WESTWOOD ONE INC /DE/
Form 8-K
November 06, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 8-K
CURRENT REPORT
PURSUANT TO SECTION 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934
Date of Report (Date of earliest event reported): November 1, 2007
WESTWOOD ONE, INC.
(Exact name of registrant as specified in its charter)

Delaware	**001-14691**	**95-3980449**
(State or other jurisdiction of incorporation)	(Commission File Number)	(IRS Employer Identification No.)

40 West 57th Street, 5th Floor **New York, NY**	**10019**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: (**212) 641-2000**

(Former name or former address, if changed since last report.)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (see General Instruction A.2. below):

o Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)
o Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)
o Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))
o Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

Section 2 Financial Information

Item 2.02 Results of Operations and Financial Condition.

On November 1, 2007, Westwood One, Inc. (the Company) issued a press release announcing earnings for the third quarter ended September 30, 2007. A copy of such press release is furnished herewith as Exhibit 99.1 and is incorporated by reference herein in its entirety.

Section 9 Financial Statements and Exhibits

Item 9.01 Financial Statements and Exhibits.

(d) Exhibits.

The following is a list of the exhibits filed as a part of this Form 8-K:

Exhibit No.	**Description of Exhibit**
99.1	Press Release, dated November 1, 2007, announcing earnings for the third quarter ended September 30, 2007.

SIGNATURES

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

WESTWOOD ONE, INC.

Date: November 5, 2007

By: /s/ David Hillman
Name: David Hillman
Title: Chief Administrative Officer; EVP, Business Affairs, General Counsel and Secretary

EXHIBIT INDEX
Current Report on Form 8-K
dated November 1, 2007
Westwood One, Inc.

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ersight services to the Company. The agreement can be cancelled upon 60-day written notice by either party. The Company pays the Manager a monthly administrative fee at an annual rate of 0.06% of the first $125 million of average net assets, 0.04% of the next $125 million of average net assets and 0.03% of average net assets in excess of $250 million subject to a minimum annual fee of $120. For the three and six months ended June 30, 2004, the Company paid administrative fees of $45 and $89, respectively, and $43 and $86 for the three and six months ended June 30, 2003, respectively, which are included in general and administrative expense on the accompanying consolidated statements of operations. The Company has entered into a $50,000 commitment to acquire shares in Carbon Capital, Inc. ("Carbon"), a private commercial real estate income opportunity fund managed by the Manager. The Carbon investment period ended on July 12, 2004; the Company's investment in Carbon as of June 30, 2004 was $48,501 and no investments were made in July 2004. The Company does not incur any additional management or incentive fees to the Manager as a result of its investment in Carbon. On June 30, 2004, the Company owned 19.8% of the outstanding shares in Carbon. During 2000, the Company completed the acquisition of CORE Cap, Inc. At the time of the CORE Cap, Inc. acquisition, the Manager agreed to pay GMAC (CORE Cap, Inc.'s external advisor) $12,500 over a ten-year period ("Installment Payment") to purchase the right to manage the CORE Cap, Inc. assets under the existing management contract ("GMAC Contract"). The GMAC Contract had to be terminated in order to allow the Company to complete the merger, as the Company's management agreement with the Manager did not provide for multiple managers. As a result the Manager offered to buy-out the GMAC Contract as the Manager estimated it would receive incremental fees above and beyond the Installment Payment, and thus was willing to pay for, and separately negotiate, the termination of the GMAC Contract. Accordingly, the value of the Installment Payment was not considered in the Company's allocation of its purchase price to the net assets acquired in the acquisition of CORE Cap, Inc. The Company agreed that should the Management Agreement with its Manager be terminated, not renewed or not extended for any reason other than for cause, the Company would pay to the Manager an amount equal to the Installment Payment less the sum of all payments made by the Manager to GMAC. As of June 30, 2004, the Installment Payment would be $6,500 payable over six years. The Company does not accrue for this contingent liability. Note 9 STOCK OPTIONS On May 25, 2004, the Company granted stock options to each of its unaffiliated directors with an exercise price equal to the closing price of the Common Stock on the New York Stock Exchange on such date (or $11.81). The options vested immediately upon grant. The fair value of the options granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions. May 25, 2004 ------------- Estimated volatility 22.6% Expected life 7 years Risk-free interest rate 1.2% Expected dividend yield 9.5% The fair value of the options granted on May 25, 2004 was negligible. There were no options granted in 2003. Note 10 BORROWINGS Certain information with respect to the Company's collateralized borrowings at June 30, 2004 is summarized as follows: Lines of Reverse Commercial Total Credit and Repurchase Collateralized Mortgage Loan Collateralized Term Loans Agreements Debt Obligations Pools Borrowings --- Outstanding borrowings $57,745* $730,701 $1,057,217 $1,298,636 $3,144,299 Weighted average borrowing rate 2.56% 1.40% 6.05% 3.72% 3.94% Weighted average remaining maturity 377 days 29 days 2,990 days 2,756 days 2,157 days Estimated fair value of assets pledged $67,875 $815,766 $1,153,990 $1,319,533 $3,357,164 * $23,081 of the line of credit borrowings are secured by CDO debt of the Company with a par of $35,919 that the Company chose not to sell at the time of issuance. At June 30, 2004, the Company's collateralized borrowings had the following remaining maturities: Lines of Reverse Commercial Total Credit and Repurchase Collateralized Mortgage Loan Collateralized Term Loans Agreements Debt Obligations Pools Borrowings --- Within 30 days $ - $717,931 $ - $ - $ 717,931 31 to 59 days - - - - - Over 60 days 57,745 12,770 1,057,217 1,298,636 2,426,368 === $57,745 $730,701 $1,057,217 1,298,636 $3,144,299 === Under the lines of credit and the reverse repurchase agreements, the respective lender retains the right to mark the underlying collateral to estimated market value. A reduction in the value of its pledged assets will require the Company to provide additional collateral or fund margin calls. From time to time, the Company expects that it will be required to provide such additional collateral or fund margin calls. Note 11 DERIVATIVE INSTRUMENTS The Company accounts for its derivative investments under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. All derivatives, whether designated in hedging relationships or not, are required to be recorded on the balance sheet at fair value. If the derivative is designated as a fair value hedge, the changes in the fair value of the derivative and of the hedged item attributable to the hedged risk are recognized in earnings. If the derivative is designated as a cash flow hedge, the effective portions of change in the fair value of the derivative are recorded in other comprehensive income ("OCI") and are recognized in the income statement when the hedged item affects earnings. Ineffective portions of changes in the fair value of cash flow hedges are recognized in earnings. The Company uses interest rate swaps to manage exposure to variable cash flows on portions of its borrowings under reverse repurchase agreements and as trading derivatives intended to offset changes in fair value related to securities held as trading assets. On the date in which the derivative contract is entered, the Company designates the derivative as either a cash flow hedge or a trading derivative. On June 30, 2004, interest rate swaps with a notional of $264,000 that were classified as trading securities were reclassified as available-for-sale securities. The reclassification was based on the Company's intent with respect to these securities with the principle objective of generating returns from other than short-term pricing differences. As of June 30, 2004, the Company had interest rate swaps with notional amounts aggregating $1,231,982 that were designated as cash flow hedges of borrowings under reverse repurchase agreements. Cash flow hedges with a fair value of $30,112 are included in other assets on the consolidated statement of financial condition and cash flow hedges with a fair value of $(13,594) are included in other liabilities on the consolidated statement of financial condition. For the six months ended June 30, 2004, the net change in the fair value of the interest rate swaps was an increase of $25,324, of which $506 was deemed ineffective and is included as a decrease to interest expense and $24,818 was recorded as an increase of OCI. As of June 30, 2004, the $1,231,982 notional of swaps that was designated as cash flow hedges had a weighted average remaining term of 7.9 years. As of June 30, 2004, the Company had interest rate swaps with notional amounts aggregating $239,445 designated as trading derivatives. Trading derivatives with a fair value of $125 are included in other assets on the consolidated statement of financial condition and trading derivatives with a fair value of $(49) are included in other liabilities on the consolidated statement of financial condition. For the six months ended June 30, 2004, the change in fair value for these trading derivatives was a decrease of $1,011 and is included as an addition to loss on securities held-for-trading in the consolidated statements of operations. As of June 30, 2004, the $239,445 notional of swaps that was designated as trading derivatives had a weighted average remaining term of 8.17 years. Occasionally, counterparties will require the Company or the Company will require counterparties to provide collateral for the interest rate swap agreements in the form of margin deposits. Net deposits are recorded as a component of either other assets or other liabilities. Should the counterparty fail to return deposits paid, the Company would be at risk for the fair market value of that asset. At June 30, 2004 and December 31, 2003, the balance of such net margin deposits owed to counterparties as collateral under these agreements totaled $420 and $10,445, respectively, and are recorded in restricted cash on the accompanying consolidated statements of financial condition. The contracts identified in the remaining portion of this note have been entered into to limit the Company's mark to market exposure to long-term interest rates. Additionally, the Company had a forward London Interbank Offered Rate ("LIBOR") cap with a notional amount of $85,000 and a fair value at June 30, 2004 of $878 which is included in other assets, and the change in fair value related to this derivative is included as a component of loss on securities held-for-trading in the consolidated statements of operations. ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS All dollar figures expressed herein are expressed in thousands, except share or per share amounts or as otherwise noted. I. General Anthracite Capital, Inc. (the "Company"), a Maryland corporation, is a real estate finance company that generates income based on the spread between the interest income on its mortgage loans and securities investments and the interest expense from borrowings to finance its investments. The Company's primary activity is investing in high yielding commercial real estate debt. The Company combines traditional real estate underwriting and capital markets expertise to exploit the opportunities arising from the continuing integration of these two disciplines. The Company focuses on acquiring pools of performing loans in the form of commercial mortgage-backed securities ("CMBS"), issuing secured debt backed by CMBS and providing strategic capital for the commercial real estate industry in the form of mezzanine loan financing. The Company commenced operations on March 24, 1998. The Company's common stock is traded on the New York Stock Exchange under the symbol "AHR." The Company's primary long-term objective is to distribute consistent dividends supported by earnings. The Company establishes its dividend by analyzing the long-term sustainability of earnings given existing market conditions and the current composition of its portfolio. This includes an analysis of the Company's credit loss assumptions, general level of interest rates and projected hedging costs. The Company is managed by BlackRock Financial Management, Inc. (the "Manager"), a subsidiary of BlackRock, Inc., a publicly traded (NYSE: BLK) asset management company with approximately $310,000,000 of assets under management as of June 30, 2004. The Manager provides an operating platform that incorporates significant asset origination, risk management, and operational capabilities. During the second quarter of 2004, the Company largely completed its repositioning into commercial real estate assets; CMBS and commercial real estate loans represent 87% of portfolio assets at quarter-end while residential mortgage-backed securities ("RMBS") represent 13%. During the quarter, the Company acquired commercial real estate assets with a market value of $135,332, comprised of $36,785 of below investment grade CMBS, $68,441 of investment grade CMBS, and $30,106 of high yield commercial real estate loans. The Company reduced its net RMBS position by $106,184 during the quarter, which resulted in a realized loss of $3,870. In July 2004, the Company acquired an additional $58,836 of commercial real estate securities, and sold $24,420 of fixed-rate RMBS. The sale of these fixed-rate RMBS will result in a net realized gain of $119 in the third quarter of 2004 and marks the completion of the repositioning of the Company's investment portfolio. At the end of the first quarter of 2004, the Board of Directors approved the Company's decision to redeem its Series B Preferred Stock, $0.001 par value per share ("Series B Preferred Stock"). The second quarter of 2004 earnings includes a charge of $0.21 per share for the redemption of the Company's Series B Preferred Stock that was reported as a charge to income in the initial first quarter 2004 earnings release but was subsequently moved to the second quarter to coincide with the timing of the actual redemption payment as reported on May 11, 2004. The Series B Preferred Stock was redeemed on May 6, 2004. The Company continues to maintain a positive, though controlled, exposure to both long- and short-term interest rates through its active hedging strategies. See "Item 3 - Quantitative and Qualitative Disclosures about Market Risk" for a discussion of interest rates and their effect on earnings and book value. The following table illustrates the mix of the Company's asset types as of June 30, 2004 and December 31, 2003: Carrying Value as of June 30, 2004 December 31, 2003 Amount % Amount % -- Commercial real estate securities $1,579,434 44.8% $1,393,010 65.8% Commercial mortgage loan pools 1,319,533 37.4 - - Commercial real estate loans(1) 152,714 4.3 97,984 4.6 Residential mortgage-backed securities(2) 474,803 13.5 627,166 29.6 -- Total $3,526,484 100.0% $2,118,160 100.0% -- (1) Includes real estate joint ventures and equity investments. (2) Net of RMBS securities sold, not yet settled. As of June 30, 2004, the Company owns thirteen different trusts where through its investment in subordinated CMBS of such trusts is in the first loss position ("Controlling Class"). The Company divides its below investment grade CMBS investment activity into two portfolios; Controlling Class CMBS and other below investment grade CMBS. The distinction between the two is in the controlling class rights the Company obtains with its investment in Controlling Class CMBS. Controlling class rights allow the Company to control the workout and/or disposition of defaults that occur in the underlying loans. These securities absorb the first losses realized in the underlying loan pools. The Company's other below investment grade CMBS have no rights associated with its ownership to control the workout and/or disposition of underlying loan defaults; however, these investments are not the first to absorb losses in the underlying pools. The coupon payment on the non-rated security can also be reduced for special servicer fees charged to the trust. The next highest rated security in the structure will then generally be downgraded to non-rated and becomes the first to absorb losses and expenses from that point on. Commercial Mortgage Loans Pools and Commercial Real Estate Securities Portfolio Activity The Company settled its eleventh Controlling Class CMBS transaction during the second quarter of 2004. The securities acquired had a total par value of $41,495 with $13,890 not rated and the balance rated BBB- through B-. In addition to these securities, the real estate mortgage investment conduit ("REMIC") trust formed for this transaction also issued $1,193,118 par value of investment grade rated securities that were not acquired by the Company. The adjusted issue price of these securities at June 30, 2004 is $1,197,982. The principal and interest payments of all these securities are secured by the principal and interest payments on $1,234,613 par value of commercial mortgage loans. The adjusted issue price of these commercial mortgage loans at June 30, 2004 is $1,232,475. As the Controlling Class holder, the Company has the ability to control dispositions or workouts of any defaulted loans in this pool. The Company negotiated for and obtained a greater degree of discretion over the disposition of the commercial mortgage loans than is typically granted to the special servicer. As a result of this expanded discretion, FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" (revised December 2003) ("FIN 46R") requires the Company to consolidate the net assets and results of operations of the issuing REMIC trust. In addition to the securities described above, the REMIC trust also issued two classes of interest-only securities that entitles the interest only security holders to a portion of the interest payments made on the loans in the trust, but does not entitle the holders to any principal payments. The amortized issue price of the interest only securities that increased the amount of long-term borrowings outstanding was $100,654 as of June 30, 2004. This amount and the unamortized premium on the mortgage loan pools ($88,182 as of June 30, 2004) are included in the Company's June 30, 2004 consolidated statement of financial condition. The net effect on the Company's consolidated statement of financial condition at June 30, 2004 from the consolidation of the net assets of the REMIC trust represents the adjusted purchase price of the Controlling Class interests acquired (see table below). The debt associated with the REMIC trust is non-recourse to the Company, and is secured only by the commercial mortgage loan pools. The consolidation of the REMIC trust results in an increase in the Company's total debt to capital ratio from 4.4:1 to 7.5:1, but has no effect on the Company's recourse debt to capital ratio. For income recognition purposes, the Company will record revenue on the underlying loans and establish a loss reserve consistent with the credit assumptions made in establishing loss adjusted yields for Controlling Class securities. A summary of the impact to the statement of financial condition related to the consolidation of the commercial mortgage loan pools under FIN 46R is as follows: Commercial mortgage loan pools at par $1,232,475 Commercial mortgage loan pools unamortized premium 87,058 Other assets - principal receivable/due diligence 980 Long-term borrowings: Secured by pledge of commercial mortgage loan pools (1,197,982) Interest only securities issued by the trust (100,654) ----------------- Net assets related to commercial mortgage loan pools $21,877 ================= Approximately 45% of the par amount of the commercial mortgage loan pool is comprised of loans that are shadow rated A2 or better by Moody's Investors Service and AA by Standard & Poor's. The Company has taken into account the credit quality of the underlying loans in formulating its loss assumptions. Credit losses assumed on the entire pool are 1.40% of the principal balance, or 2.53% of the unrated principal balance. The Company accounts for the unrated commercial mortgage loans in the pool as a single asset based on this common credit risk characteristic. The Company continues to increase its investments in commercial real estate securities. Commercial real estate securities include CMBS and investment grade real estate investment trust ("REIT") debt. During the six months ended June 30, 2004, the Company increased its commercial real estate securities portfolio by 13% from $1,393,010 to $1,579,434. This increase was primarily attributable to the purchase of CMBS and investment grade REIT debt. The Company's collateralized debt obligation ("CDO") offerings allow the Company to match fund its commercial real estate portfolio by issuing long-term debt to finance long-term assets. The CDO debt is non-recourse to the Company; therefore, the Company's losses are limited to its equity investment in the CDO. The CDO debt is also fully hedged to protect the Company from an increase in short-term interest rates. The Company considers all of its CMBS rated BB+ down to B to be financeable in a CDO transaction; as of June 30, 2004, over 88% of the market value of these assets are match funded in the Company's CDOs in this manner. Collateral as of June 30, 2004 Debt as of June 30, 2004 -- Adjusted Purchase Loss Adjusted Adjusted Issue Weighted Average Net Price Yield Price Cost of Funds* Spread -- ------ CDO I $444,341 8.89% $404,996 7.21% 1.68% CDO II 327,110 7.81 280,182** 5.73 2.08 CDO III 392,651 6.74 372,039*** 5.03 1.71

-- ------ Total ** $1,164,102 7.86% $1,057,217 6.05% 1.81% * Weighted Average Cost of Funds is the current cost of funds plus hedging expenses. ** The Company chose not to sell $22,850 of par of CDO II debt rated BBB- and BB. *** The Company chose not to sell $13,069 of par of CDO III debt rated BB. The following table details the par, fair market value, adjusted purchase price, and loss adjusted yield of the Company's commercial real estate securities outside of the CDOs as of June 30, 2004: Adjusted Loss Fair Market Dollar Purchase Dollar Adjusted Par Value Price Price Price Yield -- Investment grade CMBS $134,940 $129,405 95.90 $137,517 101.91 4.71% Investment grade REIT debt 11,000 10,449 94.99 11,217 101.97 5.14 CMBS rated BB+ to B 107,522 71,428 66.43 83,124 77.31 8.18 CMBS rated B- or lower 345,028 93,715 27.16 121,298 35.16 12.05 CMBS IOs 3,607,730 127,041 3.52 125,493 3.48 7.39 Project loans 23,754 24,796 104.39 24,818 104.48 5.67 -- Total $4,229,974 $456,834 10.80 $503,467 11.90 7.78% The following table details the par, fair market value, adjusted purchase price and loss adjusted yield of the Company's commercial real estate securities outside of the CDOs as of December 31, 2003: Adjusted Loss Fair Market Dollar Purchase Dollar Adjusted Par Value Price Price Price Yield -- Investment grade CMBS $277,276 $268,593 96.87 $272,853 98.40 4.9% Investment grade REIT debt 29,000 29,567 101.95 30,210 104.17 5.0 CMBS rated BB+ to B 186,217 133,868 71.89 150,775 80.97 8.9 CMBS rated B- or lower 304,358 80,680 26.51 107,653 35.37 12.6 CMBS IOs 2,623,456 84,493 3.22 83,704 3.19 7.5 Other CMBS 20,266 20,142 99.39 20,264 99.99 5.7 -- Total $3,440,573 $617,343 17.94 $665,459 19.34 7.4% Below Investment Grade CMBS and Underlying Loan Performance During the six months ended June 30, 2004, the Company acquired $25,386 of par of other below investment grade CMBS and $116,793 of par of new Controlling Class securities. The total par of the Company's other below investment grade CMBS at June 30, 2004 was $329,997; the average credit protection, or subordination level, of this portfolio is 5.87%. The total par of the Company's subordinated Controlling Class CMBS securities at June 30, 2004 was $880,780 and the total par of the loans underlying these securities was $15,897,820. The Company's investment in its Controlling Class CMBS securities by credit rating category at June 30, 2004 is as follows: Fair Market Dollar Adjusted Dollar Subordination Par Value Price Purchase Price Price Level --- BB+ $97,937 $85,184 86.98 $83,514 85.27 6.26% BB 88,687 76,927 86.74 73,341 82.70 4.97 BB- 98,237 67,982 69.20 75,751 77.11 4.31 B+ 61,599 38,606 62.67 41,102 66.73 3.07 B 190,738 104,877 54.98 138,800 72.77 2.78 B- 91,914 35,686 38.82 54,440 59.23 1.91 CCC+ 11,924 5,550 46.54 7,204 60.42 1.59 CCC 70,272 13,381 19.04 22,397 31.87 1.02 CC 8,940 2,561 28.64 2,648 29.61 0.64 NR 158,932 32,192 20.26 30,638 19.28 n/a --- Total $879,180 $462,946 52.66 $529,835 60.26 The Company's investment in its Controlling Class CMBS securities by credit rating category at December 31, 2003 is as follows: Fair Market Dollar Adjusted Dollar Subordination Par Value Price Purchase Price Price Level --- BB+ $84,503 $73,766 87.29 $72,680 86.01 7.54% BB 89,945 75,349 83.77 76,842 85.43 6.04 BB- 101,393 71,285 70.31 81,036 79.92 5.12 B+ 44,314 28,904 65.22 31,179 70.36 3.43 B 182,119 105,061 57.69 133,718 73.42 3.06 B- 83,296 34,160 41.01 51,935 62.35 1.54 CCC+ 11,924 5,595 46.92 7,129 59.78 1.53 CCC 70,273 13,375 19.03 22,844 32.51 1.23 C 8,940 2,531 28.31 2,734 30.58 0.62 NR 129,925 25,003 19.24 23,011 17.71 n/a --- Total $806,632 $435,029 53.93 $503,108 62.37 During the three months ended June 30, 2004, one of the Company's Controlling Class securities was upgraded from BB+ to BBB and is no longer included in the chart above. For the six months ended June 30, 2004, the par amount of the Company's Controlling Class CMBS securities was reduced by the servicers in the amount of $22,664. Further delinquencies and losses may cause par reductions to continue and cause the Company to conclude that a change in loss-adjusted yield is required along with a write down of the adjusted purchase price through the consolidated statement of operations according to Emerging Issue Task Force standard 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets." Additionally, for the six months ended June 30, 2004, $39,971 of the underlying loan pools was repaid. Pay down proceeds are distributed to the highest rated CMBS class first and reduce the percent of total underlying collateral represented by each rating category. For all of the Company's Controlling Class securities, the Company assumes that a total of 2.10% of the original loan balance will not be recoverable. This estimate was developed based on an analysis of individual loan characteristics and prevailing market conditions at the time of origination. This loss estimate equates to cumulative expected defaults of approximately 5.2% over the life of the portfolio and an average assumed loss severity of 40.0% of the defaulted loan balance. All estimated workout expenses including special servicer fees are included in these assumptions. Actual results could differ materially from these estimated results. See Item 3 -"Quantitative and Qualitative Disclosures About Market Risk" for a discussion of how differences between estimated and actual losses could affect Company earnings. The Company monitors credit performance on a monthly basis and debt service coverage ratios on a quarterly basis. Using these and other statistics, the Company maintains watch lists for loans that are delinquent thirty days or more and for loans that are not delinquent but have issues that the Company's management believes require close monitoring. As part of its ongoing credit monitoring the Company periodically performs a re-underwriting of a substantial number of the underlying loans supporting its Controlling Class CMBS. The Company is currently focusing on 1998 vintage transactions and expects to be completed with this vintage by the fourth quarter of 2004. As each transaction review is completed the Company may determine that its yields in accordance with generally accepted accounting principles in the United States of America ("GAAP") and book values need to be adjusted. The Company considers delinquency information from the Lehman Brothers Conduit Guide to be the most relevant benchmark to measure credit performance and market conditions applicable to its Controlling Class CMBS holdings. The year of issuance, or vintage year, is important, as older loan pools will tend to have more delinquencies than newly underwritten loans. The Company owns Controlling Class CMBS issued in 1998, 1999, 2001, 2003 and 2004. Comparable delinquency statistics referenced by vintage year as a percentage of current par as of June 30, 2004 are shown in the table below: Underlying Delinquencies Lehman Brothers Vintage Year Collateral Outstanding Conduit Guide -- 1998 $7,264,726 2.33% 2.40% 1999 706,817 0.88% 2.54 2001 917,072 1.58% 1.19 2003 2,187,991 0.20% 0.06 2004 4,821,214 0.00% 0.14 --- Total $15,897,820 1.22%* 1.33%* * Weighted average based on current principal balance. Morgan Stanley also tracks CMBS loan delinquencies for the specific CMBS transactions with more than $200,000 of collateral and that have been seasoned for at least one year. This seasoning criterion will generally adjust for the lower delinquencies that occur in newly originated collateral. As of June 30, 2004, the Morgan Stanley index indicated that delinquencies on 260 securitizations were 2.18%, and as of December 31, 2003, this same index indicated that delinquencies on 243 securitizations were 2.47%. See Item 3 - "Quantitative and Qualitative Disclosures About Market Risks" for a detailed discussion of how delinquencies and loan losses affect the Company. Delinquencies on the Company's CMBS collateral as a percent of principal increased in line with expectations. The Company's aggregate delinquency experience is consistent with comparable data provided in the Lehman Brothers Conduit Guide. Of the 31 delinquent loans shown on the chart in Note 3 of the consolidated financial statements, 1 loan was real estate owned and being marketed for sale, no loans were being foreclosed, and the remaining 30 loans were in some form of workout negotiations. For the 1998 and 1999 Controlling Class securities where the Company has experienced losses, aggregate losses of $8,593 were realized during six months ended June 30, 2004, bringing cumulative net losses realized to $50,026 or 25% of total estimated losses for these securities. There were no realized losses on the Company's Controlling Class securities with vintages from 2000 through 2004. These losses include special servicer and other workout expenses. Experience to date is in line with the Company's loss expectations. Realized losses and special servicer expenses are expected to increase on the underlying loans as the portfolio ages. The Company manages its credit risk through disciplined underwriting, diversification, active monitoring of loan performance and exercise of its right to control the workout process for delinquent loans as early as possible. The Company maintains diversification of credit exposures through its underwriting process and can shift its focus in future investments by adjusting the mix of loans in subsequent acquisitions. The comparative profiles of the loans underlying the Company's CMBS by property type as of June 30, 2004 and December 31, 2003 are as follows: 6/30/04 Exposure 12/31/03 Exposure -- Property Type Loan Balance % of Total Loan Balance % of Total -- Multifamily $4,826,610 30.4% $3,770,944 33.2% Retail 4,692,521 29.5 3,446,371 30.4 Office 4,497,465 28.3 2,266,160 20.0 Lodging 841,455 5.3 786,920 6.9 Industrial 679,535 4.3 713,942 6.3 Healthcare 334,838 2.1 337,333 3.0 Parking 25,396 0.1 25,611 0.2 -- Total $15,897,820 100% $11,347,281 100% == As of June 30, 2004, the fair market value of the Company's holdings of Controlling Class CMBS securities is $66,511 lower than the adjusted cost for these securities. The adjusted purchase price and market value of the Company's Controlling

Class CMBS portfolio as of June 30, 2004 represents approximately 61% and 53%, respectively, of its par amount. As the portfolio matures, the Company expects to recoup the unrealized loss, provided that the credit losses experienced are not greater than the credit losses assumed in the purchase analysis. As of June 30, 2004, the Company believes there has been no material deterioration in the credit quality of its portfolio below current expectations. As the portfolio matures and expected losses occur, subordination levels of the lower rated classes of a CMBS investment will be reduced. This may cause the lower rated classes to be downgraded which would negatively affect their market value and therefore the Company's net asset value. Reduced market value will negatively affect the Company's ability to finance any such securities that are not financed through a CDO or similar matched funding vehicle. In some cases, securities held by the Company may be upgraded to reflect seasoning of the underlying collateral and thus would increase the market value of the securities. For the six months ended June 30, 2004, the Company experienced four credit upgrades on two CMBS transactions in the Company's portfolio. No securities were downgraded. The Company's income for its CMBS securities is computed based upon a yield in accordance with GAAP, which assumes credit losses will occur. The yield to compute the Company's taxable income does not assume there will be credit losses, as a loss can only be deducted for tax purposes when it has occurred. As a result, for the period beginning with the year ended December 31, 1998 through the six months ended June 30, 2004, the Company's GAAP income accrued on its CMBS assets was approximately $30,740 lower than the taxable income accrued on its CMBS assets. Commercial Real Estate Loan Activity The Company's commercial real estate loan portfolio generally emphasizes larger transactions located in metropolitan markets, as compared to the typical loan in the CMBS portfolio. The Company has never suffered a loss in this portfolio. Because the loan portfolio is relatively small and heterogeneous, the Company has determined it is not necessary to establish a loan loss reserve. The following table summarizes the Company's commercial real estate loan portfolio by property type as of June 30, 2004 and December 31, 2003: Loan Outstanding -- Weighted Average Coupon June 30, 2004 December 31, 2003 June 30, 2004 December 31, 2003 -- Property Type Amount % Amount % -- Office $96,294 84.4% $57,381 76.4% 9.1% 9.4% Residential 2,722 2.4 2,794 3.7 3.9 3.8 Retail 193 0.2 - - 13.5 - Hotel 14,790 13.0 14,951 19.9 6.6 6.6 -- Total $113,999 100.0% $75,126 100.0% 8.7% 8.6% -- Recent Events In July 2004, the Company acquired an additional $58,836 of commercial real estate securities, and sold $24,420 of fixed-rate RMBS. The sale of these fixed-rate RMBS will result in a net realized gain of $119 in the third quarter of 2004 and marks the completion of the repositioning of the Company's investment portfolio. Recent Accounting Pronouncements In March 2004, the Emerging Issues Task Force, or EITF, reached a consensus on Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." This Issue provides clarification with respect to the meaning of other-than-temporary impairment and its application to investments classified as either available-for-sale or held-to-maturity under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," (including individual securities and investments in mutual funds), and investments accounted for under the cost method or the equity method. The guidance for evaluating whether an investment is other-than-temporarily impaired must be applied in other-than-temporary impairment evaluations made in reporting periods beginning after June 15, 2004. The Company is currently evaluating the effect of this Issue on its consolidated financial statements. II. Results of Operations Net income (loss) for the three and six months ended June 30, 2004 was $(4,177) or $(0.08) per share (basic and diluted) and $5,666 or $0.11 per share (basic and diluted), respectively. Net loss for the three and six months ended June 30, 2003 was $(12,614) or $(0.26) per share (basic and diluted) and ($4,113) or $(0.09) per share (basic and diluted), respectively. Net loss decreased to $(0.08) per share for the six months ended June 30, 2004 as compared to $(0.09) per share for the six months ended June 30, 2003. Net income for the six months ended June 30, 2004 includes a charge of $0.21 per share for the redemption of the Company's Series B Preferred Stock. Net income for the six months ended June 30, 2003 includes a charge of $0.56 per share for the impairment charge on the Company's Controlling Class CMBS securities. Interest Income: The following tables sets forth information regarding the total amount of income from certain of the Company's interest-earning assets. For the Three Months Ended June 30, 2004 2003 -- Interest Interest Income Income -- Commercial real estate securities $30,166 $23,030 Commercial mortgage loan pools 12,351 - Commercial real estate loans 1,979 2,105 RMBS 5,386 16,126 Cash and cash equivalents 103 209

-- Total $49,985 $41,470 == For the Six Months Ended June 30, 2004 2003 -- Interest Interest Income Income -- Commercial real estate securities $59,352 $45,604 Commercial mortgage loan pools 12,351 - Commercial real estate loans 3,458 3,290 RMBS 12,103 34,035 Cash and cash equivalents 191 385 -- Total $87,455 $83,314 == The following chart reconciles interest income and total income for the three and six months ended June 30, 2004 and 2003. For the Three Months Ended June 30, 2004 2003 ------------------------------------- Interest income $49,985 $41,470 Earnings from real estate joint ventures 542 238 Earnings from equity investment 1,619 702 ------------------------------------- Total Income $52,146 $42,410 ======================================= For the Six Months Ended June 30, 2004 2003 ------------------------------------- Interest income $87,455 $83,314 Earnings from real estate joint ventures 764 473 Earnings from equity investment 2,991 1,446 ------------------------------------- Total Income $91,210 $85,233 ======================================= Interest Expense: The following table sets forth information regarding the total amount of interest expense from certain of the Company's collateralized borrowings. Information is based on daily average balances during the period. For the Three Months Ended June 30, 2004 2003 -- Interest Interest Expense Expense -- Reverse repurchase agreements $2,366 $5,608 Lines of credit and term loan 477 234 CDO liabilities 15,678 6,825 Commercial mortgage loan pools 11,948 - -- Total $30,469 $12,667 == For the Six Months Ended June 30, 2004 2003 -- Interest Interest Expense Expense -- Reverse repurchase agreements $5,512 $11,065 Lines of credit and term loan 1,432 370 CDO liabilities 26,846 13,625 Commercial mortgage loan pools 11,948 - -- Total $45,738 $25,060 == The foregoing interest expense amounts for the three and six months ended June 30, 2004, respectively, do not include $(467) and $506 of interest expense related to hedge ineffectiveness, as well as $3,148 and $7,779 of interest expense related to swaps. The foregoing interest expense amounts for the three and six months ended June 30, 2003, respectively, do not include $(21) and $241 of interest expense related to hedge ineffectiveness and $9,091 and $16,141 of interest expense related to swaps. The reduction in interest expense related to swaps is primarily attributable to the issuance of the Company's third CDO as well as a reduction in swap notional. See Note 11 of the consolidated financial statements, Derivative Instruments, for a further description of the Company's hedge ineffectiveness. Net Interest Margin and Net Interest Spread from the Portfolio: The Company considers its portfolio to consist of its securities available-for-sale, mortgage loan pools, commercial mortgage loans and cash and cash equivalents because these assets relate to its core strategy of acquiring and originating high yield loans and securities backed by commercial real estate, while at the same time maintaining a portfolio of investment grade securities to enhance the Company's liquidity. Net interest margin from the portfolio is annualized net interest income from the portfolio divided by the average market value of interest-earning assets in the portfolio. Net interest income from the portfolio is total interest income from the portfolio less interest expense relating to collateralized borrowings. Net interest spread from the portfolio equals the yield on average assets for the period less the average cost of funds for the period. The yield on average assets is interest income from the portfolio divided by average amortized cost of interest earning assets in the portfolio. The average cost of funds is interest expense from the portfolio divided by average outstanding collateralized borrowings. The following chart describes the interest income, interest expense, net interest margin and net interest spread for the Company's portfolio. The following interest income and interest expense amounts exclude income and expense related to real estate joint ventures, equity investment, hedge ineffectiveness, and the effect of the consolidation of the commercial mortgage loan pools. The decrease in net interest margin is primarily a result of lower leverage and the net interest spread decrease due to investment in additional higher credit quality CMBS. For the Three Months Ended June 30, 2004 2003 --- Interest income $38,037 $41,470 Interest expense $21,669 $21,751 Net interest margin 3.05% 3.05% Net interest spread 2.43% 2.66% Other Expenses: Expenses other than interest expense consist primarily of management fees and general and administrative expenses. Management fees paid to the Manager of $2,163 and $4,293 for the three and six months ended June 30, 2004, respectively, were solely base management fees and were lower as the Manager agreed to reduce the management fees by 20% for the quarter ended March 31, 2004. Management fees paid to the Manager of $2,649 and $5,226 for the three and six months ended June 30, 2003, respectively, and were solely base management fees. General and administrative expense of $633 and $1,235 for the three and six months ended June 30, 2004, respectively, and $591 and $1,173 for the three and six months ended June 30, 2003, respectively, were comprised of accounting agent fees, custodial agent fees, directors' fees, fees for professional services, and insurance premiums. Other Gains (Losses): During the six months ended June 30, 2004 and 2003, the Company sold a portion of its securities available-for-sale for total proceeds of $280,936 and $977,843, respectively, resulting in a realized gain (loss) of $(1,222) and $3,435 for the six months ended June 30, 2004 and 2003, respectively. The losses on securities held for trading were $4,046 and $4,716 for the three months ended June 30, 2004 and 2003, respectively, and $10,030 and $15,119 for the six months ended June 30, 2004 and 2003, respectively. The foreign currency loss of $(12) for the three and six months ended June 30, 2004 relate to the Company's net investment in a commercial mortgage loan denominated in euros and associated hedging. Dividends Declared: On March 11, 2004, the Company declared distributions to its stockholders of $0.28 per share, which was paid on April 30, 2004 to stockholders of record on March 31, 2004. On May 25, 2004, the Company declared dividends to its common stockholders of $0.28 per share, payable on August 2, 2004 to stockholders of record on June 30, 2004. Changes in Financial Condition Securities Available-for-sale: The Company's securities available-for-sale, which are carried at estimated fair value, included the following at June 30, 2004 and December 31, 2003: June 30, 2004 December 31, Estimated 2003 Estimated Fair Fair Security Description Value Percentage Value Percentage -- Commercial mortgage-backed securities: CMBS IOs $ 127,040 6.2% $84,493 4.7% Investment grade CMBS 398,307 19.4 333,453 18.5 Non-investment grade rated subordinated securities 721,865 35.1 678,424 37.6 Non-rated subordinated securities 36,488 1.8 25,019 1.4 Credit tenant lease 25,277 1.2 25,696 1.4 Investment grade REIT debt 245,660 12.0 219,422 12.1 Project loans 24,797 1.2 26,503 1.4 -- Total CMBS 1,579,434 76.9 1,393,010 77.1 -- Single-family residential mortgage-backed securities: Agency adjustable rate securities 283,864 13.8 180,381 10.0 Agency fixed-rate securities 25,868 1.3 222,500 12.3 Residential CMOs 1,754 0.1 3,464 0.2 Hybrid arms 163,317 7.9 6,645 0.4 -- Total RMBS 474,803 23.1 412,990 22.9 -- -- Total securities available-for-sale $2,054,237 100.0% $1,806,000 100.0% == The Company's CMBS and investment grade REIT debt increased slightly from December 31, 2003 as the Company is continuing to purchase these types of assets. Borrowings: As of June 30, 2004, the Company's debt consisted of CDOs, commercial mortgage loan pools, line-of-credit borrowings, and reverse repurchase agreements, collateralized by a pledge of most of the Company's securities available-for-sale, commercial mortgage loan pools, securities held-for-trading, and its commercial mortgage loans. As of December 31, 2003, the Company's debt consisted of CDOs, line-of-credit borrowings, and reverse repurchase agreements, collateralized by a pledge of most of the Company's securities available-for-sale, securities held-for-trading, and its commercial mortgage loans. The Company's financial flexibility is affected by its ability to renew or replace on a continuous basis its maturing short-term borrowings. As of June 30, 2004 and December 31, 2003, the Company has obtained financing in amounts and at interest rates consistent with the Company's short-term financing objectives. Under the lines of credit, and the reverse repurchase agreements, the lender retains the right to mark the underlying collateral to market value. A reduction in the value of its pledged assets would require the Company to provide additional collateral or fund margin calls. From time to time, the Company expects that it will be required to provide such additional collateral or fund margin calls. The following table sets forth information regarding the Company's collateralized borrowings: For the Six Months Ended June 30, 2004 -- June 30, 2004 Maximum Range of Balance Balance Maturities --------------- --------------- --------------------- Collateralized debt obligations $1,057,217 $1,057,522 7.4 to 9.6 years Commercial mortgage loan pools 1,298,636 1,306,724 3.6 to 10.3 years Reverse repurchase agreements 730,701 1,148,306 1 to 379 days Line of credit and term loan borrowings 57,745 391,511 371 to 379 days --------------- --------------- --------------------- Hedging Instruments: From time to time, the Company may reduce its exposure to market interest rates by entering into various financial instruments that adjust portfolio duration. These financial instruments are intended to mitigate the effect of changes in interest rates on the value of certain assets in the Company's portfolio. At June 30, 2004, the Company had no outstanding U.S. Treasury Note future contracts. At December 31, 2003, the Company had outstanding short positions of 30 five-year and 73 ten-year U.S. Treasury Note future contracts. Interest rate swap agreements as of June 30, 2004 and December 31, 2003 consisted of the following: June 30, 2004 Weighted Average Notional Estimated Unamortized Remaining Value Fair Value Cost Term -- Interest rate swaps $521,700 $9,865 $ - 6.23 years Interest rate swaps - CDO 949,727 6,728 - 8.89 years -- Total $1,471,427 $16,593 $ - 7.95 years == December 31, 2003 Weighted Average Notional Estimated Unamortized Remaining Value Fair Value Cost Term -- Interest rate swaps $919,300 $(2,929) $23 5.46 years Interest rate swaps - CDO 626,323 (23,423) - 9.17 years -- Total $1,545,623 $(26,352) $23 6.96 years == As of June 30, 2004, the Company had designated $521,700 notional of the interest rate swap agreements as cash flow hedges. As of December 31, 2003, the Company had designated $1,066,078 notional of the interest rate swap agreements as cash flow hedges. Capital Resources and Liquidity Liquidity is a measurement of the Company's ability to meet potential cash requirements, including ongoing commitments to repay borrowings, fund investments, loan acquisition and lending activities and for other general business purposes. The primary sources of funds for liquidity consist of collateralized borrowings, principal and interest payments on and maturities of securities available-for-sale, securities held-for-trading and commercial mortgage loans, and proceeds from the maturity or sales thereof. To the extent that the Company may become unable to maintain its borrowings at their current level due to changes in the financing markets for the Company's assets, the Company may be required to sell assets in order to achieve lower borrowing levels. In this event, the Company's level of net income would decline. The Company's principal strategies for mitigating this risk are to maintain portfolio leverage at levels it believes are sustainable and to diversify the sources and types of available borrowing and capital. The Company has utilized committed bank facilities and preferred stock offerings, and will consider resecuritization or other achievable term funding of existing assets. At the end of the first quarter of 2004, the Board of Directors approved the Company's decision to redeem its Series B Preferred Stock. The second quarter of 2004 earnings includes a charge of $0.21 per share for the redemption of the Company's Series B Preferred Stock that was reported as a charge to income in the initial first quarter 2004 earnings release but was subsequently moved to the second quarter to coincide with the timing of the actual redemption payment as reported on May 11, 2004. The Series B Preferred Stock was redeemed on May 6, 2004. For the six months ended June 30, 2004, the Company issued 1,077,102 shares of Common Stock under its Dividend Reinvestment and Stock Purchase Plan (the "Dividend Reinvestment Plan"). Net proceeds to the Company were approximately $12,606. For the three and six months ended June 30, 2003, respectively, the Company issued 353,065 and 686,393 shares of Common Stock under its Dividend Reinvestment Plan. Net proceeds to the Company were approximately $4,179 and $7,697, respectively. For the three and six months ended June 30, 2004, the Company issued 213,100 shares of Common Stock under a sale agency agreement with Brinson Patrick Securities Corporation. Net proceeds to the Company were approximately $2,299. During the first quarter of 2004, the Company suspended its Dividend Reinvestment Plan for all investments after March 26, 2004, and for all future investment dates. During the second quarter of 2004, the dividend reinvestment portion of the Dividend Reinvestment Plan was reinstated for all dividend payments made after August 2, 2004, and for all future dividend payment dates with a discount of 2%. The optional cash purchase portion of the Dividend Reinvestment Plan remains suspended; however, it may be resumed at any time. As of June 30, 2004, $134,685 of the Company's $185,000 committed credit facility with Deutsche Bank, AG was available for future borrowings and $67,570 of the Company's $75,000 committed credit facility with Greenwich Capital, Inc. was available. The Company also recently renewed its committed borrowing facility from Greenwich Capital, Inc. in the amount of $75,000. This facility was scheduled to mature in July 2004 and was extended to July 2005. At June 30, 2004, the Company's collateralized borrowings had the following remaining maturities: Commercial Total Lines of Reverse Repurchase Collateralized Mortgage Loan Collateralized Credit Agreements Debt Obligations Pools Borrowings -- Within 30 days $ - $717,931 $ - $ - $717,931 31 to 59 days - - - - - 60 days to less than 1 year - - - - - 1 year to 2 years - - - - - Over 5 years 57,745 12,770 1,057,217* 1,298,636** 2,426,368 -- $57,745 $730,701 $1,057,217 $1,298,636 $3,144,299 ==

* Comprised of $404,996 of CDO debt with a weighted average remaining maturity of 7.79 years as of June 30, 2004, $280,182 of CDO debt with a weighted average remaining maturity of 7.84 years as of June 30, 2004 and $372,039 of

CDO debt with a weighted average remaining maturity of 8.9 years as of June 30, 2004. ** The commercial mortgage loan pools have a weighted average remaining maturity of 7.55 years as of June 30, 2004. The Company has no off-balance sheet financing arrangements. On March 30, 2004 the Company issued its third collateralized debt obligation ("CDO III") through Anthracite CDO 2004-1. The total par value of bonds sold was $372,456. The total cost of funds on a fully hedged basis was 5.0%. CDO III also includes a $50,000 ramp facility that will be used to finance future commercial real estate assets, thus eliminating financing risk for up to $50,000 of below investment grade CMBS investments to be acquired during the year. On June 30, 2004 the Company completed a follow-on offering of 2,100,000 shares of its common stock in an underwritten public offering. The aggregate net proceeds to the Company (after deducting underwriting fees and expenses) were approximately $23,184. The Company had granted the underwriters an option, exercisable for 30 days, to purchase up to 315,000 additional shares of Common Stock to cover over-allotments. This option was exercised on July 6, 2004 and resulted in net proceeds to the Company of approximately $3,478. The Company's operating activities provided cash flows of $4,432 and $739,347 during the six months ended June 30, 2004 and 2003, respectively, primarily through purchase of trading securities offset by net income in 2004 and through the sale of trading securities in 2003 related to the Company's reduction of its RMBS portfolio. The Company's investing activities provided (used) cash flows of $52,300 and $(325,946) during the six months ended June 30, 2004 and 2003, respectively, primarily to purchase securities available-for-sale and to fund commercial mortgage loans, offset by significant sales of securities. The Company's financing activities used $15,698 and $423,840 during the six months ended June 30, 2004 and 2003, respectively, primarily from an increase in borrowings, issuance of common stock on dividends paid in 2004 and decrease in borrowings and dividends paid in 2003. The Company is subject to various covenants in its lines of credit, including maintaining a minimum GAAP net worth of $305,000, a debt-to-equity ratio not to exceed 5.5 to 1, a minimum cash requirement based upon certain debt to equity ratios, a minimum debt service coverage ratio of 1.5, and a minimum liquidity reserve of $10,000. Due to the acquisition of the commercial mortgage loan pools (see Note 4 of the consolidated financial statements), the Company's debt to capital ratio increased from 4.4:1 at December 31, 2003 to 7.5:1 at June 30, 2004. The Company received authorization from its lenders to permit debt to capital ratios in excess of existing covenants. For the quarter ended June 30, 2004, the Company did not maintain the minimum debt service coverage ratio of 1.5; the Company's lenders agreed to waive this requirement. As of June 30, 2004, the Company was in compliance with all other covenants. The Company's ability to execute its business strategy depends to a significant degree on its ability to obtain additional capital. Factors which could affect the Company's access to the capital markets, or the costs of such capital, include changes in interest rates, general economic conditions and perception in the capital markets of the Company's business, covenants under the Company's current and future credit facilities, results of operations, leverage, financial conditions and business prospects. Consequently, there can be no assurance that the Company will be able to effectively fund future growth. Except as discussed herein, management is not aware of any other trends, events, commitments or uncertainties that may have a significant effect on liquidity. Contingent Liability During 2000, the Company completed the acquisition of CORE Cap, Inc. At the time of the CORE Cap, Inc. acquisition, the Manager agreed to pay GMAC (CORE Cap, Inc.'s external advisor) $12,500 over a ten-year period ("Installment Payment") to purchase the right to manage the CORE Cap, Inc. assets under the existing management contract ("GMAC Contract"). The GMAC Contract had to be terminated in order to allow the Company to complete the merger, as the Company's management agreement with the Manager did not provide for multiple managers. As a result the Manager offered to buy-out the GMAC Contract as the Manager estimated it would receive incremental fees above and beyond the Installment Payment, and thus was willing to pay for, and separately negotiate, the termination of the GMAC Contract. Accordingly, the value of the Installment Payment was not considered in the Company's allocation of its purchase price to the net assets acquired in the acquisition of CORE Cap, Inc. The Company agreed that should the Management Agreement with its Manager be terminated, not renewed or not extended for any reason other than for cause, the Company would pay to the Manager an amount equal to the Installment Payment less the sum of all payments made by the Manager to GMAC. As of June 30, 2004, the Installment Payment would be $6,500 payable over six years. The Company does not accrue for this contingent liability. Transactions with Affiliates The Company is managed pursuant to a management agreement, dated March 27, 1998, between the Company and the Manager (the "Management Agreement"), a majority owned indirect subsidiary of The PNC Financial Services Group, Inc. and the employer of certain directors and officers of the Company, under which the Manager is responsible for the day-to-day operations of the Company and performs such services and activities relating to the assets and operations of the Company as may be appropriate. On March 25, 2002, the Management Agreement was extended for one year through March 27, 2003, with the approval of the unaffiliated directors, on terms similar to the prior agreement with the following changes: (i) the incentive fee calculation would be based on GAAP earnings instead of funds from operations, (ii) the removal of the four-year period to value the Management Agreement in the event of termination and (iii) subsequent renewal periods of the Management Agreement would be for one year instead of two years. The Board of Directors of the Company was advised by Houlihan Lokey Howard & Zukin Financial Advisors, Inc., a national investment banking and financial advisory firm, in the renewal process. On March 6, 2003, the unaffiliated directors approved an extension of the Management Agreement from its expiration of March 27, 2003 for one year through March 31, 2004. The terms of the renewed agreement were similar to the prior agreement except for the incentive fee calculation which would provide for a rolling four-quarter high watermark rather than a quarterly calculation. In determining the rolling four-quarter high watermark, the Company would calculate the incentive fee based upon the current and prior three quarters' net income. The Manager would be paid an incentive fee in the current quarter if the Yearly Incentive Fee, as defined, is greater than what was paid to the Manager in the prior three quarters cumulatively. The Company phased in the rolling four-quarter high watermark commencing with the second quarter of 2003. Calculation of the incentive fee was based on GAAP and adjusted to exclude special one-time events pursuant to changes in GAAP accounting pronouncements after discussion between the Manager and the unaffiliated directors. The incentive fee threshold did not change. The high watermark provides for the Manager to be paid 25% of the amount of earnings (calculated in accordance with GAAP) per share that exceeds the product of the adjusted issue price of the Company's common stock per share ($11.37 as of June 30, 2004) and the greater of 9.5% or 350 basis points over the ten-year Treasury note. The Management Agreement was further extended for one year from March 31, 2004 through March 31, 2005. The base management fee was revised to equal 2% of the quarterly average total stockholders' equity for the applicable quarter. The incentive fee was revised to be 25% of the amount of earnings (calculated in accordance with GAAP) per share that exceeds the product of the adjusted issue price of the Company's common stock per share and the greater of 8.5% or 400 basis points over the ten-year Treasury note. During the year ended December 31, 2003 and for the three months ended March 31, 2004, the Company paid the Manager an annual base management fee equal to a percentage of the average invested assets of the Company as defined in the Management Agreement. The base management fee was equal to 1% per annum of the average invested assets rated less than BB- or not rated, 0.75% of average invested assets rated BB- to BB+, and 0.20% of average invested assets rated above BB+. During the third quarter of 2003, the Manager agreed to reduce the management fees by 20% from its calculated amount for the third and fourth quarter of 2003 and the first quarter of 2004. This revision resulted in $1,046 in savings to the Company during 2003 and $532 for the three months ended March 31, 2004, respectively. The Company incurred $2,163 and $4,293 in base management fees in accordance with the terms of the Management Agreement for the three and six months ended June 30, 2004, respectively, and $2,649 and $5,226 for the three and six months ended June 30, 2003, respectively. In accordance with the provisions of the Management Agreement, the Company recorded reimbursements to the Manager of $20 and $54 for certain expenses incurred on behalf of the Company for the three and six months ended June 30, 2004, respectively, and $12 and $18 for the three and six months ended June 30, 2003, respectively, which are included in general and administrative expense on the accompanying consolidated statements of operations. Pursuant to the March 25, 2002 one-year Management Agreement extension, the incentive fee was based on 25% of earnings (calculated in accordance with GAAP) of the Company. For purposes of calculating the incentive fee during 2002, the cumulative transition adjustment of $6,327 resulting from the Company's adoption of SFAS No. 142, "Goodwill and Other Intangible Assets" was excluded from earnings in its entirety and included in the calculation of future incentive fees using an amortization period of three years. The Company did not incur incentive fees for the three and six months ended June 30, 2004 and 2003. The Company has an administration agreement with the Manager. Under the terms of the administration agreement, the Manager provides financial reporting, audit coordination and accounting oversight services to the Company. The agreement can be cancelled upon 60-day written notice by either party. The Company pays the Manager a monthly administrative fee at an annual rate of 0.06% of the first $125 million of average net assets, 0.04% of the next $125 million of average net assets and 0.03% of average net assets in excess of $250 million subject to a minimum annual fee of $120. For the three and six months ended June 30, 2004, the Company paid administration fees of $45 and $89, respectively, and $43 and $86 for the three and six months ended June 30, 2003, respectively, which are included in general and administrative expense on the accompanying consolidated statements of operations. The Company has entered into a $50,000 commitment to acquire shares in Carbon Capital, Inc. ("Carbon"), a private commercial real estate income opportunity fund managed by the Manager. The Carbon investment period ended on July 12, 2004; the Company's investment in Carbon as of June 30, 2004 was $48,501 and no investments were made in July 2004. The Company does not incur any additional management or incentive fees to the Manager as a result of its investment in Carbon. On June 30, 2004, the Company owned 19.8% of the outstanding shares in Carbon. During 2000, the Company completed the acquisition of CORE Cap, Inc. At the time of the CORE Cap, Inc. acquisition, the Manager agreed to pay GMAC (CORE Cap, Inc.'s external advisor) $12,500 over a ten-year period ("Installment Payment") to purchase the right to manage the CORE Cap, Inc. assets under the existing management contract ("GMAC Contract"). The GMAC Contract had to be terminated in order to allow the Company to complete the merger, as the Company's management agreement with the Manager did not provide for multiple managers. As a result the Manager offered to buy-out the GMAC Contract as the Manager estimated it would receive incremental fees above and beyond the Installment Payment, and thus was willing to pay for, and separately negotiate, the termination of the GMAC Contract. Accordingly, the value of the Installment Payment was not considered in the Company's allocation of its purchase price to the net assets acquired in the acquisition of CORE Cap, Inc. The Company agreed that should the Management Agreement with its Manager be terminated, not renewed or not extended for any reason other than for cause, the Company would pay to the Manager an amount equal to the Installment Payment less the sum of all payments made by the Manager to GMAC. As of June 30, 2004, the Installment Payment would be $6,500 payable over six years. The Company does not accrue for this contingent liability. REIT Status: The Company has elected to be taxed as a REIT and therefore must comply with the provisions of the Internal Revenue Code with respect thereto. Accordingly, the Company generally will not be subject to federal income tax to the extent of its distributions to stockholders and as long as certain asset, income and stock ownership tests are met. The Company may, however, be subject to tax at corporate rates or at excise tax rates on net income or capital gains not distributed. ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK Market Risk: Market risk includes the exposure to loss resulting from changes in interest rates, credit curve spreads, foreign currency exchange rates, commodity prices and equity prices. The primary market risks to which the Company is exposed are interest rate risk and credit curve risk. Interest rate risk is highly sensitive to many factors, including governmental, monetary and tax policies, domestic and international economic and political considerations and other factors beyond the control of the Company. Credit curve risk is highly sensitive to the dynamics of the markets for commercial mortgage securities and other loans and securities held by the Company. Excessive supply of these assets combined with reduced demand will cause the market to require a higher yield. This demand for higher yield will cause the market to use a higher spread over the U.S. Treasury securities yield curve, or other benchmark interest rates, to value these assets. Changes in the general level of the U.S. Treasury yield curve can have significant effects on the market value of the Company's portfolio. The majority of the Company's assets are fixed-rate securities valued based on a market credit spread to U.S. Treasuries. As U.S. Treasury securities are priced to a higher yield and/or the spread to U.S. Treasuries used to price the Company's assets is increased, the market value of the Company's portfolio may decline. Conversely, as U.S. Treasury securities are priced to a lower yield and/or the spread to U.S. Treasuries used to price the Company's assets is decreased, the market value of the Company's portfolio may increase. Changes in the market value of the Company's portfolio may affect the Company's net income or cash flow directly through their impact on unrealized gains or losses on securities held-for-trading or indirectly through their impact on the Company's ability to borrow. Changes in the level of the U.S. Treasury yield curve can also affect, among other things, the prepayment assumptions used to value certain of the Company's securities and the Company's ability to realize gains from the sale of such assets. In addition, changes in the general level of the London Interbank Offered Rate ("LIBOR") money market rates can affect the Company's net interest income. As of June 30, 2004, all of the Company's liabilities outside of the CDOs are floating rate based on a market spread to LIBOR. As the level of LIBOR increases or decreases, the Company's interest expense will move in the same direction. The Company may utilize a variety of financial instruments, including interest rate swaps, caps, floors and other interest rate exchange contracts, in order to limit the effects of fluctuations in interest rates on its operations. The use of these types of derivatives to hedge interest-earning assets and/or interest-bearing liabilities carries certain risks, including the risk that losses on a hedge position will reduce the funds available for payments to holders of securities and that such losses may exceed the amount invested in such instruments. A hedge may not perform its intended purpose of offsetting losses or increased costs. Moreover, with respect to certain of the instruments used as hedges, the Company is exposed to the risk that the counterparties with which the Company trades may cease making markets and quoting prices in such instruments, which may render the Company unable to enter into an offsetting transaction with respect to an open position. If the Company anticipates that the income from any such hedging transaction will not be qualifying income for REIT income purposes, the Company may conduct part or all of its hedging activities through a to-be-formed corporate subsidiary that is fully subject to federal corporate income taxation. The profitability of the Company may be adversely affected during any period as a result of changing interest rates. The Company monitors and manages interest rate risk based on a method that takes into consideration the interest rate sensitivity of the Company's assets and liabilities, including its preferred stock. The Company's objective is to acquire assets and match fund the purchase so that interest rate risk associated with financing these assets is reduced or eliminated. The primary risks associated with acquiring and financing these assets are mark to market risk and short-term rate risk. Examples of these financing types include 30-day repurchase agreements and committed borrowing facilities. Certain secured financing arrangements provide for an advance rate based upon a percentage of the market value of the asset being financed. Market movements that cause asset values to decline would require a margin call or a cash payment to maintain the relationship between asset value and amount borrowed. A cash flow based CDO is an example of a secured financing vehicle that does not require a mark to market to establish or maintain a level of financing. When financed assets are subject to a mark to market margin call, the Company carefully monitors the interest rate sensitivity of those assets. The duration of the assets financed which are subject to a mark to market margin call was 1.38 years based on reported GAAP book value as of June 30, 2004. The Company's reported book value incorporates the market value of the Company's interest bearing assets but it does not incorporate the market value of the Company's interest bearing liabilities. The fixed-rate interest bearing liabilities and preferred stock will generally reduce the actual interest rate risk of the Company from a pure economic perspective even though changes in the value of these liabilities are not reflected in the Company's book value. The fixed-rate liabilities issued in CDO I, CDO II and CDO III reduce the Company's economic duration by approximately 5.80 years. The Series C Preferred Stock reduces the Company's economic duration by approximately 0.81 year. The Company's reported book value is not reduced by these liabilities and therefore is approximately 6.61 years longer than the economic duration. The Company's duration management strategy focuses on the economic risk and maintains economic duration within a band of 3.0 to 5.0 years. At June 30, 2004, economic duration was 4.14 years. Earnings per share is analyzed using the assumptions that interest rates, as defined by the LIBOR curve, increase or decrease and that the yield curves of the LIBOR rate shocks will be parallel to each other. Market value in this scenario is calculated using the assumption that the U.S. Treasury yield curve remains constant even though changes in both long- and short-term interest rates can occur simultaneously. Regarding the table below, all changes in income and value are measured as percentage changes from the respective values calculated in the scenario labeled as "Base Case." The base interest rate scenario assumes interest rates as of June 30, 2004. Actual results could differ significantly from these estimates. Projected Percentage Change In Earnings Per Share Given LIBOR Movements Change in LIBOR, Projected Change in +/- Basis Points Earnings per Share -- -100 $0.047 -50 $0.023 Base Case +50 $(0.023) +100 $(0.047) +200 $(0.093) Credit Risk: The Company's portfolios of commercial real estate assets are subject to a high degree of credit risk. Credit risk is the exposure to loss from loan defaults. Default rates are subject to a wide variety of factors, including, but not limited to, property performance, property management, supply/demand factors, construction trends, consumer behavior, regional economics, interest rates, the strength of the U.S. economy, and other factors beyond the control of the Company. All loans are subject to a certain probability of default. Before acquiring a Controlling Class security, the Company will perform an analysis of the quality of all of the loans proposed. As a result of this analysis, loans with unacceptable risk profiles are either removed from the proposed pool or the Company receives a price adjustment. The Company underwrites its Controlling Class CMBS investments assuming the underlying loans will suffer a certain dollar amount of defaults and these defaults will lead to some level of realized losses. Loss adjusted yields are computed based on these assumptions and applied to each class of security supported by the cash flow on the underlying loans. The most significant variables affecting loss adjusted yields include, but are not limited to, the number of defaults, the severity of loss that occurs subsequent to a default and the timing of the actual loss. The different rating levels of CMBS will react differently to changes in these assumptions. The lowest rated securities (B- or lower) are generally more sensitive to changes in timing of actual losses. The higher rated securities (B or higher) are more sensitive to the severity of losses. The Company generally assumes that all of the principal of a non-rated security and a significant portion, if not all, of CCC and a portion of B- rated securities will not be recoverable over time. The loss adjusted yields of these classes reflect that assumption; therefore, the timing of when the total loss of principal occurs is the most important assumption in determining value. The interest coupon generated by a security will cease when there is a total loss of its principal regardless of whether that principal is paid. Therefore, timing is of paramount importance because the longer the principal balance remains outstanding, the more interest coupon the holder receives; which results in a larger economic return. Alternatively, if principal is lost faster than originally assumed, there is less opportunity to receive interest coupon; which results in a lower or possibly negative return. Additional losses which occur due to greater severity will not have a significant effect as all principal is already assumed to be non-recoverable. If actual principal losses on the underlying loans exceed assumptions, the higher rated securities will be affected more significantly as a loss of principal may not have been assumed. The Company generally assumes that all principal will be recovered by classes rated B or higher. The Company manages credit risk through the underwriting process, establishing loss assumptions and careful monitoring of loan performance. After the securities have been acquired, the Company monitors the performance of the loans, as well as external factors that may affect their value. Factors that indicate a higher loss severity or acceleration of the timing of an expected loss will cause a reduction in the expected yield and therefore reduce the earnings of the Company. Furthermore, the Company may be required to write down a portion of the adjusted purchase price of the affected assets through its consolidated statements of financial condition. For purposes of illustration, a doubling of the losses in the Company's Controlling Class CMBS, without a significant acceleration of those losses, would reduce GAAP income going forward by approximately $0.31 per share of Common Stock per year and cause a significant write down at the time the loss assumption is changed. The amount of the write down depends on several factors, including which securities are most affected at the time of the write down, but is estimated to be in the range of $1.00 to $1.30 per share based on a doubling of expected losses. A significant acceleration of the timing of these losses would cause the Company's net income to decrease. The increase in these estimates from December 31, 2003 is a result of the Company's purchase of the below investment grade portion of two additional Controlling Class CMBS trusts. The Company's exposure to a write down is mitigated by the fact that most of these assets are financed on a non-recourse basis in the Company's CDOs, where a significant portion of the risk of loss is transferred to the CDO bondholders. As of June 30, 2004, securities with a total market value of $1,161,596 are collateralizing the CDO borrowings of $1,057,217; therefore, the Company's residual interest in the three CDOs is $104,379 ($1.97 per share). In accordance with GAAP, the CDO borrowings are not marked to market even though their economic value will change in response to changes in interest rates and/or credit spreads. Interest rate swap agreements contain an element of risk in the event that the counterparties to the agreements do not perform their obligations under the agreements. The Company minimizes its risk exposure by entering into agreements with parties rated at least A or better by Standard & Poor's Rating Services. Furthermore, the Company has interest rate swap agreements established with several different counterparties in order to reduce the risk of credit exposure to any one counterparty. Management does not expect any counterparty to default on their obligations. Asset and Liability Management: Asset and liability management is concerned with the timing and magnitude of the repricing and/or maturing of assets and liabilities. It is the Company's objective to attempt to control risks associated with interest rate movements. In general, management's strategy is to match the term of the Company's liabilities as closely as possible with the expected holding period of the Company's assets. This is less important for those assets in the Company's portfolio considered liquid as there is a very stable market for the financing of these securities. Other methods for evaluating interest rate risk, such as interest rate sensitivity "gap" (defined as the difference between interest-earning assets and interest-bearing liabilities maturing or repricing within a given time period), are used but are considered of lesser significance in the daily management of the Company's portfolio. Management considers this relationship when reviewing the Company's hedging strategies. Because different types of assets and liabilities with the same or similar maturities react differently to changes in overall market rates or conditions, changes in interest rates may affect the Company's net interest income positively or negatively even if the Company were to be perfectly matched in each maturity category. ITEM 4. CONTROLS AND PROCEDURES (a) Evaluation of Disclosure Controls and Procedures. The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's reports filed or submitted under the Exchange Act. (b) Changes in Internal Controls. There has been no change in the Company's internal control over financial reporting during the quarter ended June 30, 2004 that has materially affected, or is reasonably likely to materially affect, such internal control over financial reporting. Part II - OTHER INFORMATION Item 1. Legal Proceedings At June 30, 2004 there were no pending legal proceedings of which the Company was a defendant or of which any of its property was subject. Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities Total Number of Shares Purchased as Part of Maximum Number of Shares Total Number of Average Price Publicly Announced Plans that May Yet Be Purchased Shares Purchased Paid per Share or Programs Under the Plans or Programs -- January 1, 2004 through - - - - January 31, 2004 February 1, 2004 through February 29, 2004 - - - - March 1, 2004 through March 31, 2004 - - - - April 1, 2004 through April 30, 2004 - - - - May 1, 2004 through May 31, 2004 1,757,257(1) 25.00 1,757,257 - June 1, 2004 through June 30, 2004 - - - - --- Total 1,757,257 25.00 1,757,257 === (1) At the end of the first quarter of 2004, the Board of Directors approved the Company's decision to redeem its Series B Preferred Stock. The second quarter of 2004 earnings includes a charge of $0.21 per share for the redemption of the Company's Series B Preferred Stock that was reported as a charge to income in the initial first quarter 2004 earnings release but was subsequently moved to the second quarter to coincide with the timing of the actual redemption payment as reported on May 11, 2004. The Series B Preferred Stock was redeemed on May 6, 2004. Item 3. Defaults Upon Senior Securities Not applicable. Item 4. Submission of Matters to a Vote of Security Holders The Company held an Annual Meeting of Stockholders on May 25, 2004, pursuant to a Notice of Annual Meeting of Stockholders and Proxy Statement dated April 16, 2004, (a copy of which has been filed previously with the Securities and Exchange Commission), at which the Company's stockholders approved the election of four directors for a term of three years and the ratification for the appointment of Deloitte & Touche LLP as the auditors of the financial statements for fiscal year 2004. Proposal 1: To elect three directors for a three-year term expiring in 2007 and one director to serve for a term expiring in 2006. Results: In Favor Withheld -------- -------- Donald G. Drapkin 39,559,084 8,308,635 Carl F. Geuther 47,348,700 519,019 Leon T. Kendall 47,511,379 356,338 Clay G. Lebhar 47,468,422 399,297 Proposal 2: To ratify and approve the appointment of Deloitte & Touche LLP as the Company's Independent Auditors for the year ending December 31, 2004. Results: For Against Abstain --- ------- ------- 47,346,723 401,382 119,612 There were no broker non-votes with respect to the two proposals. The continuing directors of the Company are Laurence D. Fink, Hugh R. Frater, Ralph L. Schlosstein, and Jeffrey C. Keil. Item 5. Other Information On April 6, 2004, the Board of Directors approved the Company's decision to redeem its Series B Preferred Stock, $0.001 par value per share ("Series B Preferred Stock"), which redemption closed on May 6, 2004. The Company initially considered the decision to redeem as a recharacterization of the Series B Preferred Stock from conditionally redeemable to mandatorily redeemable, and recorded the cost to retire the Series B Preferred Stock in excess of its carrying value of $10,508,000, in the Consolidated Statements of Operations for the six months ended June 30, 2004, as included in the Company's Form 8-K dated May 7, 2004. At the time of the Company's May 7, 2004 8-K, the Company considered after consultation with its independent auditors Deloitte & Touche LLP ("D&T") the conversion option included in the Series B Preferred Stock to be nonsubstantive, as the redemption price of the Series B Preferred Stock of $25 per share was substantially higher than the approximately $16.24 per share stockholders would receive if the Series B Preferred Stock were converted into Common Stock of the Company on the date of redemption. Subsequent to May 7, 2004, the Company in consultation with D&T determined that the conversion option should be evaluated only at the original issuance of the Series B Preferred Stock, at which time the conversion feature was substantive. Therefore, the cost to retire the Series B Preferred Stock was recorded in the second quarter of 2004 instead of the first quarter of 2004, as previously reported. As a result, for the three months ended March 31, 2004 the Company's net income available to common stockholders per share was $9,843 ($0.20 per share) versus a net loss to common stockholders of $665 ($0.01 per share) as previously reported. Item 6. Exhibits and Reports on Form 8-K (a) Exhibits 31.1 Section 302 Certification of Chief Executive Officer. 31.2 Section 302 Certification of Chief Financial Officer. 32.1 Section 906 Certification of Chief Executive Officer and Chief Financial Officer. Reports on Form 8-K On May 7, 2004, the Company filed a Current Report on Form 8-K to report under Item 5 the Company's earnings for the quarter ended March 31, 2004. On May 25, 2004, the Company filed a Current Report on Form 8-K to report under Item 5 the declaration of a cash dividend on the common stock of the Company for the quarter ending June 30, 2004. On June 24, 2004, the Company filed a current report on Form 8-K to report under Item 5 the public offering by the Company of 2,100,000 shares of its common stock, with an option to the underwriters to purchase up to 315,000 additional shares of common stock, and to file certain documents relating to the sale of the common stock. SIGNATURES Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized. ANTHRACITE CAPITAL, INC. Dated: August 9, 2004 By: /s/ Christopher A. Milner ---------------------------- Name: Christopher A. Milner Title: President and Chief Executive Officer (duly authorized representative) Dated: August 9, 2004 By: /s/ Richard M. Shea ------------------------------ Name: Richard M. Shea Title: Chief Operating Officer and Chief Financial Officer