for-trading	1,875	1,864	5,597	4,777
Management and incentive fees	4,176	2,799	13,900	8,039
General and administrative expense	1,144	933	3,382	2,691
<b>Total expenses</b>	<b>61,380</b>	<b>46,536</b>	<b>171,224</b>	<b>129,008</b>
<b>Other gains (losses):</b>				
Gain on sale of securities available-for-sale, net	446	31	386	88
Gain (loss) on securities held-for-trading, net	(18)	897	2,297	(1,781)
Foreign currency gain (loss)	682	87	997	(257)
Loss on impairment of assets	(361)		(5,795)	(3,231)
<b>Total other gain (loss)</b>	<b>749</b>	<b>1,015</b>	<b>(2,115)</b>	<b>(5,181)</b>
<b>Income from Continuing Operations</b>	<b>13,922</b>	<b>16,417</b>	<b>50,398</b>	<b>43,181</b>
<b>Income from Discontinued Operations</b>			<b>1,366</b>	
<b>Net income</b>	<b>13,922</b>	<b>16,417</b>	<b>51,764</b>	<b>43,181</b>
<b>Dividends on preferred stock</b>	<b>1,348</b>	<b>1,348</b>	<b>4,044</b>	<b>4,044</b>

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Net income available to common stockholders	\$ 12,574	\$ 15,069	\$ 47,720	\$ 39,137
Net income per common share, basic:	\$ 0.22	\$ 0.28	\$ 0.84	\$ 0.73
Net income per common share, diluted:	\$ 0.22	\$ 0.28	\$ 0.83	\$ 0.73

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	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income from continuing operations per share of common stock, after preferred dividends				
Basic	\$ 0.22	\$ 0.28	\$ 0.82	\$ 0.73
Diluted	\$ 0.22	\$ 0.28	\$ 0.81	\$ 0.73
Income from discontinued operations per share of common stock				
Basic			\$ 0.02	
Diluted			\$ 0.02	
Weighted average number of shares outstanding:				
Basic	57,167	54,115	56,970	53,573
Diluted	57,458	54,124	57,164	53,583
Dividend declared per share of Common Stock	\$ 0.29	\$ 0.28	\$ 0.86	\$ 0.84

The accompanying notes are an integral part of these consolidated financial statements.

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**Anthracite Capital, Inc. and Subsidiaries**  
**Consolidated Statement of Changes in Stockholders Equity (Unaudited)**  
**For the Nine Months Ended September 30, 2006**  
**(in thousands)**

	Common Stock, Par Value	Series C Preferred Stock	Additional Paid-In Capital	Distributions In Excess Of Earnings	Accumulated Other Comprehensive Income	Comprehensive Income	Total Stockholders Equity
Balance at January 1, 2006	\$ 56	\$ 55,435	\$ 612,368	\$ (130,038)	\$ 60,197		\$ 598,018
Net income				51,764		\$ 51,764	51,764
Unrealized gain on cash flow hedges					8,638	8,638	8,638
Reclassification of losses from cash flow hedges included in net income					3,925	3,925	3,925
Change in net unrealized gain on securities available-for-sale, net of reclassification adjustment					28,076	28,076	28,076
Other comprehensive income						40,639	
Comprehensive income						\$ 92,403	
Dividends declared-common stock				(49,248)			(49,248)
Dividends declared preferred stock				(4,044)			(4,044)
Issuance of common stock	2		15,035				15,037

Balance at September 30, 2006	\$ 58	\$ 55,435	\$ 627,403	\$ (131,566)	\$ 100,836	\$ 652,166
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**Disclosure of  
reclassification  
adjustment:**

Unrealized holding gain					\$ 27,902	
Reclassification for realized gains previously recorded as unrealized						174
					\$ 28,076	

The accompanying notes are an integral part of these consolidated financial statements.

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Consolidated Statements of Cash Flows (Unaudited)  
(in thousands)**

	For the Nine Months Ended September 30, 2006	For the Nine Months Ended September 30, 2005
Cash flows from operating activities:		
Net income	\$ 51,764	\$ 43,181
Adjustments to reconcile net income to net cash provided by operating activities:		
Net decrease (increase) in trading securities	28,487	(37,777)
Net (gain) loss on sale of securities	(2,683)	1,693
Gain on sale of real estate held for sale	(1,366)	
Earnings from subsidiary trust	(325)	(2)
Distributions from subsidiary trust	294	
Earnings from equity investments and real estate joint ventures	(22,001)	(8,558)
Distributions of earnings from equity investments and real estate joint ventures	13,215	5,512
Amortization of collateralized debt obligation issuance costs	1,913	1,744
Amortization of junior subordinated note issuance costs	126	2
Premium amortization (Discount accretion), net	3,670	(645)
Loss on impairment of assets	5,795	3,231
Unrealized net foreign currency (gain) loss	(9,926)	1,229
Proceeds (disbursements) from sale of interest rate swap agreements	15,253	(2,108)
(Increase) decrease in other assets	(2,325)	3,935
Increase (decrease) in other liabilities	13,771	(6,187)
Net cash provided by operating activities	95,662	5,250
Cash flows from investing activities:		
Purchase of securities available-for-sale	(651,852)	(321,808)
Proceeds from sale of securities available-for-sale	109,021	55,082
Principal payments received on securities available-for-sale	34,898	2,636
Funding of commercial mortgage loans	(234,098)	(83,519)
Repayments received from commercial mortgage loans	100,079	82,971
Repayments received from commercial mortgage loan pools	6,607	5,899
Purchase of real estate held-for-sale	(5,435)	
Proceeds from sale of real estate held-for-sale	6,801	
Increase in restricted cash equivalents	(19,255)	(69,358)
Investment in subsidiary trust		(2,380)
Return of capital from equity investments and joint ventures	14,742	26,869
Investment in equity investments	(72,202)	(12,359)
Net cash used in investing activities	(710,694)	(315,967)

Cash flows from financing activities:

Net increase in borrowings under reverse repurchase agreements and credit facilities	9	154,685	70,793
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	For the Nine Months Ended September 30, 2006	For the Nine Months Ended September 30, 2005
Repayments of borrowings secured by commercial mortgage loan pools	(11,811)	(5,899)
Issuance of collateralized debt obligations	417,000	239,660
Issuance costs for collateralized debt obligations	(7,057)	(5,025)
Repayments of collateralized debt obligations	(4,073)	(776)
Issuance of junior subordinated notes to subsidiary trust	100,000	77,380
Issuance costs of junior subordinated notes	(3,208)	(2,250)
Dividends paid on preferred stock	(4,044)	(4,044)
Proceeds from issuance of common stock, net of offering costs	12,937	24,923
Dividends paid on common stock	(48,307)	(44,770)
 Net cash provided by financing activities	 606,122	 349,992
 Net (decrease) increase in cash and cash equivalents	 (8,910)	 39,275
Cash and cash equivalents, beginning of period	40,556	23,755
 Cash and cash equivalents, end of period	 \$ 31,646	 \$ 63,030
 Supplemental disclosure of cash flow information:		
Interest paid	\$ 149,806	\$ 78,685
Investments purchased not settled	\$ 42,519	\$ 87,829
 Supplemental disclosure of non-cash investing and financing activities:		
Investments in subsidiary trusts	\$ 3,097	\$ 2,380
Incentive fees paid by the issuance of common stock	\$ 2,100	\$

The accompanying notes are an integral part of these consolidated financial statements.

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**Anthracite Capital, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements (Unaudited)**

**(Dollar amounts in thousands, except share and per share data)**

**Note 1 ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES**

Anthracite Capital, Inc., a Maryland corporation, and its subsidiaries (the Company) is a specialty finance company that invests in commercial real estate assets on a global basis. The Company primarily generates income based on the spread between the interest income, gains and net operating income on its commercial real estate assets and the interest expense from borrowings to finance its investments. The Company seeks to earn high returns on a risk-adjusted basis to support a consistent quarterly dividend. The Company has elected to be taxed as a real estate investment trust ( REIT ) under the United States Internal Revenue Code of 1986, as amended (the Code ) and, therefore, its income is largely exempt from corporate taxation. The Company commenced operations on March 24, 1998.

The Company's ongoing investment activities primarily encompass three core investment activities:

- 1) Commercial Real Estate Securities
- 2) Commercial Real Estate Loans
- 3) Commercial Real Estate Equity

The accompanying September 30, 2006 unaudited consolidated financial statements have been prepared in conformity with the instructions to Form 10-Q and Article 10, Rule 10-01 of Regulation S-X for interim financial statements. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America ( GAAP ) for complete financial statements. In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations and changes in cash flows have been made. These consolidated financial statements should be read in conjunction with the annual audited financial statements and notes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission (the SEC ).

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the statements of financial condition and revenues and expenses for the periods covered. Actual results could differ from those estimates and assumptions. Significant estimates in the financial statements include the valuation of certain of the Company's mortgage-backed securities and certain other investments.

***Recent Accounting Developments***

***Accounting Changes and Corrections***

In June 2005, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ( SFAS No. 154 ). SFAS No. 154 replaces Accounting Principles Board ( APB ) Opinion No. 20, *Accounting Changes*, and SFAS

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No. 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS No. 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented in accordance with the new accounting principle. SFAS No. 154 also requires that a change in the method of depreciating or amortizing a long-lived non-financial asset be accounted for prospectively as a change in estimate, and correction of errors in previously issued financial statements should be termed restatements. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The implementation of SFAS No. 154 had no impact on the Company's consolidated financial statements.

*Stock Based Compensation*

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment*. This statement is a revision to SFAS No. 123, *Accounting for Stock-Based Compensation*, and superseded APB Opinion No. 25, *Accounting for Stock Issued to Employees*. This statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services, primarily focusing on the accounting for transactions in which an entity obtains employee services in share-based payment transactions. Entities will be required to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service (usually the vesting period) in exchange for the award. The grant-date fair value of employee share options and similar instruments will be estimated using option-pricing models. If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification. As amended by Rule 4-01(a) of Regulation S-X promulgated by the SEC, this statement is effective as of the beginning of the first interim or annual reporting period of the Company's first fiscal year beginning on or after December 15, 2005. The Company adopted SFAS No. 123R, as amended, effective January 1, 2006 with no impact on the consolidated financial statements as there are no unvested options as of December 31, 2005 and the Company applied the fair value method to all options issued after January 1, 2003.

*Reverse Repurchase Agreements*

The FASB has placed an item on its agenda relating to the treatment of transactions where mortgage-backed securities purchased from a particular counterparty are financed via a repurchase agreement with the same counterparty. Currently, the Company records such assets and the related financing gross on the consolidated statement of financial condition, and the corresponding interest income and interest expense gross on the consolidated statement of operations. Any change in fair value of the security is reported through other comprehensive income pursuant to SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, because the security is classified as available-for-sale. However, in a transaction where the mortgage-backed securities are acquired from and financed under a repurchase agreement with the same counterparty, the acquisition may not qualify as a sale from the seller's perspective under the provisions of SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. In such cases, the seller may be required to continue to consolidate the assets sold to the Company, based on their continuing involvement with such investments. Depending on the ultimate outcome of the FASB deliberations, the Company may be precluded from

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presenting the assets gross on the Company's balance sheet and should instead be treating the Company's net investment in such assets as a derivative. If it is determined that these transactions should be treated as investments in derivatives, the derivative instruments entered into by the Company to hedge the Company's interest rate exposure with respect to the borrowings under the associated repurchase agreements may no longer qualify for hedge accounting, and would then, as with the underlying asset transactions, also be marked to market through the income statement. This potential change in accounting treatment does not affect the economics of the transactions but does affect how the transactions would be reported on the consolidated financial statements. The Company's cash flows, liquidity and ability to pay a dividend would be unchanged, and the Company does not believe its REIT taxable income or REIT status would be affected. The Company's net equity would not be materially affected. At September 30, 2006, the Company has identified available-for-sale securities with a fair value of approximately \$148,953 which had been purchased from and financed with reverse repurchase agreements totaling approximately \$116,765 with the same counterparty since their purchase. If the Company were to change the current accounting treatment for these transactions at September 30, 2006, total assets and total liabilities would be reduced by approximately \$116,765.

*Variable Interest Entities*

The consolidated financial statements include the financial statements of the Company and its subsidiaries, which are wholly-owned or controlled by the Company or entities which are variable interest entities ( VIEs ) in which the Company is the primary beneficiary under FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003) ( FIN 46R ). FIN 46R requires a VIE to be consolidated by its primary beneficiary. The primary beneficiary is the party that absorbs the majority of the VIE's anticipated losses and/or the majority of the expected returns. All significant inter-company balances and transactions have been eliminated in consolidation. The Company has analyzed the governing pooling and servicing agreements for each of its Controlling Class CMBS and believes that the terms are industry standard and are consistent with the qualifying special-purpose entity ( QSPE ) criteria. However, there is uncertainty with respect to QSPE treatment due to ongoing review by accounting standard setters, potential actions by various parties involved with the QSPE, as well as varying and evolving interpretations of the QSPE criteria under SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ( SFAS No. 140 ). Future guidance from the accounting standard setters may require the Company to consolidate CMBS trusts in which the Company has invested.

*Impairment of Investments*

In November 2005, the FASB issued FASB Staff Position ( FSP ) FAS 115-1/124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, which provides guidance for determining when impairment charges should be taken on certain debt and equity securities. FSP FAS 115-1/124-1 requires that debt and equity securities subject to the provisions of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and equity securities subject to the provisions of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, but which are not accounted for under the equity method (i.e., securities accounted for under the cost method) shall be reviewed for impairment when circumstances warrant. For securities subject to SFAS

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No. 115, a review for other-than-temporary impairments shall occur in each accounting period where the fair value of the security is less than its cost. For securities subject to APB Opinion No. 18, a review for other-than-temporary impairments shall occur in each accounting period where a) circumstances indicate that impairment may exist and b) the fair value of the security is less than its carrying value. The provisions of the FSP were required to be applied to reporting periods beginning after December 15, 2005. The adoption of FSP FAS 115-1/124-1 on January 1, 2006 had no material impact on the Company's consolidated financial statements.

*Certain Hybrid Financial Instruments*

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The Statement provides, among other things, that:

For embedded derivatives which would otherwise be required to be bifurcated from their host contracts and accounted for at fair value in accordance with SFAS No. 133, an irrevocable election may be made on an instrument-by-instrument basis, to be measured as hybrid financial instrument at fair value in its entirety, with changes in fair value recognized in earnings.

Concentrations of credit risk in the form of subordination are not considered embedded derivatives.

Clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133. SFAS No. 155 is effective for all financial instruments acquired, issued or subject to remeasurement after the beginning of an entity's first fiscal year that begins after September 15, 2006. Upon adoption, differences between the total carrying amount of the individual components of an existing bifurcated hybrid financial instrument and the fair value of the combined hybrid financial instrument should be recognized as a cumulative effect adjustment to beginning retained earnings. Prior periods should not be restated. The Company is currently evaluating the impact of adopting SFAS No. 155.

*Determining the Variability in a Potential VIE*

The FASB issued FASB Staff Position FIN 46(R)-6, *Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R)* ( FSP FIN 46(R)-6 ) in April 2006. FSP FIN 46(R)-6 addresses the application of FIN 46(R), *Consolidation of Variable Interest Entities*, in determining whether certain contracts or arrangements with a variable interest entity ( VIE ) are variable interests by requiring companies to base such evaluations on an analysis of the VIE's purpose and design, rather than its legal form or accounting classification.

FSP FIN 46(R)-6 is required to be applied for all reporting periods beginning after June 15, 2006. The adoption of this FSP did not result in material differences from the Company's existing accounting policies regarding the consolidation of VIEs.

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*Accounting for Uncertainty in Income Taxes*

In July 2006, the FASB issued FASB Interpretation ( FIN ) No. 48, *Accounting for Uncertainty in Income Taxes and Related Implementation Issues*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a threshold and measurement attribute for recognition in the financial statements of an asset or liability resulting from a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective as of the beginning of fiscal years that begin after December 15, 2006. The Company is currently evaluating the effect of implementing this new standard.

*Fair Value Measurements*

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. SFAS No. 157 requires companies to disclose the fair value of its financial instruments according to a fair value hierarchy (i.e., levels 1, 2, and 3, as defined). Additionally, companies are required to provide enhanced disclosure regarding instruments in the level 3 category (which require significant management judgment), including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and all interim periods within those fiscal years. The Company is currently evaluating the impact of adopting SFAS No. 157.

*Effects of Prior Year Misstatements*

In September 2006, the SEC issued Staff Accounting Bulletin ( SAB ) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB No. 108 provides guidance on the consideration of effects of the prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The SEC staff believes registrants must quantify errors using both a balance sheet and income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB No. 108 is effective for the first annual period ending after November 15, 2006 with early application encouraged. The Company is currently evaluating the impact of adopting SAB No. 108.

***Reclassifications***

Certain items previously reported have been reclassified to conform to the current presentation.

**Table of Contents****Note 2 NET INCOME PER SHARE**

Net income per share is computed in accordance with SFAS No. 128, *Earnings Per Share*. Basic income per share is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted income per share is calculated using the weighted average number of common shares outstanding during the period plus the additional dilutive effect, if any, of common stock equivalents. The dilutive effect of outstanding stock options is calculated using the treasury stock method.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Numerator:				
Net income available to common stockholders	\$ 12,574	\$ 15,069	\$ 47,720	\$ 39,137
Numerator for basic and diluted earnings per share	\$ 12,574	\$ 15,069	\$ 47,720	\$ 39,137
Denominator:				
Denominator for basic earnings per share weighted average common shares Outstanding	57,166,798	54,114,955	56,969,930	53,573,433
Dilutive effect of stock options	2,925	9,391	2,148	9,084
Dilutive effect of stock based incentive fee	288,190		192,127	
Denominator for diluted earnings per share weighted average common shares outstanding and common stock equivalents outstanding	57,457,913	54,124,346	57,164,205	53,582,517
Basic net income per weighted average common share:	\$ 0.22	\$ 0.28	\$ 0.84	\$ 0.73
Diluted net income per weighted average common share and common share equivalents:	\$ 0.22	\$ 0.28	\$ 0.83	\$ 0.73

Total anti-dilutive stock options excluded from the calculation of net income per share were 1,380,151 and 1,384,151 for the three and nine months ended September 30, 2006, respectively. Total anti-dilutive stock options excluded from the calculation of net income per share were 1,380,151 and 1,375,151 for the three and nine months ended September 30, 2005.

**Table of Contents****Note 3 SECURITIES AVAILABLE-FOR-SALE**

The Company's securities available-for-sale are carried at estimated fair value. The amortized cost and estimated fair value of securities available-for-sale at September 30, 2006 are summarized as follows:

Security Description	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value
<b>CMBS:</b>				
CMBS interest only securities ( IOs )	\$ 84,383	\$ 624	\$ (1,799)	\$ 83,208
Investment grade CMBS	761,527	59,361	(8,080)	812,808
Non-investment grade rated subordinated securities	630,025	64,220	(4,330)	689,914
Non-rated subordinated securities	63,788	5,053	(775)	68,067
Credit tenant leases	24,581	872	(660)	24,793
Investment grade REIT debt	248,141	6,225	(3,563)	250,803
Multifamily agency securities	455,138	3,140	(6,307)	451,971
CDO investments	116,810	3,858	(3,857)	116,811
<b>Total CMBS</b>	<b>2,384,393</b>	<b>143,353</b>	<b>(29,371)</b>	<b>2,498,375</b>
<b>Single-family RMBS:</b>				
Agency adjustable rate securities	1,816	12		1,828
Residential CMOs	137,073	520	(1,236)	136,357
Hybrid adjustable rate mortgages ( ARMs )	12,950		(326)	12,624
<b>Total RMBS</b>	<b>151,839</b>	<b>532</b>	<b>(1,562)</b>	<b>150,809</b>
<b>Total securities available-for-sale</b>	<b>\$2,536,232</b>	<b>\$143,885</b>	<b>\$(30,933)</b>	<b>\$2,649,184</b>

At September 30, 2006, the Company's securities available-for-sale included non-U.S. dollar denominated assets with an estimated fair value of \$146,338.

At September 30, 2006, an aggregate of \$2,505,209 in estimated fair value of the Company's securities available-for-sale was pledged to secure its collateralized borrowings.

During the nine months ended September 30, 2006, the Company sold seven securities classified as available for sale. Total proceeds from the sales were \$109,021. The sales resulted in a gain of \$1,588 from six securities and a loss of \$1,202 on the seventh security sold. The Company sold this security with an unrealized loss prior to maturity due to a change in the underlying collateral which was expected to significantly impact the market value of the security.

During the nine months ended September 30, 2005, the Company realized a gain of \$88 on securities available-for-sale.



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The following table shows the Company's estimated fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2006.

	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
CMBS IOs	\$ 18,988	\$ (671)	\$ 30,062	\$ (1,128)	\$ 49,050	\$ (1,799)
Investment grade CMBS	41,504	(417)	136,965	(7,663)	178,469	(8,080)
Non-investment grade rated subordinated securities	181,578	(3,412)	24,757	(918)	206,335	(4,330)
Non-rated subordinated securities	15,912	(678)	2,432	(97)	18,344	(775)
Credit tenant leases			15,729	(660)	15,729	(660)
Investment grade REIT debt	9,966	(107)	67,485	(3,456)	77,451	(3,563)
Multifamily agency securities	122,842	(574)	175,454	(5,733)	298,296	(6,307)
CDO investments	30,916	(3,857)			30,916	(3,857)
Residential CMOs	93,193	(1,236)			93,193	(1,236)
Hybrid ARMs			12,624	(326)	12,624	(326)
Total temporarily impaired securities	\$514,899	\$(10,952)	\$465,508	\$(19,981)	\$980,407	\$(30,933)

The temporary impairment of the available-for-sale securities results from the estimated fair value of the securities falling below the amortized cost basis. These unrealized losses are primarily the result of market factors other than credit impairment and the Company believes the carrying value of the securities are fully recoverable over their expected holding period. Management possesses both the intent and the ability to hold the securities until maturity, allowing for the anticipated recovery in estimated fair value of the securities held. As such, management does not believe any of the securities held are other-than-temporarily impaired at September 30, 2006.

At September 30, 2006, the anticipated weighted average yield to maturity based upon the amortized cost of the Company's securities available-for-sale (reported yield) was 7.5% per annum. At September 30, 2006, the anticipated weighted average yields of the Company's subordinated CMBS and investment grade securities available-for-sale were 10.1% and 6.3%, respectively. The Company's anticipated yields on its subordinated CMBS and other securities available-for-sale are based upon a number of assumptions that are subject to certain business and economic uncertainties and contingencies. Examples of these include, among other things, the rate and timing of principal payments (including prepayments, repurchases, defaults, and liquidations and related expenses), the pass-through or coupon rate, and interest rate fluctuations. The Company considers the CMBS securities where it maintains the right to influence the foreclosure/workout process on the underlying loans to be its controlling class CMBS (Controlling Class). Additional factors that may affect the Company's anticipated yields to maturity on its Controlling Class CMBS include interest payment shortfalls due to delinquencies on the underlying mortgage loans, and the timing and magnitude of credit losses on the mortgage loans underlying the Controlling Class CMBS that are a result of the general condition of the real estate market (including competition for tenants and their related credit quality) and changes in market rental rates. As these uncertainties and contingencies are difficult to



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predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yields to maturity, discussed above and elsewhere, will be achieved.

**Note 4 IMPAIRMENTS CMBS**

The Company updates its estimated cash flows for securities subject to Emerging Issues Task Force Issue 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* ( EITF 99-20 ) on a quarterly basis. The Company compares the yields resulting from the updated cash flows to the current accrual yields. An impairment charge is required under EITF 99-20 if the updated yield is lower than the current accrual yield and the security has a market value less than its adjusted purchase price. The Company carries all these securities at their market value on its consolidated statement of financial condition. For the nine months ended September 30, 2006, the Company had nine CMBS that required an impairment charge of \$5,795, of which \$4,572 was attributed to higher prepayment rates on a pool of Small Business Administration commercial mortgages. The decline in the updated yields that caused the remaining impairment charge of \$1,223 is not related to increases in losses but rather accelerated prepayments and changes in the timing of credit losses. For the nine months ended September 30, 2005, the Company had two CMBS that required an impairment charge of \$3,231, of which \$3,072 was attributable to the Company increasing its underlying loan loss expectations on a 1998 vintage CMBS. The remaining impairment charge of \$159 was not related to an increase in losses but rather a change in prepayment assumptions.

**Note 5 COMMERCIAL MORTGAGE LOAN POOLS**

During the second quarter of 2004, the Company acquired subordinated CMBS in a trust establishing a Controlling Class interest. The Company negotiated for and obtained a greater degree of influence over the disposition of the commercial mortgage loans than is typically granted to the special servicer. As a result of this expanded influence, the trust was not a qualifying special-purpose entity ( QSPE ) and FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised December 2003) ( FIN 46R ) required the Company to consolidate the net assets and results of operations of the trust.

Approximately 45% of the par amount of the commercial mortgage loan pool is comprised of investment grade loans and the remaining 55% are unrated. For income recognition purposes, the Company considers the investment grade and unrated commercial mortgage loans in the pool as single assets reflecting the credit assumptions made in establishing loss adjusted yields for Controlling Class securities. The Company has taken into account the credit quality of the underlying loans in formulating its loss assumptions. Credit losses assumed on the entire pool are 1.40% of the principal balance, or 2.53% of the unrated principal balance.

Over the life of the commercial mortgage loan pools, the Company reviews and updates its loss assumptions to determine the impact on expected cash flows to be collected. A decrease in estimated cash

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flows will reduce the amount of interest income recognized in future periods and may result in a loan loss reserve depending upon the severity of the cash flow reductions. An increase in estimated cash flows will first reduce the loan loss reserve and any additional cash will increase the amount of interest income recorded in future periods.

**Note 6 SECURITIES HELD-FOR-TRADING**

The Company's securities held-for-trading are carried at estimated fair value. At September 30, 2006, the Company's securities held-for-trading consisted of FNMA Mortgage Pools with an estimated fair value of \$139,217 and subordinated CMBS with an estimated fair value of \$22,067. The FNMA Mortgage Pools, and the underlying mortgages, bear interest at fixed rates for specified periods, generally three to seven years, after which the rates are periodically reset to market.

**Note 7 COMMERCIAL MORTGAGE LOANS**

The following is a summary of the Company's commercial mortgage loans for the nine months ended September 30, 2006:

	Par	Book Value
Balance at December 31, 2005	\$ 373,625	\$ 365,806
Adjustment for discount accretion and foreign currency		7,918
Proceeds from repayment of mortgage loans	(100,079)	(100,079)
Investments in commercial mortgage loans	249,014	234,098
Balance at September 30, 2006	\$ 522,560	\$ 507,743

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The following table summarizes the Company's commercial real estate loan portfolio by property type at September 30, 2006 and December 31, 2005:

Property Type	Carrying Value				Weighted Average Yield	
	September 30, 2006		December 31, 2005		2006	2005
	Amount	%	Amount	%		
Retail	\$189,933	37.4%	\$ 76,502	20.9%	7.9%	7.3%
Office	142,753	28.1	94,432	25.8	8.5	8.9
Residential	53,158	10.5	57,466	15.7	9.0	8.6
Hotel	48,981	9.6	79,840	21.8	9.7	8.6
Industrial	34,942	6.9	2,423	0.7	8.3	8.1
Storage	34,059	6.7	32,913	9.0	9.0	9.1
Other Mixed Use	3,917	.8	2,230	0.6	8.0	8.1
Communication Tower			20,000	5.5		9.4
<b>Total</b>	<b>\$507,743</b>	<b>100.0%</b>	<b>\$365,806</b>	<b>100.0%</b>	<b>8.5%</b>	<b>8.5%</b>

Included in the chart above are non-U.S. dollar denominated commercial real estate loans with a carrying value of \$281,208 and \$129,951 at September 30, 2006 and December 31, 2005, respectively.

At September 30, 2006, all commercial real estate loans owned directly by the Company were performing in line with expectations.

**Note 8 EQUITY INVESTMENTS**

The following is a summary of the Company's equity investments for the nine months ended September 30, 2006:

	BlackRock Diamond	Carbon I	Carbon II	Dynamic India Fund IV	Total
Balance at December 31, 2005	\$ 51,004	\$ 18,458	\$41,188	\$	\$110,650
Contributions to investments	41,901		32,782	3,850	78,533
Distributions from investments	(2,389)	(16,109)	(9,459)		(27,957)
Equity earnings	12,357	807	8,837		22,001
<b>Balance at September 30, 2006</b>	<b>\$102,873</b>	<b>\$ 3,156</b>	<b>\$73,348</b>	<b>\$ 3,850</b>	<b>\$183,227</b>

On December 13, 2005, the Company entered into a \$75,000 commitment to acquire shares of BlackRock Diamond Property Fund ( BlackRock Diamond ). On February 21, 2006, the Company increased its capital commitment by an additional \$25,000, resulting in a total capital commitment of

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\$100,000. At September 30, 2006, 93% of the total commitment has been called and the Company owned approximately 21% of BlackRock Diamond. The Company's investment in BlackRock Diamond at September 30, 2006 was \$102,873.

The Company recorded \$12,357 of income related to its ownership in BlackRock Diamond for the nine months ended September 30, 2006, as reported by BlackRock Diamond. Of the \$12,357 in income, \$1,434 represented current income and \$10,923 represented unrealized capital appreciation. To date, the Company has invested an aggregate of \$92,603, which represents a 21% interest in BlackRock Diamond, and has remaining capital commitments totaling \$7,397. At September 30, 2006, BlackRock Diamond's portfolio consisted of 20 assets with a total estimated market value of approximately \$552,117. BlackRock Diamond carries its real estate investments at estimated fair values based upon valuations performed internally and upon appraisal reports prepared annually by independent real estate appraisers. The estimated fair values of real estate may differ significantly from those that could be realized if the real estate were actually offered for sale in the marketplace.

The Company entered into a \$50,000 commitment on July 20, 2001 to acquire shares in Carbon Capital, Inc. ( Carbon I ). On July 12, 2004, Carbon I's investment period expired. The Company's investment in Carbon I at September 30, 2006 was \$3,156. At September 30, 2006, the Company owned approximately 20% of Carbon I.

The Company entered into an aggregate commitment of \$100,000 to acquire shares in Carbon Capital II, Inc. ( Carbon II ). The Company's investment in Carbon II at September 30, 2006 was \$73,348. The Company's remaining commitment at September 30, 2006 was \$28,958. At September 30, 2006, the Company owned approximately 26% of Carbon II.

The Company's investment in Carbon II includes a \$28,300 mezzanine loan which defaulted during July 2006. The underlying property is a hotel located in the South Beach area of Miami, Florida. Subsequently, the borrower cured its default and the loan is now current.

Carbon II also holds two commercial real estate loans with an aggregate carrying value of \$24,000. The underlying assets are multi-family properties being converted to condominiums and located in Florida. The condominium conversion market has slowed significantly in Florida and both properties are experiencing a slow down in condominium sales. However, both commercial real estate loans remain current. Based on the credit analysis performed by Carbon II, the Company concluded that a loan loss reserve is not necessary at this time. To the extent a loan loss reserve becomes necessary, the Company would incur 26% of the loss, which represents the Company's pro rata ownership of Carbon II. All other commercial real estate loans in the Carbon Capital Funds are performing as expected.

On December 22, 2005, the Company entered into an \$11,000 commitment to acquire shares of Dynamic India Fund IV. At September 30, 2006, 35% of the commitment has been called. The Company's investment in Dynamic India Fund IV at September 30, 2006 was \$3,850. The Company's remaining commitment at September 30, 2006 was \$7,150.

**Note 9 REAL ESTATE, HELD-FOR-SALE**

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SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* specifies that long-lived assets to be disposed by sale, which meet certain criteria, should be classified as real estate held-for-sale and measured at the lower of its carrying amount or fair value less costs of sale. In addition, depreciation is not recorded for real estate held-for-sale.

On March 6, 2006, the Company purchased a defaulted loan from a Controlling Class CMBS trust. The loan was secured by a first mortgage on a multi-family property in Texas. Subsequent to the loan purchase, the property was acquired by the Company at foreclosure. The Company sold the property during the second quarter of 2006 and recorded a gain from discontinued operations of \$1,366 on the consolidated statement of operations.

**Note 10 BORROWINGS**

The Company's borrowings consist of reverse repurchase agreements, credit facilities, commercial mortgage loan pools, CDOs and trust preferred securities.

Certain information with respect to the Company's borrowings at September 30, 2006 is summarized as follows:

	Reverse Repurchase Agreements	Credit Facilities	Commercial Mortgage Loan Pools	Collateralized Debt Obligations	Trust Preferred Securities	Total Borrowings
Outstanding borrowings	\$909,783	\$343,883	\$1,256,231	\$1,480,632	\$180,477	\$4,171,003
Weighted average borrowing rate	5.34%	5.35%	3.98%	6.18%	7.64%	5.33%
Weighted average remaining maturity	22 days	1.1 years	6.1 years	7.4 years	29.4 years	5.8 years
Estimated fair value of assets pledged	\$959,809	\$463,821	\$1,276,471	\$1,727,571		\$4,427,673

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At September 30, 2006, the Company's borrowings had the following remaining maturities:

	Reverse Repurchase Agreements	Credit Facilities	Commercial Mortgage Loan Pools	Collateralized Debt Obligations*	Trust Preferred Securities	Total Borrowings
Within 30 days	\$886,860	\$ 10,523	\$	\$	\$	\$ 897,383
31 to 59 days	22,923					22,923
60 days to less than 1 year						
1 year to 3 years		333,360				333,360
3 years to 5 years						
Over 5 years			1,256,231	1,480,632	180,477	2,917,340
	\$909,783	\$343,883	\$1,256,231	\$1,480,632	\$180,477	\$4,171,006

\* At September 30, 2006, collateralized debt obligations are comprised of \$405,772 of CDO debt with a weighted average remaining maturity of 5.79 years, \$291,573 of CDO debt with a weighted average remaining maturity of 6.16 years, \$366,565 of CDO debt with a weighted average remaining maturity of 6.89 years, and \$416,722 of CDO debt with a weighted average remaining



maturity of  
10.18 years.

*Reverse Repurchase Agreements and Credit Facilities*

On February 16, 2006, the Company entered into a \$200,000 committed non-U.S. dollar credit facility with Morgan Stanley Mortgage Servicing, Inc. which matures in February 2008. Outstanding borrowings under this credit facility bear interest at LIBOR based variable rates consistent with the pledged assets. At September 30, 2006, there was \$130,890 of borrowings under this facility.

On March 17, 2006, the Company entered into a \$100,000 committed non-U.S. dollar credit facility with Bank of America, N.A. which matures in September 2008. The facility can be increased up to \$15,000 based on the change in exchange rates of the non-US dollar loans. However, any amounts drawn under this provision must be repaid in ninety days. Outstanding borrowings under this credit facility bear interest at LIBOR based variable rates consistent with the pledged assets. At September 30, 2006, there was \$100,716 of borrowings under this facility. The Company repaid borrowings during October 2006 to satisfy the ninety day provision.

On July 18, 2002, the Company entered into a \$75,000 committed credit facility with Greenwich Capital, Inc. Outstanding borrowings under this credit facility bear interest at LIBOR based variable rates consistent with the pledged assets. The facility, which had a maturity of July 7, 2006, has been extended through July 6, 2007. At September 30, 2006, there was \$10,553 of borrowings under this facility.

Under the credit facilities and the reverse repurchase agreements, the respective lender retains the right to mark the underlying collateral to estimated fair value. A reduction in the estimated fair value of its pledged assets will require the Company to provide additional collateral or fund margin calls. From time to time, the Company expects that it will be required to provide such additional collateral or fund margin calls.

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The Company is subject to various covenants in its credit facilities, including maintaining a minimum net worth measured on GAAP of \$400,000, a recourse debt-to-equity of 3.0 to 1, a minimum cash requirement based upon certain debt-to-equity ratios, a minimum quarterly recourse debt service coverage ratio of 1.75 and a minimum liquidity reserve of \$10,000. For the quarter ended September 30, 2006, the Company's debt service coverage ratio was 1.67 to 1. The primary reason for the shortfall was the decrease in income from the Company's investment in BlackRock Diamond for the third quarter of 2006. The Company received authorization from its lenders to permit a debt service coverage ratio less than 1.75. At September 30, 2006, the Company was in compliance with all other covenants in its credit facilities.

*CDOs*

On May 23, 2006, the Company closed its sixth CDO issuance ( CDO HY3 ) resulting in the issuance of \$417,000 of non-recourse debt to investors. The debt is secured by a portfolio of CMBS and subordinated commercial real estate loans. This debt, rated AAA through BBB-, was privately placed, and the Company retained additional debt rated BB and 100% of the preferred shares issued by the CDO HY3.

In accordance with the terms of this offering, the Company contributed \$50,000 of additional CMBS to CDO HY3 during a ramp-up period which ended in October 2006. The additional CMBS were contributed at face value. The debt issuance match funded existing Company assets that were contributed to CDO HY3 at closing as well as the assets purchased during the ramp-up period, with long-term liabilities. The Company accounts for this transaction as a financing. All debt placed has final legal maturity of May 2051 but an assumed weighted average life of 8.1 years. Including interest rate hedges, this debt has a cost of funds after issuance expenses of approximately 6.3%.

*Trust Preferred*

On January 31, 2006, the Company issued \$50,000 of trust preferred securities through its wholly owned subsidiary, Anthracite Capital Trust II, a Delaware statutory trust ( Trust II ). The trust preferred securities have a thirty-year term ending April 30, 2036 with interest at a fixed rate of 7.73% for the first ten years and at a floating rate of three-month LIBOR plus 2.7% thereafter. The trust preferred securities can be redeemed at par by the Company beginning in April 2011. Trust II issued \$1,550 aggregate liquidation amount of common securities, representing 100% of the voting common stock of Trust II to the Company for a purchase price of \$1,550. The Company realized net proceeds from this offering of approximately \$48,491.

On March 16, 2006, the Company issued \$50,000 of trust preferred securities through its wholly owned subsidiary, Anthracite Capital Trust III, a Delaware statutory trust ( Trust III and collectively with Trust II, the Trusts ). The trust preferred securities have a thirty-year term ending March 15, 2036 with interest at a fixed rate of 7.77% for the first ten years and at a floating rate of three-month LIBOR plus 2.7% thereafter. The trust preferred securities can be redeemed at par by the Company beginning in March 2011. Trust III issued \$1,547 aggregate liquidation amount of common securities, representing 100% of the voting common stock of Trust III to the Company for a purchase price of \$1,547. The Company realized net proceeds from this offering of approximately \$48,435.

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The Trusts used the proceeds from the sale of the trust preferred securities and the common securities to purchase the Company's junior subordinated notes. The terms of the junior subordinated notes match the terms of the trust preferred securities. The notes are subordinate and junior in right of payment to all present and future senior indebtedness and certain other of our financial obligations.

The Company's interests in the Trusts are accounted for using the equity method and the assets and liabilities of the Trusts are not consolidated into the Company's financial statements. Interest on the junior subordinated notes is included in interest expense on the consolidated statement of operations while the common securities are included as a component of other assets on the Company's consolidated statement of financial condition.

*Senior Unsecured Notes*

During October 2006, the Company announced the private placement of \$75 million of unsecured senior notes due in 2016 with a weighted average cost of funds of 7.21%. The unsecured senior notes can be redeemed in whole by the Company subject to certain provisions, which could include the payment of fees.

**Note 11 COMMON STOCK**

Pursuant to its 2006 Management Agreement (defined below), 30% of the incentive fees earned in 2005 or after may be paid in shares of the Company's Common Stock. During the nine months ended September 30, 2006, the Company issued 189,077 shares of Common Stock related to \$2,100 of incentive fees. See Note 12 of the consolidated financial statements, Transactions with Affiliates, for further discussion of the Company's Management Agreement.

For the nine months ended September 30, 2006, the Company issued 590,216 shares of Common Stock under its Dividend Reinvestment and Stock Purchase Plan (the Dividend Reinvestment Plan). Net proceeds to the Company were approximately \$6,270. For the nine months ended September 30, 2005, the Company issued 497,188 shares of Common Stock under its Dividend Reinvestment Plan. Net proceeds to the Company were approximately \$5,743.

As of February 24, 2006, the Company suspended the Dividend Reinvestment Plan for all future investments dates.

However, as of September 9, 2006, the dividend reinvestment portion of the Dividend Reinvestment Plan was reinstated for all dividend payments made after September 8, 2006, and for all future dividend payment dates, with a discount of 2%. The optional cash purchase portion of the Dividend Reinvestment Plan was also reinstated for all investment periods commencing after October 1, 2006, with a discount of 1%.

During the nine months ended September 30, 2006, 24,700 stock options with a weighted average exercise price of \$8.45 per share were exercised pursuant to the Company's stock option plan (the 1998 Stock Option Plan). Net proceeds to the Company were \$209.

For the nine months ended September 30, 2006, the Company issued 495,500 shares of Common

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Stock, under a sale agency agreement with Brinson Patrick Securities Corporation. Net proceeds to the Company were approximately \$6,458. Subsequent to September 30, 2006, an additional 169,400 shares of Common Stock were issued resulting in net proceeds to the Company of \$2,168.

On September 8, 2006, the Company declared dividends to its common stockholders of \$0.29 per share, payable on October 31, 2006 to stockholders of record on September 29, 2006. For U.S. federal income tax purposes, the dividends are expected to be ordinary income to the Company's stockholders.

**Note 12 TRANSACTIONS WITH AFFILIATES**

The Company has a Management Agreement with the Manager, the employer of certain directors and all of the officers of the Company, under which the Manager manages the Company's day-to-day operations, subject to the direction and oversight of the Company's Board of Directors ( Management Agreement ). Pursuant to the Management Agreement, the Manager formulates investment strategies, arranges for the acquisition of assets, arranges for financing, monitors the performance of the Company's assets and provides certain other advisory and managerial services in connection with the operations of the Company. For performing these services, the Company pays the Manager a base management fee equal to 2.0% of the quarterly average total stockholders' equity for the applicable quarter.

To provide an incentive, the Manager is entitled to receive a quarterly incentive fee equal to 25% of the amount by which the rolling four-quarter GAAP net income before the incentive fee exceeds the greater of 8.5% or 400 basis points over the ten-year Treasury note multiplied by the adjusted per share issue price of the common stock (\$11.35 per common share at September 30, 2006).

The Company's unaffiliated directors approved an extension of the Management Agreement to March 31, 2007 at the Board of Directors' February 2006 meeting. Additionally, pursuant to a resolution of the Company's Board of Directors adopted at the February 2006 meeting, 30% of the incentive fees earned in 2005 or after may be paid in shares of the Company's Common Stock subject to certain provisions. The Board of Directors also authorized a stock based incentive plan where one-half of one percent of common shares outstanding will be paid to the Manager in 2006. The following is a summary of management and incentives incurred for the three and nine months ended September 30, 2006 and 2005:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2006	2005	2006	2005
Management fee	\$3,179	\$2,799	\$ 9,339	\$ 8,039
Incentive fee			2,708	
Incentive fee - stock based	997		1,853	
Total management and incentive fees	\$4,176	\$2,799	\$ 13,900	\$ 8,039

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At September 30, 2006 and 2005, respectively, management and incentive fees of \$2,979 and \$2,668 remained payable to the Manager and are included on the accompanying consolidated statement of financial condition as a component of other liabilities.

In accordance with the provisions of the Management Agreement, the Company recorded reimbursements to the Manager of \$100 and \$300 for certain expenses incurred on behalf of the Company for the three and nine months ended September 30, 2006, respectively, and \$40 and \$120 for the three and nine months ended September 30, 2005, respectively, which are included in general and administrative expense on the accompanying consolidated statements of operations.

The Company has administration and investment accounting agreements with the Manager. Under the terms of the administration agreement, the Manager provides financial reporting, audit coordination and accounting oversight services to the Company. Under the terms of the investment accounting agreement, the Manager provides investment accounting services to the Company. For the nine months ended September 30, 2006 and 2005, the Company recorded administration and investment accounting fees of \$175 and \$156, respectively, which are included in general and administrative expense on the accompanying consolidated statements of operations.

The special servicer on 23 of the Company's 27 Controlling Class trusts is Midland Loan Services, Inc. (Midland), a wholly owned indirect subsidiary of PNC Bank. Midland therefore may be presumed to be an affiliate of the Manager. The Company's fees for Midland's services are at market rates.

On December 13, 2005, the Company entered into a \$75,000 commitment to acquire shares of BlackRock Diamond Property Fund (BlackRock Diamond). On February 21, 2006, the Company increased its capital commitment by an additional \$25,000, resulting in a total capital commitment of \$100,000. BlackRock Diamond is a private REIT managed by BlackRock Realty Advisors, Inc., a subsidiary of the Manager. At September 30, 2006, 93% of the total commitment has been called and the Company owned approximately 21% of BlackRock Diamond. The Company does not incur any additional management or incentive fees to the Manager as a result of its investment in BlackRock Diamond. The Company's investment in BlackRock Diamond at September 30, 2006 was \$102,873. The Company's unaffiliated directors approved this transaction in September 2005.

During 2001, the Company entered into a \$50,000 commitment to acquire shares in Carbon I, a private commercial real estate income opportunity fund managed by the Manager. The Carbon I investment period ended on July 12, 2004 and the Company's investment in Carbon I at September 30, 2006 was \$3,156. The Company does not incur any additional management or incentive fees to the Manager as a result of its investment in Carbon I. On September 30, 2006, the Company owned approximately 20% of the outstanding shares in Carbon I. The Company's unaffiliated directors approved this transaction in July 2001.

The Company entered into an aggregate commitment of \$100,000 to acquire shares in Carbon II, a private commercial real estate income opportunity fund managed by the Manager. At September 30, 2006, the Company's investment in Carbon II was \$73,348 and the Company's remaining commitment to Carbon II is \$28,958. The Company does not incur any additional management or

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incentive fees to the Manager as a result of its investment in Carbon II. The Company's unaffiliated directors approved this transaction in September 2004.

During 2000, the Company completed the acquisition of CORE Cap, Inc. At the time of the CORE Cap, Inc. acquisition, the Manager agreed to pay GMAC (CORE Cap, Inc.'s external advisor) \$12,500 over a ten-year period ( Installment Payment ) to purchase the right to manage the CORE Cap, Inc. assets under the existing management contract ( GMAC Contract ). The GMAC Contract had to be terminated in order to allow the Company to complete the merger, as the Company's management agreement with the Manager did not provide for multiple managers. As a result the Manager offered to buy-out the GMAC Contract as the Manager estimated it would receive incremental fees above and beyond the Installment Payment, and thus was willing to pay for, and separately negotiate, the termination of the GMAC Contract. Accordingly, the value of the Installment Payment was not considered in the Company's allocation of its purchase price to the net assets acquired in the acquisition of CORE Cap, Inc. The Company agreed that should the Management Agreement with its Manager be terminated, not renewed or not extended for any reason other than for cause, the Company would pay to the Manager an amount equal to the Installment Payment less the sum of all payments made by the Manager to GMAC. At September 30, 2006, the Installment Payment would be \$4,000 payable over four years. The Company does not accrue for this contingent liability.

**Note 13 DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

The Company accounts for its derivative investments under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. All derivatives, whether designated in hedging relationships or not, are required to be recorded on the consolidated statement of financial condition at estimated fair value. If the derivative is designated as a cash flow hedge, the effective portions of change in the estimated fair value of the derivative are recorded in other comprehensive income ( OCI ) and are recognized in the income statement when the hedged item affects earnings. Ineffective portions of changes in the estimated fair value of cash flow hedges are recognized in earnings. If the derivative is designated as a fair value hedge, the changes in the estimated fair value of the derivative and of the hedged item attributable to the hedged risk are recognized in earnings.

The Company uses interest rate swaps to manage exposure to variable cash flows on portions of its borrowings under reverse repurchase agreements and the floating rate debt of its CDOs and as trading derivatives intended to offset changes in estimated fair value related to securities held as trading assets. On the date in which the derivative contract is entered, the Company designates the derivative as either a cash flow hedge or a trading derivative.

Occasionally, counterparties will require the Company or the Company will require counterparties to provide collateral for the interest rate swap agreements in the form of margin deposits. Net deposits are recorded as a component of either other assets or other liabilities. Should the counterparty fail to return

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deposits paid, the Company would be at risk for the estimated fair value of that asset. At September 30, 2006, the balance of such net margin deposits owed to counterparties as collateral under these agreements totaled \$9,555. At December 31, 2005, the balance of such net margin deposits held by the Company as collateral under these agreements totaled \$1,246.

At September 30, 2006, the Company had interest rate swaps with notional amounts aggregating \$1,679,513 designated as cash flow hedges of borrowings under reverse repurchase agreements and the floating rate debt of its CDOs. Cash flow hedges with an estimated fair value of \$29,520 are included in other assets on the consolidated statement of financial condition and cash flow hedges with an estimated fair value of \$18,090 are included in other liabilities on the consolidated statement of financial condition. For the nine months ended September 30, 2006, the net change in the estimated fair value of the interest rate swaps was an increase of \$9,039, of which \$401 was deemed ineffective and is included as a decrease of interest expense and \$8,638 was recorded as an addition to OCI. At September 30, 2006, the \$1,679,513 notional of swaps designated as cash flow hedges had a weighted average remaining term of 7.5 years.

During the nine months ended September 30, 2006, the Company terminated ten of its interest rate swaps with a notional amount of \$276,350 that were designated as a cash flow hedge of borrowings under reverse repurchase agreements. The Company will reclassify the \$14,351 gain in value incurred from OCI to interest expense over 9.1 years, which was the weighted average remaining term of the swaps at the time they were closed out. For the nine months ended September 30, 2006, \$498 was reclassified as a decrease to interest expense and \$1,317 will be reclassified as a decrease to interest expense for the next twelve months. At September 30, 2006 the Company has, in aggregate, \$16,922 of net losses related to terminated swaps in OCI. For the quarter ended September 30, 2006, \$1,155 was reclassified as an increase to interest expense and \$4,594 will be reclassified as an increase to interest expense for the next twelve months.

At September 30, 2006, the Company had interest rate swaps with notional amounts aggregating \$323,445 designated as trading derivatives. Trading derivatives with an estimated fair value of \$3,622 are included in other assets on the consolidated statement of financial condition and trading derivatives with an estimated fair value of \$132 are included in other liabilities on the consolidated statement of financial condition. For the nine months ended September 30, 2006, the change in estimated fair value for these trading derivatives was an increase of \$904 and is included as a reduction of loss on securities held-for-trading on the consolidated statement of operations. At September 30, 2006, the \$323,445 notional of swaps designated as trading derivatives had a weighted average remaining term of 6.0 years. At September 30, 2006, the Company had a forward LIBOR cap with a notional amount of \$85,000 and an estimated fair value at September 30, 2006 of \$260 which is included in other assets, and the change in estimated fair value related to this derivative is included as a component of gain (loss) on securities held-for-trading on the consolidated statements of operations.

***Foreign Currency***

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The U.S. dollar is considered the functional currency for the Company's international subsidiaries. Foreign currency transaction gains or losses related to the Company's non-U.S. dollar denominated assets and liabilities are recognized in the period incurred and are included in other gain (loss) on the consolidated statement of operations. The Company uses foreign currency forward commitments to hedge the Company's net foreign investments. Gains and losses on foreign currency forward commitments are included in other gain (loss) on the consolidated statement of operations. The Company recorded net foreign currency transaction gain of \$682 and \$997 for the three and nine months ended September 30, 2006, respectively, and foreign currency transaction gain (loss) of \$87 and \$(257) for the three and nine months ended September 30, 2005, respectively. At September 30, 2006 and December 31, 2005, the Company also had foreign currency forward commitments with an estimated fair value of \$(143,428) and \$(55,390).



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**ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

All currency figures expressed herein are expressed in thousands, except share or per share amounts or as otherwise noted.

***I. General***

Anthracite Capital, Inc., a Maryland corporation, and subsidiaries (the Company) is a specialty finance company that invests in commercial real estate assets on a global basis. The Company seeks to generate income from the spread between the interest income, gains and net operating income on its commercial real estate assets and the interest expense from borrowings to finance its investments. The Company's primary activity is investing in high yielding commercial real estate debt. The Company combines traditional real estate underwriting and capital markets expertise to maximize the opportunities arising from the continuing integration of these two disciplines. The Company focuses on acquiring pools of performing loans in the form of commercial mortgage-backed securities (CMBS), issuing secured debt backed by CMBS and providing strategic capital for the commercial real estate industry in the form of mezzanine loan financing. The Company also began investing in diversified portfolios of commercial real estate in the United States during December 2005. The Company commenced operations on March 24, 1998.

The Company's common stock is traded on the New York Stock Exchange under the symbol AHR. The Company's primary long-term objective is to distribute consistent dividends supported by earnings. The Company establishes its dividend by analyzing the long-term sustainability of earnings given existing market conditions and the current composition of its portfolio. This includes an analysis of the Company's credit loss assumptions, general level of interest rates, projected hedging costs and the estimated return potential of its real estate investments.

The Company is managed by BlackRock Financial Management, Inc. (the Manager), a subsidiary of BlackRock, Inc., a publicly traded (NYSE:BLK) asset management company with approximately \$1.075 trillion of assets under management, including more than \$15 billion in real estate equity and debt, at September 30, 2006. The Manager provides an operating platform that incorporates significant asset origination, risk management, operational and property management capabilities.

The Company's ongoing investment activities primarily encompass three core investment activities:

- 1) Commercial Real Estate Securities
- 2) Commercial Real Estate Loans
- 3) Commercial Real Estate Equity

The commercial real estate securities portfolio provides diversification and high yields that are adjusted for anticipated losses over a period of time (typically, a ten-year weighted average life) and can be financed through the issuance of secured debt that matches the life of the investment. Commercial real estate loans provide attractive risk adjusted returns over shorter periods of time through strategic investments in specific property types or regions. The Company's equity strategy is to invest in a diverse portfolio of commercial real estate with the objective of repositioning the property to maximize its value. The return objective is to provide strong returns over a medium term period of four to seven years through

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a combination of real estate operating income and capital gains. It is expected that, over the short term, current returns will fluctuate as gains and losses are reported based on a valuation process each quarter. The Company believes that the combination of these activities will result in a sustainable dividend stream for its stockholders.

The Company's fixed income investment activity continues to be managed to maintain a positive, though controlled, exposure to both long- and short-term interest rates through its active hedging strategies. See Item 3 Quantitative and Qualitative Disclosures About Market Risk for a discussion of interest rates and their effect on earnings and book value.

The following table illustrates the mix of the Company's asset types at September 30, 2006 and December 31, 2005:

	Carrying Value at			
	September 30, 2006		December 31, 2005	
	Amount	%	Amount	%
Commercial real estate securities	\$2,520,442	52.8%	\$2,005,383	49.7%
Commercial mortgage loan pools <sup>(1)</sup>	1,276,471	26.7	1,292,407	32.0
Commercial real estate loans <sup>(2)</sup>	584,247	12.2	425,453	10.6
Commercial real estate equity <sup>(3)</sup>	106,723	2.2	51,003	1.3
Total commercial real estate assets	4,487,883	93.9	3,774,246	93.6
Residential mortgage-backed securities	290,026	6.1	259,026	6.4
Total	\$4,777,909	100.0%	\$4,033,272	100.0%

(1) Represents a Controlling Class CMBS that is consolidated for accounting purposes. See Note 5 of the consolidated financial statements.

(2) Includes the Company's investments in Carbon Capital, Inc. ( Carbon I ) and Carbon Capital II, Inc. ( Carbon II ), and collectively with Carbon I, the

Carbon Capital  
Funds ) at  
September 30,  
2006 and  
December 31,  
2005.

- (3) Includes the  
Company's  
investments in  
BlackRock  
Diamond  
Property Fund  
( BlackRock  
Diamond ) at  
September 30,  
2006 and  
December 31,  
2005 and  
Dynamic India  
Fund IV at  
September 30,  
2006.

During the nine months ended September 30, 2006, the Company purchased a total of \$858,139 of commercial real estate assets. Included in this amount is \$309,728 of non-U.S. dollar denominated assets as the Company continues to expand its global investment activities. Commercial real estate assets purchased were comprised of: \$322,061 of CMBS, \$193,395 of multifamily agency securities, \$23,660 of investment grade real estate investment trust ( REIT ) debt, \$267,839 of commercial real estate loans and \$51,184 of real estate equity. During the nine months ended September 30, 2006, the Company sold commercial real estate assets of \$43,725, which were comprised of \$13,662 of CMBS, \$24,628 of investment grade REIT debt and \$5,435 of commercial real estate equity. In addition, the Company purchased \$142,767 of investment grade residential mortgage-backed securities ( RMBS ) and sold RMBS of \$69,594.

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During the nine months ended September 30, 2006, the Company sold seven securities classified as available for sale. Total proceeds from the sales were \$109,021. The sales resulted in a gain of \$1,588 from six securities and a loss of \$1,202 on the seventh security sold. During the nine months ended September 30, 2005, the Company realized a gain of \$88 on securities available-for-sale.

**Summary of Commercial Real Estate Assets**

A summary of the Company's commercial real estate assets with estimated fair values in local currencies at September 30, 2006 is as follows:

	Commercial Real Estate Securities	Commercial Real Estate Loans <sup>(1)</sup>	Commercial Real Estate Equity	Commercial Mortgage Loan Pools	Total Commercial Real Estate Assets	Total Commercial Real Estate Assets (USD)
USD	\$2,374,104	\$ 303,039	\$ 102,873	\$1,276,471	\$4,056,487	\$ 4,056,487
GBP	£ 28,041	£ 44,014			£ 72,055	\$ 134,859
EURO	73,978	156,720			230,698	\$ 292,687
Indian Rupees			Rs176,907		Rs176,907	\$ 3,850
Total USD Equivalent	\$2,520,442	\$ 584,247	\$ 106,723	\$1,276,471	\$4,487,883	\$ 4,487,883

<sup>(1)</sup> Includes the Company's investments in the Carbon Capital Funds at September 30, 2006.

A summary of the Company's commercial real estate assets with estimated fair values in local currencies at December 31, 2005 is as follows:

	Commercial Real Estate Securities	Commercial Real Estate Loans <sup>(1)</sup>	Commercial Real Estate Equity	Commercial Mortgage Loan Pools	Total Commercial Real Estate Assets	Total Commercial Real Estate Assets (USD)
USD	\$1,968,063	\$ 295,499	\$ 51,003	\$1,292,407	\$3,606,972	\$ 3,606,972
GBP	£ 16,334	£ 33,139			£ 49,473	\$ 85,027
EURO	7,809	61,642			69,451	\$ 82,247
Total USD Equivalent	\$2,005,383	\$ 425,453	\$ 51,003	\$1,292,407	\$3,774,246	\$ 3,774,246

<sup>(1)</sup> Includes the Company's investments in

the Carbon  
Capital Funds at  
December 31,  
2005.

The Company has foreign currency rate exposure related to its non-U.S. dollar denominated assets. The Company's primary currency exposures are Euro and British pound. Changes in currency rates can adversely impact the estimated fair value and earnings of the Company's non-U.S. holdings. The Company mitigates this impact by utilizing local currency-denominated financing on its foreign investments and foreign currency forward commitments to hedge the net exposure. Foreign currency gain (loss) was \$997 and \$(257) for the nine months ended September 30, 2006 and 2005, respectively.

**Table of Contents****Commercial Real Estate Assets Portfolio Activity**

The following table details the par, carrying value, adjusted purchase price, and expected yield of the Company's commercial real estate assets included in as well as outside its collateralized debt obligations ( CDO ) at September 30, 2006:

Commercial real estate securities outside CDOs	Par	Carrying Value	Dollar Price	Adjusted Purchase Price	Dollar Price	Expected Yield
Investment grade CMBS	\$ 125,586	\$ 137,851	97.81	\$ 143,848	103.28	4.51%
Investment grade REIT debt	23,000	21,244	92.36	22,845	99.32	5.49%
CMBS rated BB+ to B	142,293	157,001	89.74	154,552	89.67	7.92%
CMBS rated B- or lower	112,420	39,543	35.17	36,471	32.44	6.53%
CDO Investments	423,268	116,811	26.73	116,810	26.75	15.33%
CMBS Interest Only securities ( IOs )	3,267,755	83,208	2.55	84,383	2.58	7.64%
Multifamily agency securities	449,094	451,972	100.64	455,138	101.35	5.03%
Commercial mortgage loan pools	1,214,471	1,276,471	105.11	1,276,471	105.11	4.14%
<b>Total commercial real estate assets outside CDOs</b>	<b>5,757,887</b>	<b>2,284,101</b>	<b>38.84</b>	<b>2,290,518</b>	<b>39.00</b>	<b>5.34%</b>
<b>Commercial real estate loans and equity outside CDOs</b>						
Commercial real estate loans	241,943	396,287		387,771		
Commercial real estate	96,453	106,723		96,453		
<b>Total commercial real estate loans and equity outside CDOs</b>	<b>6,096,283</b>	<b>2,787,111</b>		<b>2,774,742</b>		
<b>Commercial real estate assets included in CDOs</b>						
Investment grade CMBS	691,805	695,204	100.49	638,124	92.24	7.79%
Investment grade REIT debt	223,445	229,559	102.74	225,297	100.83	6.04%
CMBS rated BB+ to B	587,420	492,538	83.85	437,621	74.50	10.05%
CMBS rated B- or lower	186,239	70,718	37.97	66,889	35.92	8.55%
Credit tenant lease	23,928	24,793	103.61	24,581	102.73	5.67%
Commercial real estate loans	199,074	187,960	94.42	187,958	94.42	9.67%
<b>Total commercial real estate assets included in CDOs</b>	<b>1,911,911</b>	<b>1,700,772</b>	<b>88.96</b>	<b>1,580,470</b>	<b>82.66</b>	<b>8.39%</b>
<b>Total commercial real estate assets</b>	<b>\$8,008,194</b>	<b>\$4,487,883</b>		<b>\$4,355,212</b>		



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The following table details the par, carrying value, adjusted purchase price and expected yield of the Company's commercial real estate assets included in as well as outside its CDOs at December 31, 2005:

Commercial real estate securities outside CDOs	Par	Carrying Value	Dollar Price	Adjusted Purchase Price	Dollar Price	Expected Yield
Investment grade CMBS	\$ 150,128	\$ 151,889	96.22	\$ 161,314	102.17	4.00%
Investment grade REIT debt	23,000	21,828	94.90	22,828	99.25	5.49%
CMBS rated BB+ to B	104,784	90,289	78.38	92,931	80.69	7.77%
CMBS rated B- or lower	132,242	47,854	34.05	45,070	31.59	9.17%
CDO Investments	423,349	124,549	29.42	112,577	26.59	17.29%
CMBS IOs	3,505,646	103,363	2.95	103,120	2.94	6.58%
Multifamily agency securities	256,398	263,362	102.72	268,319	104.65	4.77%
Commercial mortgage loan pools	1,221,302	1,292,407	105.82	1,292,407	105.82	4.14%
<b>Total commercial real estate securities outside CDOs</b>	<b>5,816,849</b>	<b>2,095,541</b>	<b>17.19</b>	<b>2,098,566</b>	<b>17.24</b>	<b>5.43%</b>
<b>Commercial real estate loans and equity outside CDOs</b>						
Commercial real estate loans	368,433	405,782		404,217		
Commercial real estate	50,704	51,004		50,704		
<b>Total commercial real estate loans and equity outside CDOs</b>	<b>419,137</b>	<b>456,786</b>		<b>454,921</b>		
<b>Commercial real estate securities included in CDOs</b>						
Investment grade CMBS	375,502	377,291	100.48	354,561	94.42	7.37%
Investment grade REIT debt	223,445	233,939	104.70	226,583	101.40	6.15%
CMBS rated BB+ to B	656,207	566,181	86.28	513,446	78.24	9.16%
Credit tenant lease	24,317	24,837	102.14	24,995	102.79	5.68%
Commercial real estate loans	20,175	19,671	97.49	20,160	99.93	6.96%
<b>Total commercial real estate assets included in CDOs</b>	<b>1,299,647</b>	<b>1,221,919</b>	<b>94.02</b>	<b>1,139,745</b>	<b>87.70</b>	<b>8.17%</b>
<b>Total commercial real estate assets</b>	<b>\$7,535,633</b>	<b>\$3,774,246</b>		<b>\$3,693,232</b>		

During the nine months ended September 30, 2006, the Company's commercial real estate asset portfolio increased by approximately 18.9% from an estimated fair value of \$3,774,246 at December 31, 2005, compared with \$4,487,883 at September 30, 2006.



The Company's CDO offerings allow the Company to match fund its commercial real estate portfolio by issuing long-term debt to finance long-term assets. The CDO debt is non-recourse to the Company; therefore, the Company's maximum potential loss is limited to its equity investment in the CDO. The CDO debt is also substantially hedged to protect the Company from an increase in short-term interest

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rates. At September 30, 2006, over 73% of the estimated fair value of the Company's subordinated CMBS is match funded in the Company's CDOs in this manner.

The Company retained 100% of the equity of CDOs I, II, III and HY3 (each as defined below) and recorded the transactions on its consolidated financial statements as secured financing. The table below summarizes the Company's CDO debt and collateral at September 30, 2006.

	Collateral at September 30, 2006		Debt at September 30, 2006		
	Adjusted Purchase Price	Loss Adjusted Yield	Adjusted Issue Price	Weighted Average Cost of Funds *	Net Spread
CDO I	\$ 445,631	9.24%	\$ 405,772	7.27%	1.97%
CDO II	327,750	8.01%	291,573**	5.95%	2.06%
CDO III	378,387	7.28%	366,565**	4.96%	2.32%
CDO HY3	454,109	8.72%	416,722**	6.35%	2.37%
Total	\$ 1,605,877	8.38%	\$ 1,480,632	6.18%	2.20%

\* Weighted Average Cost of Funds is the current cost of funds plus hedging expenses.

\*\* The Company chose not to sell \$10,000 of par of CDO II debt rated BB, \$13,069 of par of CDO III debt rated BB and \$47,000 par of CDO HY3 debt rated BB.

**Securitizations**

On July 26, 2005, the Company closed its fifth CDO ( CDO HY2 ) and issued non-recourse liabilities with a face amount of \$365,010. Senior investment grade notes with a face amount of \$240,134 were issued and sold in a private placement. The Company retained the floating rate BBB- note, the below investment grade notes and the preferred shares. The Company recorded CDO HY2 as a secured financing for accounting purposes and consolidated the assets, liabilities, income and expenses of CDO HY2 until the sale of the floating rate BBB- note in December 2005, at which point CDO HY2 qualified as a sale under Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ( SFAS No. 140 ).

The Company received cash proceeds of \$244,212 as well as all of the retained interests that had an estimated fair value of \$105,025 at December 31, 2005. The transaction raised investable proceeds of \$56,226. The following table

summarizes the impact of this transaction on 2005 results:

Net realized gain related to sale of CDO HY2	\$ 16,523
Increase in accumulated other comprehensive income	9,611
Total stockholders' equity impact	\$ 26,134

**Real Estate Credit Profile of Below Investment Grade CMBS**

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The Company's below investment grade CMBS investment activities can be viewed as two portfolios: Controlling Class CMBS and other below investment grade CMBS. The Company considers the CMBS securities where it maintains the right to influence the foreclosure/workout process on the underlying loans to be its controlling class CMBS ( Controlling Class ). The distinction between the two is in the rights the Company obtains with its investment in Controlling Class CMBS. Controlling Class rights allow the Company to influence the workout and/or disposition of defaults that occur in the underlying loans. These securities absorb the first losses realized in the underlying loan pools. The coupon payment on the non-rated security also can be reduced for special servicer fees charged to the trust. The next highest rated security in the structure then generally will have its rating withdrawn and will then be non-rated. This non-rated security will become the first to absorb losses and expenses from that point on. At September 30, 2006, the Company owns 27 different trusts where it is in the first loss position and is designated as the controlling class representative by owning the lowest rated or non-rated CMBS class. The total par of the loans underlying these securities was \$39,405,741. At September 30, 2006, subordinated Controlling Class CMBS with a par of \$866,666 were included on the Company's consolidated statement of financial condition. Subordinated Controlling Class CMBS with a par of \$711,373 were held as collateral for CDOs HY1 and HY2. The Company's other below investment grade CMBS have more limited rights associated with its ownership to influence the workout and/or disposition of underlying loan defaults. The total par of the Company's other below investment grade CMBS at September 30, 2006 was \$161,705; the average credit protection, or subordination level, of this portfolio is 1.74%. The Company's investment in its subordinated Controlling Class CMBS by credit rating category at September 30, 2006 is as follows:

Adjusted	Weighted Average
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