PLEXUS CORP
Form 10-Q
May 03, 2019
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

---

FORM 10-Q

---

ý Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended March 30, 2019
OR
¨ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
Commission File Number 001-14423

---

PLEXUS CORP.
(Exact name of registrant as specified in charter)

---

| Wisconsin | 39-1344447 |
|---|---|
| (State of Incorporation) | (IRS Employer Identification No.) |

One Plexus Way
Neenah, Wisconsin 54957
(Address of principal executive offices)(Zip Code)
Telephone Number (920) 969-6000
(Registrant's telephone number, including Area Code)

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. Yes ý No ¨
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes ý No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ý Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨ Emerging growth company ¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No ý
Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Trading Symbol | Name of each exchange on which registered |
|---|---|---|
| Common Stock, $0.01 par value | PLXS | The Nasdaq Global Select Market |

As of April 30, 2019, there were 30,105,120 shares of common stock outstanding.

Table of Contents

PLEXUS CORP.
TABLE OF CONTENTS
March 30, 2019


| | |
|---|---|
| PART I. FINANCIAL INFORMATION | 3 |
| ITEM 1. FINANCIAL STATEMENTS | 3 |
| Condensed Consolidated Statements of Comprehensive Income (Loss) | 3 |
| Condensed Consolidated Balance Sheets | 4 |
| Condensed Consolidated Statements of Shareholders' Equity | 5 |
| Condensed Consolidated Statements of Cash Flows | 6 |
| Notes to Condensed Consolidated Financial Statements | 7 |
| ITEM 2. MANAGEMENT'S DICUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS | 20 |
| "Safe Harbor" Cautionary Statement Under the Private Securities Litigation Reform Act of 1995 | 20 |
| Overview | 20 |
| Results of Operations | 21 |
| Liquidity of Capital Resources | 26 |
| Contractual Obligations, Commitments and Off-Balance Sheet Obligations | 30 |
| Disclosure About Critical Accounting Policies | 31 |
| New Accounting Pronouncements | 31 |
| ITEM 3. QUANTITATIVE AND QUALITIATIVE DISCLOSURES ABOUT MARKET RISK | 32 |
| ITEM 4. CONTROLS AND PROCEDURES | 32 |
| PART II. OTHER INFORMATION | 33 |
| ITEM 1A. Risk Factors | 33 |
| ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds | 33 |
| ITEM 6. Exhibits | 33 |
| SIGNATURES | 35 |

Table of Contents

PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

PLEXUS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(in thousands, except per share data)
Unaudited

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | March 30, 2019 | March 31, 2018 | March 30, 2019 | March 31, 2018 |
| Net sales | $789,051 | $698,651 | $1,554,595 | $1,375,945 |
| Cost of sales | 718,415 | 645,699 | 1,411,576 | 1,259,470 |
| Gross profit | 70,636 | 52,952 | 143,019 | 116,475 |
| Selling and administrative expenses | 37,462 | 35,637 | 72,894 | 67,603 |
| Operating income | 33,174 | 17,315 | 70,125 | 48,872 |
| Other income (expense): | | | | |
| Interest expense | (3,145) | (3,547) | (5,394) | (7,272) |
| Interest income | 440 | 1,426 | 965 | 2,981 |
| Miscellaneous, net | (1,773) | (477) | (2,885) | (823) |
| Income before income taxes | 28,696 | 14,717 | 62,811 | 43,758 |
| Income tax expense | 3,938 | 2,427 | 15,827 | 129,961 |
| Net income (loss) | $24,758 | $12,290 | $46,984 | $(86,203) |
| Earnings (loss) per share: | | | | |
| Basic | $0.81 | $0.37 | $1.52 | $(2.57) |
| Diluted | $0.79 | $0.36 | $1.48 | $(2.57) |
| Weighted average shares outstanding: | | | | |
| Basic | 30,603 | 33,538 | 31,003 | 33,552 |
| Diluted | 31,385 | 34,387 | 31,836 | 33,552 |
| Comprehensive income (loss): | | | | |
| Net income (loss) | $24,758 | $12,290 | $46,984 | $(86,203) |
| Other comprehensive income: | | | | |
| Derivative instrument fair value adjustment | 1,984 | 1,229 | 2,362 | 2,768 |
| Foreign currency translation adjustments | 515 | 4,773 | (1,356) | 6,915 |
| Other comprehensive income | 2,499 | 6,002 | 1,006 | 9,683 |
| Total comprehensive income (loss) | $27,257 | $18,292 | $47,990 | $(76,520) |

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

Table of Contents

PLEXUS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)
Unaudited

| | March 30, 2019 | September 29, 2018 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $184,028 | $297,269 |
| Restricted cash | 331 | 417 |
| Accounts receivable, net of allowances of $1,251 and $885, respectively | 445,053 | 394,827 |
| Contract assets | 86,803 | — |
| Inventories, net | 802,261 | 794,346 |
| Prepaid expenses and other | 30,987 | 30,302 |
| Total current assets | 1,549,463 | 1,517,161 |
| Property, plant and equipment, net | 373,918 | 341,306 |
| Deferred income taxes | 10,889 | 10,825 |
| Intangible assets, net | 7,511 | 8,239 |
| Other | 59,070 | 55,111 |
| Total non-current assets | 451,388 | 415,481 |
| Total assets | $2,000,851 | $1,932,642 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current portion of long-term debt and capital lease obligations | $93,197 | $5,532 |
| Accounts payable | 476,481 | 506,322 |
| Customer deposits | 129,068 | 90,782 |
| Accrued salaries and wages | 52,939 | 66,874 |
| Other accrued liabilities | 92,989 | 68,163 |
| Total current liabilities | 844,674 | 737,673 |
| Long-term debt and capital lease obligations, net of current portion | 187,120 | 183,085 |
| Long-term accrued income taxes payable | 58,296 | 56,130 |
| Deferred income taxes payable | 14,991 | 14,376 |
| Other liabilities | 20,326 | 20,235 |
| Total non-current liabilities | 280,733 | 273,826 |
| Total liabilities | 1,125,407 | 1,011,499 |
| Commitments and contingencies | | |
| Shareholders' equity: | | |
| Preferred stock, $.01 par value, 5,000 shares authorized, none issued or outstanding | — | — |
| Common stock, $.01 par value, 200,000 shares authorized, 52,832 and 52,567 shares issued, respectively, and 30,241 and 31,838 shares outstanding, respectively | 528 | 526 |
| Additional paid-in capital | 586,279 | 581,488 |
| Common stock held in treasury, at cost, 22,591 and 20,729 shares, respectively | (817,435) | (711,138) |
| Retained earnings | 1,117,045 | 1,062,246 |
| Accumulated other comprehensive loss | (10,973) | (11,979) |
| Total shareholders' equity | 875,444 | 921,143 |
| Total liabilities and shareholders' equity | $2,000,851 | $1,932,642 |

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

Table of Contents

PLEXUS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(in thousands)
Unaudited

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | March 30, 2019 | March 31, 2018 | March 30, 2019 | March 31, 2018 |
| Common stock - shares outstanding | | | | |
| Beginning of period | 30,992 | 33,607 | 31,838 | 33,464 |
| Exercise of stock options and vesting of other stock awards | 241 | 199 | 265 | 500 |
| Treasury shares purchased | (992) | (513) | (1,862) | (671) |
| End of period | 30,241 | 33,293 | 30,241 | 33,293 |
| | | | | |
| Total stockholders' equity, beginning of period | $905,163 | $933,848 | $921,143 | $1,025,939 |
| Common stock - par value | | | | |
| Beginning of period | 526 | 522 | 526 | 519 |
| Exercise of stock options and vesting of other stock awards | 2 | 2 | 2 | 5 |
| End of period | 528 | 524 | 528 | 524 |
| Additional paid-in capital | | | | |
| Beginning of period | 587,011 | 567,562 | 581,488 | 555,297 |
| Stock-based compensation expense | 5,176 | 4,524 | 9,929 | 8,420 |
| Exercise of stock options and vesting of other stock awards, including tax benefits | (5,908) | (4,551) | (5,138) | 3,818 |
| End of period | 586,279 | 567,535 | 586,279 | 567,535 |
| Treasury stock | | | | |
| Beginning of period | (761,189) | (583,651) | (711,138) | (574,104) |
| Treasury shares purchased | (56,246) | (31,612) | (106,297) | (41,159) |
| End of period | (817,435) | (615,263) | (817,435) | (615,263) |
| Retained earnings | | | | |
| Beginning of period | 1,092,287 | 950,713 | 1,062,246 | 1,049,206 |
| Net income (loss) | 24,758 | 12,290 | 46,984 | (86,203) |
| Cumulative effect adjustment for adoption of new accounting pronouncement (1) | — | — | 7,815 | — |
| End of period | 1,117,045 | 963,003 | 1,117,045 | 963,003 |
| Accumulated other comprehensive income (loss) | | | | |
| Beginning of period | (13,472) | (1,298) | (11,979) | (4,979) |
| Other comprehensive income | 2,499 | 6,002 | 1,006 | 9,683 |
| End of period | (10,973) | 4,704 | (10,973) | 4,704 |
| Total stockholders' equity, end of period | $875,444 | $920,503 | $875,444 | $920,503 |

(1) See Note 1, "Basis of Presentation," for a discussion of recently adopted accounting pronouncements.
The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents

PLEXUS CORP. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
Unaudited

| | Six Months Ended | |
|---|---|---|
| | March 30, 2019 | March 31, 2018 |
| Cash flows from operating activities | | |
| Net income (loss) | $46,984 | $(86,203) |
| Adjustments to reconcile net income (loss) to net cash flows from operating activities: | | |
| Depreciation and amortization | 25,468 | 23,602 |
| Deferred income taxes | 1,622 | 22,326 |
| Share-based compensation expense | 9,929 | 8,420 |
| Other, net | 92 | (45) |
| Changes in operating assets and liabilities, excluding impacts of acquisition: | | |
| Accounts receivable | (50,717) | (32,326) |
| Contract assets | (10,298) | — |
| Inventories | (77,917) | (42,781) |
| Other current and noncurrent assets | (4,367) | (4,766) |
| Accrued income taxes payable | (824) | 102,220 |
| Accounts payable | (28,187) | 15,611 |
| Customer deposits | 38,197 | (3,680) |
| Other current and noncurrent liabilities | 15,486 | 463 |
| Cash flows (used in) provided by operating activities | (34,532) | 2,841 |
| Cash flows from investing activities | | |
| Payments for property, plant and equipment | (54,556) | (29,115) |
| Proceeds from sales of property, plant and equipment | 93 | 273 |
| Business acquisition | 1,180 | — |
| Cash flows used in investing activities | (53,283) | (28,842) |
| Cash flows from financing activities | | |
| Borrowings under debt agreements | 667,025 | 504,616 |
| Payments on debt and capital lease obligations | (581,360) | (612,961) |
| Repurchases of common stock | (106,297) | (41,159) |
| Proceeds from exercise of stock options | 1,264 | 9,194 |
| Payments related to tax withholding for share-based compensation | (6,400) | (5,371) |
| Cash flows used in financing activities | (25,768) | (145,681) |
| Effect of exchange rate changes on cash and cash equivalents | 256 | 5,743 |
| Net decrease in cash and cash equivalents and restricted cash | (113,327) | (165,939) |
| Cash and cash equivalents and restricted cash: | | |
| Beginning of period | 297,686 | 569,254 |
| End of period | $184,359 | $403,315 |

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

Table of Contents

PLEXUS CORP. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE AND SIX MONTHS ENDED MARCH 30, 2019 AND MARCH 31, 2018
Unaudited

1. Basis of Presentation

Basis of Presentation:

The accompanying Condensed Consolidated Financial Statements included herein have been prepared by Plexus Corp. and its subsidiaries (together “Plexus” or the “Company”) without audit and pursuant to the rules and regulations of the United States (“U.S.”) Securities and Exchange Commission (“SEC”). The accompanying Condensed Consolidated Financial Statements reflect all adjustments, which include normal recurring adjustments necessary for the fair statement of the consolidated financial position of the Company as of March 30, 2019 and September 29, 2018, the results of operations and shareholders' equity for the three and six months ended March 30, 2019 and March 31, 2018, and the cash flows for the same six month periods.

The Company’s fiscal year ends on the Saturday closest to September 30. The Company uses a “4-4-5” weekly accounting system for the interim periods in each quarter. Each quarter, therefore, ends on a Saturday at the end of the 4-4-5 period. Periodically, an additional week must be added to the fiscal year to re-align with the Saturday closest to September 30. All fiscal quarters presented herein included 13 weeks.

Certain information and footnote disclosures, normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America ("U.S. GAAP"), have been condensed or omitted pursuant to the SEC’s rules and regulations dealing with interim financial statements. However, the Company believes that the disclosures made in the Condensed Consolidated Financial Statements included herein are adequate to make the information presented not misleading. It is suggested that these Condensed Consolidated Financial Statements be read in conjunction with the Consolidated Financial Statements and notes thereto included in the Company’s 2018 Annual Report on Form 10-K.

Recently Adopted Accounting Pronouncements:

In October 2016, the Financial Accounting Standards Board (the "FASB") issued ASU 2016-16 related to the income tax consequences of intra-entity transfers of assets other than inventory. The new standard eliminates the exception for an intra-entity transfer of an asset other than inventory and requires an entity to recognize the income tax consequences when the transfer occurs. The Company adopted this guidance under the modified retrospective approach during the first quarter of fiscal 2019. The Company recognized no net impact to its fiscal 2019 opening Retained Earnings balance upon adoption and does not anticipate any material impact to the Company's future Consolidated Financial Statements.

In August 2016, the FASB issued ASU 2016-15 related to the classification of certain cash receipts and cash payments, which clarifies how entities should classify certain cash receipts and cash payments on the statement of cash flows. The new standard addresses certain issues where diversity in practice was identified. It also amends existing guidance, which is principles based and often requires judgment to determine the appropriate classification of cash flows as operating, investing or financing activities and clarifies how the predominance principle should be applied when cash receipts and cash payments have aspects of more than one class of cash flows. The Company adopted this guidance during the first quarter of fiscal 2019 with no material impact to the Company's Condensed Statements of Cash Flows.

In May 2014, the FASB issued ASU 2014-09, which requires an entity to recognize revenue relating to contracts with customers that depicts the transfer of promised goods or services to customers in an amount reflecting the consideration to which the entity expects to be entitled in exchange for such goods or services ("Topic 606"). Topic 606 also requires disclosures enabling users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers and was effective for the Company beginning in the first quarter of fiscal year 2019.

On September 30, 2018, the Company adopted and applied Topic 606 to all contracts using the modified retrospective method of adoption. Upon adoption, the Company recognized an increase to its beginning Retained Earnings balance of $7.8 million. The comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods. Refer to Note 13, "Revenue from Contracts with Customers," for further information.

Recently Issued Accounting Pronouncements Not Yet Adopted:

In February 2016, the FASB issued ASU 2016-02, which requires lessees to recognize most leases on their balance sheets but record expenses on their income statements in a manner similar to current accounting. For lessors, the guidance modifies the

Table of Contents

classification criteria and the accounting for sales-type and direct financing leases. The guidance is effective for the Company beginning in the first quarter of fiscal year 2020. Early adoption is permitted. The Company is currently in the process of assessing the impact of the adoption of the new standard on its Consolidated Financial Statements and plans to adopt the standard in the first quarter of fiscal year 2020.

In August 2017, the FASB issued ASU 2017-12 related to the accounting for hedging activities. The pronouncement expands and refines hedge accounting, aligns the recognition and presentation of the effects of hedging instruments and hedge items in the financial statements, and includes certain targeted improvements to ease the application of current guidance related to the assessment of hedge effectiveness. The guidance is effective for the Company beginning in the first quarter of fiscal year 2020. Early adoption is permitted. The Company is currently in the process of assessing the impact of the adoption of the new standard on its Consolidated Financial Statements and the timing of adoption.

The Company believes that no other recently issued accounting standards will have a material impact on its Consolidated Financial Statements, or apply to its operations.

2. Inventories

Inventories as of March 30, 2019 and September 29, 2018 consisted of the following (in thousands):

| | March 30, 2019 | September 29, 2018 |
|---|---|---|
| Raw materials | $657,125 | $ 579,377 |
| Work-in-process | 55,888 | 102,337 |
| Finished goods | 89,248 | 112,632 |
| Total inventories, net | $802,261 | $ 794,346 |

In certain circumstances, per contractual terms, customer deposits are received by the Company to offset obsolete and excess inventory risks. The total amount of customer deposits related to inventory and included within current liabilities on the accompanying Condensed Consolidated Balance Sheets as of March 30, 2019 and September 29, 2018 was $126.7 million and $87.7 million, respectively.

In the first quarter of fiscal year 2019, the Company adopted and applied Topic 606 to all contracts using the modified retrospective method of adoption. The prior year comparative information has not been restated and continues to be reported under the accounting standards in effect for fiscal 2018. Refer to Note 13, "Revenue from Contracts with Customers," for further information.

3. Debt, Capital Lease Obligations and Other Financing

Debt and capital lease obligations as of March 30, 2019 and September 29, 2018, consisted of the following (in thousands):

| | March 30, 2019 | September 29, 2018 |
|---|---|---|
| 4.05% Senior Notes, due June 15, 2025 | $100,000 | $ 100,000 |
| 4.22% Senior Notes, due June 15, 2028 | 50,000 | 50,000 |
| Borrowings under the credit facility | 87,000 | — |
| Capital lease and other financing obligations | 44,413 | 39,857 |
| Unamortized deferred financing fees | (1,096) | (1,240) |
| Total obligations | 280,317 | 188,617 |
| Less: current portion | (93,197) | (5,532) |
| Long-term debt and capital lease obligations, net of current portion | $187,120 | $ 183,085 |

On June 15, 2018, the Company entered into a Note Purchase Agreement (the “2018 NPA”) pursuant to which it issued an aggregate of $150.0 million in principal amount of unsecured senior notes, consisting of $100.0 million in principal amount

Table of Contents

of 4.05% Series A Senior Notes, due on June 15, 2025, and $50.0 million in principal amount of 4.22% Series B Senior Notes, due on June 15, 2028 (collectively, the “2018 Notes”), in a private placement. The 2018 NPA includes customary operational and financial covenants with which the Company is required to comply, including, among others, maintenance of certain financial ratios such as a total leverage ratio and a minimum interest coverage ratio. The 2018 Notes may be prepaid in whole or in part at any time, subject to payment of a make-whole amount. Interest on the 2018 Notes is payable semiannually. At March 30, 2019, the Company was in compliance with the covenants under the 2018 NPA.

The Company also has a senior unsecured revolving credit facility (the "Credit Facility"), with a $300.0 million maximum commitment that expires on July 5, 2021. The Credit Facility may be further increased to $500.0 million, generally by mutual agreement of the Company and the lenders, subject to certain customary conditions. During the six months ended March 30, 2019, the highest daily borrowing was $229.0 million; the average daily borrowings were $98.9 million. The Company borrowed $666.5 million and repaid $579.5 million of revolving borrowings under the Credit Facility during the six months ended March 30, 2019. As of March 30, 2019, the Company was in compliance with all financial covenants relating to the Credit Facility, which are generally consistent with those in the 2018 NPA discussed above. The Company is required to pay a commitment fee on the daily unused revolver credit commitment based on the Company's leverage ratio; the fee was 0.175% as of March 30, 2019.

The fair value of the Company’s debt, excluding capital leases, was $237.5 million and $151.9 million as of March 30, 2019 and September 29, 2018, respectively. The carrying value of the Company's debt, excluding capital leases, was $237.0 million and $150.0 million as of March 30, 2019 and September 29, 2018, respectively. If measured at fair value in the financial statements, the Company's debt would be classified as Level 2 in the fair value hierarchy. Refer to Note 4, "Derivatives," for further information regarding the Company's fair value calculations and classifications.

4. Derivatives

All derivatives are recognized in the accompanying Condensed Consolidated Balance Sheets at their estimated fair value. The Company uses derivatives to manage the variability of foreign currency obligations. The Company has cash flow hedges related to forecasted foreign currency obligations, in addition to non-designated hedges to manage foreign currency exposures associated with certain foreign currency denominated assets and liabilities. The Company does not enter into derivatives for speculative purposes.

Changes in the fair value of the derivatives that qualify as cash flow hedges are recorded in "Accumulated other comprehensive loss" in the accompanying Condensed Consolidated Balance Sheets until earnings are affected by the variability of the cash flows. In the next twelve months, the Company estimates that $0.7 million of unrealized gains, net of tax, related to cash flow hedges will be reclassified from other comprehensive income (loss) into earnings. Changes in the fair value of the non-designated derivatives related to recognized foreign currency denominated assets and liabilities are recorded in "Miscellaneous, net" in the accompanying Condensed Consolidated Statements of Comprehensive Income (Loss).

The Company enters into forward currency exchange contracts for its operations in Malaysia and Mexico on a rolling basis. The Company had cash flow hedges outstanding with a notional value of $77.1 million as of March 30, 2019, and $74.0 million as of September 29, 2018. These forward currency contracts fix the exchange rates for the settlement of future foreign currency obligations that have yet to be realized. The total fair value of the forward currency exchange contracts was a $0.7 million asset as of March 30, 2019, and a $1.7 million liability as of September 29, 2018.

The Company had additional forward currency exchange contracts outstanding with a notional value of $34.6 million as of March 30, 2019, and $28.6 million as of September 29, 2018. The Company did not designate these derivative instruments as hedging instruments. The net settlement amount (fair value) related to these contracts is recorded on the Condensed Consolidated Balance Sheets as either a current or long-term asset or liability, depending on the term, and as an element of "Miscellaneous, net" within the Condensed Consolidated Statements of Comprehensive Income (Loss). The total fair value of these derivatives was a $0.3 million asset as of March 30, 2019, and a $0.1 million liability as of September 29, 2018.

Table of Contents

The tables below present information regarding the fair values of derivative instruments and the effects of derivative instruments on the Company’s Condensed Consolidated Financial Statements:

Fair Values of Derivative Instruments
In thousands of dollars

| | Asset Derivatives | | | Liability Derivatives | | |
|---|---|---|---|---|---|---|
| | | March 30, 2019 | September 29, 2018 | | March 30, 2019 | September 29, 2018 |
| Derivatives Designated as Hedging Instruments | Balance Sheet Classification | Fair Value | Fair Value | Balance Sheet Classification | Fair Value | Fair Value |
| Foreign currency forward contracts | Prepaid expenses and other | $ 670 | $ 292 | Other accrued liabilities | $ — | $ 1,984 |

Fair Values of Derivative Instruments
In thousands of dollars

| | Asset Derivatives | | | Liability Derivatives | | |
|---|---|---|---|---|---|---|
| | | March 30, 2019 | September 29, 2018 | | March 30, 2019 | September 29, 2018 |
| Derivatives Not Designated as Hedging Instruments | Balance Sheet Classification | Fair Value | Fair Value | Balance Sheet Classification | Fair Value | Fair Value |
| Foreign currency forward contracts | Prepaid expenses and other | $ 378 | $ 42 | Other accrued liabilities | $ 62 | $ 81 |

Derivative Impact on Accumulated Other Comprehensive Income ("OCI")
for the Three Months Ended
In thousands of dollars

| Derivatives in Cash Flow Hedging Relationships | Amount of Gain Recognized in OCI on Derivatives (Effective Portion) | |
|---|---|---|
| | March 30, 2019 | March 31, 2018 |
| Foreign currency forward contracts | $ 1,241 | $ 3,625 |

Derivative Impact on Gain (Loss) Recognized in Income
for the Three Months Ended
In thousands of dollars

| Derivatives in Cash Flow Hedging Relationships | Classification of (Loss) Gain Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of (Loss) Gain Reclassified from Accumulated OCI into Income (Effective Portion) | |
|---|---|---|---|
| | | March 30, 2019 | March 31, 2018 |
| Foreign currency forward contracts | Selling and administrative expenses | $ (73 ) | $ 224 |
| Foreign currency forward contracts | Cost of sales | $ (670 ) | $ 2,091 |
| Treasury Rate Locks | Interest expense | $ — | $ 81 |

| Derivatives Not Designated as Hedging Instruments | Location of (Loss) Gain Recognized on Derivatives in Income | Amount of Gain (Loss) on Derivatives Recognized |
|---|---|---|

| | | in Income | |
|---|---|---|---|
| | | March 30, 2019 | March 31, 2018 |
| Foreign currency forward contracts | Miscellaneous, net | $843 | $(416) |

Derivative Impact on Accumulated Other Comprehensive Income ("OCI")
for the Six Months Ended
In thousands of dollars

| Derivatives in Cash Flow Hedging Relationships | Amount of Gain Recognized in OCI on Derivatives (Effective Portion) | |
|---|---|---|
| | March 30, 2019 | March 31, 2018 |
| Foreign currency forward contracts | $ 853 | $ 6,339 |

10

Table of Contents

Derivative Impact on Gain (Loss) Recognized in Income
for the Six Months Ended
In thousands of dollars

| Derivatives in Cash Flow Hedging Relationships | Classification of (Loss) Gain Reclassified from Accumulated OCI into Income (Effective Portion) | Amount of (Loss) Gain Reclassified from Accumulated OCI into Income (Effective Portion) | |
|---|---|---|---|
| | | March 30, 2019 | March 31, 2018 |
| Foreign currency forward contracts | Selling and administrative expenses | $ (155 ) | $ 329 |
| Foreign currency forward contracts | Cost of sales | $ (1,354 ) | $ 3,082 |
| Treasury Rate Locks | Interest expense | $ — | $ 160 |

| Derivatives Not Designated as Hedging Instruments | Location of Gain (Loss) Recognized on Derivatives in Income | Amount of Gain (Loss) on Derivatives Recognized in Income | |
|---|---|---|---|
| | | March 30, 2019 | March 31, 2018 |
| Foreign currency forward contracts | Miscellaneous, net | $1,630 | $(951) |

There were no gains or losses recognized in income for derivatives related to ineffective portions and amounts excluded from effectiveness testing for the three or six months ended March 30, 2019 and March 31, 2018.

Fair Value Measurements:

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (or exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. The Company uses quoted market prices when available or discounted cash flows to calculate fair value. The accounting guidance establishes a fair value hierarchy based on three levels of inputs that may be used to measure fair value. The input levels are:

Level 1: Quoted (observable) market prices in active markets for identical assets or liabilities.

Level 2: Inputs other than Level 1 that are observable, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

Level 3: Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the asset or liability.

The following table lists the fair values of liabilities of the Company’s derivatives as of March 30, 2019 and September 29, 2018, by input level:

Fair Value Measurements Using Input Levels (Liability)/Asset
In thousands of dollars

| March 30, 2019 | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Derivatives | | | | |
| Forward currency forward contracts | $ — | $986 | $ — | $986 |

September 29, 2018

| Derivatives | | | | |
|---|---|---|---|---|
| Forward currency forward contracts | $ — | $ (1,731) | $ — | $ (1,731) |

The fair value of foreign currency forward contracts is determined using a market approach, which includes obtaining directly or indirectly observable values from third parties active in the relevant markets. Inputs in the fair value of the foreign currency forward contracts include prevailing forward and spot prices for currency and interest rate forward curves.

Table of Contents

5. Income Taxes

Income tax expense for the three and six months ended March 30, 2019 was $3.9 million and $15.8 million, respectively, compared to $2.4 million and $130.0 million for the three and six months ended March 31, 2018, respectively.

The effective tax rates for the three and six months ended March 30, 2019, were 13.7% and 25.2%, respectively, compared to the effective tax rates of 16.5% and 297.0% for the three and six months ended March 31, 2018, respectively. The effective tax rate for the three months ended March 30, 2019 decreased from the effective tax rate for the three months ended March 31, 2018, primarily due to the $13.5 million one-time bonus paid to full-time, non-executive employees ("one-time employee bonus") paid during the three months ended March 31, 2018, and the geographical distribution of pre-tax earnings. The effective tax rate for the six months ended March 30, 2019 decreased from the effective tax rate for the six months ended March 31, 2018, primarily due to the impact of the U.S. Tax Cuts & Jobs Act (“Tax Reform”), which was enacted on December 22, 2017, and an increase in pre-tax earnings which was impacted by the one-time employee bonus in the prior year.

There were no material additions to the amount of unrecognized tax benefits recorded for uncertain tax positions for the three months ended March 30, 2019. For the six months ended March 30, 2019, the Company recorded an income tax benefit of $1.7 million primarily related to unrecognized tax benefits as the U.S. Department of Treasury issued additional guidance for Tax Reform. The guidance proposed related to the treatment of foreign taxes paid that impacted the tax on the deemed repatriation of historical undistributed foreign earnings. The Company recognizes accrued interest and penalties on uncertain tax positions as a component of income tax expense. The amount of interest and penalties recorded for the three and six months ended March 30, 2019 was not material.

One or more uncertain tax positions may be settled within the next 12 months. Settlement of these matters is not expected to have a material effect on the Company's consolidated results of operations, financial position and cash flows. The Company is not currently under examination by taxing authorities in the U.S. or any foreign jurisdictions in which the Company operates.

The Company maintains valuation allowances when it is more likely than not that all or a portion of a net deferred tax asset will not be realized. During the three months ended March 30, 2019, the Company continued to record a full valuation allowance against its net deferred tax assets in certain jurisdictions within the EMEA segment and a partial valuation against its net deferred tax assets in certain jurisdictions within the AMER segment, as it was more likely than not that these assets would not be fully realized based primarily on historical performance. The Company will continue to provide a valuation allowance against its net deferred tax assets in each of the applicable jurisdictions going forward until it determines it is more likely than not that the deferred tax assets will be realized.

6. Earnings Per Share

The following is a reconciliation of the amounts utilized in the computation of basic and diluted earnings per share for the three and six months ended March 30, 2019 and March 31, 2018 (in thousands, except per share amounts):

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | March 30, 2019 | March 31, 2018 | March 30, 2019 | March 31, 2018 |
| Net income (loss) | 24,758 | 12,290 | 46,984 | (86,203 ) |
| Basic weighted average common shares outstanding | 30,603 | 33,538 | 31,003 | 33,552 |
| Dilutive effect of share-based awards outstanding | 782 | 849 | 833 | — |
| Diluted weighted average shares outstanding | 31,385 | 34,387 | 31,836 | 33,552 |
| Earnings (loss) per share: | | | | |
| Basic | $0.81 | $ 0.37 | $ 1.52 | $ (2.57) |
| Diluted | $0.79 | | | |
| Less than one year | $ – | $ – | –% | |

| | | | |
|---|---|---|---|
| Greater than one year and less than five years | 1,355,910 | 1,377,537 | 4.91% |
| Greater than five years | 34,767 | 35,497 | 5.60% |
| Total | $ 1,390,677 | $ 1,413,034 | 4.92% |

The estimated weighted-average lives of the Company’s mortgage-backed and other asset-backed securities are based upon data provided through subscription-based financial information services, assuming constant principal prepayment factors to the balloon or reset date for each security. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rate of the outstanding loan, loan age, margin and volatility. The actual weighted-average lives of the agency residential mortgage-backed securities in the Company's investment portfolio could be longer or shorter than the estimates in the table above depending on the actual prepayment factors experienced over the lives of the applicable securities and are sensitive to changes in both prepayment factors and interest rates.

*(back to index)*

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 4 - SECURITIES AVAILABLE-FOR-SALE – (Continued)**

The following tables show the Company's investments' 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 (in thousands):

| | Less than 12 Months | | Total | |
|---|---|---|---|---|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| **March 31, 2006:** | | | | |
| Agency residential mortgage-backed | $ 835,277 | $ (18,260) | $ 835,277 | $ (18,260) |
| Non-agency residential mortgage-backed | 144,986 | (1,806) | 144,986 | (1,806) |
| Commercial mortgage-backed | 18,656 | (993) | 18,656 | (993) |
| Other asset-backed | 8,530 | (252) | 8,530 | (252) |
| Total temporarily impaired securities | $ 1,007,449 | $ (21,311) | $ 1,007,449 | $ (21,311) |
| **December 31, 2005:** | | | | |
| Agency residential mortgage-backed | $ 978,570 | $ (12,918) | $ 978,570 | $ (12,918) |
| Non-agency residential mortgage-backed | 294,359 | (9,085) | 294,359 | (9,085) |
| Commercial mortgage-backed | 26,905 | (608) | 26,905 | (608) |
| Other asset-backed | 12,944 | (124) | 12,944 | (124) |
| Private equity | 1,954 | (30) | 1,954 | (30) |
| Total temporarily impaired securities | $ 1,314,732 | $ (22,765) | $ 1,314,732 | $ (22,765) |

The temporary impairment of the available-for-sale securities results from the fair value of the securities falling below the amortized cost basis and is solely attributed to changes in interest rates. As of March 31, 2006 and December 31, 2005, respectively, none of the securities held by the Company had been downgraded by a credit rating agency since their purchase. The Company intends and has the ability to hold the securities until the fair value of the securities held is recovered, which may be maturity if necessary. As such, the Company does not believe any of the securities held are other-than-temporarily impaired at March 31, 2006 and December 31, 2005, respectively.

(back to index)

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 5 - LOANS**

The following is a summary of the Company's loans at March 31, 2006 (in thousands).

| Loan Description | Principal | Unamortized Premium | Net Amortized Cost |
|---|---|---|---|
| **March 31, 2006:** | | | |
| Syndicated loans | $ 470,792 | $ 929 | $ 471,721 |
| A note | 20,000 | – | 20,000 |
| B notes | 136,262 | – | 136,262 |
| Mezzanine loans | 55,925 | – | 55,925 |
| Total | $ 682,979 | $ 929 | $ 683,908 |
| | | | |
| **December 31, 2005:** | | | |
| Syndicated loans | $ 397,869 | $ 916 | $ 398,785 |
| B notes | 121,945 | – | 121,945 |
| Mezzanine loans | 49,500 | – | 49,500 |
| Total | $ 569,314 | $ 916 | $ 570,230 |

At March 31, 2006, the Company's syndicated loan portfolio consisted of $471.5 million of floating rate loans, which bear interest between LIBOR plus 1.38% and 7.50% with maturity dates ranging from September 2006 to December 2014, and a $249,000 fixed rate loan, which bears interest at 6.25% with a maturity date of September 2015.

At March 31, 2006, the Company's commercial real estate loan portfolio consisted of:

- one A note with an amortized cost of $20.0 million which bears interest at a floating rate of LIBOR plus 1.25% with a maturity date of January 2008;

- eight B notes with an amortized cost of $136.3 million which bear interest at floating rates ranging from LIBOR plus 2.15% to LIBOR plus 6.25% and have maturity dates ranging from January 2007 to April 2008;

- four mezzanine loans with an amortized cost of $44.4 million which bear interest at floating rates between LIBOR plus 2.25% and LIBOR plus 4.50% with maturity dates ranging from August 2007 to July 2008;

- one mezzanine loan with an amortized cost of $6.5 million which bears interest at the 10-Year Treasury rate plus 6.64% with a maturity date of January 2016; and

- one mezzanine loan with an amortized cost of $5.0 million which bears interest at a fixed rate of 9.50% with a maturity of May 2010.

*(back to index)*

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 5 - LOANS – (Continued)**

At December 31, 2005, the Company's syndicated loan portfolio consisted of $398.5 million of floating rate loans, which bear interest between LIBOR plus 1.00% and 7.00% with maturity dates ranging from April 2006 to October 2020, and a $250,000 fixed rate loan, which bears interest at 6.25% with a maturity date of August 2015.

At December 31, 2005, the Company's commercial real estate loan portfolio consisted of:

- seven B notes with an amortized cost of $121.9 million which bear interest at floating rates ranging from LIBOR plus 2.15% to LIBOR plus 6.25% and have maturity dates ranging from January 2007 to April 2008;

- four mezzanine loans with an amortized cost of $44.5 million which bear interest at floating rates between LIBOR plus 2.25% and LIBOR plus 4.50% with maturity dates ranging from August 2007 to July 2008; and

- one mezzanine loan with an amortized cost of $5.0 million which bears interest at a fixed rate of 9.50% with a maturity of May 2010.

As of March 31, 2006 and December 31, 2005, the Company had not recorded an allowance for loan losses. At March 31, 2006 and December 31, 2005, all of the Company's loans were current with respect to the scheduled payments of principal and interest. In reviewing the portfolio of loans and the observable secondary market prices, the Company did not identify any loans with characteristics indicating that impairment had occurred.

**NOTE 6 -DIRECT FINANCING LEASES AND NOTES**

The Company's direct financing leases have initial lease terms of 65 months and 54 months, as of March 31, 2006 and December 31, 2005, respectively. The interest rates on notes receivable range from 7% to 9% and 8% and 9%, as of March 31, 2006 and December 31, 2005, respectively. Investments in direct financing leases and notes, net of unearned income, were as follows (in thousands):

| | As of March 31, 2006 | As of December 31, 2005 |
|---|---|---|
| Direct financing leases, net of unearned income | $ 17,708 | $ 18,141 |
| Notes receivable | 43,831 | 5,176 |
| Total | $ 61,539 | $ 23,317 |

The components of the net investment in direct financing leases are as follows (in thousands):

| | As of March 31, 2006 | As of December 31, 2005 |
|---|---|---|
| Total future minimum lease payments | $ 21,050 | $ 21,370 |
| Unearned income | (3,342) | (3,229) |
| Total | $ 17,708 | $ 18,141 |

20

*(back to index)*

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 6 - DIRECT FINANCING LEASES AND NOTES – (Continued)**

The future minimum lease payments expected to be received on non-cancelable direct financing leases and notes were as follows on March 31, 2006 (in thousands):

| Years Ending March 31, | Direct Financing Leases | Notes | Total |
|---|---|---|---|
| 2007 | $ 6,357 | $ 9,293 | $ 15,650 |
| 2008 | 5,954 | 9,303 | 15,257 |
| 2009 | 3,967 | 8,221 | 12,188 |
| 2010 | 2,110 | 6,058 | 8,168 |
| 2011 | 2,000 | 2,840 | 4,840 |
| Thereafter | 662 | 8,116 | 8,778 |
| | $ 21,050 | $ 43,831 | $ 64,881 |

**NOTE 7 - BORROWINGS**

The Company finances the acquisition of its investments, including securities available-for-sale, loans and equipment leases and notes primarily through the use of secured and unsecured borrowings in the form of repurchase agreements, warehouse facilities, CDOs, secured term facilities and other secured and unsecured borrowings. The Company recognizes interest expense on all borrowings on an accrual basis.

Certain information with respect to the Company’s borrowings at March 31, 2006 and December 31, 2005 is summarized in the following table (dollars in thousands):

| | Repurchase Agreements | Ischus CDO II Senior Notes (1) | Apidos CDO I Senior Notes (2) | Apidos CDO III Warehouse Agreement | Secured Term Facility | Unsecured Revolving Credit Facility | Total |
|---|---|---|---|---|---|---|---|
| **March 31, 2006:** | | | | | | | |
| Outstanding borrowings | $ 917,293 | $ 370,719 | $ 316,967 | $ 132,793 | $ 55,767 | – | $ 1,793,539 |
| Weighted-average borrowing rate | 4.96% | 5.14% | 5.11% | 4.60% | 6.23% | N/A | 5.04% |
| Weighted-average remaining maturity | 22 days | 34.4 years | 11.3 years | 39 days | 4.1 years | 2.8 years | |
| Value of the collateral | $ 1,009,334 | $ 393,082 | $ 338,941 | $ 132,780 | $ 61,539 | N/A | $ 1,935,676 |
| | | | | | | | |
| **December 31, 2005:** | | | | | | | |
| Outstanding borrowings | $ 1,068,277 | $ 370,569 | $ 316,838 | $ 62,961 | – | $ 15,000 | $ 1,833,645 |
| Weighted-average borrowing rate | 4.48% | 4.80% | 4.42% | 4.29% | N/A | 6.37% | 4.54% |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Weighted-average remaining maturity | 17 days | 34.6 years | 11.6 years | 90 days | N/A | 3.0 years | |
| Value of the collateral | $ 1,146,711 | $ 387,053 | $ 335,831 | $ 62,954 | N/A | $ 45,107 | $ 1,977,656 |

(1) Amount represents principal outstanding of $376.0 million less unamortized issuance costs of $5.3 million and $5.4 million as of March 31, 2006 and December 31, 2005, respectively.

(2) Amount represents principal outstanding of $321.5 million less unamortized issuance costs of $4.5 million and $4.7 million as of March 31, 2006 and December 31, 2005, respectively.

(back to index)

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 7 - BORROWINGS – (Continued)**

The Company had repurchase agreements with the following counterparties at the dates indicated (dollars in thousands):

| | | Amount at Risk (1) | Weighted-Average Maturity in Days | Weighted-Average Interest Rate |
|---|---|---|---|---|
| **March 31, 2006:** | | | | |
| Credit Suisse Securities (USA) LLC | $ | 20,324 | 22 | 4.77% |
| UBS Securities LLC | $ | 6,692 | 24 | 4.79% |
| Bear, Stearns International Limited | $ | 36,111 | 18 | 5.88% |
| Deutsche Bank AG, Cayman Islands Branch | $ | 29,105 | 18 | 6.04% |
| | | | | |
| **December 31, 2005:** | | | | |
| Credit Suisse Securities (USA) LLC | $ | 31,158 | 17 | 4.34% |
| Bear, Stearns International Limited | $ | 36,044 | 17 | 5.51% |
| Deutsche Bank AG, Cayman Islands Branch | $ | 16,691 | 18 | 5.68% |

(1) Equal to the fair value of securities or loans sold, plus accrued interest income, minus the sum of repurchase agreement liabilities plus accrued interest expense.

In July 2005, the Company closed Ischus CDO II, a $400.0 million CDO transaction that provides financing for mortgage-backed and other asset-backed securities. The investments held by Ischus CDO II collateralize the debt it issued and, as a result, those investments are not available to the Company, its creditors or stockholders. Ischus CDO II issued a total of $376.0 million of senior notes at par to investors and RCC Real Estate purchased a $27.0 million equity interest representing 100% of the outstanding preference shares. The equity interest is subordinate in right of payment to all other securities issued by Ischus CDO II.

The senior notes issued to investors by Ischus CDO II consist of the following classes: (i) $214.0 million of class A-1A notes bearing interest at 1-month LIBOR plus 0.27%; (ii) $50.0 million of class A-1B delayed draw notes bearing interest on the drawn amount at 1-month LIBOR plus 0.27%; (iii) $28.0 million of class A-2 notes bearing interest at 1-month LIBOR plus 0.45%; (iv) $55.0 million of class B notes bearing interest at 1-month LIBOR plus 0.58%; (v) $11.0 million of class C notes bearing interest at 1-month LIBOR plus 1.30%; and (vi) $18.0 million of class D notes bearing interest at 1-month LIBOR plus 2.85%. All of the notes issued mature on August 6, 2040, although the Company has the right to call the notes at par any time after August 6, 2009 until maturity.

In August 2005, the Company closed Apidos CDO I, a $350.0 million CDO transaction that provides financing for syndicated bank loans. The investments held by Apidos CDO I collateralize the debt it issued and, as a result, the investments are not available to the Company, its creditors or stockholders. Apidos CDO I issued a total of $321.5 million of senior notes at par to investors and RCC Commercial purchased a $28.5 million equity interest representing 100% of the outstanding preference shares. The equity interest is subordinated in right of payment to all other securities issued by Apidos CDO I.

The senior notes issued to investors by Apidos CDO I consists of the following classes: (i) $265.0 million of class A-1 notes bearing interest at 3-month LIBOR plus 0.26%; (ii) $15.0 million of class A-2 notes bearing interest at 3-month LIBOR plus 0.42%; (iii) $20.5 million of class B notes bearing interest at 3-month LIBOR plus 0.75%; (iv) $13.0 million of class C notes bearing interest at 3-month LIBOR plus 1.85%; and (v) $8.0 million of class D notes bearing interest at a fixed rate of 9.251%. All of the notes issued mature on July 27, 2017, although the Company has the right to call the notes anytime after July 27, 2010 until maturity.

*(back to index)*

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 7 - BORROWINGS – (Continued)**

In July 2005, the Company formed Apidos CDO III and began borrowing on a warehouse facility provided by Citigroup Financial Products, Inc. to purchase syndicated loans to include in Apidos CDO III. At March 31, 2006 and December 31, 2005, Apidos CDO III had borrowed $132.8 million and $63.0 million, respectively. The facility allows borrowings of up to $200.0 million which can be increased upon mutual agreement of the parties. The facility bears interest at a rate of LIBOR plus 0.25%, which was 5.00% and 4.61% at March 31, 2006 and December 31, 2005, respectively. RCC Commercial intends to purchase 100% of the equity interest in Apidos CDO III upon execution of the CDO transaction.

The Company entered into a master repurchase agreement with CS to finance the purchase of agency RMBS securities. Each repurchase transaction specifies its own terms, such as identification of the assets subject to the transaction, sales price, repurchase price, rate and term. At March 31, 2006, the Company had borrowed $549.3 million with a weighted average interest rate of 4.77%. At December 31, 2005, the Company had borrowed $947.1 million with a weighted average interest rate of 4.34%.

The Company entered into a master repurchase agreement with UBS Securities LLC to finance the purchase of agency RMBS securities. Each repurchase transaction specifies its own terms, such as identification of the assets subject to the transaction, sales price, repurchase price, rate and term. At March 31, 2006, the Company had borrowed $218.8 million with a weighted average interest rate of 4.79%. At December 31, 2005, the Company had no borrowings under this agreement.

In August 2005, the Company entered into a master repurchase agreement with Bear, Stearns International Limited to finance the purchase of commercial real estate loans. The maximum amount of the Company’s borrowing under the repurchase agreement is $150.0 million. Each repurchase transaction specifies its own terms, such as identification of the assets subject to the transaction, sales price, repurchase price, rate and term. At March 31, 2006, the Company had borrowed $80.6 million with a weighted average interest rate of LIBOR plus 1.14%, which was 5.88% at March 31, 2006. At December 31, 2005, the Company had borrowed $80.6 million with a weighted average interest rate of LIBOR plus 1.14%, which was 5.51% at December 31, 2005.

In December 2005, the Company entered into a master repurchase agreement with Deutsche Bank AG, Cayman Islands Branch to finance the purchase of commercial real estate loans. The maximum amount of the Company’s borrowing under the repurchase agreement is $300.0 million. Each repurchase transaction specifies its own terms, such as identification of the assets subject to the transaction, sales price, repurchase price, rate and term. At March 31, 2006, the Company had borrowed $67.2 million with a weighted average interest rate of LIBOR plus 1.29%, which was 6.04% at March 31, 2006. At December 31, 2005, the Company had borrowed $38.5 million with a weighted average interest rate of LIBOR plus 1.32%, which was 5.68% at December 31, 2005.

In December 2005, the Company entered into a $15.0 million unsecured revolving credit facility with Commerce Bank, N.A. Outstanding borrowings bear interest at one of two rates elected at the Company’s option; (i) the lender’s prime rate plus a margin ranging from 0.50% to 1.50% based upon the Company’s leverage ratio; or (ii) LIBOR plus a margin ranging from 1.50% to 2.50% based upon the Company’s leverage ratio. The facility expires in December 2008. As of March 31, 2006, no borrowings were outstanding under this facility. At December 31, 2005, the balance outstanding was $15.0 million at an interest rate of 6.37%.

In March 2006, the Company entered into a secured term credit facility with Bayerische Hypo - und Vereinsbank AG to finance the purchase of equipment leases and notes. The maximum amount of the Company's borrowing under this facility is $100.0 million.

*(back to index)*

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 7 - BORROWINGS – (Continued)**

Borrowings under this facility bear interest at one of two rates, determined by asset class:

- Pool A - one-month LIBOR plus 110 basis points; or
- Pool B - one-month LIBOR plus 80 basis points.

The facility expires March 2010. As of March 31, 2006, the Company had borrowed $55.8 million at an interest rate of 6.23%.

At March 31, 2006, the Company has complied, to the best of its knowledge, with all of the financial covenants under its debt agreements.

**NOTE 8 - CAPITAL STOCK AND EARNINGS PER SHARE**

The Company had 500,000,000 shares of common stock, par value $0.001 per share, authorized and 17,813,096 and 15,682,334 shares (including 234,224 and 349,000 restricted shares) outstanding as of March 31, 2006 and December 31, 2005, respectively. The Company had 100,000,000 shares of preferred stock, par value $0.001 per share, authorized and none issued and outstanding as of March 31, 2006.

On March 8, 2005, the Company completed a private placement of 15,333,334 shares of common stock at an offering price of $15.00 per share, including the sale of 666,667 shares of common stock pursuant to the over-allotment option of the initial purchasers/placement agents. The Company received proceeds from these transactions in the amount of $214.8 million, net of underwriting discounts and commissions, placement agent fees and other offering costs.

On March 8, 2005, the Company granted 345,000 shares of restricted common stock and options to purchase 651,666 common shares at an exercise price of $15.00 per share, to the Manager (see Note 15). The restrictions with respect to the restricted common stock lapse and full rights of ownership vest for one-third of the shares and options on the first anniversary of the grant date, for one-third of the shares and options on the second anniversary and for the last one-third of the shares and options on the third anniversary. Vesting is predicated on the continuing involvement of the Manager in providing services to the Company. One third of the shares of restricted stock and options vested on March 8, 2006. In addition, the Company granted 4,000 shares of restricted common stock to the Company's non-employee directors as part of their annual compensation. These shares vested in full on March 8, 2006.

On March 8, 2006, the Company granted 4,224 shares of restricted stock to the Company's non-employee directors as part of their annual compensation. These shares vest in full on the first anniversary of the date of the grant.

The following table summarizes restricted common stock transactions:

| | Manager | Non-Employee Directors | Total |
|---|---|---|---|
| **Unvested shares as of December 31, 2005** | 345,000 | 4,000 | 349,000 |
| Issued | – | 4,224 | 4,224 |

| | | | |
|---|---|---|---|
| Vested | (115,000) | (4,000) | (119,000) |
| Forfeited | – | – | – |
| **Unvested shares as of March 31, 2006** | 230,000 | 4,224 | 234,224 |

*(back to index)*

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 8 - CAPITAL STOCK AND EARNINGS PER SHARE – (Continued)**

Pursuant to SFAS No. 123(R), the Company is required to value any unvested shares of restricted common stock granted to the Manager at the current market price. The fair value of the shares of restricted stock granted, including shares issued to the non-employee directors, was $4,922,381 and $5,235,000 at March 31, 2006 and December 31, 2005, respectively.

The following table summarizes common stock option transactions:

| | Number of Options | Weighted-Average Exercise Price |
|---|---|---|
| **Outstanding as of December 31, 2005** | 651,666 | $ 15.00 |
| Granted | – | – |
| Exercised | – | – |
| Forfeited | – | – |
| **Outstanding as of March 31, 2006** | 651,666 | $ 15.00 |

None of the common stock options outstanding were exercised at March 31, 2006 and December 31, 2005, respectively. As of March 31, 2006, 217,222 common stock options were exercisable, and no common stock options were exercisable as of December 31, 2005. The common stock options are valued using the Black-Scholes model using the following assumptions:

| | As of March 31, 2006 | As of December 31, 2005 |
|---|---|---|
| Expected life | 9.1 years | 10 years |
| Discount rate | 4.965% | 4.603% |
| Volatility | 23.10% | 20.11% |
| Dividend yield | 11.00% | 12.00% |

The fair value of the total common stock options was approximately $305,000 and $158,300 at March 31, 2006 and December 31, 2005, respectively. The fair value of each option grant at March 31, 2006 and December 31, 2005, respectively, was $0.468 and $0.243. For the quarter ended March 31, 2006 and the period from March 8, 2005 (date operations commenced) through March 31, 2005, the components of share-based compensation expense are as follows (in thousands):

| | Three Months Ended March 31, 2006 | Period from March 8, 2005 (Date Operations Commenced) to March 31, 2005 |
|---|---|---|
| Options granted to Manager | $ 112 | $ 6 |
| Restricted shares granted to Manager | 455 | 199 |
| | 15 | 4 |

| | | | | |
|---|---|---|---|---|
| Restricted shares granted to non-employee directors | | | | |
| Total share-based compensation expense | $ | 582 | $ | 209 |

25

*(back to index)*

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 8 - CAPITAL STOCK AND EARNINGS PER SHARE – (Continued)**

On January 13, 2006, the Company paid a special dividend to stockholders of record on January 4, 2006, including holders of restricted stock, consisting of warrants to purchase our common stock. Each warrant entitles the holder to purchase one share of common stock at an exercise price of $15.00 per share. Stockholders received one warrant for each ten shares of common stock and restricted stock held. If an existing stockholder owned shares in other than a ten-share increment, the stockholder received an additional warrant. The warrants will expire on January 13, 2009 and will not be exercisable until January 13, 2007. An aggregate of 1,568,244 shares are issuable upon exercise of the warrants.

On February 10, 2006, the Company completed the initial public offering of 4,000,000 shares of its common stock (including 1,879,200 shares sold by certain selling stockholders of the Company) at a price of $15.00 per share. The offering generated gross proceeds to the Company of approximately $31.8 million and net proceeds to the Company, after deducting the underwriters' discounts and commissions and offering expenses, of approximately $27.6 million. The Company did not receive any proceeds from the shares sold by the selling stockholders.

At March 31, 2006, the Manager had received 5,738 shares as incentive compensation, valued at $86,000, pursuant to the management agreement in connection with the three months ended December 31, 2005.

The following table presents a reconciliation of basic and diluted earnings per share for the three months ended March 31, 2006 and for the period from March 8, 2005 (date operations commenced) to March 31, 2005 (in thousands, except share and per share amounts):

| | Three Months Ended March 31, 2006 | Period from March 8, 2005 (Date Operations Commenced) to March 31, 2005 |
|---|---|---|
| **Basic:** | | |
| Net income (loss) | $ 5,150 | $ (48) |
| Weighted-average number of shares outstanding | 16,617,808 | 15,333,334 |
| Basic net income (loss) per share | $ 0.31 | $ (0.00) |
| | | |
| **Diluted:** | | |
| Net income (loss) | $ 5,150 | $ (48) |
| Weighted-average number of common shares outstanding | 16,617,808 | 15,333,334 |
| Additional shares due to assumed conversion of dilutive instruments | 134,712 | – |
| Adjusted weighted-average number of common shares outstanding | 16,752,520 | 15,333,334 |
| Diluted net income (loss) per share | $ 0.31 | $ (0.00) |

Potentially dilutive shares relating to stock options to purchase 651,666 shares of common stock and warrants to purchase 1,568,244 shares of common stock for the three months ended March 31, 2006 and 349,000 restricted shares and options to purchase 651,666 shares of common stock for the period from March 8, 2005 (date operations commenced) to March 31, 2005 are not included in the calculation of diluted net income per share because the effect is anti-dilutive.

*(back to index)*

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 9 - MANAGEMENT AGREEMENT**

On March 8, 2005, the Company entered into a Management Agreement pursuant to which the Manager will provide the Company investment management, administrative and related services. The Manager receives fees and is reimbursed for its expenses as follows:

· A monthly base management fee equal to 1/12th of the amount of the Company's equity multiplied by 1.50%. Under the Management Agreement, ''equity'' is equal to the net proceeds from any issuance of shares of common stock less other offering related costs plus or minus the Company's retained earnings (excluding non-cash equity compensation incurred in current or prior periods) less any amounts the Company paid for common stock repurchases. The calculation may be adjusted for one-time events due to changes in GAAP as well as other non-cash charges, upon approval of the independent directors of the Company.

· Incentive compensation calculated as follows: (i) 25% of the dollar amount by which, (A) the Company's net income (determined in accordance with GAAP) per common share (before non-cash equity compensation expense and incentive compensation) for a quarter (based on the weighted average number of shares outstanding) exceeds, (B) an amount equal to (1) the weighted average share price of shares of common stock in the offerings of the Company, multiplied by, (2) the greater of (A) 2.00% or (B) 0.50% plus one-fourth of the Ten Year Treasury rate (as defined in the Management Agreement) for such quarter, multiplied by, (ii) the weighted average number of common shares outstanding for the quarter. The calculation may be adjusted for one-time events due to changes in GAAP as well as other non-cash charges upon approval of the independent directors of the Company.

· Reimbursement of out-of-pocket expenses and certain other costs incurred by the Manager that relate directly to the Company and its operations.

Incentive compensation is paid quarterly. Up to 75% of the incentive compensation is paid in cash and at least 25% is paid in the form of a stock award. The Manager may elect to receive more than 25% of its incentive compensation in stock. All shares are fully vested upon issuance. However, the Manager may not sell such shares for one year after the incentive compensation becomes due and payable. Shares payable as incentive compensation are valued at the average of the closing bid or sales price as applicable over the thirty day period ending three days prior to the issuance of such shares.

The initial term of the Management Agreement ends March 31, 2008. The Management Agreement automatically renews for a one year term at the end of the initial term and each renewal term. With a two-thirds vote of the independent directors, the independent directors may elect to terminate the Management Agreement because of the following:

· unsatisfactory performance; or

· unfair compensation payable to the Manager where fair compensation cannot be agreed upon by the Company (pursuant to a vote of two-thirds of the independent directors) and the Manager.

*(back to index)*

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 9 - MANAGEMENT AGREEMENT – (Continued)**

In the event that the Agreement is terminated based on the foregoing provisions, the Company must pay the Manager a termination fee equal to four times the sum of the average annual base management fee and the average annual incentive during the two 12-month periods immediately preceding the date of such termination. The Company is also entitled to terminate the Management Agreement for cause (as defined therein) without payment of any termination fee.

The base and incentive management fees for the three months ended March 31, 2006 were approximately $880,000 and $113,000, respectively, and the base management fee for the period from March 8, 2005 to March 31, 2005 was approximately $208,000. No incentive fee was earned by the Manager as of March 31, 2005.

**NOTE 10 - RELATED-PARTY TRANSACTIONS**

At March 31, 2006, the Company was indebted to the Manager for base and incentive management fees of approximately $613,000 and $113,000, respectively, and reimbursement of expenses of approximately $197,000. At December 31, 2005, the Company was indebted to the Manager for base and incentive management fees of approximately $552,000 and $344,000, respectively, and reimbursement of expenses of approximately $143,000. These amounts are included in management and incentive fee payable and accounts payable and accrued liabilities, respectively.

Resource Real Estate, a subsidiary of RAI,  originates finances and manages our commercial real estate loan portfolio, including A notes, B notes and mezzanine loans. The Company reimburses Resource Real Estate for loan origination costs associated with all loans originated. At March 31, 2006 and December 31, 2005, the Company was indebted to Resource Real Estate for loan origination costs in connection with the Company’s commercial real estate loan portfolio of approximately $295,000 and $22,000, respectively.

LEAF Financial Corporation (“LEAF”), a subsidiary of RAI, originates and manages equipment leases and notes on the Company’s behalf. The Company purchases these leases and notes from LEAF at a price equal to their book value plus a reimbursable origination cost not to exceed 1% to compensate LEAF for its origination costs. In addition, the Company pays LEAF an annual servicing fee, equal to 1% of the book value of managed assets, for servicing our equipment leases and notes. At March 31, 2006 and December 31, 2005, the Company was indebted to LEAF for servicing fees in connection with the Company’s equipment finance portfolio of approximately $35,000 and $41,000, respectively.

At March 31, 2006, the corporate parent of the Manager had a 10.7% ownership interest in the Company, consisting of 1,000,000 shares purchased in the private placement, 900,000 shares purchased in the public offering and 7,792 shares received as incentive compensation pursuant to the management agreement. Certain officers of the Manager and its affiliates purchased 232,167 shares of the Company’s common stock in the Company’s private placement for $3.5 million and 72,500 shares of the Company’s common stock in the Company’s public offering for $1.1 million, constituting 1.7% of the outstanding shares of the Company’s common stock as of March 31, 2006. All such shares were purchased at the same price at which shares were purchased by the other investors.

Until 1996, the Company’s Chairman, Edward Cohen, was of counsel to Ledgewood Law Firm. The Company paid Ledgewood approximately $198,000 and $400,000 for the three months ended March 31, 2006 and period ended

March 31, 2005, respectively. Mr. Cohen receives certain debt service payments from Ledgewood related to the termination of his affiliation with Ledgewood and its redemption of his interest.



---

(back to index)

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

## NOTE 11 - DISTRIBUTIONS

In order to qualify as a REIT, the Company must currently distribute at least 90% of its taxable income. In addition, the Company must distribute 100% of its taxable income in order not to be subject to corporate federal income taxes on retained income. The Company anticipates it will distribute substantially all of its taxable income to its stockholders. Because taxable income differs from cash flow from operations due to non-cash revenues or expenses (such as depreciation), in certain circumstances, the Company may generate operating cash flow in excess of its distributions or, alternatively, may be required to borrow to make sufficient distribution payments.

On December 27, 2005, the Company declared a quarterly distribution of $0.36 per share of common stock, $5.6 million in the aggregate, which was paid on January 17, 2006 to stockholders of record as of December 30, 2005.

On January 13, 2006, the Company paid a special dividend to stockholders of record on January 4, 2006, including holders of restricted stock, consisting of warrants to purchase our common stock. Each warrant entitles the holder to purchase one share of common stock at an exercise price of $15.00 per share. Stockholders received one warrant for each ten shares of common stock and restricted stock held. If an existing stockholder owned shares in other than a ten-share increment, the stockholder received an additional warrant. The warrants will expire on January 13, 2009 and will not be exercisable until January 13, 2007. An aggregate of 1,568,244 shares are issuable upon exercise of the warrants.

On March 16, 2006, the Company declared a quarterly distribution of $0.33 per share of common stock, $5.9 million in the aggregate, which was paid on April 10, 2006 to stockholders of record as of March 27, 2006.

## NOTE 12 - FAIR VALUE OF FINANCIAL INSTRUMENTS

SFAS No. 107, “Disclosure About Fair Value of Financial Instruments,” requires disclosure of the fair value of financial instruments for which it is practicable to estimate value. The fair value of available-for-sale securities, derivatives and direct financing leases and notes is equal to their respective carrying value presented in the consolidated balance sheets. The fair value of loans held for investment was $686.8 million and $571.7 million as of March 31, 2006 and December 31, 2005, respectively. The fair value of cash and cash equivalents, restricted cash, interest receivable, accounts receivable, due from broker, principal paydowns receivables, other assets, repurchase agreements (including accrued interest), warehouse agreements, liabilities and all other payables approximate carrying value as of March 31, 2006 and December 31, 2005 due to the short-term nature of these items.

## NOTE 13 - INTEREST RATE RISK

The primary market risk to the Company is interest rate risk. Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond the Company’s control. Changes in the general level of interest rates can affect net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with the interest-bearing liabilities, by affecting the spread between the interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates also can affect the value of the Company’s interest-earning assets and the Company’s ability to realize gains from the sale of these assets. A decline in the value of the Company’s interest-earning assets pledged as collateral for borrowings under repurchase agreements could result in the counterparties demanding additional collateral pledges or liquidation of some of the existing collateral to reduce

borrowing levels.



---

*(back to index)*

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 13 - INTEREST RATE RISK – (Continued)**

The Company seeks to manage the extent to which net income changes as a function of changes in interest rates by matching adjustable-rate assets with variable-rate borrowings. During periods of changing interest rates, interest rate mismatches could negatively impact the Company's consolidated financial condition, consolidated results of operations and consolidated cash flows. In addition, the Company mitigates the potential impact on net income of periodic and lifetime coupon adjustment restrictions in its investment portfolio by entering into interest rate hedging agreements such as interest rate caps and interest rate swaps.

Changes in interest rates may also have an effect on the rate of mortgage principal prepayments and, as a result, prepayments on mortgage-backed securities in the Company's investment portfolio. The Company seeks to mitigate the effect of changes in the mortgage principal repayment rate by balancing assets purchased at a premium with assets purchased at a discount. At March 31, 2006 and December 31, 2005, the aggregate discount exceeded the aggregate premium on the Company's mortgage-backed securities by approximately $2.7 million and $2.8 million, respectively.

In addition, the Company's leveraged loans and commercial real estate loans may bear exposure to credit loss.

**NOTE 14 - DERIVATIVE INSTRUMENTS**

The Company uses derivative financial instruments to hedge all or a portion of the interest rate risk associated with its borrowings. The principal objective of such arrangements is to minimize the risks and/or costs associated with the Company's operating and financial structure as well as to hedge specific anticipated transactions. The counterparties to these contractual arrangements are major financial institutions with which the Company and its affiliates may also have other financial relationships. In the event of nonperformance by the counterparties, the Company is potentially exposed to credit loss. However, because of their high credit ratings, the Company does not anticipate that any of the counterparties will fail to meet their obligations. On the date the Company enters into a derivative contract, the derivative is designated as either: (1) designated as a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (''cash flow'' hedge) or (2) a contract not designated as a hedge for hedge accounting (''free standing'' derivative).

At March 31, 2006, the Company had eight interest rate swap contracts outstanding whereby the Company will pay an average fixed rate of 4.22% and receive a variable rate equal to one-month and three-month LIBOR. The aggregate notional amount of these contracts is $804.7 million. In addition, the Company had one interest rate cap agreement outstanding whereby it reduced its exposure to variability in future cash outflows attributable to changes in LIBOR. The aggregate notional amount of this contract was $15.0 million at March 31, 2006.

At December 31, 2005, the Company had six interest rate swap contracts outstanding whereby the Company will pay an average fixed rate of 3.89% and receive a variable rate equal to one-month and three-month LIBOR. The aggregate notional amount of these contracts was $972.2 million at December 31, 2005. In addition, the Company had one interest rate cap agreement outstanding whereby it reduced its exposure to variability in future cash outflows attributable to changes in LIBOR. The aggregate notional amount of this contract was $15.0 million at December 31, 2005.

(back to index)

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 14 - DERIVATIVE INSTRUMENTS – (Continued)**

The interest rate swap and cap agreements (‘‘hedge instruments’’) were entered into to hedge the Company’s exposure to variable cash flows from forecasted variable rate financing transactions and, pursuant to SFAS No. 133, the hedge instruments were designated as cash flow hedges. The hedge instruments were evaluated at inception and the Company concluded that each hedge instrument was expected to be highly effective pursuant to the rules of SFAS No. 133, as amended and interpreted. As such, the Company accounts for the hedge instruments using hedge accounting and records them at their fair market value each accounting period with any changes in fair market value being recorded in accumulated other comprehensive income. The hedge instruments will be evaluated on an ongoing basis to determine whether they continue to qualify for hedge accounting. Each hedge instrument must be highly effective in achieving offsetting changes in the hedged item attributable to the risk being hedged in order to qualify for hedge accounting. Should there be any ineffectiveness in the future, the amount of the ineffectiveness will be recorded in the Company’s consolidated statements of operations.

The fair value of the Company’s interest rate swaps and interest rate cap was $5.0 million and $3.0 million as of March 31, 2006 and December 31, 2005, respectively. The Company had aggregate unrealized gains of $5.2 million and $2.8 million on the interest rate swap agreements and interest rate cap agreement, as of March 31, 2006 and December 31, 2005, respectively, which is recorded in accumulated other comprehensive loss. The unrealized gain as of March 31, 2006 included approximately $400,000 of unamortized gain related to the termination of one of the Company’s interest rate swap agreements in January 2006, which had an original termination date of April 2006. The Company replaced this swap with an amortizing swap agreement that extended the period of time the Company has hedged the risk on its agency RMBS portfolio through October 2007.

**NOTE 15 - STOCK INCENTIVE PLAN**

Upon formation of the Company, the 2005 Stock Incentive Plan (the “Plan”) was adopted for the purpose of attracting and retaining executive officers, employees, directors and other persons and entities that provide services to the Company. The Plan authorizes the issuance of options to purchase common stock and the grant of stock awards, performance shares and stock appreciation rights.

Up to 1,533,333 shares of common stock are available for issuance under the Plan. The share authorization and the terms of outstanding awards may be adjusted as the board of directors determines is appropriate in the event of a stock dividend, stock split, reclassification of shares or similar events. Upon completion of the March 2005 private placement, the Company granted the Manager 345,000 shares of restricted stock and options to purchase 651,666 shares of common stock with an exercise price of $15.00 per share under the Plan. One third of the shares of restricted stock and options vested on March 8, 2006. The Company’s non-employee directors were also granted 4,000 shares of restricted stock as part of their annual compensation. These shares vested in full on March 8, 2006.

In addition, on March 8, 2006, the Company granted 4,224 shares of restricted stock to the Company’s non-employee directors as part of their annual compensation. These shares vest in full on the first anniversary of the date of grant.

**NOTE 16 - SEGMENT REPORTING**

SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" ("SFAS No. 131"), establishes standards for the way that public entities report information about operating segments in their financial statements.

The Company is a REIT focused primarily on acquiring loans and securities related to real estate and under the provisions of SFAS No. 131 currently operates in only one segment.

*(back to index)*

**RESOURCE CAPITAL CORP. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**MARCH 31, 2006 – (Continued)**
**(Unaudited)**

**NOTE 17 - INCOME TAXES**

The Company intends to elect to be taxed as a REIT for federal income tax purposes effective for its initial taxable year ending December 31, 2005. Accordingly, the Company and its qualified REIT subsidiaries are not subject to federal income tax to the extent that their distributions to stockholders satisfy the REIT requirements and certain asset, income and ownership tests. The Company may retain up to 10% of its REIT taxable income and pay corporate income taxes on this retained income while continuing to maintain its REIT status. The Company intends to distribute 100% of its 2006 ordinary REIT taxable income and, accordingly, the Company has not recorded a provision for income taxes. The Company may be subject to franchise taxes in certain states that impose taxes on REITs.

Apidos CDO I, the Company's foreign taxable REIT subsidiary, is organized as an exempted company incorporated with limited liability under the laws of the Cayman Islands, and is generally exempt from federal and state income tax at the corporate entity level because it restricts its activities in the United States to trading in stock and securities for its own account. Therefore, despite its status as a TRS, it generally will not be subject to corporate income tax on its earnings and no provisions for income taxes are required; however, the Company will generally be required to include its current taxable income in the Company's calculation of REIT taxable income.

Resource TRS, a domestic taxable REIT subsidiary is subject to corporate income tax on its earnings. Resource TRS is inactive and, as a result, no provision for income taxes has been recorded. In addition, Resource TRS does not have any items which give rise to temporary differences between its GAAP consolidated financial statements and the federal income tax basis of assets and liabilities as of the consolidated balance sheet date. Accordingly, Resource TRS has no deferred income tax assets and liabilities recorded.

**NOTE 18 - SUBSEQUENT EVENTS**

On March 16, 2006, the board of directors declared a quarterly distribution of $0.33 per share of common stock, $5.9 million in the aggregate, which was paid on April 10, 2006 to stockholders of record as of March 27, 2006.

On May 9, 2006, the Apidos CDO III warehouse facility terminated and approximately $222.6 million of syndicated loan assets were transferred into a collateralized debt obligation structure in which the Company purchased a $23.0 million equity interest representing 100% of the outstanding preference shares.

(back to index)

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (unaudited)**

***This report contains certain forward-looking statements. Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts. In some cases, you can identify forward-looking statements by terms such as "anticipate," "believe," "could," "estimate," "expects," "intend," "may," "plan," "potential," "project," "should," "will" and "would" or the negative of these terms or other comparable terminology. Such statements are subject to the risks and uncertainties more particularly described in Item 1A, under the caption "Risk Factors," in our Annual Report on Form 10-K for fiscal 2005. These risks and uncertainties could cause actual results to differ materially. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. We undertake no obligation to publicly release the results of any revisions to forward-looking statements which we may make to reflect events or circumstances after the date of this Form 10-Q or to reflect the occurrence of unanticipated events, except as may be required under applicable law.***

**Overview**

We are a specialty finance company that intends to qualify and will elect to be taxed as a real estate investment trust, or REIT, for federal income tax purposes commencing with our taxable year ending December 31, 2005. Our objective is to provide attractive risk-adjusted total returns over time to our stockholders through both stable quarterly distributions and capital appreciation. We make investments in a combination of real estate-related assets and, to a lesser extent, higher-yielding commercial finance assets. We finance a substantial portion of our portfolio investments through borrowing strategies seeking to match the maturities and repricing dates of our financings with the maturities and repricing dates of those investments and to mitigate interest rate risks through derivative instruments.

We generate our income primarily from the spread between the revenues we receive from our assets and the cost to finance the purchase of those assets and hedge interest rate risks. We generate revenues from the interest we earn on our agency and non-agency residential mortgage-backed securities, or RMBS, commercial mortgage-backed securities, or CMBS, mezzanine debt, first priority tranches of commercial mortgage loans, or A notes, subordinated tranches of commercial mortgage loans, or B notes, other asset-backed securities, or ABS, syndicated bank loans and payments on equipment leases and notes. We use a substantial amount of leverage to enhance our returns and we finance each of our different asset classes with different degrees of leverage. The cost of borrowings to finance our investments comprises a significant part of our expenses. Our net income will depend on our ability to control these expenses relative to our revenue. In our non-agency RMBS, CMBS, other ABS, syndicated bank loans and equipment leases and notes, we use warehouse facilities as a short-term financing source and collateralized debt obligations, or CDOs, and, to a lesser extent, other term financing as a long-term financing source. In our commercial real estate loan portfolio, we use repurchase agreements as a short-term financing source and CDOs and, to a lesser extent, other term financing as a long-term financing source. We expect that our other term financing will consist of long-term match-funded financing provided through long-term bank financing and asset-backed financing programs. In our agency RMBS portfolio, we finance the acquisition of our investments with short-term repurchase arrangements. We seek to mitigate the risk created by any mismatch between the maturities and repricing dates of our agency RMBS and the maturities and repricing dates of the repurchase agreements we use to finance them through derivative instruments, principally floating-to-fixed interest rate swap agreements and interest rate cap agreements.

On March 8, 2005, we received net proceeds of $214.8 million from a private placement of 15,333,334 shares of common stock. On February 10, 2006, we received net proceeds of $27.6 million from our initial public offering of 4,000,000 shares of common stock (including 1,879,200 shares sold by certain selling stockholders of the Company). As of March 31, 2006, we had invested 12.1% of our portfolio in commercial real estate-related assets, 42.3% in agency RMBS, 17.4% in non-agency RMBS and 28.2% in commercial finance assets. We intend to diversify our portfolio over our targeted asset classes during the next 12 months as follows: between 20% and 25% in commercial

real estate-related assets, between 25% and 30% in agency RMBS, between 15% and 20% in non-agency RMBS, and between 30% and 35% in commercial finance assets, subject to the availability of appropriate investment opportunities and changes in market conditions. We expect that diversifying our portfolio by shifting the mix towards higher-yielding assets will increase our earnings, subject to

33

(back to index)

maintaining the credit quality of our portfolio. If we are unable to maintain the credit quality of our portfolio, however, our earnings will decrease. Because the amount of leverage we intend to use will vary by asset class, our asset allocation may not reflect the relative amounts of equity capital we have invested in the respective classes.

**Results of Operations**

Our portfolio investments have been comprised of commercial real estate loans, agency RMBS, non-agency RMBS, other ABS, syndicated bank loans, private equity and equipment leases and notes. We have financed our agency RMBS portfolio and commercial real estate loan portfolio through short-term repurchase agreements, our non-agency RMBS, other ABS and syndicated bank loans through warehouse facilities as a short-term financing source and our equipment lease and notes portfolio through a secured term facility. We intend to use CDOs and other secured borrowings as a long-term financing source for our non-agency RMBS, other ABS, syndicated bank loans and commercial real estate loans. In 2005, we closed two CDO financings and entered into an arrangement with respect to a third CDO financing. In general, to the extent that we do not hedge the interest rate exposure within our agency RMBS portfolio, rising interest rates (particularly short-term rates) will decrease our net interest income from levels that might otherwise be expected, as the cost of our repurchase agreements will rise faster than the yield on our agency RMBS. In addition, our agency RMBS are subject to interest rate caps while the short-term repurchase agreements we use to finance them are not. As a result, if interest rates rise to the point where increases in our interest income are limited by these caps, our net interest income could be reduced or, possibly, we could incur losses. In January 2006, we entered into an amortizing swap agreement that will extend the period of time we have hedged the risks on our agency RMBS portfolio through October 2007. Concurrently with entering into this interest rate swap agreement, we sold approximately $125.4 million of agency RMBS, thereby reducing our portfolio of agency RMBS to $853.5 million, on a cost basis. We expect to continue to lower our exposure to this asset class as prepayments are received on this portfolio. As of March 31, 2006, we had entered into interest rate swaps that seek to hedge a substantial portion of the risks associated with increasing interest rates with maturities ranging from May 2006 through October 2007.

***For the Three Months Ended March 31, 2006***

*Summary*

Our net income for the three months ended March 31, 2006 was $5.2 million, or $0.31 per weighted-average common share (basic and diluted).

*Net Interest Income*

Net interest income for the three months ended March 31, 2006 totaled $8.2 million. Investment income totaled $29.4 million and was comprised of $10.2 million of interest income on our agency RMBS portfolio, $6.1 million of interest income on our non-agency RMBS, CMBS and other ABS portfolio, $7.5 million of interest income on our syndicated loan portfolio, $3.5 million of interest income on our commercial real estate loan portfolio, $536,000 of interest income from our private equity and leasing portfolios, $1.2 million related to interest rate swap agreements and $324,000 of income from our temporary investment of offering proceeds in over-night repurchase agreements. Our interest income was offset by $21.2 million of interest expense, consisting of $9.1 million on our repurchase agreements on our agency RMBS portfolio, $8.6 million on our CDO senior notes, $1.2 million on our warehouse agreements, $1.8 million on our commercial real estate loan portfolio, $279,000 of amortization of debt issuance costs related to our two CDO offerings and $138,000 on our leasing portfolio term credit facility and corporate credit facility.

*Other Gains and Losses*

Net realized loss on investments for the three months ended March 31, 2006 of $699,000 consisted of $1.4 million of losses related to the sale of available-for-sale securities, $143,000 of net realized gains on the sale of bank loans and $570,000 related to the early termination of two equipment leases.

***(back to index)***

*Non-Investment Expenses*

Non-investment expenses for the three months ended March 31, 2006 totaled $2.4 million. Management fees for the period totaled $993,000, of which $880,000 was related to base management fees and $113,000 was related to incentive management fees due to the Manager pursuant to our management agreement. Equity compensation expense-related party totaled $582,000 and consisted of amortization related to the March 8, 2005 grant of restricted common stock to the Manager and consisted of amortization related to the March 8, 2005 and 2006 grants of restricted common stock to our non-employee independent directors and the grant of options to the Manager to purchase common stock. Professional services totaled $261,000 and consisted of audit, tax and legal costs. Insurance expense of $120,000 was the amortization related to our purchase of directors' and officers' insurance. General and administrative expenses totaled $426,000 which includes $272,000 of expense reimbursements due to the Manager and $45,000 of rating agency expenses.

***For the Period from March 8, 2005 (Date Operations Commenced) to March 31, 2005***

*Summary*

Our net loss for the period from March 8, 2005 to March 31, 2005 was $48,000, or $0.00 per weighted-average common share (basic and diluted). Since we only had 23 days of operations during the period from inception through March 31, 2005, which represented our initial period of operations following our private placement, we do not deem this period to be comparable to the quarter ended March 31, 2006.

*Net Interest Income*

Net interest income for the period totaled $484,000. Investment income totaled $694,000 and was comprised of $404,000 of interest income on our agency RMBS portfolio and $290,000 of income from our temporary investment of offering proceeds in over-night repurchase agreements. Our interest income was offset by $210,000 of interest expense on our repurchase agreements on our agency RMBS portfolio.

*Non-Investment Expenses*

Non-investment expenses for the period totaled $532,000. Management fees for the period totaled $208,000, all of which was related to base management fees due to the Manager pursuant to our management agreement. Equity compensation expense-related party totaled $209,000 and consisted of amortization related to the March 8, 2005 grant of restricted common stock to the Manager and our non-employee independent directors and the grant of options to the Manager to purchase common stock. Professional services totaled $22,000 and consisted of audit, tax and legal costs. Insurance expense of $30,000 was the amortization related to our purchase of directors' and officers' insurance. General and administrative expenses totaled $63,000, which includes $52,000 of expense reimbursements due to the Manager.

*Income Taxes*

We do not pay federal income tax on income we distribute to our stockholders, subject to our compliance with REIT qualification requirements. However, Resource TRS, our domestic TRS, is taxed as a regular subchapter C corporation under the provisions of the Internal Revenue Code. As of March 31, 2006 and 2005, we did not conduct any of our operations through Resource TRS.

Apidos CDO I, our foreign TRS, was formed to complete a securitization transaction structured as a secured financing. Apidos CDO I is organized as an exempt company incorporated with limited liability under the laws of the

Cayman Islands and is generally exempt from federal and state income tax at the corporate level because its activities in the United States are limited to trading in stock and securities for its own account. Therefore, despite its status as a TRS, it generally will not be subject to corporate tax on its earnings and no provision for income taxes is required; however, we generally will be required to include Apidos CDO I's current taxable income in our calculation of REIT taxable income. We also intend to make an election to treat Apidos CDO III as a TRS. Apidos CDO III was formed to complete a securitization transaction and is expected to close in May 2006.



---

*(back to index)*

**Financial Condition**

*Summary*

Our total assets at March 31, 2006 were $2.04 billion, as compared to $2.05 billion at December 31, 2005. The reduction in total assets principally was due to the sale of approximately $125.4 million of agency RMBS coupled with principal repayments of $35.6 million on this portfolio. This decrease was largely offset by an increase of $69.8 million in our syndicated loans held by Apidos CDO III, a $40.7 million increase in our commercial real estate loan portfolio resulting from the purchase of two additional loans and two additional fundings on existing loan positions and a $38.2 million increase in equipment leases and notes in connection with our second purchase of leasing assets from LEAF Financial Corporation in March 2006. As a result of the sale of approximately $125.4 million of agency RMBS, we reduced the associated debt with this portfolio. Our liquidity at March 31, 2006 was strengthened over that at December 31, 2005 by the completion of our initial public offering in February 2006 which resulted in net proceeds of $27.6 million after deducting underwriters' discounts and commissions and offering expenses. As of March 31, 2006, we had approximately $23.7 million of cash and cash equivalents that we had not deployed or leveraged.

*Investment Portfolio*

The tables below summarize the amortized cost and estimated fair value of our investment portfolio as of March 31, 2006 and as of December 31, 2005, classified by interest rate type. The tables below include both (i) the amortized cost of our investment portfolio and the related dollar price, which is computed by dividing amortized cost by par amount, and (ii) the estimated fair value of our investment portfolio and the related dollar price, which is computed by dividing the estimated fair value by par amount (in thousands, except percentages):

| | March 31, 2006 | | | | | |
|---|---|---|---|---|---|---|
| | **Amortized cost** | **Dollar price** | **Estimated fair value** | **Dollar price** | **Estimated fair value less amortized cost** | **Dollar price** |
| **Floating rate** | | | | | | |
| Non-agency RMBS | $ 339,038 | 99.12% | $ 338,917 | 99.08% | $ (121) | -0.04% |
| CMBS | 444 | 100.00% | 445 | 100.23% | 1 | 0.23% |
| Other ABS | 18,244 | 99.87% | 18,231 | 99.80% | (13) | -0.07% |
| A notes | 20,000 | 100.00% | 20,000 | 100.00% | – | 0.00% |
| B notes | 136,262 | 99.90% | 136,262 | 99.90% | – | 0.00% |
| Mezzanine loans | 50,913 | 99.88% | 50,913 | 99.88% | – | 0.00% |
| Syndicated bank loans | 471,472 | 100.20% | 474,331 | 100.81% | 2,859 | 0.61% |
| **Total floating rate** | $ 1,036,373 | 99.78% | $ 1,039,099 | 100.04% | $ 2,726 | 0.26% |
| | | | | | | |
| **Hybrid rate** | | | | | | |
| Agency RMBS | $ 853,536 | 100.08% | $ 835,276 | 97.94% | $ (18,260) | -2.14% |
| **Total hybrid rate** | $ 853,536 | 100.08% | $ 835,276 | 97.94% | $ (18,260) | -2.14% |
| | | | | | | |
| **Fixed rate** | | | | | | |
| Non-agency RMBS | $ 6,000 | 100.00% | $ 5,792 | 96.53% | $ (208) | -3.47% |
| CMBS | 27,520 | 98.66% | 26,570 | 95.26% | (950) | -3.40% |
| Other ABS | 3,314 | 99.97% | 3,127 | 94.33% | (187) | -5.64% |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Mezzanine loans | | 5,012 | 100.24% | | 5,012 | 100.24% | | – | 0.00% |
| Syndicated bank loans | | 249 | 99.60% | | 249 | 99.60% | | – | 0.00% |
| Equipment leases and notes | | 61,539 | 100.00% | | 61,539 | 100.00% | | – | 0.00% |
| **Total fixed rate** | $ | 103,634 | 99.65% | $ | 102,289 | 98.36% | $ | (1,345) | -1.29% |
| **Grand total** | $ | 1,993,543 | 99.90% | $ | 1,976,664 | 99.06% | $ | (16,879) | -0.84% |

36

(back to index)

| | December 31, 2005 | | | | | |
|---|---|---|---|---|---|---|
| | Amortized cost | Dollar price | Estimated fair value | Dollar price | Estimated fair value less amortized cost | Dollar price |
| **Floating rate** | | | | | | |
| Non-agency RMBS | $ 340,460 | 99.12% | $ 331,974 | 96.65% | $ (8,486) | -2.47% |
| CMBS | 458 | 100.00% | 459 | 100.22% | 1 | 0.22% |
| Other ABS | 18,731 | 99.88% | 18,742 | 99.94% | 11 | 0.06% |
| B notes | 121,945 | 100.00% | 121,945 | 100.00% | – | 0.00% |
| Mezzanine loans | 44,500 | 100.00% | 44,500 | 100.00% | – | 0.00% |
| Syndicated bank loans | 398,536 | 100.23% | 399,979 | 100.59% | 1,443 | 0.36% |
| Private equity | 1,984 | 99.20% | 1,954 | 97.70% | (30) | -1.50% |
| **Total floating rate** | $ 926,614 | 99.77% | $ 919,553 | 99.01% | $ (7,061) | -0.76% |
| | | | | | | |
| **Hybrid rate** | | | | | | |
| Agency RMBS | $ 1,014,575 | 100.06% | $ 1,001,670 | 98.79% | $ (12,905) | -1.27% |
| **Total hybrid rate** | $ 1,014,575 | 100.06% | $ 1,001,670 | 98.79% | $ (12,905) | -1.27% |
| | | | | | | |
| **Fixed rate** | | | | | | |
| Non-agency RMBS | $ 6,000 | 100.00% | $ 5,771 | 96.18% | $ (229) | -3.82% |
| CMBS | 27,512 | 98.63% | 26,904 | 96.45% | (608) | -2.18% |
| Other ABS | 3,314 | 99.97% | 3,203 | 96.62% | (111) | -3.35% |
| Mezzanine loans | 5,000 | 100.00% | 5,000 | 100.00% | – | 0.00% |
| Syndicated bank loans | 249 | 99.60% | 246 | 98.40% | (3) | -1.20% |
| Equipment leases and notes | 23,317 | 100.00% | 23,317 | 100.00% | – | 0.00% |
| **Total fixed rate** | $ 65,392 | 99.42% | $ 64,441 | 97.97% | $ (951) | -1.45% |
| **Grand total** | $ 2,006,581 | 99.90% | $ 1,985,664 | 98.86% | $ (20,917) | -1.04% |

*Residential Mortgage-Backed Securities*

At March 31, 2006 and December 31, 2005, the mortgages underlying our hybrid adjustable rate agency RMBS had fixed interest rates for a weighted average of approximately 56 months and 52 months, respectively, after which time the rates reset and become adjustable. The average length of time until maturity of those mortgages was 28.8 years and 29.1 years, respectively. These mortgages are also subject to interest rate caps that limit both the amount that the applicable interest rate can increase during any year, known as an annual cap, and the amount that it can rise through maturity of the mortgage, known as a lifetime cap. After the interest rate reset date, interest rates on our hybrid adjustable rate agency RMBS float based on spreads over various London Interbank Offered Rate, or LIBOR indices. The weighted average lifetime cap for our portfolio is an increase of 6%; the weighted average maximum annual increase is 2%.

The following tables summarize our hybrid adjustable rate agency RMBS portfolio as of March 31, 2006 and December 31, 2005 (dollars in thousands):

| | March 31, 2006 | | | |
|---|---|---|---|---|
| | | | Weighted average | |
| Security description | Amortized cost | Estimated fair value | Coupon | Months to reset [1] |
| 3-1 hybrid adjustable rate RMBS | $ 259,087 | $ 255,545 | 4.13% | 26.7 |
| 5-1 hybrid adjustable rate RMBS | 173,024 | 169,734 | 4.72% | 54.4 |
| 7-1 hybrid adjustable rate RMBS | 421,425 | 409,997 | 4.81% | 75.6 |
| Total | $ 853,536 | $ 835,276 | 4.58% | 56.3 |

37

(back to index)

| | December 31, 2005 | | | |
|---|---|---|---|---|
| | | | Weighted average | |
| Security description | Amortized cost | Estimated fair value | Coupon | Months to reset [(1)] |
| 3-1 hybrid adjustable rate RMBS | $ 405,047 | $ 400,807 | 4.16% | 25.2 |
| 5-1 hybrid adjustable rate RMBS | 178,027 | 176,051 | 4.73% | 54.3 |
| 7-1 hybrid adjustable rate RMBS | 431,501 | 424,812 | 4.81% | 75.6 |
| Total | $ 1,014,575 | $ 1,001,670 | 4.54% | 51.7 |

(1) Represents number of months before conversion to floating rate.

At March 31, 2006, we held $835.3 million of agency RMBS, at fair value, which is based on market prices provided by dealers, net of unrealized losses of $18.3 million, as compared to $1.0 billion at December 31, 2005, net of unrealized gains of $13,000 and unrealized losses of $12.9 million. As of March 31, 2006, our agency RMBS portfolio had a weighted-average amortized cost of 100.08%, largely unchanged from the weighted-average amortized cost of 100.06% at December 31, 2005. Our agency RMBS were purchased at a premium of $716,000 and $594,000 at March 31, 2006 and December 31, 2005, respectively, and were valued below par because the weighted-average coupons of 4.58% and 4.54% and the corresponding interest rates of loans underlying our agency RMBS were below prevailing market rates. In the current increasing interest rate environment, we expect that the fair value of our RMBS will continue to decrease, thereby increasing our net unrealized losses.

At March 31, 2006, we held $344.7 million of non-agency RMBS, at fair value, which is based on market prices provided by dealers, net of unrealized gains of $1.5 million and unrealized losses of $1.8 million as compared to $337.7 million at December 31, 2006, net of unrealized gains of $370,000 and unrealized losses of $9.1 million. At both March 31, 2006 and December 31, 2005, our non-agency RMBS portfolio had a weighted-average amortized cost of 99.13%. As of March 31, 2006 and December 31, 2005, our non-agency RMBS were valued below par, in the aggregate, because of wide credit spreads during the respective periods. The decrease in the unrealized loss position of this portfolio during the three months ended March 31, 2006 resulted from a tightening of credit spreads. If credit spreads continue to tighten, we expect that the fair value of our non-agency RMBS will continue to increase, thereby decreasing our net unrealized losses.

At both March 31, 2006 and December 31, 2005, none of the securities whose fair market value was below amortized cost had been downgraded by a credit rating agency and 85.2% and 76.9%, respectively, were guaranteed by either Freddie Mac or Fannie Mae. We intend and have the ability to hold these securities until maturity to allow for the anticipated recovery in fair value as they reach maturity.

The following tables summarize our RMBS classified as available-for-sale as of March 31, 2006 and December 31, 2005, which are carried at fair value (in thousands, except percentages):

| | March 31, 2006 | | |
|---|---|---|---|
| | Agency RMBS | Non-agency RMBS | Total RMBS |
| RMBS, gross | $ 852,820 | $ 348,065 | $ 1,200,885 |
| Unamortized discount | (518) | (3,191) | (3,709) |
| Unamortized premium | 1,234 | 164 | 1,398 |
| Amortized cost | 853,536 | 345,038 | 1,198,574 |
| Gross unrealized gains | – | 1,477 | 1,477 |
| Gross unrealized losses | (18,260) | (1,806) | (20,066) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Estimated fair value | $ | 835,276 | $ | 344,709 | $ | 1,179,985 |
| Percent of total | | 70.8% | | 29.2% | | 100.0% |

*(back to index)*

| | December 31, 2005 | | |
|---|---|---|---|
| | Agency RMBS | Non-agency RMBS | Total RMBS |
| RMBS, gross | $ 1,013,981 | $ 349,484 | $ 1,363,465 |
| Unamortized discount | (777) | (3,188) | (3,965) |
| Unamortized premium | 1,371 | 164 | 1,535 |
| Amortized cost | 1,014,575 | 346,460 | 1,361,035 |
| Gross unrealized gains | 13 | 370 | 383 |
| Gross unrealized losses | (12,918) | (9,085) | (22,003) |
| Estimated fair value | $ 1,001,670 | $ 337,745 | $ 1,339,415 |
| Percent of total | 74.8% | 25.2% | 100.0% |

The table below describes the terms of our RMBS portfolio as of March 31, 2006 and December 31, 2005 (dollars in thousands). Dollar price is computed by dividing amortized cost by par amount.

| | March 31, 2006 | | December 31, 2005 | |
|---|---|---|---|---|
| | Amortized cost | Dollar price | Amortized cost | Dollar price |
| **Moody's ratings category:** | | | | |
| Aaa | $ 853,536 | 100.08% | $ 1,014,575 | 100.06% |
| A1 through A3 | 42,324 | 100.23% | 42,172 | 100.23% |
| Baa1 through Baa3 | 279,740 | 99.84% | 281,929 | 99.85% |
| Ba1 through Ba3 | 22,974 | 89.51% | 22,359 | 89.20% |
| Total | $ 1,198,574 | 99.81% | $ 1,361,035 | 99.82% |
| | | | | |
| **S&P ratings category:** | | | | |
| AAA | $ 853,536 | 100.08% | $ 1,014,575 | 100.06% |
| AA+ through AA- | – | –% | 2,000 | 100.00% |
| A+ through A- | 59,586 | 99.58% | 59,699 | 99.55% |
| BBB+ through BBB- | 262,729 | 99.01% | 262,524 | 98.99% |
| BB+ through BB- | 1,723 | 92.39% | 1,199 | 94.78% |
| No rating provided | 21,000 | 100.00% | 21,038 | 100.00% |
| Total | $ 1,198,574 | 99.81% | $ 1,361,035 | 99.82% |
| | | | | |
| Weighted average rating factor | 118 | | 104 | |
| Weighted average original FICO [(1)] | 631 | | 633 | |
| Weighted average original LTV [(1)] | 79.01% | | 80.02% | |

---

(1) Weighted average only reflects the 29.2% and 25.2%, respectively, of the RMBS in our portfolio that are non-agency.

The constant prepayment rate to balloon, or CPB, on our RMBS for both the three months ended March 31, 2006 and the period ended December 31, 2005 was 15%. CPB attempts to predict the percentage of principal that will repay over the next 12 months based on historical principal paydowns. As interest rates rise, the rate of refinancing typically

declines, which we believe may result in lower rates of prepayments and, as a result, a lower portfolio CPB.


---

(back to index)

*Commercial Mortgage-Backed Securities*

At March 31, 2006 and December 31, 2005, we held $27.0 million and $27.4 million, respectively, of CMBS at fair value, which is based on market prices provided by dealers, net of unrealized gains of $44,000 and $1,000, respectively, and unrealized losses of $993,000 and $608,000, respectively. In the aggregate, we purchased our CMBS portfolio at a discount. As of March 31, 2006, the remaining discount to be accreted into income over the remaining lives of the securities was $373,000, which was substantially the same as the $380,000 to be accreted into income at December 31, 2005. These securities are classified as available-for-sale and as a result are carried at their fair market value.

The table below describes the terms of our CMBS as of March 31, 2006 and December 31, 2005 (dollars in thousands). Dollar price is computed by dividing amortized cost by par amount.

| | March 31, 2006 | | December 31, 2005 | |
|---|---|---|---|---|
| | Amortized cost | Dollar price | Amortized cost | Dollar price |
| **Moody's ratings category:** | | | | |
| Baa1 through Baa3 | $ 27,964 | 98.68% | $ 27,970 | 98.66% |
| Total | $ 27,964 | 98.68% | $ 27,970 | 98.66% |
| | | | | |
| **S&P ratings category:** | | | | |
| BBB+ through BBB- | $ 12,215 | 99.01% | $ 12,225 | 98.98% |
| No rating provided | 15,749 | 98.43% | 15,745 | 98.41% |
| Total | $ 27,964 | 98.68% | $ 27,970 | 98.66% |
| | | | | |
| Weighted average rating factor | 346 | | 346 | |

*Other Asset-Backed Securities*

At March 31, 2006 and December 31, 2005, we held $21.4 million and $21.9 million, respectively, of other ABS at fair value, which is based on market prices provided by dealers, net of unrealized gains of $52,000 and $24,000, respectively, and unrealized losses of $252,000 and $124,000, respectively. In the aggregate, we purchased our other ABS portfolio at a discount. As of March 31, 2006 and December 31, 2005, the remaining discount to be accreted into income over the remaining lives of securities was $24,000 and $25,000, respectively. These securities are classified as available-for-sale and, as a result, are carried at their fair market value.

The table below describes the terms of our other ABS as of March 31, 2006 and December 31, 2005 (dollars in thousands). Dollar price is computed by dividing amortized cost by par amount.

| | March 31, 2006 | | December 31, 2005 | |
|---|---|---|---|---|
| | Amortized cost | Dollar price | Amortized cost | Dollar price |
| **Moody's ratings category:** | | | | |
| Baa1 through Baa3 | $ 21,558 | 99.88% | $ 22,045 | 99.89% |
| Total | $ 21,558 | 99.88% | $ 22,045 | 99.89% |
| | | | | |
| **S&P ratings category:** | | | | |
| BBB+ through BBB- | $ 19,091 | 99.87% | $ 19,091 | 99.87% |

| | | | | | | |
|---|---|---|---|---|---|---|
| No rating provided | | 2,467 | 99.96% | | 2,954 | 100.00% |
| Total | $ | 21,558 | 99.88% | $ | 22,045 | 99.89% |
| | | | | | | |
| Weighted average rating factor | | 398 | | | 398 | |

40

(back to index)

*Private Equity Investments*

In February 2006, we sold our private equity investment for approximately $2.0 million. We intend to invest in trust preferred securities and private equity investments with an emphasis on securities of small- to middle-market financial institutions, including banks, savings and thrift institutions, insurance companies, holding companies for these institutions and REITS. Trust preferred securities are issued by a special purpose trust that holds a subordinated debenture or other debt obligation issued by a company to the trust.

*Commercial Loans*

At March 31, 2006, our commercial real estate loan portfolio consisted of:

- one A note with an amortized cost of $20.0 million which bears interest at a floating rate of LIBOR plus 1.25% with a maturity date of January 2008;
- eight B notes with an amortized cost of $136.3 million which bear interest at floating rates ranging from LIBOR plus 2.15% to LIBOR plus 6.25% and have maturity dates ranging from January 2007 to April 2008;
- four mezzanine loans with an amortized cost of $44.4 million which bear interest at floating rates between LIBOR plus 2.25% and LIBOR plus 4.50% with maturity dates ranging from August 2007 to July 2008;
- one mezzanine loan with an amortized cost of $6.5 million which bears interest at the 10-Year Treasury rate plus 6.64% with a maturity date of January 2016; and
- one mezzanine loan with an amortized cost of $5.0 million which bears interest at a fixed rate of 9.50% with a maturity of May 2010.

At December 31, 2005, the Company's commercial real estate loan portfolio consisted of:

- seven B notes with an amortized cost of $121.9 million which bear interest at floating rates ranging from LIBOR plus 2.15% to LIBOR plus 6.25% and have maturity dates ranging from January 2007 to April 2008;
- four mezzanine loans with an amortized cost of $44.5 million which bear interest at floating rates between LIBOR plus 2.25% and LIBOR plus 4.50% with maturity dates ranging from August 2007 to July 2008; and
- one mezzanine loan with an amortized cost of $5.0 million which bears interest at a fixed rate of 9.50% with a maturity of May 2010.

*Syndicated Bank Loans*

At March 31, 2006, we held a total of $474.6 million of syndicated loans at fair value, of which $341.0 million are held by and secure the debt issued by Apidos CDO I, an increase of $74.4 million and $3.8 million, respectively, over our holdings at December 31, 2005. The increase in total syndicated loans was principally due to the continued ramping of Apidos CDO III. We own 100% of the equity issued by Apidos CDO I, which we have determined is a variable interest entity, or VIE, and are therefore deemed to be its primary beneficiary. In addition, at March 31, 2006, $133.6 million ($63.0 million at December 31, 2005) of our syndicated loans were financed and held on our Apidos CDO III warehouse facility. As a result, we consolidate Apidos CDO I and also consolidated Apidos CDO III as of March 31, 2006 and December 31, 2005, even though we do not yet own any of the equity of Apidos CDO III. We accrued interest income based on the contractual terms of the loans and recognized interest expense in accordance

with the terms of the warehouse agreement in our consolidated statements of operations.

*(back to index)*

The table below describes the terms of our syndicated bank loan investments as of March 31, 2006 and December 31, 2005 (dollars in thousands). Dollar price is computed by dividing amortized cost by par amount.

| | March 31, 2006 | | December 31, 2005 | |
|---|---|---|---|---|
| | **Amortized cost** | **Dollar price** | **Amortized cost** | **Dollar price** |
| **Moody's ratings category:** | | | | |
| Ba1 through Ba3 | $ 193,600 | 100.18% | $ 155,292 | 100.24% |
| B1 through B3 | 277,865 | 100.21% | 243,493 | 100.23% |
| Caa1 and through Caa3 | 256 | 102.40% | – | –% |
| Total | $ 471,721 | 100.20% | $ 398,785 | 100.23% |
| | | | | |
| **S&P ratings category:** | | | | |
| BBB+ through BBB- | $ 5,158 | 100.14% | $ 15,347 | 100.20% |
| BB+ through BB- | 180,496 | 100.17% | 131,607 | 100.22% |
| B+ through B- | 283,865 | 100.22% | 246,335 | 100.24% |
| CCC+ through CCC- | 1,202 | 99.42% | 5,496 | 100.37% |
| No rating provided | 1,000 | 100.00% | – | –% |
| Total | $ 471,721 | 100.20% | $ 398,785 | 100.23% |
| | | | | |
| Weighted average rating factor | 2,070 | | 2,089 | |

*Equipment Leases and Notes*

Investments in direct financing leases and notes as of March 31, 2006 and December 31, 2005 were as follows (in thousands):

| | As of March 31, 2006 | As of December 31, 2005 |
|---|---|---|
| Direct financing leases | $ 17,708 | $ 18,141 |
| Notes receivable | 43,831 | 5,176 |
| Total | $ 61,539 | $ 23,317 |

*Interest Receivable*

The amount of our interest receivable was largely unchanged at March 31, 2006 as compared to December 31, 2005. At March 31, 2006, we had interest receivable of $10.6 million, which consisted of $10.5 million of interest on our securities, loans and equipment leases and notes, $24,000 of purchased interest that had been accrued on securities and loans purchased and $160,000 of interest earned on escrow and sweep accounts. At December 31, 2005, we had interest receivable of $9.5 million, which consisted of $9.2 million of interest on our securities, loans and equipment leases and notes, $172,000 of purchased interest that had been accrued when our securities and loans were purchased and $98,000 of interest earned on escrow and sweep accounts.

*Other Assets*

Other assets at March 31, 2006 of $2.2 million consisted primarily of $1.0 million of proceeds to be received on syndicated loans sold, $544,000 of loan origination costs associated with our revolving credit facility, commercial real estate loan portfolio and secured term facility, $471,000 of prepaid directors' and officers' liability insurance, $87,000 of equipment lease and security deposit receivables, $65,000 of prepaid costs associated with the structuring of our

hedging transactions and $8,000 of prepaid expenses.



---

*(back to index)*

Other assets at December 31, 2005 of $1.1 million, consisted primarily of $89,000 of prepaid directors' and officers' liability insurance, $1.2 million of prepaid costs, principally professional fees, associated with the preparation and filing with the SEC of a registration statement for our initial public offering and $34,000 of prepaid costs associated with the structuring of our hedging transactions. These were partially offset by $164,000 of deferred loan origination fees associated with our commercial real estate loan portfolio.

*Hedging Instruments*

As of March 31, 2006 and December 31, 2005, we had entered into hedges with a notional amount of $819.7 million and $987.2 million, respectively. The decrease in notional amount was the result of the decreased size of the underlying hedged portfolio. Our hedges at March 31, 2006 and December 31, 2005 were fixed-for-floating interest rate swap agreements whereby we swapped the floating rate of interest on the liabilities we hedged for a fixed rate of interest. The maturities of these hedges range from May 2006 to September 2015 and April 2006 to June 2014, as of March 31, 2006 and December 31, 2005, respectively. At March 31, 2006 and December 31, 2005, the unrealized gain on our interest rate swap agreements was $5.2 million and $2.8 million, respectively. In an increasing interest rate environment, we expect that the fair value of our hedges will continue to increase. We intend to continue to seek such hedges for our floating rate debt in the future.

*Repurchase Agreements*

We have entered into repurchase agreements to finance our agency RMBS and commercial real estate loans. These agreements are secured by our agency RMBS and commercial real estate loans and bear interest rates that have historically moved in close relationship to LIBOR. At March 31, 2006, we had established nine borrowing arrangements with various financial institutions and had utilized four of these arrangements, principally our arrangement with Credit Suisse Securities (USA) LLC. None of the counterparties to these agreements are affiliates of the Manager or us.

We seek to renew our repurchase agreements as they mature under the then-applicable borrowing terms of the counterparties to our repurchase agreements. Through March 31, 2006, we have encountered no difficulties in effecting renewals of our repurchase agreements.

At March 31, 2006, we had outstanding $549.3 million of repurchase agreements secured by our agency RMBS with Credit Suisse Securities (USA) LLC, which was substantially lower than our December 31, 2005 outstanding balance of $947.1 million, all of which matured in less than 30 days. This decrease resulted primarily from two events that occurred during the quarter ended March 31, 2006:

- the sale of approximately $125.4 million of our agency RMBS portfolio and the corresponding reduction in debt associated with this sale; and

- the completion of transitioning our financing on 19 agency RMBS transactions, originally purchased and financed with Credit Suisse Securities (USA) LLC, to another counterparty, UBS Securities LLC, which is consistent with our strategy as previous discussed in our Annual Report on Form 10-K. This transition eliminates our exposure to same party transactions at March 31, 2006, as covered under SFAS 140.

The weighted-average current borrowing rates of repurchase agreements under this facility were 4.77% and 4.34% at March 31, 2006 and December 31, 2005, respectively. The repurchase agreements were secured by agency RMBS with an estimated fair value of $570.5 million and $975.3 million at March 31, 2006 and December 31, 2005, respectively, with weighted-average maturities of 22 days and 17 days, respectively. The net amount at risk, defined as the sum of the fair value of securities sold plus accrued interest income minus the sum of repurchase agreement

liabilities plus accrued interest expense, was $20.3 million and $31.2 million at March 31, 2006 and December 31, 2005, respectively.

***(back to index)***

At March 31, 2006, we had outstanding $218.7 million of repurchase agreements secured by our agency RMBS with UBS Securities LLC with a weighted-average current borrowing rate of 4.79%, all of which matured in less than 30 days. At March 31, 2006, the repurchase agreements were secured by agency RMBS with an estimated fair value of $225.7 million and a weighted-average maturity of 24 days. The net amount at risk was $6.7 million at March 31, 2006. At December 31, 2005, we had no borrowings under repurchase agreements with UBS Securities LLC.

In August 2005, we also entered into a master repurchase agreement with Bear, Stearns International Limited to finance the purchase of commercial real estate loans. The maximum amount of our borrowing under the repurchase agreement is $150.0 million. Each repurchase transaction specifies its own terms, such as identification of the assets subject to the transaction, sales price, repurchase price, rate and term. At both March 31, 2006 and December 31, 2005, we had outstanding $80.6 million of repurchase agreements with weighted average current borrowing rates of 5.88% and 5.51%, respectively, all of which matured in less than 30 days. At March 31, 2006, the repurchase agreements were secured by commercial real estate loans with an estimated fair value of $116.9 million, which was largely unchanged from our estimated fair value of $116.3 million at December 31, 2005. The repurchase agreements had weighted average maturities of 18 days and 17 days at March 31, 2006 and December 31, 2005, respectively. The net amount of risk was $36.1 million and $36.0 million at March 31, 2006 and December 31, 2005, respectively.

In December 2005, we entered into a master repurchase agreement with Deutsche Bank AG, Cayman Islands Branch to finance the purchase of commercial real estate loans. The maximum amount of our borrowing under the repurchase agreement is $300.0 million. Each repurchase transaction specifies its own terms, such as identification of the assets subject to the transaction, sales price, repurchase price, rate and term. At March 31, 2006, we had outstanding $67.2 million of repurchase agreements, which was substantially higher than the outstanding balance at December 31, 2005 of $38.5 million, all of which matured in less than 30 days. This increase resulted from the purchase of two additional loans and two additional fundings on existing loan positions. The weighted average current borrowing rates were 6.04% and 5.68% at March 31, 2006 and December 31, 2005, respectively. At March 31, 2006 and December 31, 2005, the repurchase agreements were secured by commercial real estate loans with an estimated fair value of $96.2 million and $55.0 million, respectively, and had weighted average maturities of 18 days each. The net amount of risk was $29.1 million and $16.7 million at March 31, 2006 and December 31, 2005, respectively.

*Collaterized Debt Obligations*

As of March 31, 2006, we had executed two CDO transactions. In July 2005, we closed Ischus CDO II, a $400.0 million CDO transaction that provided financing for mortgage-backed and other asset-backed securities. The investments held by Ischus CDO II collateralize $376.0 million of senior notes issued by the CDO vehicle. In August 2005, we closed Apidos CDO I, a $350.0 million CDO transaction that provided financing for syndicated bank loans. The investments held by Apidos CDO I collateralize $321.5 million of senior notes issued by the CDO vehicle.

*Warehouse Facility*

In May 2005, we formed Apidos CDO III and began borrowing on a warehouse facility provided by Citigroup Financial Products, Inc. to purchase syndicated loans. At March 31, 2006, $132.8 million was outstanding under the facility, which was substantially higher than the outstanding balance of $63.0 million at December 31, 2005. This increase was due to the continued ramping of syndicated loans in connection with the May 2006 closing of Apidos CDO III. The facility bears interest at a rate of LIBOR plus 0.25%, which was 5.00% at March 31, 2006.

***(back to index)***

*Term Facility*

In March 2006, we entered into a secured term credit facility with Bayerische Hypo - und Vereinsbank AG, New York Branch to finance the purchase of equipment leases and notes. The maximum amount of our borrowing under this facility is $100.0 million. At March 31, 2006, $55.8 million was outstanding under the facility. The facility bears interest at one of two rates, determined by asset class.

- Pool A - one-month LIBOR plus 110 basis points; or
- Pool B - one-month LIBOR plus 80 basis points.

The interest rate was 6.23% at March 31, 2006.

*Credit Facility*

In December 2005, we entered into a $15.0 million corporate credit facility with Commerce Bank, N.A. The unsecured revolving credit facility permits us to borrow up to the lesser of the facility amount and the sum of 80% of the sum of our unsecured assets rated higher than Baa3 or better by Moody's and BBB- or better by Standard and Poor's plus our interest receivables plus 65% of our unsecured assets rated lower than Baa3 by Moody's and BBB- from Standard and Poor's. Up to 20% of the borrowings under the facility may be in the form of standby letters of credit. At March 31, 2006, no balance was outstanding under this facility.

**Stockholders' Equity**

Stockholders' equity at March 31, 2006 was $227.9 million and included $19.7 million of net unrealized losses on securities classified as available-for-sale, offset by $5.2 million of unrealized gains on cash flow hedges, shown as a component of accumulated other comprehensive loss. The unrealized losses consist of $18.3 million of net unrealized losses on our agency RMBS portfolio and $1.5 million of net unrealized losses on our non-agency RMBS, CMBS, and other ABS portfolio. Stockholders' equity at December 31, 2005 was $195.3 million and included $22.4 million of net unrealized losses on securities classified as available-for-sale, offset by $2.8 million of unrealized gains on cash flow hedges, shown as a component of accumulated other comprehensive loss. The unrealized losses consist of $12.9 million of net unrealized losses on our agency RMBS portfolio, $9.4 million of net unrealized losses on our non-agency RMBS, CMBS, and other ABS portfolio and a $30,000 unrealized loss on a private equity investment. The increase during the quarter ended March 31, 2006 was principally due to the completion of our initial public offering of 4,000,000 shares of our common stock (including 1,879,200 shares sold by certain selling stockholders) at a price of $15.00 per share. The offering generated net proceeds of $27.6 million after deducting underwriters' discounts and commissions and offering expenses.

As a result of our ''available-for-sale'' accounting treatment, unrealized fluctuations in market values of assets do not impact our income determined in accordance with GAAP, or our taxable income, but rather are reflected on our consolidated balance sheets by changing the carrying value of the asset and stockholders' equity under ''Accumulated Other Comprehensive Income (Loss).'' By accounting for our assets in this manner, we hope to provide useful information to stockholders and creditors and to preserve flexibility to sell assets in the future without having to change accounting methods.

*(back to index)*

**Estimated REIT Taxable Income**

Estimated REIT taxable income, which is a non-GAAP financial measure, is calculated according to the requirements of the Internal Revenue Code, rather than GAAP. The following table reconciles net income to estimated REIT taxable income for the three months ended March 31, 2006 and for the period from March 8, 2005 (date operations commenced) to March 31, 2005 (in thousands):

| | Three Months Ended March 31, 2006 | Period from March 8, 2005 (date operations commenced) to March 31, 2005 |
|---|---|---|
| Net income (loss) | $ 5,150 | $ (48) |
| Additions: | | |
| Share-based compensation to related parties | 582 | 209 |
| Incentive management fee expense to related parties paid in shares | 31 | – |
| Capital losses from the sale of available-for-sale securities | 1,412 | – |
| Estimated REIT taxable income | $ 7,175 | $ 161 |

We believe that a presentation of REIT taxable income provides useful information to investors regarding our financial condition and results of operations as this measurement is used to determine the amount of dividends that we are required to declare to our stockholders in order to maintain our status as a REIT for federal income tax purposes. Since we, as a REIT, expect to make distributions based on taxable earnings, we expect that our distributions may at times be more or less than our reported earnings. Total taxable income is the aggregate amount of taxable income generated by us and by our domestic and foreign taxable REIT subsidiaries. REIT taxable income excludes the undistributed taxable income of our domestic taxable REIT subsidiary, if any such income exists, which is not included in REIT taxable income until distributed to us. There is no requirement that our domestic taxable REIT subsidiary distribute its earning to us. REIT taxable income, however, includes the taxable income of our foreign taxable REIT subsidiaries because we will generally be required to recognize and report their taxable income on a current basis. We use REIT taxable income for this purpose. Because not all companies use identical calculations, this presentation of REIT taxable income may not be comparable to other similarly-titled measures of other companies.

**Liquidity and Capital Resources**

Through March 31, 2006, our principal sources of funds were the net proceeds from our March 2005 private placement, net proceeds from our February 2006 public offering, repurchase agreements totaling $917.3 million, including accrued interest of $1.5 million with a weighted average current borrowing rate of 4.96%, CDO financings totaling $687.7 million with a weighted average current borrowing rate of 5.13%, warehouse agreements totaling $132.8 million, with a weighted average current borrowing rate of 4.60% and an equipment leasing secured term facility totaling $55.8 million, with a weighted average current borrowing rate of 6.23%. We expect to continue to borrow funds in the form of repurchase agreements to finance our agency RMBS and commercial real estate loan portfolios, through warehouse agreements to finance our non-agency RMBS, CMBS, other ABS, syndicated bank loans, trust preferred securities and private equity investments and through our secured term facility to finance our equipment leases and notes prior to the execution of CDOs and other term financing vehicles.

We held cash and cash equivalents of $23.7 million at March 31, 2006. In addition, we held $42.9 million of available-for-sale securities that had not been pledged as collateral under our repurchase agreements at March 31, 2006.

We anticipate that, upon repayment of each borrowing under a repurchase agreement, we will immediately use the collateral released by the repayment as collateral for borrowing under a new repurchase agreement. We also anticipate that our borrowings under our warehouse credit facility will be refinanced through the issuance of CDOs. Our leverage ratio may vary as a result of the various funding strategies we use. As of March 31, 2006, our leverage ratio was 7.9 times. Our target leverage ratio is eight to 12 times.

*(back to index)*

We have entered into master repurchase agreements with Credit Suisse Securities (USA) LLC, Barclays Capital Inc., J.P. Morgan Securities Inc., Countrywide Securities Corporation, Deutsche Bank Securities Inc., Morgan Stanley & Co. Incorporated, Goldman Sachs & Co., Bear, Stearns International Limited and UBS Securities LLC. As of March 31, 2006, we had $549.3 million outstanding under our agreement with Credit Suisse Securities (USA) LLC and $218.8 million outstanding under our agreement with UBS Securities LLC to finance our agency RMBS portfolio.

We have also entered into a master repurchase agreement with Bear, Stearns International Limited to finance our commercial real estate loan portfolio. As of March 31, 2006, we had $80.6 million outstanding under this agreement.

We have also entered into a master repurchase agreement with Deutsche Bank AG, Cayman Islands Branch, an affiliate of Deutsche Bank Securities, Inc. to finance our commercial real estate loan portfolio. As of March 31, 2006, we had $67.2 million outstanding under this agreement.

We have a warehouse facility with Citigroup Financial Products, Inc. pursuant to which it will provide up to $200.0 million of financing for the acquisition of syndicated bank loans to be sold to Apidos CDO III. At March 31, 2006, approximately $132.8 million had been funded through the facility at a weighted average interest rate of 4.60%.

In December 2005, we entered into a $15.0 million corporate credit facility with Commerce Bank, N.A. At March 31, 2006, no borrowings were outstanding under this facility.

In March 2006, we entered into a $100.0 million secured term credit facility with Bayerische Hypo - und Vereinsbank AG, New York Branch to finance the purchase of equipment leases and notes. At March 31, 2006, we had $55.8 million outstanding under the facility.

Our liquidity needs consist principally of funds to make investments, make distributions to our stockholders and pay our operating expenses, including our management fees. Our ability to meet our liquidity needs will be subject to our ability to generate cash from operations and, with respect to our investments, our ability to obtain additional debt financing and equity capital. Through March 31, 2006, we have not experienced difficulty utilizing any of our repurchase agreements. We may increase our capital resources through offerings of equity securities (possibly including common stock and one or more classes of preferred stock), CDOs or other forms of term financing. Such financing will depend on market conditions. If we are unable to renew, replace or expand our sources of financing on substantially similar terms, we may be unable to implement our investment strategies successfully and may be required to liquidate portfolio investments. If required, a sale of portfolio investments could be at prices lower than the carrying value of such assets, which would result in losses and reduced income.

In order to maintain our qualification as a REIT and to avoid corporate-level income tax on the income we distribute to our stockholders, we intend to make regular quarterly distributions of all or substantially all of our net taxable income to holders of our common stock. This requirement can impact our liquidity and capital resources.

During the quarter ended March 31, 2006, we declared a dividend of $5.9 million or $0.33 per common share, which was paid on April 10, 2006 to stockholders of record as of March 27, 2006.

*(back to index)*

**Contractual Obligations and Commitments**

The table below summarizes our contractual obligations as of March 31, 2006. The table below excludes contractual commitments related to our derivatives, which we discuss in our Annual Report on Form 10-K for fiscal 2005 in Item 7A – "Quantitative and Qualitative Disclosures about Market Risk," and the management agreement that we have with our Manager, which we discuss in our Annual Report on Form 10-K for fiscal 2005 in Item 1 – "Business" – and Item 13 – "Certain Relationships and Related Transactions" because those contracts do not have fixed and determinable payments.

**Contractual commitments**
**(dollars in thousands)**

| | Payments due by period | | | | |
|---|---|---|---|---|---|
| | Total | Less than 1 year | 1 - 3 years | 3 - 5 years | More than 5 years |
| Repurchase agreements[1] | $ 917,293 | $ 917,293 | $ – | $ – | $ – |
| Warehouse agreements | 132,793 | 132,793 | – | – | – |
| CDOs | 687,686 | – | – | – | 687,686 |
| Equipment leasing secured term facility | 55,767 | – | – | 55,767 | – |
| Base management fees[2] | 3,693 | 3,693 | – | – | – |
| Total | $ 1,797,232 | $ 1,053,779 | $ – | $ 55,767 | $ 687,686 |

(1) Includes accrued interest of $1.5 million.
(2) Calculated only for the next 12 months based on our current equity, as defined in our management agreement.

At March 31, 2006, we had eight interest rate swap contracts with a notional value of $804.7 million. These contracts are fixed-for-floating interest rate swap agreements under which we contracted to pay a fixed rate of interest for the term of the hedge and will receive a floating rate of interest. As of March 31, 2006, the average fixed pay rate of our interest rate hedges was 4.22% and our receive rate was one-month and three-month LIBOR, or 4.73%.

At March 31, 2006, we also had one interest rate cap with a notional value of $15.0 million. This cap reduces our exposure to the variability in future cash flows attributable to changes in LIBOR.

**Off-Balance Sheet Arrangements**

As of March 31, 2006, we did not maintain any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities or variable interest entities, established for the purpose of facilitating off-balance sheet arrangements or contractually narrow or limited purposes. Further, as of March 31, 2006, we had not guaranteed any obligations of unconsolidated entities or entered into any commitment or intent to provide additional funding to any such entities.

**Recent Developments**

On March 16, 2006, our board of directors declared a quarterly distribution of $0.33 per share of common stock, $5.9 million in the aggregate, which will be paid on April 10, 2006 to stockholders of record as of March 27, 2006.

On May 9, 2006, the Apidos CDO III warehouse facility terminated and approximately $222.6 million of syndicated loan assets were transferred into a collateralized debt obligation structure in which we purchased a $23.0 million equity interest representing 100% of the outstanding preference shares.

*(back to index)*

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As of March 31, 2006 and December 31, 2005, the primary component of our market risk was interest rate risk, as described below. While we do not seek to avoid risk completely, we do seek to assume risk that can be quantified from historical experience, to actively manage that risk, to earn sufficient compensation to justify assuming that risk and to maintain capital levels consistent with the risk we undertake or to which we are exposed.

The following sensitivity analysis tables show, at March 31, 2006 and December 31, 2005, the estimated impact on the fair value of our interest rate-sensitive investments and repurchase agreement liabilities of changes in interest rates, assuming rates instantaneously fall 100 basis points and rise 100 basis points (dollars in thousands):

| | March 31, 2006 | | |
|---|---|---|---|
| | **Interest rates fall 100 basis points** | **Unchanged** | **Interest rates rise 100 basis points** |
| Hybrid adjustable-rate agency RMBS and other ABS[(1)] | | | |
| Fair value | $ 897,414 | $ 872,485 | $ 849,248 |
| Change in fair value | $ 24,929 | $ – | $ (23,237) |
| Change as a percent of fair value | 2.86% | – | 2.66% |
| | | | |
| Repurchase and warehouse agreements [(2)] | | | |
| Fair value | $ 1,105,853 | $ 1,105,853 | $ 1,105,853 |
| Change in fair value | $ – | $ – | $ – |
| Change as a percent of fair value | – | – | – |
| | | | |
| Hedging instruments | | | |
| Fair value | $ (10,581) | $ 4,985 | $ 10,095 |
| Change in fair value | $ (15,566) | $ – | $ 5,110 |
| Change as a percent of fair value | n/m | – | n/m |

| | December 31, 2005 | | |
|---|---|---|---|
| | **Interest rates fall 100 basis points** | **Unchanged** | **Interest rates rise 100 basis points** |
| Hybrid adjustable-rate agency RMBS and other ABS[(1)] | | | |
| Fair value | $ 1,067,628 | $ 1,038,878 | $ 1,011,384 |
| Change in fair value | $ 28,750 | $ – | $ (27,494) |
| Change as a percent of fair value | 2.77% | – | 2.65% |
| | | | |
| Repurchase and warehouse agreements [(2)] | | | |
| Fair value | $ 1,131,238 | $ 1,131,238 | $ 1,131,238 |
| Change in fair value | $ – | $ – | $ – |
| Change as a percent of fair value | – | – | – |
| | | | |
| Hedging instruments | | | |
| Fair value | $ (4,651) | $ 3,006 | $ 4,748 |
| Change in fair value | $ (7,657) | $ – | $ 1,742 |

| | | | |
|---|---|---|---|
| Change as a percent of fair value | n/m | – | n/m |

(1) Includes the fair value of other available-for-sale investments that are sensitive to interest rate changes.

(2) The fair value of the repurchase agreements and warehouse agreements would not change materially due to the short-term nature of these instruments.

49

*(back to index)*

For purposes of the tables, we have excluded our investments with variable interest rates that are indexed to LIBOR. Because the variable rates on these instruments are short-term in nature, we are not subject to material exposure to movements in fair value as a result of changes in interest rates.

It is important to note that the impact of changing interest rates on fair value can change significantly when interest rates change beyond 100 basis points from current levels. Therefore, the volatility in the fair value of our assets could increase significantly when interest rates change beyond 100 basis points from current levels. In addition, other factors impact the fair value of our interest rate-sensitive investments and hedging instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, in the event of changes in actual interest rates, the change in the fair value of our assets would likely differ from that shown above and such difference might be material and adverse to our stockholders.

## ITEM 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Securities Exchange Act of 1934 reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Under the supervision of our Chief Executive Officer and Chief Financial Officer, we have carried out an evaluation of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective at the reasonable assurance level.

There were no changes in our internal controls over financial reporting during the quarter ended March 31, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



---

*(back to index)*

**PART II. OTHER INFORMATION**

**ITEM 6. EXHIBITS**

| Exhibit No. | Description |
|---|---|
| 3.1 (1) | Restated Certificate of Incorporation of Resource Capital Corp. |
| 3.2 (1) | Amended and Restated Bylaws of Resource Capital Corp. |
| 4.1 (1) | Form of Certificate for Common Stock for Resource Capital Corp. |
| 10.1 (1) | Registration Rights Agreement among Resource Capital Corp. and Credit Suisse Securities (USA) LLC for the benefit of certain holders of the common stock of Resource Capital Corp., dated as of March 8, 2005. |
| 10.2 (1) | Management Agreement between Resource Capital Corp., Resource Capital Manager, Inc. and Resource America, Inc. dated as of March 8, 2005. |
| 10.3 (1) | 2005 Stock Incentive Plan |
| 10.4 (1) | Form of Stock Award Agreement |
| 10.5 (1) | Form of Stock Option Agreement |
| 10.6 (1) | Form of Warrant to Purchase Common Stock |
| 21.1 (1) | List of Subsidiaries of Resource Capital Corp. |
| 31.1 | Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Executive Officer. |
| 31.2 | Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Financial Officer. |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code. |
| 32.2 | Certification of Chief Financial Officer pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code. |

---

(1) Filed previously as an exhibit to the Company's registration statement on Form S-11, Registration No. 333-126517.

***(back to index)***

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**RESOURCE CAPITAL CORP.**
**(Registrant)**

| | |
|---|---|
| Date: May 12, 2006 | By: /s/ Jonathan Z. Cohen<br>Jonathan Z. Cohen<br>Chief Executive Officer and President |
| Date: May 12, 2006 | By: /s/ Thomas C. Elliott<br>Thomas C. Elliott<br>Chief Financial Officer, Chief Accounting Officer and Treasurer |

*(back to index)*