CAPITALSOURCE INC
Form 10-Q
November 15, 2004

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2004

Commission File No. 1-31753

CapitalSource Inc.

(Exact name of registrant as specified in its charter)

Delaware	**35-2206895**
(State of Incorporation)	*(I.R.S. Employer Identification No.)*

4445 Willard Avenue, 12th Floor

Chevy Chase, MD 20815
(Address of Principal Executive Offices, Including Zip Code)

(800) 370-9431

(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 þ No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

As of November 1, 2004, the number of shares of the Registrant s Common Stock, par value $.01 per share, outstanding was 117,831,685.

CAPITALSOURCE INC.

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CAPITALSOURCE INC.

CONSOLIDATED BALANCE SHEETS

	September 30, 2004	December 31, 2003
	(Unaudited)	
	($ in thousands)	
ASSETS		
Cash and cash equivalents	$ 121,357	$ 69,865
Restricted cash	110,188	79,913
Loans:		
Loans	3,783,077	2,416,907
Less deferred loan fees and discounts	(80,785)	(59,793)
Less allowance for loan losses	(32,612)	(18,025)
Loans, net	3,669,680	2,339,089
Investments	43,638	39,788
Deferred financing fees, net	34,435	17,348
Property and equipment, net	9,985	8,590
Other assets	29,534	12,498
Total assets	$4,018,817	$2,567,091
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Repurchase agreements	$	$ 8,446
Credit facilities	1,266,825	737,998
Term debt	1,252,720	923,208
Convertible debt	557,780	
Accounts payable and other liabilities	37,583	29,466
Due diligence deposits	951	841
Total liabilities	3,115,859	1,699,959
Shareholders equity:		
Preferred stock (50,000,000 shares authorized; no shares outstanding)		
Common stock ($0.01 par value, 500,000,000 shares authorized; 119,118,235 and 118,780,773 shares issued; 117,818,235 and 118,780,773 shares outstanding, respectively)	1,178	1,188
Additional paid-in capital	759,828	777,766
Retained earnings	194,249	108,182
Deferred compensation	(21,751)	(21,065)
Accumulated other comprehensive (loss) income, net	(620)	1,061
Treasury stock, at cost	(29,926)	
Total shareholders equity	902,958	867,132
Total liabilities and shareholders equity	$4,018,817	$2,567,091

See accompanying notes.

CAPITALSOURCE INC.

CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
	(Unaudited) ($ in thousands, except per share data)			
Net interest and fee income:				
Interest	$ 86,344	$ 47,336	$ 218,325	$ 121,372
Fee income	26,010	15,105	61,848	35,238
Total interest and fee income	112,354	62,441	280,173	156,610
Interest expense	21,922	10,304	51,296	27,409
Net interest and fee income	90,432	52,137	228,877	129,201
Provision for loan losses	7,832	3,687	20,238	8,461
Net interest and fee income after provision for loan losses	82,600	48,450	208,639	120,740
Operating expenses:				
Compensation and benefits	19,627	11,553	51,613	30,618
Other administrative expenses	8,838	5,761	26,691	14,884
Total operating expenses	28,465	17,314	78,304	45,502
Other income (expense):				
Diligence deposits forfeited	1,249	230	4,345	2,224
(Loss) gain on investments	(435)	4,985	(455)	5,099
(Loss) gain on derivatives	(223)	431	(480)	(68)
Other income	3,423	1,077	7,886	2,231
Total other income	4,014	6,723	11,296	9,486
Net income before income taxes	58,149	37,859	141,631	84,724
Income taxes	23,841	6,564	55,564	6,564
Net income	$ 34,308	$ 31,295	$ 86,067	$ 78,160
Net income per share:				
Basic	$ 0.30	$ 0.29	$ 0.74	$ 0.77
Diluted	$ 0.29	$ 0.28	$ 0.73	$ 0.75
Average shares outstanding:				
Basic	115,913,505	108,969,401	116,208,773	101,751,387
Diluted	117,358,735	110,824,452	117,600,329	103,600,367

See accompanying notes.

CAPITALSOURCE INC.

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

	Common Stock	Additional Paid-In Capital	Retained Earnings	Deferred Compensation	Accumulated Other Comprehensive Income (Loss), net	Treasury Stock, at cost	Total Shareholders Equity
				(Unaudited) ($ in thousands)			
Total shareholders equity as of December 31, 2003	$1,188	$777,766	$108,182	$(21,065)	$ 1,061	$	$867,132
Net income			86,067				86,067
Other comprehensive income:							
Unrealized losses, net of tax					(1,681)		(1,681)
Total comprehensive income							84,386
Proceeds from issuance of common stock, net		239					239
Stock option expense		272					272
Exercise of options	1	796					797
Purchase of treasury stock	(13)					(29,926)	(29,939)
Purchase of call option, net		(25,577)					(25,577)
Restricted stock activity	2	4,194		(4,196)			
Amortization of deferred stock compensation				3,510			3,510
Tax benefit on purchase of call option		1,351					1,351
Tax benefit on exercise of options		787					787
Total shareholders equity as of September 30, 2004	$1,178	$759,828	$194,249	$(21,751)	$ (620)	$(29,926)	$902,958

See accompanying notes.

CAPITALSOURCE INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2003
	(Unaudited) ($ in thousands)	
Operating activities:		
Net income	$ 86,067	$ 78,160
Adjustments to reconcile net income to net cash provided by operating activities:		
Stock option expense	272	262
Amortization of deferred loan fees	(33,327)	(24,836)
Provision for loan losses	20,238	8,461
Amortization of deferred financing fees	9,603	5,449
Depreciation and amortization	1,743	931
Benefit for deferred income taxes	(8,516)	(1,979)
Amortization of deferred stock compensation	3,510	170
Loss (gain) on investments	455	(5,099)
Loss on derivatives	480	68
Decrease (increase) in other assets	216	(2,614)
Increase in accounts payable and other liabilities	7,187	15,128
Increase (decrease) in due diligence deposits	110	(811)
Cash provided by operating activities	88,038	73,290
Investing activities:		
Increase in restricted cash	(29,387)	(10,907)
Increase in loans, net	(1,228,768)	(864,312)
Acquisition of CIG, net	(93,446)	
Acquisition of investments, net	(6,444)	(10,282)
Acquisition of property and equipment	(3,138)	(2,844)
Cash used in investing activities	(1,361,183)	(888,345)
Financing activities:		
Payment of deferred financing fees	(26,690)	(10,518)
(Repayments of) borrowings under repurchase agreements, net	(7,949)	53,016
Borrowings on credit facilities, net	528,827	379,242
Borrowings of term debt	765,625	371,309
Repayments of term debt	(435,696)	(199,012)
Borrowings of convertible debt	555,000	
Members contributions, net		71,153
Distributions to members		(32,698)
Proceeds from issuance of common stock, net	239	242,616
Proceeds from exercise of options	797	63
Call option transactions, net	(25,577)	
Purchase of treasury stock	(29,939)	
Cash provided by financing activities	1,324,637	875,171
Increase in cash and cash equivalents	51,492	60,116
Cash and cash equivalents as of beginning of period	69,865	49,806

Cash and cash equivalents as of end of period	$ 121,357	$ 109,922

See accompanying notes.

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NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Organization

CapitalSource Inc. (CapitalSource), a Delaware corporation, is a commercial finance company that provides a broad array of financial products to small and medium-sized businesses. We provide the following products:

Senior Secured Asset-Based Loans loans that are underwritten based on our assessment of the client s eligible accounts receivable and/or inventory;

Senior Secured Cash Flow Loans loans that are underwritten based on our assessment of a client s ability to generate cash flows sufficient to repay the loan and maintain or increase its enterprise value during the term of the loan, thereby facilitating repayment of the principal at maturity;

Mortgage Loans loans that are secured by first mortgages on the property of the client;

Term B, Second Lien, and Mezzanine Loans loans, including subordinated mortgage loans, that come after a client s senior loans in right of payment or upon liquidation; and

Private Equity Co-Investments opportunistic equity investments, typically in conjunction with lending relationships and on the same terms as other equity investors.

As of September 30, 2004, we are the parent company of the following wholly owned significant subsidiaries:

Entity	Purpose
CapitalSource Finance LLC	Primary operating subsidiary that conducts lending business of CapitalSource.
CapitalSource Holdings Inc., formerly CapitalSource Holdings LLC	Holding company for CapitalSource Finance LLC.
CapitalSource Funding LLC	Single-purpose, bankruptcy-remote subsidiary established in accordance with a warehouse credit facility.
CS Funding II Depositor LLC	Single-purpose, bankruptcy-remote subsidiary established in accordance with a warehouse credit facility.
CapitalSource Commercial Loan Trust 2004-1	Single-purpose, bankruptcy-remote subsidiary established for issuance of term debt.

On August 6, 2003, CapitalSource became the successor to CapitalSource Holdings LLC through a reorganization. In the reorganization, a wholly owned subsidiary of CapitalSource merged with and into CapitalSource Holdings LLC, with CapitalSource Holdings LLC continuing as a wholly owned subsidiary of CapitalSource. As a result of the merger, the holders of units of membership interest in CapitalSource Holdings LLC received, on a one-for-one basis, shares of CapitalSource common stock in exchange for their units, and the shares of CapitalSource common stock owned by CapitalSource Holdings LLC were canceled.

In September 2004, CapitalSource Holdings LLC was incorporated under the laws of Delaware and changed its name to CapitalSource Holdings Inc. (CapitalSource Holdings).

Note 2. Summary of Significant Accounting Policies

Unaudited Interim Consolidated Financial Statements Basis of Presentation

Our interim consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and pursuant to the requirements for

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NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

reporting on Form 10-Q and Article 10 of Regulation S-X (Regulation S-X). Accordingly, certain disclosures accompanying annual consolidated financial statements prepared in accordance with GAAP are omitted. In the opinion of management, all adjustments and eliminations, consisting solely of normal recurring accruals, considered necessary for the fair presentation of financial statements for the interim periods, have been included. The current period s results of operations are not necessarily indicative of the results that ultimately may be achieved for the year. The interim unaudited consolidated financial statements and notes thereto should be read in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2003.

The accompanying financial statements reflect our consolidated accounts, including all of our subsidiaries and the related consolidated results of operations with all intercompany balances and transactions eliminated in consolidation.

Certain amounts in prior period s consolidated financial statements have been reclassified to conform to the current period presentation.

Our accounting policies are described in Note 1 of our audited December 31, 2003 financial statements included in our Annual Report on Form 10-K and Note 1 of our unaudited March 31, 2004 and June 30, 2004 financial statements included in our Quarterly Reports on Form 10-Q. The accounting policies that management has identified as critical or complex accounting policies are described on Page 38 of this Form 10-Q under the caption *Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies.*

Note 3. Recently Issued Accounting Guidance

In March and July 2004, we issued two series of contingent convertible debentures (Contingent Convertibles) that are convertible into 7,401,420 and 10,382,262 shares of common stock, respectively. Contingent Convertibles combine the features of contingently issuable shares with a convertible debt instrument. These instruments generally become convertible into common stock only if one or more specified events occur, such as the underlying common stock achieving a specified price target.

Under current interpretations of Statement of Financial Accounting Standards (SFAS) No. 128, *Earnings Per Share,* issuers of Contingent Convertibles exclude the potential common shares underlying the Contingent Convertibles from the calculation of diluted net income per share until the market price or other substantive contingency is met. When the contingency is met, generally the if-converted method is used to calculate the dilutive impact of the instrument. Under the if-converted method, the instrument is considered converted, with the resulting number of shares included in the denominator of the net income per share calculation and the interest expense, net of tax, added back to the numerator of the net income per share calculation. Under these interpretations, we did not include any of the shares issuable upon conversion of our Contingent Convertibles in our calculation of diluted net income or diluted net income per share for the periods ended March 31, 2004, June 30, 2004, or September 30, 2004.

In September 2004, the Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) reached a final conclusion on EITF Issue No. 04-8, *The Effect of Contingently Convertible Debt on Diluted Earnings Per Share* (EITF 04-8). The EITF concluded the common stock underlying contingent convertible debt instruments such as our Contingent Convertibles should be included in diluted net income per share computations using the if-converted method regardless of whether the market price trigger or other contingent feature has been met. The EITF concluded that this new treatment should be applied retroactively, with the result that issuers of securities like our Contingent Convertibles would be required to restate previously issued diluted earnings per share. In October 2004, the FASB approved EITF 04-8 and established an implementation date of December 15, 2004.

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Under the terms of the indentures governing our Contingent Convertibles, we have the ability to make irrevocable elections to pay the principal balance of the Contingent Convertibles in cash upon any conversion prior to or at maturity. By making these elections, under current interpretations of SFAS No. 128 and consistent with the provisions of EITF 90-19, *Convertible Bonds with Issuer Option to Settle for Cash upon Conversion,* the common stock underlying the principal amount of the Contingent Convertibles would not be required to be included in our calculation of diluted net income per share and would have no past or future impact on our diluted net income per share. The only impact on diluted net income per share from our Contingent Convertibles would be from the application of the treasury stock method to any conversion spread on those instruments. Prior to the effective date of EITF 04-8, we intend to make such irrevocable elections for each series of our Contingent Convertibles. As a result, we do not anticipate the adoption of EITF 04-8 will have any impact on our net income or our diluted net income per share.

Note 4. Credit Quality

As of September 30, 2004 and December 31, 2003, the net principal balance of impaired loans, as defined by SFAS No. 114, *Accounting by Creditors for Impairment of a Loan,* totaled $42.4 million and $15.3 million, respectively. As of September 30, 2004 and December 31, 2003, specific reserves for the impaired loans were $5.6 million and $2.7 million, respectively. Additionally, as of September 30, 2004 and December 31, 2003, loans with an aggregate net principal balance of $44.1 million and $8.8 million, respectively, were on non-accrual status.

For the nine months ended September 30, 2004, we had no new loans that were accounted for as troubled debt restructurings as defined by SFAS No. 15, *Accounting for Debtors and Creditors for Troubled Debt Restructuring.* For the year ended December 31, 2003, loans with a carrying value of $36.3 million as of December 31, 2003 were classified as troubled debt restructurings. The specific reserve for loans classified as troubled debt restructurings was $0.5 million as of December 31, 2003.

Activity in the allowance for loan losses for the nine months ended September 30, 2004 and 2003 was as follows:

	Nine Months Ended September 30,	
	2004	**2003**
	($ in thousands)	
Balance as of beginning of period	$ 18,025	$ 6,688
Provision for loan losses	20,238	8,461
Charge offs	(5,651)	
Balance as of end of period	$ 32,612	$ 15,149

Note 5. Acquisition

On July 1, 2004, we acquired all of the outstanding equity of CIG International, LLC and CIG Holdings, Inc. (collectively, CIG), a Washington, D.C.-based specialty lender that provides mezzanine debt financing to the for-sale residential real estate development industry, for approximately $96.6 million. As part of our effort to increase our overall market share, we acquired CIG to expand our real estate lending activities into mezzanine financing for residential development projects. The results of CIG s operations have been included in our consolidated financial statements since July 1, 2004.

We accounted for the acquisition as a business combination and applied the purchase method of accounting in accordance with SFAS No. 141, *Business Combinations.* Accordingly, the purchase price was allocated to the assets acquired and liabilities assumed in the transaction based on estimates of fair value at

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NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the date of acquisition. The fair value of assets acquired included loans of $89.1 million, real estate owned of $3.8 million, goodwill of $3.8 million, cash of $3.2 million, and $3.3 million of other net liabilities. Identifiable intangible assets for this acquisition were not significant. Real estate owned and goodwill are included in other assets in the consolidated balance sheet.

The allocation of the purchase price is subject to change and reallocation as adjustments are made to initial acquisition asset and liability fair value estimates and classifications. In addition, the purchase price could change based on the settlement of $0.9 million of contingencies for certain matters present at the acquisition date if any such settlement occurs.

Pro forma disclosure of the acquisition has not been presented as CIG does meet the definition of a significant subsidiary under Regulation S-X.

Note 6. Borrowings

As of September 30, 2004 and December 31, 2003, we had outstanding borrowings totaling $3.1 billion and $1.7 billion, respectively. For a detailed discussion of our borrowings, see Note 8, *Borrowings,* in our audited consolidated financial statements for the year ended December 31, 2003 included in our Form 10-K, as filed with the SEC on March 12, 2004.

The following changes to our borrowings occurred during the three months ended September 30, 2004:

Convertible Debt

In July 2004, we completed an offering of $330.0 million principal amount of 3.5% senior convertible debentures due 2034 (the Debentures) in a private offering pursuant to Rule 144A under the Securities Act of 1933, as amended. The Debentures will also pay contingent interest, subject to certain limitations as described in the offering memorandum, beginning on July 15, 2011. The Debentures are initially convertible, subject to certain conditions, into shares of our common stock at a conversion rate of 31.4614 shares of common stock per $1,000 principal amount of Debentures, representing an initial effective conversion price of approximately $31.78 per share. The Debentures will be redeemable for cash at our option at any time on or after July 15, 2011 at a redemption price of 100% of their principal amount plus accrued interest. Holders of the Debentures will have the right to require us to repurchase some or all of their Debentures for cash on July 15, 2011; July 15, 2014; July 15, 2019; July 15, 2024 and July 15, 2029 at a price of 100% of their principal amount plus accrued interest. Holders of the Debentures will also have the right to require us to repurchase some or all of their Debentures upon certain events constituting a fundamental change. The Debentures are unsecured and unsubordinated obligations, and are guaranteed by CapitalSource Holdings and CapitalSource Finance LLC (CapitalSource Finance), two of our wholly owned subsidiaries.

Holders of the Debentures may convert their Debentures prior to maturity only if: (1) the price of our common stock reaches certain thresholds during periods of time specified by the Debentures, (2) specified corporate transactions occur, (3) the Debentures have been called for redemption, or (4) the trading price of the Debentures falls below a certain threshold.

We received net proceeds from the offering of approximately $321.4 million, after deducting the initial purchasers discounts and commissions and estimated expenses in the aggregate of approximately $8.6 million. We used the net proceeds from this offering to repay outstanding indebtedness under our credit facilities and for other general corporate purposes.

In September 2004, we filed a shelf registration statement with respect to the resale of the Debentures and the common stock issuable upon the conversion of the Debentures with the Securities and Exchange Commission. Also, in September 2004, we filed a shelf registration statement with respect to the resale of the $225.0 million in aggregate principal amount of senior convertible debentures issued in March 2004 and the

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NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

common stock issuable upon the conversion of the debentures. On October 20, 2004, these registration statements were declared effective by the Securities and Exchange Commission.

Note 7. Guarantor Information

The following represents the unaudited supplemental consolidating condensed financial statements of CapitalSource Inc., which was the issuer of the convertible debt issued in March 2004, CapitalSource Holdings and CapitalSource Finance, which are guarantors of the convertible debentures, and our subsidiaries that are not guarantors of the convertible debentures as of September 30, 2004 and December 31, 2003 and for the three and nine months ended September 30, 2004 and 2003. CapitalSource Holdings and CapitalSource Finance have guaranteed the debentures, jointly and severally, on a senior basis. CapitalSource Finance is a wholly owned subsidiary of CapitalSource Holdings. Separate consolidated financial statements of each guarantor are not presented, as we have determined that they would not be material to investors.

CAPITALSOURCE INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

CONSOLIDATING BALANCE SHEET

September 30, 2004

	CapitalSource Inc.	CapitalSource Holdings Inc. Combined Non-Guarantor Subsidiaries	CapitalSource Holdings Inc. Combined Guarantor Subsidiaries	Eliminations	Consolidated CapitalSource Inc.
			(Unaudited) ($ in thousands)		
ASSETS					
Cash and cash equivalents	$	$ 89,425	$ 31,932	$	$ 121,357
Restricted cash		27,083	83,105		110,188
Loans:					
Loans		3,610,522	179,262	(6,707)	3,783,077
Less deferred loan fees and discounts		(41)	(80,744)		(80,785)
Allowance for loan losses			(32,612)		(32,612)
Loans, net		3,610,481	65,906	(6,707)	3,669,680
Investment in subsidiaries	1,437,100		1,193,124	(2,630,224)	
Intercompany due from/ (due to)		9,982	(9,982)		
Intercompany note receivable			35,617	(35,617)	
Investments			43,638		43,638
Deferred financing fees, net	13,705	20,600	130		34,435
Property and equipment, net		4	9,981		9,985
Other assets	11,960	1,923	15,651		29,534
Total assets	$ 1,462,765	$ 3,759,498	$ 1,469,102	$ (2,672,548)	$ 4,018,817
LIABILITIES AND SHAREHOLDERS EQUITY					
Liabilities:					
Credit facilities	$	$ 1,266,825	$	$	$ 1,266,825
Term debt		1,254,835	(2,115)		1,252,720
Convertible debt	557,780				557,780
Accounts payable and other liabilities	2,027	8,908	33,355	(6,707)	37,583
Intercompany note payable		35,617		(35,617)	
Due diligence deposits		189	762		951
Total liabilities	559,807	2,566,374	32,002	(42,324)	3,115,859
Shareholders equity:					
Preferred stock					
Common stock	1,178				1,178
Additional paid-in capital	759,828	758,568	1,110,394	(1,868,962)	759,828

Retained earnings	194,249	434,752	327,517	(762,269)	194,249
Deferred compensation	(21,751)				(21,751)
Accumulated other comprehensive loss, net	(620)	(196)	(811)	1,007	(620)
Treasury stock, at cost	(29,926)				(29,926)
Total shareholders equity	902,958	1,193,124	1,437,100	(2,630,224)	902,958
Total liabilities and shareholders equity	$1,462,765	$3,759,498	$1,469,102	$(2,672,548)	$4,018,817

CAPITALSOURCE INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

CONSOLIDATING BALANCE SHEET

December 31, 2003

	CapitalSource Inc.	CapitalSource Holdings Inc. Combined Non-Guarantor Subsidiaries	CapitalSource Holdings Inc. Combined Guarantor Subsidiaries	Eliminations	Consolidated CapitalSource Inc.
			(Unaudited) ($ in thousands)		
ASSETS					
Cash and cash equivalents	$	$ 37,848	$ 32,017	$	$ 69,865
Restricted cash		16,860	63,053		79,913
Loans:					
Loans		2,400,601	27,419	(11,113)	2,416,907
Less deferred loan fees and discounts		1,221	(61,014)		(59,793)
Allowance for loan losses			(18,025)		(18,025)
Loans, net		2,401,822	(51,620)	(11,113)	2,339,089
Investment in subsidiaries	864,073		1,030,148	(1,894,221)	
Intercompany (due to)/ due from		9,727	(9,727)		
Intercompany note receivable		246,985	33,046	(280,031)	
Investments			39,788		39,788
Deferred financing fees, net		17,216	132		17,348
Property and equipment, net		5	8,585		8,590
Other assets	3,623	972	7,903		12,498
Total assets	$ 867,696	$ 2,731,435	$ 1,153,325	$ (2,185,365)	$ 2,567,091
LIABILITIES AND SHAREHOLDERS EQUITY					
Liabilities:					
Repurchase agreements	$	$	$ 8,446	$	$ 8,446
Credit facilities		737,998			737,998
Term debt		923,503	(295)		923,208
Accounts payable and other liabilities	564	6,554	33,461	(11,113)	29,466
Intercompany note payable		33,046	246,985	(280,031)	
Due diligence deposits		186	655		841
Total liabilities	564	1,701,287	289,252	(291,144)	1,699,959
Shareholders equity:					
Preferred stock					
Common stock	1,188				1,188
Additional paid-in capital	777,766	799,263	701,500	(1,500,763)	777,766

Retained earnings	108,182	230,875	161,522	(392,397)	108,182
Deferred compensation	(21,065)				(21,065)
Accumulated other comprehensive income, net	1,061	10	1,051	(1,061)	1,061
Total shareholders equity	867,132	1,030,148	864,073	(1,894,221)	867,132
Total liabilities and shareholders equity	$867,696	$2,731,435	$1,153,325	$(2,185,365)	$2,567,091

CAPITALSOURCE INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

CONSOLIDATING STATEMENT OF INCOME

Three Months Ended September 30, 2004

		CapitalSource Holdings Inc.			
	CapitalSource Inc.	Combined Non-Guarantor Subsidiaries	Combined Guarantor Subsidiaries	Eliminations	Consolidated CapitalSource Inc.
			(Unaudited) ($ in thousands)		
Net interest and fee income:					
Interest	$	$83,327	$ 3,678	$ (661)	$ 86,344
Fee income		11,908	14,102		26,010
Total interest and fee income		95,235	17,780	(661)	112,354
Interest expense	3,899	18,476	208	(661)	21,922
Net interest and fee income	(3,899)	76,759	17,572		90,432
Provision for loan losses			7,832		7,832
Net interest and fee income after provision for loan losses	(3,899)	76,759	9,740		82,600
Operating expenses:					
Compensation and benefits		344	19,283		19,627
Other administrative expenses	3	112	8,723		8,838
Total operating expenses	3	456	28,006		28,465
Other income (expense):					
Diligence deposits forfeited			1,249		1,249
Loss on investments			(435)		(435)
(Loss) gain on derivatives		(1,799)	1,576		(223)
Other income		2,607	816		3,423
Earnings in subsidiaries	62,051		78,645	(140,696)	
Intercompany		1,534	(1,534)		
Total other income	62,051	2,342	80,317	(140,696)	4,014
Net income before income taxes	58,149	78,645	62,051	(140,696)	58,149
Income taxes	23,841				23,841
Net income	$34,308	$78,645	$62,051	$(140,696)	$ 34,308

CAPITALSOURCE INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

CONSOLIDATING STATEMENT OF INCOME

Nine Months Ended September 30, 2004

		CapitalSource Holdings Inc.			
	CapitalSource Inc.	Combined Non-Guarantor Subsidiaries	Combined Guarantor Subsidiaries	Eliminations	Consolidated CapitalSource Inc.
			(Unaudited) ($ in thousands)		
Net interest and fee income:					
Interest	$	$222,112	$ 7,035	$ (10,822)	$218,325
Fee income		24,605	37,243		61,848
Total interest and fee income		246,717	44,278	(10,822)	280,173
Interest expense	5,039	47,633	9,446	(10,822)	51,296
Net interest and fee income	(5,039)	199,084	34,832		228,877
Provision for loan losses			20,238		20,238
Net interest and fee income after provision for loan losses	(5,039)	199,084	14,594		208,639
Operating expenses:					
Compensation and benefits		946	50,667		51,613
Other administrative expenses	43	496	26,152		26,691
Total operating expenses	43	1,442	76,819		78,304
Other income (expense):					
Diligence deposits forfeited			4,345		4,345
Loss on investments			(455)		(455)
(Loss) gain on derivatives		(2,965)	2,485		(480)
Other income		6,668	1,218		7,886
Earnings in subsidiaries	146,713		205,482	(352,195)	
Intercompany		4,137	(4,137)		
Total other income	146,713	7,840	208,938	(352,195)	11,296
Net income before income taxes	141,631	205,482	146,713	(352,195)	141,631
Income taxes	55,564				55,564
Net income	$ 86,067	$205,482	$146,713	$(352,195)	$ 86,067

CAPITALSOURCE INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

CONSOLIDATING STATEMENT OF INCOME

Three Months Ended September 30, 2003

		CapitalSource Holdings Inc.			
	CapitalSource Inc.	Combined Non-Guarantor Subsidiaries	Combined Guarantor Subsidiaries	Eliminations	Consolidated CapitalSource Inc.
			(Unaudited) ($ in thousands)		
Net interest and fee income:					
Interest	$	$48,460	$ 1,809	$ (2,933)	$47,336
Fee income		3,753	11,352		15,105
Total interest and fee income		52,213	13,161	(2,933)	62,441
Interest expense		10,882	2,355	(2,933)	10,304
Net interest and fee income		41,331	10,806		52,137
Provision for loan losses			3,687		3,687
Net interest and fee income after provision for loan losses		41,331	7,119		48,450
Operating expenses:					
Compensation and benefits		154	11,399		11,553
Other administrative expenses		76	5,685		5,761
Total operating expenses		230	17,084		17,314
Other income (expense):					
Diligence deposits forfeited			230		230
Gain on investments			4,985		4,985
Gain (loss) on derivatives		565	(134)		431
Other income		526	551		1,077
Earnings in subsidiaries	27,744		40,375	(68,119)	
Intercompany		(1,817)	1,817		
Total other income (expense)	27,744	(726)	47,824	(68,119)	6,723
Net income before income taxes	27,744	40,375	37,859	(68,119)	37,859
Income taxes	6,564				6,564
Net income	$21,180	$40,375	$37,859	$(68,119)	$31,295

CAPITALSOURCE INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

CONSOLIDATING STATEMENT OF INCOME

Nine Months Ended September 30, 2003

		CapitalSource Holdings Inc.			
	CapitalSource Inc.	Combined Non-Guarantor Subsidiaries	Combined Guarantor Subsidiaries	Eliminations	Consolidated CapitalSource Inc.
			(Unaudited) ($ in thousands)		
Net interest and fee income:					
Interest	$	$121,183	$ 4,367	$ (4,178)	$121,372
Fee income		8,444	26,794		35,238
Total interest and fee income		129,627	31,161	(4,178)	156,610
Interest expense		28,922	2,665	(4,178)	27,409
Net interest and fee income		100,705	28,496		129,201
Provision for loan losses			8,461		8,461
Net interest and fee income after provision for loan losses		100,705	20,035		120,740
Operating expenses:					
Compensation and benefits		437	30,181		30,618
Other administrative expenses		252	14,632		14,884
Total operating expenses		689	44,813		45,502
Other income (expense):					
Diligence deposits forfeited			2,224		2,224
Gain on investments			5,099		5,099
(Loss) gain on derivatives		(467)	399		(68)
Other income		1,669	562		2,231
Earnings in subsidiaries	27,744		99,401	(127,145)	
Intercompany		(1,817)	1,817		
Total other income (expense)	27,744	(615)	109,502	(127,145)	9,486
Net income before income taxes	27,744	99,401	84,724	(127,145)	84,724
Income taxes	6,564				6,564
Net income	$21,180	$ 99,401	$ 84,724	$(127,145)	$ 78,160

CAPITALSOURCE INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

CONSOLIDATING STATEMENT OF CASH FLOWS

Nine Months Ended September 30, 2004

	CapitalSource Inc.	CapitalSource Holdings Inc. Combined Non-Guarantor Subsidiaries	CapitalSource Holdings Inc. Combined Guarantor Subsidiaries	Eliminations	Consolidated CapitalSource Inc.
			(Unaudited) ($ in thousands)		
Operating activities:					
Net income	$ 86,067	$ 205,482	$ 146,713	$ (352,195)	$ 86,067
Adjustments to reconcile net income to net cash (used in) provided by operating activities:					
Stock option expense	272				272
Amortization of deferred loan fees			(33,327)		(33,327)
Provision for loan losses			20,238		20,238
Amortization of deferred financing fees	899	8,641	63		9,603
Depreciation and amortization			1,743		1,743
Benefit for deferred income taxes	(8,516)				(8,516)
Amortization of deferred stock compensation	3,510				3,510
(Gain) loss on investments		(172)	627		455
Loss (gain) on derivatives		2,968	(2,488)		480
Decrease (increase) in note receivable		246,985	(2,571)	(244,414)	
Decrease (increase) in other assets	179	(951)	988		216
Increase (decrease) in accounts payable and other liabilities	6,381	3,179	(7,239)	4,866	7,187
Increase in due diligence deposits		3	107		110
Net transfers with subsidiaries	(574,708)	(42,508)	265,021	352,195	
Cash (used in) provided by operating activities	(485,916)	423,627	389,875	(239,548)	88,038
Investing activities:					
Increase in restricted cash		(10,223)	(19,164)		(29,387)
Increase in loans, net		(1,211,626)	(12,276)	(4,866)	(1,228,768)
Acquisition of CIG			(93,446)		(93,446)
Acquisition of investments			(6,444)		(6,444)
			(3,138)		(3,138)

Acquisition of property and equipment					
Cash used in investing activities		(1,221,849)	(134,468)	(4,866)	(1,361,183)
Financing activities:					
Payment of deferred financing fees	(14,604)	(12,025)	(61)		(26,690)
Increase (decrease) in intercompany note payable		2,571	(246,985)	244,414	
Borrowings under (repayments of) repurchase agreements, net		497	(8,446)		(7,949)
Borrowings on credit facilities, net		528,827			528,827
Borrowings of term debt		765,625			765,625
Repayments of term debt		(435,696)			(435,696)
Borrowings of convertible debt	555,000				555,000
Proceeds from issuance of common stock, net	239				239
Proceeds from exercise of options	797				797
Call option transactions, net	(25,577)				(25,577)
Purchase of treasury stock	(29,939)				(29,939)
Cash provided by (used in) financing activities	485,916	849,799	(255,492)	244,414	1,324,637
Increase (decrease) in cash and cash equivalents		51,577	(85)		51,492
Cash and cash equivalents as of beginning of period		37,848	32,017		69,865
Cash and cash equivalents as of end of period	$	$ 89,425	$ 31,932	$	$ 121,357

CAPITALSOURCE INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

CONSOLIDATING STATEMENT OF CASH FLOWS

Nine Months Ended September 30, 2003

		CapitalSource Holdings Inc.			
	CapitalSource Inc.	Combined Non-Guarantor Subsidiaries	Combined Guarantor Subsidiaries	Eliminations	Consolidated CapitalSource Inc.
			(Unaudited) ($ in thousands)		
Operating activities:					
Net income	$ 21,180	$ 99,401	$ 84,724	$(127,145)	$ 78,160
Adjustments to reconcile net income to net cash (used in) provided by operating activities:					
Stock option expense	60		202		262
Amortization of deferred loan fees			(24,836)		(24,836)
Provision for loan losses			8,461		8,461
Amortization of deferred financing fees		5,406	43		5,449
Depreciation and amortization			931		931
Benefit for deferred income taxes	(1,979)				(1,979)
Amortization of deferred stock compensation	170				170
Gain on investments			(5,099)		(5,099)
Loss (gain) on derivatives		272	(204)		68
(Increase) decrease in note receivable		(246,985)	6,376	240,609	
Decrease (increase) in other assets	12	(142)	(2,484)		(2,614)
Increase in accounts payable and other liabilities	8,544	917	9,603	(3,936)	15,128
Increase in due diligence deposits		112	(923)		(811)
Net transfers with subsidiaries	(270,640)	544,925	(401,430)	127,145	
Cash (used in) provided by operating activities	(242,653)	403,906	(324,636)	236,673	73,290
Investing activities:					
Increase in restricted cash		(5,477)	(5,430)		(10,907)
Increase in loans, net		(915,891)	47,643	3,936	(864,312)
Acquisition of investments			(10,282)		(10,282)
Acquisition of property and equipment			(2,844)		(2,844)

Cash used in (provided by) investing activities		(921,368)	29,087	3,936	(888,345)
Financing activities:					
Payment of deferred financing fees		(10,101)	(417)		(10,518)
(Decrease) increase in intercompany note payable		(6,376)	246,985	(240,609)	
Borrowings under (repayments of) repurchase agreements, net		44,376	8,640		53,016
Borrowings on credit facilities, net		379,242			379,242
Borrowings of term debt		371,309			371,309
Repayments of term debt		(199,012)			(199,012)
Members contributions, net			71,153		71,153
Distributions to members			(32,698)		(32,698)
Proceeds from issuance of common stock, net	242,616				242,616
Proceeds from exercise of options	37		26		63
Cash provided by financing activities	242,653	579,438	293,689	(240,609)	875,171
Increase (decrease) in cash and cash equivalents		61,976	(1,860)		60,116
Cash and cash equivalents as of beginning of period		40,191	9,615		49,806
Cash and cash equivalents as of end of period	$	$ 102,167	$ 7,755	$	$ 109,922

CAPITALSOURCE INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 8. Shareholders Equity

Common Stock Shares Outstanding

Common stock share activity for the nine months ended September 30, 2004 was as follows:

Outstanding as of December 31, 2003	118,780,773
Exercise of options	125,952
Issuance of shares under the Employee Stock Purchase Plan	32,517
Restricted stock and other stock grants, net	178,993
Repurchase of treasury stock	(1,300,000)
Outstanding as of September 30, 2004	117,818,235

Employee Stock Purchase Plan

Effective with our initial public offering on August 6, 2003, our Board of Directors and stockholders adopted the CapitalSource Inc. Employee Stock Purchase Plan (ESPP). A total of 2.0 million shares of common stock were initially reserved for issuance under the ESPP. Such shares of common stock may be authorized but unissued shares of common stock, treasury shares or shares of common stock purchased on the open market by us. The ESPP will expire upon the earliest of such time as the Board of Directors, in its discretion, chooses to terminate the ESPP, when all of the shares of common stock have been issued under the plan or upon the expiration of ten years from the effective date of the ESPP. We issued 32,517 shares under the ESPP during the nine months ended September 30, 2004. As of September 30, 2004, there are currently 1,908,790 shares remaining available for issuance under the ESPP.

Equity Incentive Plan

Effective with our initial public offering on August 6, 2003, our Board of Directors and stockholders adopted the CapitalSource Inc. Second Amended and Restated Equity Incentive Plan (successor to the Equity Incentive Plan, the Plan). A total of 14.0 million shares of common stock were initially reserved for issuance under the Plan. The Plan will expire on the earliest of (1) the date as of which the Board of Directors, in it sole discretion, determines that the Plan shall terminate, (2) following certain corporate transactions such as a merger or sale of our assets if the Plan is not assumed by the surviving entity, (3) at such time as all shares of common stock that may be available for purchase under the Plan have been issued or (4) ten years after the effective date of the Plan. The Plan is intended to give eligible employees, members of the Board of Directors, and our consultants and advisors awards that are linked to the performance of our common stock. As of September 30, 2004, there are currently 7,811,165 shares remaining available for issuance under the Plan.

Restricted Stock

Pursuant to the Plan, we have granted shares of restricted common stock to certain employees and non-employee directors of the Board of Directors, which vest over time, generally between one and five years. Of the 14.0 million shares initially authorized for awards under the Plan, up to 5.0 million shares were initially authorized to be granted in the form of restricted stock. For the nine months ended September 30, 2004, we issued 221,463 shares of restricted stock at a weighted-average fair value of $22.05. For the nine months ended September 30, 2004, 42,970 shares of restricted stock were forfeited. As of September 30, 2004, there are currently 3,712,757 shares of the initially authorized 5.0 million shares available for issuance as restricted stock under the Plan.

CAPITALSOURCE INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. Income Taxes

The effective tax rate differed from the statutory federal corporate income tax rate for the three and nine months ended September 30, 2004 and 2003 as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Federal statutory rate	35.0%	35.0%	35.0%	35.0%
State income taxes, net of federal tax benefit	5.7	2.1	4.1	0.9
Benefit from deferred taxes(1)		(10.5)		(4.7)
Other(2)	0.3	(9.3)	0.1	(23.5)
Effective tax rate(3)	41.0%	17.3%	39.2%	7.7%

(1) Immediately after reorganizing as a C corporation on August 6, 2003, we recorded a $4.0 million net deferred tax asset and corresponding deferred tax benefit which lowered the effective tax rate.

(2) After reorganizing as a C corporation on August 6, 2003, we provided for income taxes on the income earned from August 7, 2003 through December 31, 2003 based on a 38% effective tax rate. Prior to our reorganization as a C corporation on August 6, 2003, we operated as a limited liability company and all income taxes were paid by the members.

(3) Our effective tax rate was 41% for the third quarter 2004, compared to 38% for the previous quarters in 2004. This increase in the effective tax rate is the result of both a reconciliation of our previous provision for income taxes with actual tax expense for 2003 plus a change in the estimated tax rate for 2004 which was accounted for in the third quarter 2004 resulting in an increase in income taxes of $1.1 million. We have provided for income taxes on the total income earned in 2004 based on a 39.2% effective tax rate.

Note 10. Comprehensive Income

Comprehensive income for the three and nine months ended September 30, 2004 and 2003 was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	($ in thousands)			
Net income	$34,308	$31,295	$86,067	$78,160
Unrealized (loss) gain on available for sale security, net of tax	(297)	83	(1,476)	83
Unrealized loss on cash flow hedges, net of tax	(85)		(205)	
Comprehensive income	$33,926	$31,378	$84,386	$78,243

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CAPITALSOURCE INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 11. Net Income per Share

The computation of basic and diluted net income per share for the three and nine months ended September 30, 2004 and 2003 was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	($ in thousands, except per share data)			
Basic net income per share:				
Net income	$ 34,308	$ 31,295	$ 86,067	$ 78,160
Average shares basic	115,913,505	108,969,401	116,208,773	101,751,387
Basic net income per share	$ 0.30	$ 0.29	$ 0.74	$ 0.77
Diluted net income per share:				
Net income	$ 34,308	$ 31,295	$ 86,067	$ 78,160
Average shares basic	115,913,505	108,969,401	116,208,773	101,751,387
Effect of dilutive securities:				
Option shares and unvested restricted stock	1,445,230	1,855,051	1,391,556	1,848,980
Convertible debt				
Call option				
Average shares diluted	117,358,735	110,824,452	117,600,329	103,600,367
Diluted net income per share	$ 0.29	$ 0.28	$ 0.73	$ 0.75

Note 12. Stock-Based Compensation

We account for our stock-based compensation plan under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related interpretations. In accordance with APB 25, compensation cost is recognized for our options and restricted stock granted to employees where the exercise price is less than the market price of the underlying common stock on the date of grant. Such expense is recognized on a ratable basis over the related vesting period of the award. The effect on net income and net income per share as if we had applied the fair

CAPITALSOURCE INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation,* to stock-based compensation for the three and nine months ended September 30, 2004 and 2003 was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
	($ in thousands, except per share data)			
Net income as reported	$34,308	$31,295	$86,067	$78,160
Add back: Stock-based compensation expense from options included in reported net income, net of tax in 2004	109	81	140	317
Deduct: Stock-based compensation expense determined under fair value-based method for all option awards, net of tax in 2004	(421)	(367)	(1,234)	(1,154)
Pro forma net income	$33,996	$31,009	$84,973	$77,323
Net income per share:				
Basic as reported	$ 0.30	$ 0.29	$ 0.74	$ 0.77
Basic pro forma	$ 0.29	$ 0.28	$ 0.73	$ 0.76
Diluted as reported	$ 0.29	$ 0.28	$ 0.73	$ 0.75
Diluted pro forma	$ 0.29	$ 0.28	$ 0.72	$ 0.75

The fair value of each option grant was estimated on the date of the grant using the Black-Scholes option-pricing model with weighted-average assumptions for the three and nine months ended September 30, 2004 and 2003 as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Dividend yield				
Expected volatility	25%	30%	31%	30%
Risk-free interest rate	3.72%	3.43%	3.67%	3.43%
Expected life	6 years	6 years	6 years	6 years

The pro forma net effect of the total stock-based compensation expense determined under fair value-based method for all awards may not be representative of future disclosures because the estimated fair value of options is amortized to expense over the vesting period, and additional options may be granted in future years.

Note 13. Commitments and Contingencies

As of September 30, 2004, we had unfunded commitments to extend credit to our clients of $1.7 billion. As of September 30, 2004, we had arranged for $88.8 million of standby letters of credit in conjunction with certain loans to our borrowers. If a borrower defaults on its commitment(s) subject to any letter of credit issued under these arrangements, we would be responsible to meet the borrower s financial obligation and would seek repayment of that financial obligation from the borrower through a collateralized draw on an existing loan to the borrower. In accordance with FASB Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others,* we included the fair value of these obligations, totaling $2.0 million, in the consolidated balance sheet as of September 30, 2004.

CAPITALSOURCE INC.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of September 30, 2004, we are committed to contribute $15.8 million of additional capital to ten private equity funds.

From time to time we are party to legal proceedings. We do not believe that any currently pending or threatened proceeding, if determined adversely to us, would have a material adverse effect on our business, financial condition or results of operations, including our cash flows.

Note 14. Subsequent Events

In October 2004, we amended our Citigroup facility to increase Citigroup s aggregate commitment to $660 million from $460 million and decrease the LIBOR Margin on a $600 million portion of the facility to 0.90% from 1.00%. The maturity date was also extended to October 6, 2005.

In October 2004, we completed an offering of floating-rate asset-backed notes, which are backed by a $1.1 billion pool of senior and subordinated commercial loans originated by us. The offered notes totaled $1.0 billion, or 90.2% of the collateral pool. We plan to use the proceeds to repay outstanding indebtedness under our credit facilities and for general corporate purposes.

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

FORWARD-LOOKING STATEMENTS AND PROJECTIONS

This Form 10-Q, including the footnotes to our unaudited consolidated financial statements included herein, contains forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements relate to future events or our future financial performance. We generally identify forward-looking statements by terminology such as may, will, should, expects, plans, anticipates, could, intends, target, projects, contemplates, believes, estimates, pre
the negative of these terms or other similar words. These statements are only predictions. The outcome of the events described in these forward-looking statements is subject to known and unknown risks, uncertainties and other factors that may cause our clients or our industry s actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievement expressed or implied by these forward-looking statements. More detailed information about these factors is contained herein in *Management s Discussion and Analysis of Financial Condition and Results of Operations* and in our Form 10-K as filed with the Securities and Exchange Commission on March 12, 2004.

The forward-looking statements made in this Form 10-Q relate only to events as of the date on which the statements are made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events.

The information contained in this section should be read in conjunction with our unaudited consolidated financial statements and related notes included in this report.

OVERVIEW

We are a specialized commercial finance company providing loans to small and medium-sized businesses. Our goal is to be the lender of choice for small and medium-sized businesses with annual revenues ranging from $5 million to $250 million that require customized and sophisticated debt financing. We conduct our business in one reportable segment through three focused lending groups:

Corporate Finance, which generally provides senior and mezzanine loans principally to businesses backed by private equity sponsors;

Healthcare Finance, which generally provides asset-based revolving lines of credit, first mortgage loans, equipment financing and other senior and mezzanine loans to a broad range of healthcare companies; and

Structured Finance, which generally provides asset-based lending to finance companies and commercial real estate owners.

We offer a range of senior secured asset-based loans, first mortgage loans, senior secured cash flow loans and mezzanine loans to our clients. Our loans generally mature in two to five years and generally range in size from $1 million to $50 million, with an average loan size as of September 30, 2004 of $6.3 million. Substantially all of our loans require monthly interest payments at floating rates. In many cases, our loans provide for interest rate floors that help us maintain our yields when interest rates are low or declining. Consequently, as interest rates rise, our interest income on these loans will not increase until the contractual interest rates exceed the level of the floor. As of September 30, 2004, $2.9 billion, or 77%, of the aggregate outstanding principal amount of our loan portfolio had interest rate floors. Of this amount, $1.5 billion of loans had contractual rates of interest exceeding the interest rate floor, $113 million of loans had contractual rates of interest at the interest rate floor, and $1.3 billion of loans had contractual rates of interest below the interest rate floor.

Our revenue consists of interest and fees from our loans and, to a lesser extent, other income which includes unrealized appreciation (depreciation) on certain equity interests, gains (losses) on the sale of warrants and other equity interests, gains (losses) on derivatives, third-party loan servicing income, income from fee generating business and deposits forfeited by our prospective borrowers. Our expenses consist principally of interest expense and operating expenses which include compensation and employee benefits and other administrative expenses.

The primary driver of our results of operations and financial condition has been our significant growth since our inception on September 7, 2000. Our interest earning assets, which consist primarily of loans, grew to $4.0 billion as of September 30, 2004, an increase of 54% from $2.6 billion as of December 31, 2003, and generated a gross yield of 11.59% for the nine months ended September 30, 2004.

We have been able to manage our significant growth since inception without material adverse effects on the credit quality of our portfolio. We have provided an allowance for loan losses consistent with our expectation of losses inherent in our portfolio. As of September 30, 2004, loans with an aggregate net principal balance of $25.2 million were 60 or more days delinquent. As of September 30, 2004, loans with an aggregate net principal balance of $44.1 million were on non-accrual status.

Our business depends on our access to external sources of financing and the cost of such funds. Since inception, we have funded our business through a combination of credit facilities, term debt, convertible debt, repurchase agreements, $511.0 million of equity capital raised from private investors, $241.6 million of equity from our initial public offering and retained earnings. The weighted average interest cost of our borrowings for the nine months ended September 30, 2004 was 2.91%. All of our term debt securitizations have been accounted for as on balance sheet financings with no gain or loss recorded on the transactions. As of September 30, 2004, our debt to equity ratio was 3.41x. Our ability to continue to grow depends to a large extent on our ability to continue to borrow from our lenders and our access to the debt capital markets. To the extent these markets were to suffer from prolonged disruptions, our ability to finance continued growth could be hampered. We believe that our capital structure and access to additional funding sources provide us with the flexibility to continue to grow our assets as we pursue attractive lending opportunities.

We accelerated our hiring and investments in other operational assets during our first years in operation and have continued to make these investments. We believe our expenses generally will continue to decrease as a percentage of our average total assets as we continue to monitor our operating expenses and spread these expenses over a growing portfolio of loans. For the nine months ended September 30, 2004, the ratio of our operating expenses to average total assets was 3.22%, down from 3.49% for the nine months ended September 30, 2003.

Portfolio Composition

The schedule below shows the composition of our loan portfolio by type and by lending group as of September 30, 2004 and December 31, 2003:

	September 30, 2004		December 31, 2003	
	($ in thousands)			
Composition of portfolio by loan type:				
Senior secured asset-based loans	$1,014,328	27%	$ 802,115	33%
Senior secured cash flow loans	1,497,285	40	832,871	35
First mortgage loans	1,027,466	27	677,404	28
Mezzanine loans	243,998	6	104,517	4
Total	$3,783,077	100%	$2,416,907	100%

	September 30, 2004		December 31, 2003	
	($ in thousands)			
Composition of portfolio by lending group:				
Corporate Finance	$1,700,175	45%	$ 972,105	40%
Healthcare Finance	888,154	23	656,671	27
Structured Finance	1,194,748	32	788,131	33
Total	$3,783,077	100%	$2,416,907	100%

The schedule below shows the number of loans, average loan size, number of clients and average loan size per client by lending group as of September 30, 2004:

	Number of Loans	Average Loan Size	Number of Clients	Average Loan Size Per Client
	($ in thousands)			
Composition of portfolio by lending group:				
Corporate Finance	207	$8,213	97	$17,528
Healthcare Finance	193	4,602	144	6,168
Structured Finance	200	5,974	187	6,389
Overall portfolio	600	6,305	428	8,839

The schedule below shows the scheduled maturities of our loans as of September 30, 2004:

	Due in One Year Or Less	Due in One to Five Years	Due After Five Years	Total
	($ in thousands)			
Scheduled maturities by loan type:				
Senior secured asset-based loans	$189,897	$ 824,292	$ 139	$1,014,328
Senior secured cash flow loans	169,488	1,279,121	48,676	1,497,285
First mortgage loans	183,558	804,596	39,312	1,027,466
Mezzanine loans	63,183	159,889	20,926	243,998
Total	$606,126	$3,067,898	$109,053	$3,783,077

The schedule below shows the dollar amount of all fixed-rate and adjustable-rate loans as of September 30, 2004:

	Fixed Rates	Adjustable Rates	Total
	($ in thousands)		
Composition of portfolio by loan type:			
Senior secured asset-based loans	$ 12,287	$1,002,041	$1,014,328
Senior secured cash flow loans	42,953	1,454,332	1,497,285

First mortgage loans	12,940	1,014,526	1,027,466
Mezzanine loans	102,447	141,551	243,998
Total	$170,627	$3,612,450	$3,783,077

We also invest in equity interests, often in connection with a loan to a client. The equity interests include common stock, preferred stock, limited liability company interests, limited partnership interests and warrants to purchase equity instruments. As of September 30, 2004 and December 31, 2003, the carrying value of investments was $43.6 million and $39.8 million, respectively. As of September 30, 2004, investments totaling $6.5 million are carried at fair value with increases and decreases recorded in other income (expense).

As of September 30, 2004, we are committed to contribute $15.8 million of additional capital to ten private equity funds.

Interest and Fee Income

Interest and fee income represents loan interest and net fee income earned from our loan operations. Substantially all of our loans charge interest at variable rates that generally adjust monthly. Fee income includes the amortization of loan origination fees, net of the direct costs of origination, amortization of original issue discount, the amortization of the discount on loans acquired, and other fees charged to borrowers. Loan prepayments may materially affect fee income since, in the period of prepayment, the amortization of remaining net loan origination fees and discounts is accelerated and additional prepayment penalties may be assessed on the prepaid loans.

Interest Expense

Interest expense is the amount paid on borrowings, including the amortization of deferred financing fees. With the exception of our convertible debt, which pays a fixed rate, all of our borrowings charge interest at variable rates based on LIBOR or commercial paper rates plus a margin. As our borrowings increase and as interest rates rise, our interest expense will increase. Deferred financing fees and the costs of acquiring debt, such as commitment fees and legal fees, are amortized over the shorter of either the first call period or the contractual maturity of the borrowing. Loan prepayments may materially affect interest expense since in the period of prepayment the amortization of remaining deferred financing fees and debt acquisition costs is accelerated.

Provision for Loan Losses

The provision for loan losses is the periodic cost of maintaining an appropriate allowance for loan losses inherent in our portfolio. As the size of our portfolio increases, or if the credit quality of the portfolio declines, we record a provision to increase the allowance for loan losses.

Operating Expenses

Operating expenses include compensation and benefits, professional fees, travel, rent, insurance, depreciation and amortization, marketing and other general and administrative expenses.

Other Income (Expense)

Other income (expense) consists of gains (losses) on the sale of warrants and other equity interests, unrealized appreciation (depreciation) on certain equity interests, gains (losses) on derivatives, due diligence deposits forfeited, fees associated with HUD origination activities, third-party servicing income, and other miscellaneous fees not attributable to our loan operations.

Income Taxes

We were originally organized as a limited liability company. During the period that we were organized as a limited liability company, all income taxes were the responsibility of our individual members; therefore, our historical consolidated statements of income do not include any provision for income taxes. Since our reorganization into a C corporation for income tax purposes in August 2003, we are responsible for paying federal, state and local income taxes. Deferred tax liabilities and assets have been reflected in the consolidated balance sheets. Deferred tax liabilities and assets are determined based on the differences between the book value and the tax basis of particular assets and liabilities, using tax rates scheduled to be in effect for the years in which the differences are expected to reverse.

Segment Reporting

Statement of Financial Accounting Standards (SFAS) No. 131, *Disclosures about Segments of an Enterprise and Related Information,* requires that a public business enterprise report financial and descriptive information about its reportable operating segments including a measure of segment profit or loss, certain specific revenue and expense items, and segment assets.

We operate as a single business segment and, therefore, this statement is not applicable. Because our clients require customized and sophisticated debt financing, we have created three lending groups to develop the industry experience required to structure loans that reflect the particular credit and security characteristics required by different types of clients. However, we manage our lending business as a whole rather than by lending group. For example:

To date, our resources have been sufficient to support our lending business. We obtain resources for the benefit of the entire company and do not allocate resources to specific lending groups based on their individual or relative performance. We fund all of our loans from common funding sources.

We have established common loan origination, credit underwriting, credit approval, and loan monitoring processes, which are used by all lending groups.

We do not factor the identity of the lending group originating a loan into our decision as to whether to fund proposed loans. Rather, we fund every loan that is approved by our credit committee and is acceptable to our customers, and we expect this trend to continue.

RESULTS OF OPERATIONS

Our results of operations have been driven primarily by our rapid growth since inception. The most significant factors influencing our results of operations for the periods described in this section were:

Significant growth in average interest earning assets;

Increased borrowings to fund our growth;

Increased provision for loan losses as our portfolio grew and became more seasoned; and

Increased operating expenses, consisting primarily of higher employee compensation directly related to increases in the number of employees necessary to originate and manage our loan portfolio.

Comparison of the Three Months Ended September 30, 2004 and 2003

Interest Income

Interest income was $86.3 million for the three months ended September 30, 2004, an increase of $39.0 million, or 82%, from $47.3 million for the three months ended September 30, 2003. The increase was due to growth in average interest earning assets of $1.7 billion, or 85%, and the increase in interest rates, offset by a decrease in the yield on average interest earning assets of 30 basis points.

Fee Income

Fee income was $26.0 million for the three months ended September 30, 2004, an increase of $10.9 million, or 72%, from $15.1 million for the three months ended September 30, 2003. The increase was due to the recognition of fee income associated with the accelerated amortization of deferred net origination fees and loan discounts and prepayment fees from loans that prepaid and the overall growth in interest earning assets.

Interest Expense

Interest expense was $21.9 million for the three months ended September 30, 2004, an increase of $11.6 million, or 113%, from $10.3 million for the three months ended September 30, 2003. The increase was due to an increase in average borrowings of $1.6 billion, or 122%, to fund growth in interest earning assets and an increase in our debt to equity ratio to 3.41x as of September 30, 2004 from 1.53x as of September 30, 2003. This increase was partially offset by a decrease in our cost of borrowings of 12 basis points to 3.00% for the three months ended September 30, 2004 from 3.12% for the three months ended September 30, 2003. This decrease was primarily the result of funding of our portfolio growth with lower cost sources of capital.

Net Interest Margin

Net interest margin, defined as net interest income divided by average interest earning assets, was 9.50% for the three months ended September 30, 2004, a decrease of 60 basis points from 10.10% for the three months ended September 30, 2003. The decrease in net interest margin was due to the decreases in yield from prepayment-related fee income and yield from interest income due to the growth in interest earning assets, and the effect of higher leverage, partially offset by the decrease in cost of funds. Net interest spread, the difference between our gross yield on interest earning assets and the total cost of our interest bearing liabilities, was 8.80% for the three months ended September 30, 2004, a decrease of 18 basis points from 8.98% for the three months ended September 30, 2003. Gross yield is the sum of interest and fee income divided by our average interest earning assets. The decrease in net interest spread is attributable to the changes in its components as described above.

The yield and cost of interest earning assets and interest bearing liabilities for the three months ended September 30, 2004 and 2003 were as follows:

	Three Months Ended September 30,					
	2004			2003		
	($ in thousands)					
	Weighted Average Balance	Interest and Fee Income/ Interest Expense	Average Yield/ Cost	Weighted Average Balance	Interest and Fee Income/ Interest Expense	Average Yield/ Cost
Interest earning assets:						
Interest income		$ 86,344	9.07%		$47,336	9.17%
Fee income		26,010	2.73		15,105	2.93
Total interest earning assets(1)	$3,786,683	112,354	11.80	$2,047,672	62,441	12.10
Total interest bearing liabilities(2)	2,902,374	21,922	3.00	1,308,889	10,304	3.12
Net interest spread		$ 90,432	8.80%		$52,137	8.98%
Net interest margin (net yield on interest earning assets)			9.50%			10.10%

(1) Interest earning assets include cash, restricted cash and gross loans.

(2) Interest bearing liabilities include repurchase agreements, credit facilities, term debt and convertible debt.

Provision for Loan Losses

The provision for loan losses increased to $7.8 million for the three months ended September 30, 2004 from $3.7 million for the three months ended September 30, 2003. The increase in the provision reflected the growth and seasoning of the portfolio. As of September 30, 2004 and December 31, 2003, loans with an aggregate net principal balance of $25.2 million and $4.3 million, respectively, were 60 or more days delinquent. Additionally, as of September 30, 2004 and December 31, 2003, loans with an aggregate net principal balance of $44.1 million and $8.8 million, respectively, were on non-accrual status. During the three months ended September 30, 2004 and 2003, we recorded specific reserves of $5.0 million and $1.8 million, respectively, for loans which we considered to be impaired. We consider a loan to be impaired when, based on current information, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement, including principal and scheduled interest payments. No loans were charged off during the three months ended September 30, 2004 or 2003.

Operating Expenses

Operating expenses were $28.5 million for the three months ended September 30, 2004, an increase of $11.2 million, or 65%, from $17.3 million for the three months ended September 30, 2003. Contributing to the increase were greater employee compensation and benefits, which increased $8.1 million, or 70%. The greater employee compensation and benefits were attributable to the increase in employees to 387 as of September 30, 2004 from 269 as of September 30, 2003. A significant portion of the employee compensation comprises annual bonuses, which we accrue throughout the year. For the three months ended September 30, 2004 and 2003, bonus expense totaled $8.1 million and $5.1 million, respectively. The remaining $3.1 million increase in operating expenses for the three months ended September 30, 2004 was attributable to an increase of $0.8 million in professional fees, $0.6 million in travel and entertainment expense, $0.5 million in depreciation and amortization, $0.5 million in rent, and $0.7 million in other general business expenses.

Operating expenses as a percentage of average total assets increased to 2.96% for the three months ended September 30, 2004 from 3.36% for the three months ended September 30, 2003. Our efficiency ratio, which represents operating expenses as a percentage of our net interest and fee income and other income, increased to 30.1% for the three months ended September 30, 2004 from 29.4% for the three months ended September 30, 2003.

Other Income

Other income was $4.0 million for the three months ended September 30, 2004, a decrease of $2.7 million, or 40%, from $6.7 million for the three months ended September 30, 2003. The decrease in other income was the result of a $5.4 million decrease in gain on investments to $(0.4) million for the three months ended September 30, 2004 compared with $5.0 million for the three months ended September 30, 2003, and a $0.6 million decrease in gain on derivatives to $(0.2) million for the three months ended September 30, 2004 from $0.4 million for the three months ended September 30, 2003. Partially offsetting this decrease in other income was a $1.0 million increase in diligence deposits forfeited to $1.2 million for the three months ended September 30, 2004 from $0.2 million for the three months ended September 30, 2003, a $1.0 million increase in income generated by our mortgage finance subsidiary to $1.6 million for the three months ended September 30, 2004 from $0.7 million for the three months ended September 30, 2003, and an addition of $1.2 million of third-party loan servicing income.

Income Taxes

Our effective tax rate was 41% for the three months ended September 30, 2004, compared to 38% for the previous periods in 2004. This increase in the effective tax rate is the result of both a reconciliation of our previous provision for income taxes with actual tax expense for 2003 plus a change in the estimated tax rate for 2004 which was accounted for in the third quarter 2004 resulting in an increase in income taxes of $1.1 million. We have provided for income taxes on the total income earned in 2004 based on a 39.2% effective tax rate. We expect to provide for income taxes on the income earned in the fourth quarter 2004 based on a 39.2% effective tax rate. Prior to our reorganization as a C corporation on August 6, 2003, we operated as a limited liability company and all income taxes were paid by our members. At the reorganization date, we recorded a $4.0 million net deferred tax asset and corresponding deferred tax benefit which lowered the effective tax rate. Our effective tax rate for the three months ended September 30, 2003 was 17.3%.

Comparison of the Nine Months Ended September 30, 2004 and 2003

Interest Income

Interest income was $218.3 million for the nine months ended September 30, 2004, an increase of $96.9 million, or 80%, from $121.4 million for the nine months ended September 30, 2003. The increase was due to growth in average interest earning assets of $1.5 billion, or 85%, and the increase in interest rates, offset by a decrease in the yield on average interest earning assets of 42 basis points.

Fee Income

Fee income was $61.8 million for the nine months ended September 30, 2004, an increase of $26.6 million, or 76%, from $35.2 million for the nine months ended September 30, 2003. The increase was due to the recognition of fee income associated with the accelerated amortization of deferred net origination fees and loan discounts and prepayment fees from loans that prepaid and the overall growth in interest earning assets.

Interest Expense

Interest expense was $51.3 million for the nine months ended September 30, 2004, an increase of $23.9 million, or 87%, from $27.4 million for the nine months ended September 30, 2003. The increase was due to an increase in average borrowings of $1.2 billion, or 110%, to fund growth in interest earning assets and an increase in our debt to equity ratio to 3.41x as of September 30, 2004 from 1.53x as of September 30, 2003. This increase was partially offset by a decrease in our cost of borrowings of 35 basis points to 2.91% for the nine months ended September 30, 2004 from 3.26% for the nine months ended September 30, 2003. This decrease was primarily the result of funding our portfolio growth with lower cost sources of capital.

Net Interest Margin

Net interest margin, defined as net interest income divided by average interest earning assets, was 9.47% for the nine months ended September 30, 2004, a decrease of 44 basis points from 9.91% for the nine months ended September 30, 2003. The decrease in net interest margin was due to decreases in yield from prepayment-related fee income and yield from interest income due to the growth in interest earning assets and the increase in interest expense due to higher leverage, partially offset by the decrease in cost of funds. Net interest spread, the difference between our gross yield on interest earning assets and the total cost of our interest bearing liabilities, was 8.68% for the nine months ended September 30, 2004, a decrease of 7 basis points from 8.75% for the nine months ended September 30, 2003. Gross yield is the sum of interest and fee income divided by our average interest earning assets. The decrease in net interest spread is attributable to the changes in its components as described above.

The yield and cost of interest earning assets and interest bearing liabilities for the nine months ended September 30, 2004 and 2003 were as follows:

	Nine Months Ended September 30,					
	2004			2003		
	($ in thousands)					
	Weighted Average Balance	Interest and Fee Income/ Interest Expense	Average Yield/ Cost	Weighted Average Balance	Interest and Fee Income/ Interest Expense	Average Yield/ Cost
Interest earning assets:						
Interest income		$218,325	9.03%		$121,372	9.31%
Fee income		61,848	2.56		35,238	2.70
Total interest earning assets(1)	$3,228,631	280,173	11.59	$1,743,419	156,610	12.01
Total interest bearing liabilities(2)	2,356,923	51,296	2.91	1,122,794	27,409	3.26
Net interest spread		$228,877	8.68%		$129,201	8.75%
Net interest margin (net yield on interest earning assets)			9.47%			9.91%

(1) Interest earning assets include cash, restricted cash and gross loans.

(2) Interest bearing liabilities include repurchase agreements, credit facilities, term debt and convertible debt.

Provision for Loan Losses

The provision for loan losses increased to $20.2 million for the nine months ended September 30, 2004 from $8.5 million for the nine months ended September 30, 2003. The increase in the provision reflected the growth and seasoning of the portfolio. As of September 30, 2004 and December 31, 2003, loans with an aggregate net principal balance of $25.2 million and $4.3 million, respectively, were 60 or more days delinquent. Additionally, as of September 30, 2004 and December 31, 2003, loans with an aggregate net principal balance of $44.1 million and $8.8 million, respectively, were on non-accrual status. During the nine months ended September 30, 2004 and 2003, we recorded specific reserves of $8.7 million and $2.1 million, respectively, for loans which we considered to be impaired. We consider a loan to be impaired when, based on current information, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement, including principal and scheduled interest payments. During the nine months ended September 30, 2004, we charged off loans totaling $5.7 million. No loans were charged off during the nine months ended September 30, 2003.

Operating Expenses

Operating expenses were $78.3 million for the nine months ended September 30, 2004, an increase of $32.8 million, or 72%, from $45.5 million for the nine months ended September 30, 2003. Contributing to the increase were greater employee compensation and benefits, which increased $21.0 million, or 69%. The greater employee compensation and benefits were attributable to the increase in employees to 387 as of September 30, 2004 from 269 as of September 30, 2003. A significant portion of the employee compensation comprises annual bonuses, which we accrue throughout the year. For the nine months ended September 30, 2004 and 2003, bonus expense totaled $20.7 million and $13.7 million, respectively. The remaining $11.8 million increase in operating expenses for the nine months ended September 30, 2004 was attributable to an increase of $3.9 million in professional fees, $1.9 million in travel and entertainment expenses, $1.6 million in rent, $1.5 million in insurance, and $2.9 million in other general business expenses.

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Operating expenses as a percentage of average total assets decreased to 3.22% for the nine months ended September 30, 2004 from 3.49% for the nine months ended September 30, 2003. Our efficiency ratio, which represents operating expenses as a percentage of our net interest and fee income and other income, decreased to 32.6% for the nine months ended September 30, 2004 from 32.8% for the nine months ended September 30, 2003.

Other Income

Other income was $11.3 million for the nine months ended September 30, 2004, an increase of $1.8 million, or 19%, from $9.5 million for the nine months ended September 30, 2003. The increase in other income was the result of a $3.5 million increase in income generated by our mortgage finance subsidiary to $5.2 million for the nine months ended September 30, 2004 from $1.7 million for the nine months ended September 30, 2003, a $2.1 million increase in diligence deposits forfeited to $4.3 million for the nine months ended September 30, 2004 from $2.2 million for the nine months ended September 30, 2003, and an addition of $2.3 million of third-party loan servicing income in the second quarter 2004. Partially offsetting the increase in other income was a $5.6 million decrease in income from investments and a $0.4 million decrease in gain on derivatives.

Income Taxes

Prior to our reorganization as a C corporation on August 6, 2003, we operated as a limited liability company and all income taxes were paid by our members. At the reorganization date, we recorded a $4.0 million net deferred tax asset and corresponding deferred tax benefit which lowered the effective tax rate. Our effective tax rate for the nine months ended September 30, 2004 and 2003 was 39.2% and 7.7%, respectively.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash and Cash Equivalents

As of September 30, 2004 and December 31, 2003, we had $121.4 million and $69.9 million, respectively, in cash and cash equivalents. The increase in cash as of September 30, 2004 from December 31, 2003 was largely attributable to significant loan collections at the end of September 2004. We invest cash on hand in short-term liquid investments. Our objective is to maintain a low cash balance to avoid negative arbitrage. We generally fund new loan originations and growth in revolving loan balances using advances under our credit facilities.

We had $110.2 million and $79.9 million of restricted cash as of September 30, 2004 and December 31, 2003, respectively. The restricted cash represents interest collections on loans collateralizing our credit facilities, collateral for letters of credit issued for the benefit of clients, principal and interest collections on loans collateralizing our term debt, and client holdbacks and escrows. Interest rate swap payments, interest payable and servicing fees are deducted from the monthly interest collections funded by loans collateralizing our credit facilities and term debt, and the remaining restricted cash is returned to us and becomes unrestricted at that time.

Asset Quality and Allowance for Loan Losses

As of September 30, 2004 and December 31, 2003, loans with an aggregate net principal balance of $25.2 million and $4.3 million, respectively, were 60 or more days delinquent. As of September 30, 2004 and December 31, 2003, loans with an aggregate net principal balance of $44.1 million and $8.8 million, respectively, were on non-accrual status. As of September 30, 2004 and December 31, 2003, the net principal balance of impaired loans, as defined by SFAS No. 114, *Accounting by Creditors for Impairment of a Loan,* totaled $42.4 million and $15.3 million, respectively. As of September 30, 2004 and December 31, 2003 specific reserves for the impaired loans were $5.6 million and $2.7 million, respectively. For the nine months ended September 30, 2004, we had no new loans that were accounted for as troubled debt restructurings as defined by SFAS No. 15, *Accounting for Debtors and Creditors for Troubled Debt Restructuring.* For the year ended December 31, 2003, loans with a carrying value of $36.3 million as of December 31, 2003 were classified as troubled debt restructurings.

We have provided an allowance for loan losses to cover estimated losses inherent in the loan portfolio. Our allowance for loan losses as of September 30, 2004 and December 31, 2003 was $32.6 million and $18.0 million, respectively. These amounts equate to 0.86% and 0.75% of loans as of September 30, 2004 and December 31, 2003, respectively. As of September 30, 2004 and December 31, 2003, $5.6 million and $2.7 million, respectively, of allowance for loan losses related to specific reserves. During the nine months ended September 30, 2004, we charged off loans totaling $5.7 million. Middle market lending involves credit risks which we believe will result in credit losses in our portfolio.

Activity in the allowance for loan losses for the nine months ended September 30, 2004 and 2003 was as follows:

	Nine Months Ended September 30,	
	2004	**2003**
	($ in thousands)	
Balance as of beginning of period	$18,025	$ 6,688
Provision for loan losses	20,238	8,461
Charge offs	(5,651)	
Balance as of end of period	$32,612	$15,149

Investments

As of September 30, 2004 and December 31, 2003, we had $43.6 million and $39.8 million, respectively, in investments. This increase resulted from $18.7 million in additional investments, offset by $11.3 million from sales of investments and return of capital and the recognition of $3.6 million in unrealized losses on our investments.

Borrowings and Liquidity

As of September 30, 2004 and December 31, 2003, we had outstanding borrowings totaling $3.1 billion and $1.7 billion, respectively. Borrowings under our various credit facilities, term debt, convertible debt and repurchase agreements have supported our loan growth. For a detailed discussion of our borrowings, see Note 8, *Borrowings,* in our audited consolidated financial statements for the year ended December 31, 2003 included in our Form 10-K, as filed with the SEC on March 12, 2004 and Note 4, *Borrowings,* in our unaudited consolidated financial statements for the three and nine months ended September 30, 2004.

As of September 30, 2004, our funding sources, maximum facility amounts, amounts outstanding, and unused available commitments, subject to certain minimum equity requirements and other covenants and conditions, were as follows:

Funding Source	**Maximum Facility Amount**	**Amounts Outstanding(1)**	**Unused Capacity**
		($ in thousands)	
Repurchase agreements	$ 300,000	$	$300,000
Credit facilities	1,660,000	1,266,825	393,175
Term debt(2)		1,252,720	
Convertible debt(2)		557,780	
Total		$3,077,325	$693,175

(1) Amounts outstanding include accrued interest and interest rate swaps.

(2) Our term and convertible debt are one-time fundings without providing any ability for us to draw down additional amounts.

The following changes to our borrowings have occurred during the three months ended September 30, 2004:

Convertible Debt

In July 2004, we completed an offering of $330.0 million principal amount of 3.5% senior convertible debentures due 2034 (the Debentures) in a private offering pursuant to Rule 144A under the Securities Act of 1933, as amended. The Debentures will also pay contingent interest, subject to certain limitations as described in the offering memorandum, beginning on July 15, 2011. The Debentures are initially convertible, subject to certain conditions, into shares of our common stock at a conversion rate of 31.4614 shares of common stock per $1,000 principal amount of Debentures, representing an initial effective conversion price of approximately $31.78 per share. The Debentures will be redeemable for cash at our option at any time on or after July 15, 2011 at a redemption price of 100% of their principal amount plus accrued interest. Holders of the Debentures will have the right to require us to repurchase some or all of their Debentures for cash on July 15, 2011; July 15, 2014; July 15, 2019; July 15, 2024 and July 15, 2029 at a price of 100% of their principal amount plus accrued interest. Holders of the Debentures will also have the right to require us to repurchase some or all of their Debentures upon certain events constituting a fundamental change. As discussed in Note 6, *Borrowings,* of our unaudited consolidated financial statements for the three and nine months ended September 30, 2004, the Debentures are unsecured and unsubordinated obligations, and are guaranteed by two of our wholly owned subsidiaries.

Holders of the Debentures may convert their Debentures prior to maturity only if: (1) the price of our common stock reaches certain thresholds during periods of time specified by the Debentures, (2) specified corporate transactions occur, (3) the Debentures have been called for redemption, or (4) the trading price of the Debentures falls below a certain threshold.

In September 2004, we filed a shelf registration statement with respect to the resale of the Debentures and the common stock issuable upon the conversion of the Debentures with the Securities and Exchange Commission. Also, in September 2004, we filed a shelf registration statement with respect to the resale of the $225.0 million in aggregate principal amount of senior convertible debentures issued in March 2004. These registration statements were declared effective in October 2004 by the Securities and Exchange Commission.

Other Liquidity

Additional liquidity is provided by our cash flow from operations. For the nine months ended September 30, 2004 and 2003 and the year ended December 31, 2003, we generated cash flow from operations of $88.0 million, $73.3 million and $86.8 million, respectively.

Proceeds from our equity offerings, borrowings on our credit facilities, the issuance of asset-backed notes in our term debt securitizations and the issuance of convertible debt provide cash from financing activities. For the nine months ended September 30, 2004 and 2003 and the year ended December 31, 2003, we generated cash flow from financing activities of $1.3 billion, $0.9 billion and $1.3 billion, respectively.

Investing activities primarily relate to loan origination. For the nine months ended September 30, 2004 and 2003 and the year ended December 31, 2003, we used cash in investing activities of $1.4 billion, $0.9 billion and $1.3 billion, respectively.

As of September 30, 2004, the amount of our unfunded commitments to extend credit to our clients exceeded our unused funding sources and unrestricted cash by $864 million. Our requirement to fund unfunded commitments generally is based on our clients ability to provide additional collateral to secure the requested additional fundings, the additional collateral s satisfaction of eligibility requirements and our clients ability to meet certain other preconditions to borrowing. Provided our clients additional collateral meets all of the eligibility requirements of our funding sources, we believe that we have sufficient funding capacity to meet short-term needs related to unfunded commitments. If we do not have sufficient funding capacity to satisfy these commitments, our failure to satisfy our full contractual funding commitment to one or more of our clients could create breach of contract liability for us and damage our reputation in the marketplace, which could have a material adverse effect on our business.

We expect cash from operations, other sources of capital, including additional borrowings on existing and future credit facilities and term debt, to be adequate to support our projected needs for funding our existing loan commitments in the short-term. For the long term, the growth rate of our portfolio and other assets will determine our requirement for additional capital. Continuing to grow our portfolio at the accelerated rate at which it has been growing will require us to raise significant amounts of capital. In addition to continuing to access the secured debt market, we also will explore additional capital market financings should we determine that our growth rate requires us to raise additional capital. This could include the general unsecured debt markets, equity-related securities such as convertible debt or the issuance of common equity. To date in 2004, we have completed two convertible debt offerings which provided us with significant additional liquidity to fund our growth. We cannot assure you, however, that we will have access to any of these funding sources in the future.

Off Balance Sheet Risk

Depending on the legal structure of the transaction, term debt securitizations may either be accounted for as off balance sheet with a gain or loss on the sale recorded in the statement of income or accounted for as on balance sheet financings. All of our term debt securitizations to date, including the October 2004 securitization, have been recorded as on balance sheet financings.

We are subject to off balance sheet risk in the normal course of business primarily from commitments to extend credit. As of September 30, 2004 and December 31, 2003, we had unfunded commitments to extend credit to our clients of $1.7 billion and $1.3 billion, respectively. These commitments are subject to the same underwriting and ongoing portfolio maintenance as the on balance sheet financial instruments we hold.

We use interest rate swap agreements to hedge fixed-rate and prime rate loans pledged as collateral for our term debt. Our interest rate swap agreements modify our exposure to interest rate risk by converting fixed-rate and prime rate loans to a 30-day LIBOR rate. We enter into interest rate swaps to offset the basis swaps required by our term debt. Additionally, we use interest rate cap agreements to hedge loans with embedded interest rate caps that are pledged as collateral for our term debt. Our interest rate hedging activities partially protect us from the risk that interest collected under fixed-rate and prime rate loans will not be sufficient to service the interest due under the 30-day LIBOR-based term debt. The fair market values of the interest rate swap agreements were $(1.0) million and $(1.9) million as of September 30, 2004 and December 31, 2003, respectively. The fair value of the interest rate cap agreements was not significant as of September 30, 2004 and December 31, 2003.

We are required to enter into interest rate swaps if we have more than $50.0 million of fixed-rate loans collateralizing our multi-bank credit facility. As of September 30, 2004, we had $40.8 million of fixed-rate loans collateralizing the facility. Therefore, as of September 30, 2004, we were not required to enter into fixed-rate interest rate swaps. We may make additional fixed rate loans in the future, which could require us to enter into new interest rate swap agreements.

For a detailed discussion of our derivatives and off balance sheet financial instruments, see Note 16, *Derivatives and Off Balance Sheet Financial Instruments,* in our audited consolidated financial statements for the year ended December 31, 2003 included in our Form 10-K, as filed with the SEC on March 12, 2004 and *Qualitative and Quantitative Disclosures About Market Risk* below.

CRITICAL ACCOUNTING POLICIES

Our consolidated financial statements are based on the selection and application of critical accounting policies, many of which require management to make estimates and assumptions. The following describes the areas in which judgments are made by our management in the application of our accounting policies that significantly affect our financial condition and results of operations.

Income Recognition

Interest and fee income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For amortizing term loans, original issue discounts and loan fees (net of direct costs of origination) are amortized into fee income using the effective interest method over the contractual life of the loan. For revolving lines of credit and non-amortizing term loans, original issue discounts and loan fees (net of direct costs of origination) are amortized into fee income using the straight-line method over the contractual life of the loan. Fees due at maturity are recorded over the contractual life of the loan in accordance with our policy to the extent that such amounts are expected to be collected.

If a loan is 90 days or more past due, or we expect that the borrower will not be able to service its debt and other obligations, we will place the loan on non-accrual status. When a loan is placed on non-accrual status, interest and fees previously recognized as income but not yet paid is reversed and the recognition of interest and fee income on that loan will stop until factors indicating doubtful collection no longer exist and the loan has been brought current. We will make exceptions to this policy if the loan is well secured and in the process of collection.

Loan origination fees are deferred and amortized as adjustments to the related loan s yield over the contractual life of the loan. In certain loan arrangements, we receive warrants or other equity interests from the client as additional origination fees. The clients granting these interests typically are not publicly traded companies. We record the equity interests received at estimated fair value as determined using various valuation models which attempt to estimate the underlying value of the associated entity. These models are then applied to our ownership share factoring in any discounts for transfer restrictions or other terms which impact the value. Any resulting discount on the loan from recordation of warrant and other equity instruments are accreted into income over the term of the loan. If our estimates of value of the equity interests received are not accurate, our income would be misstated.

Allowance for Loan Loss

Our allowance for loan losses reflects the aggregate amount of our reserves we have recorded for the loans in our portfolio. Using a proprietary loan reserve matrix, we assign a reserve factor to each loan in the portfolio. The reserve factor assigned dictates the percentage of the total outstanding loan balance that we reserve. The actual determination of a given loan s reserve factor is a function of three elements:

the type of loan, for example, whether the loan is underwritten based on the borrower s assets, real estate or cash flow;

whether the loan is senior or subordinated; and

the internal credit rating assigned to the loan.

For example, riskier types of loans, such as cash flow loans, are assigned higher reserve factors than less risky loans such as asset-based loans. Further, a subordinate loan would generally have a higher reserve factor than a senior loan, and loans with lower internal credit ratings would be assigned reserve factors higher than those with higher internal credit ratings.

We evaluate the internal credit ratings assigned to loans monthly to reflect the current credit risk of the borrower. The reserve factors are primarily based on historical industry loss statistics adjusted for our own credit experience and economic conditions.

We also establish specific allowances for loan losses for impaired loans based on a comparison of the recorded carrying value of the loan to either the present value of the loan s expected cash flow, the loan s estimated market price or the estimated fair value of the underlying collateral. We charge off loans against the allowance when realization from the sale of the collateral or the enforcement of guarantees does not exceed the outstanding loan amount. As of September 30, 2004, we maintained a specific allowance for loan losses of $5.6 million.

If our internal credit ratings, reserve factors, or specific allowances for loan losses are not accurate, our assets would be misstated.

Valuation of Investments

With respect to investments in publicly traded equity interests, we use quoted market values to value investments. With respect to investments in privately held equity interests, each investment is valued using industry valuation benchmarks, and then the value is assigned a discount reflecting the illiquid nature of the investment, as well as our minority, non-control position. When an external event such as a purchase transaction, public offering or subsequent equity sale occurs, the pricing indicated by the external event will be used to corroborate our private equity valuation. Securities that are traded in the over-the-counter market or on a stock exchange generally will be valued at the prevailing bid price on the valuation date. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily ascertainable market value, the fair value of our investments may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

Term Debt Securitizations

Periodically, we transfer pools of loans to special purpose entities for use in term debt securitizations. These on balance sheet term debt securitizations comprise a significant source of our overall funding, with the face amount of the outstanding loans assumed by third parties totaling $1.5 billion and $1.1 billion as of September 30, 2004 and December 31, 2003, respectively. Transfers of loans have not met the requirements of SFAS No. 140 for sales treatment and are, therefore, treated as secured borrowings, with the transferred loans remaining in investments and the related liability recorded in borrowings. If our judgments as to whether the term debt securitizations met the requirements for on balance sheet financing were not appropriate, the accounting would be materially different with gains or losses recorded on the transfer of loans.

Item 3: ***Quantitative and Qualitative Disclosures About Market Risk***

Except as described below, there have been no material changes to our exposures to market risk since December 31, 2003. These exposures are discussed in detail in Management s Discussion and Analysis of Financial Condition and Results of Operations in the *Quantitative and Qualitative Disclosures About Market Risk* section. In addition, for a detailed discussion of our derivatives and off balance sheet financial instruments, see Note 16, *Derivatives and Off Balance Sheet Financial Instruments,* in our audited consolidated financial statements for the year ended December 31, 2003 included in our Form 10-K, as filed with the SEC on March 12, 2004.

Equity Price Risk

The debentures we issued in March 2004 are initially convertible into our common stock at a conversion price of $30.40 per share, subject to adjustment upon the occurrence of specified events. At the initial conversion price, each $1,000 of principal of the debentures is convertible into 39.8952 shares of our common stock, subject to adjustment upon the occurrence of specified events. Prior to the effective date of EITF 04-8, we intend to make the irrevocable election to pay the principal balance of the debentures in cash upon any conversion or repurchase prior to or at their respective maturities. Holders of the debentures may convert their debentures prior to maturity only if: (1) the price of our common stock reaches $36.48 during specified periods of time, (2) specified corporate transactions occur, (3) the debentures have been called for redemption, or (4) the trading price of the debentures falls below a certain threshold.

In addition, in the event of a significant change in our corporate ownership or structure, the holders may require us to repurchase all or any portion of their debentures for 100% of the principal amount.

Concurrently with our sale of the debentures, we entered into two separate call option transactions with an affiliate of one of the initial purchasers, in each case covering the same number of shares as into which the debentures are initially convertible. In one transaction, we purchased a call option at a strike price equal to the initial conversion price of the debentures. This option expires on March 15, 2009 and requires physical settlement. At the time we make the irrevocable election to pay the principal balance of the debentures in cash, we also intend to amend this option to provide that it may be settled in net shares so that the option continues to mirror the terms of the debentures. We intend to exercise this call option from time to time as necessary to acquire shares that we may be required to deliver upon receipt of a notice of conversion of the debentures. In the second transaction, we sold warrants to one of the initial purchasers for the purchase of up to 7.4 million of our common shares at a strike price of approximately $40.30 per share. The warrants expire at various dates from March 2009 through June 2009 and must be settled in net shares. The net effect of entering into the call option and warrant transactions was to minimize potential dilution as a result of the conversion of the debentures by increasing the effective conversion price of the debentures to a 75% premium over the March 15, 2004 closing price of our common stock. The call option and warrant transactions were net settled at a net cost of approximately $25.6 million, which we paid from the proceeds of our sale of the debentures and is included as a net reduction in shareholders equity in the consolidated balance sheet.

The debentures we issued in July 2004 are initially convertible into our common stock at a conversion price of $31.78 per share, subject to adjustment upon the occurrence of specified events. At the initial conversion price, each $1,000 of principal of the debentures is convertible into 31.4614 shares of our common stock, subject to adjustment upon the occurrence of specified events. Prior to the effective date of EITF 04-8, we intend to make the irrevocable election to pay the principal balance of the debentures in cash upon any conversion or repurchase prior to or at their respective maturities. Holders of the debentures may convert their debentures prior to maturity only if: (1) the price of our common stock reaches specified thresholds, (2) the trading price of the debentures falls below a specified threshold, (3) the debentures have been called for redemption, or (4) specified corporate transactions occur, each as described in the offering memorandum.

In addition, in the event of a significant change in our corporate ownership or structure, the holders may require us to repurchase all or any portion of their debentures for 100% of the principal amount.

Item 4: ***Controls and Procedures***

As of September 30, 2004, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure and controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to CapitalSource (including our consolidated subsidiaries) that is required to be disclosed in our Exchange Act reports filed with the Securities and Exchange Commission and in ensuring that such information is recorded, processed, summarized, and reported within the time periods specified in the SEC s rules and forms. There have been no significant changes in our internal controls or, to our knowledge, in other factors that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1: ***Legal Proceedings***

None

Item 2: ***Unregistered Sales of Equity Securities and Use of Proceeds***

In July 2004, in a private placement pursuant to Section 4(2) of the Securities Act of 1933, as amended, we issued the Debentures to Goldman, Sachs & Co., Citigroup Global Markets Inc., and Wachovia Capital Markets, LLC, for resale to qualified institutional buyers pursuant to SEC Rule 144A, for which we received net proceeds of approximately $321.4 million after the initial purchasers discounts and commissions and other transaction fees of approximately $8.6 million. The Debentures are initially convertible into our common stock at a conversion price of $31.78 per share, subject to adjustment upon the occurrence of specified events.

At the initial conversion price, each $1,000 of principal of the Debentures is convertible into 31.4614 shares of our common stock, subject to adjustment upon the occurrence of specified events. Holders of the Debentures may convert their Debentures prior to maturity only if: (1) the price of our common stock reaches certain thresholds during specified periods of time, (2) specified corporate transactions occur, (3) the Debentures have been called for redemption, or (4) the trading price of the Debentures falls below a certain threshold. Prior to the effective date of EITF 04-8, we intend to make the irrevocable election to pay the principal balance of the Debentures in cash upon any conversion or repurchase prior to or at their respective maturities.

In addition, in the event of a significant change in our corporate ownership or structure, the holders may require us to repurchase all or any portion of their Debentures for 100% of the principal amount.

We did not repurchase any shares of our common stock during the three months ended September 30, 2004.

Item 3: ***Defaults Upon Senior Securities***

None

Item 4: ***Submission of Matters to a Vote of Security Holders***

None

Item 5: ***Other Information***

None

Item 6: ***Exhibits***

(a) Exhibits

The Index to Exhibits attached hereto is incorporated herein by reference.

SIGNATURES

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

Date: November 15, 2004	/s/ JOHN K. DELANEY John K. Delaney Chairman of the Board and Chief Executive Officer (Principal Executive Officer)
Date: November 15, 2004	/s/ THOMAS A. FINK Thomas A. Fink Chief Financial Officer (Principal Financial Officer)
Date: November 15, 2004	/s/ JAMES M. MOZINGO James M. Mozingo Chief Accounting Officer (Principal Accounting Officer)

INDEX TO EXHIBITS

Exhibit No.	Description
3.1	Amended and Restated Certificate of Incorporation (incorporated by reference to the same-numbered exhibit to the registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 2003).
3.2	Amended and Restated Bylaws (incorporated by reference to the same-numbered exhibit to the registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 2003).
4.1	Form of Certificate of Common Stock of CapitalSource Inc. (incorporated by reference to the same-numbered exhibit to the registrant s Registration Statement on Form S-1 (Reg. No. 333-106076)).
4.2	Indenture dated as of May 16, 2002, by and between CapitalSource Commercial Loan Trust 2002-1, as Issuer, and Wells Fargo Bank Minnesota, National Association, as Indenture Trustee (incorporated by reference to the same-numbered exhibit to the registrant s Registration Statement on Form S-1 (Reg. No. 333-106076)).
4.3	Indenture dated as of October 30, 2002, by and between CapitalSource Commercial Loan Trust 2002-2, as Issuer, and Wells Fargo Bank Minnesota, National Association, as Indenture Trustee (incorporated by reference to the same-numbered exhibit to the registrant s Registration Statement on Form S-1 (Reg. No. 333-106076)).
4.4	Indenture dated as of April 17, 2003, by and between CapitalSource Commercial Loan Trust 2003-1, as Issuer, and Wells Fargo Bank Minnesota, National Association, as Indenture Trustee (incorporated by reference to the same-numbered exhibit to the registrant s Registration Statement on Form S-1 (Reg. No. 333-106076)).
4.5	Indenture dated as of September 17, 2003, between CapitalSource Funding II Trust and Wells Fargo Bank Minnesota, National Association, as Indenture Trustee (incorporated by reference to the same-numbered exhibit to the registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 2003).
4.6	Indenture dated as of November 25, 2003, by and between CapitalSource Commercial Loan Trust 2003-2, as Issuer, and Wells Fargo Bank Minnesota, National Association, as Indenture Trustee (incorporated by reference to the same-numbered exhibit to the registrant s Registration Statement on Form S-1 (Reg. No. 333-112002)).
4.7	Indenture dated as of March 19, 2004, by and among CapitalSource Inc., as Issuer, U.S. Bank National Association, as Trustee, and CapitalSource Holdings LLC and CapitalSource Finance LLC, as Guarantors, including form of 3.5% Senior Convertible Debenture Due 2034 (incorporated by reference to the same-numbered exhibit to the registrant s Quarterly Report on Form 10-Q for the quarter ended March 31, 2004).
4.7.1	First Supplemental Indenture dated as of October 18, 2004, by and among the registrant, CapitalSource Holdings Inc. and CapitalSource Finance LLC, as Guarantors, and U.S. Bank National Association, as Trustee (incorporated by reference to Exhibit 4.1.1 to the registrant s Registration Statement on Form S-3 (Reg. No. 333-118744)).
4.8	Indenture dated as of June 22, 2004, by and among CapitalSource Commercial Loan Trust 2004-1, as Issuer, and Wells Fargo Bank Minnesota, National Association, as Indenture Trustee (incorporated by reference to the same-numbered exhibit to the registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2004).
4.9	Indenture dated as of October 28, 2004, by and between CapitalSource Commercial Loan Trust 2004-2, as the Issuer, and Wells Fargo Bank, National Association, as the Indenture Trustee (incorporated by reference to the same-numbered exhibit to the registrant s Current Report on Form 8-K dated October 28, 2004).
4.10	Indenture dated as of July 7, 2004, by and among CapitalSource Inc., as Issuer, U.S. Bank National Association, as Trustee, and CapitalSource Holdings LLC and CapitalSource Finance LLC, as Guarantors, including form of 3.5% Senior Convertible Debenture Due 2034 (incorporated by reference to Exhibit 4.1 to the registrant s Registration Statement on Form S-3 (Reg. No. 333-118738)).

Exhibit No.	Description
4.10.1	First Supplemental Indenture dated as of October 18, 2004, by and among the registrant, CapitalSource Holdings Inc. and CapitalSource Finance LLC, as Guarantors, and U.S. Bank National Association, as Trustee (incorporated by reference to Exhibit 4.1.1 to the registrant s Registration Statement on Form S-3 (Reg. No. 333-118738)).
10.27.1	Amended and Restated Sale and Servicing Agreement, dated as of September 17, 2003 and Amended and restated as of October 7, 2004, among CapitalSource Funding II Trust, as Issuer, and CS Funding II Depositor LLC, as depositor, and CapitalSource Finance LLC, as Loan Originator and Servicer, and Wells Fargo Bank Minnesota, National Association, as Indenture Trustee, Collateral Custodian and Backup Servicer (incorporated by reference to the same-numbered exhibit to the registrant s Current Report on Form 8-K dated October 13, 2004).
10.27.2	Amended and Restated Note Purchase Agreement, dated as of September 17, 2003 and Amended and restated as of October 7, 2004, among CapitalSource Funding II Trust, as Issuer, CS Funding II Depositor LLC, as depositor, CapitalSource Finance LLC, as Loan Originator, and Citigroup Global Markets Realty Corp., as Purchaser (incorporated by reference to the same-numbered exhibit to the registrant s Current Report on Form 8-K dated October 13, 2004).
10.28	Sale and Servicing Agreement, dated as of October 28, 2004, by and among CapitalSource Commercial Loan Trust 2004-2, as the Issuer, CapitalSource Commercial Loan LLC, 2004-2, as the Trust Depositor, CapitalSource Finance LLC, as the Originator and as the Servicer, and Wells Fargo Bank, National Association, as the Indenture Trustee and as the Backup Servicer (incorporated by reference to the same-numbered exhibit to the registrant s Current Report on Form 8-K dated October 28, 2004).
10.29	Registration Rights Agreement dated as of July 7, 2004, among the registrant, CapitalSource Finance LLC, CapitalSource Holdings LLC and Citigroup Global Markets Inc. (incorporated by reference to Exhibit 4.2 to the registrant s Registration Statement on Form S-3 (Reg. No. 333-118738)).
31.1	Certificate of Chairman and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certificate of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Filed herewith.