STARWOOD PROPERTY TRUST, INC.
Form 10-Q
May 06, 2014
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2014

OR

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

Commission file number 001-34436

Starwood Property Trust, Inc.

(Exact name of registrant as specified in its charter)

Maryland (State or Other Jurisdiction of Incorporation or Organization)	**27-0247747** (I.R.S. Employer Identification No.)
591 West Putnam Avenue **Greenwich, Connecticut** (Address of Principal Executive Offices)	**06830** (Zip Code)

Registrant s telephone number, including area code:

(203) 422-8100

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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

The number of shares of the issuer s common stock, $0.01 par value, outstanding as of May 6, 2014 was 221,385,672.

Table of Contents

Special Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q contains certain forward-looking statements, including without limitation, statements concerning our operations, economic performance and financial condition. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are developed by combining currently available information with our beliefs and assumptions and are generally identified by the words believe, expect, anticipate and other similar expressions. Forward-looking statements do not guarantee future performance, which may be materially different from that expressed in, or implied by, any such statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of their dates.

These forward-looking statements are based largely on our current beliefs, assumptions and expectations of our future performance taking into account all information currently available to us. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to us or within our control, and which could materially affect actual results, performance or achievements. Factors that may cause actual results to vary from our forward-looking statements include, but are not limited to:

- factors described in our Annual Report on Form 10-K for the year ended December 31, 2013, including those set forth under the captions Risk Factors and Business ;

- defaults by borrowers in paying debt service on outstanding indebtedness;

- impairment in the value of real estate property securing our loans;

- availability of mortgage origination and acquisition opportunities acceptable to us;

- our ability to fully integrate LNR Property LLC, a Delaware limited liability company (LNR), which was acquired on April 19, 2013, into our business and achieve the benefits that we anticipate from this acquisition;

- potential mismatches in the timing of asset repayments and the maturity of the associated financing agreements;

- national and local economic and business conditions;

- general and local commercial and residential real estate property conditions;
- changes in federal government policies;
- changes in federal, state and local governmental laws and regulations;
- increased competition from entities engaged in mortgage lending and securities investing activities;
- changes in interest rates; and
- the availability of and costs associated with sources of liquidity.

In light of these risks and uncertainties, there can be no assurances that the results referred to in the forward-looking statements contained in this Quarterly Report on Form 10-Q will in fact occur. Except to the extent required by applicable law or regulation, we undertake no obligation to, and expressly disclaim any such obligation to, update or revise any forward-looking statements to reflect changed assumptions, the occurrence of anticipated or unanticipated events, changes to future results over time or otherwise.

Table of Contents

TABLE OF CONTENTS

Table of Contents

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Starwood Property Trust, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(Unaudited, amounts in thousands, except share data)

	As of March 31, 2014	As of December 31, 2013
Assets:		
Cash and cash equivalents	$ 226,471	$ 317,627
Restricted cash	43,117	69,052
Loans held-for-investment, net	4,634,923	4,363,718
Loans held-for-sale, at fair value	186,837	206,672
Loans transferred as secured borrowings	143,042	180,414
Investment securities ($553,933 and $566,789 held at fair value)	923,085	935,107
Intangible assets servicing rights ($144,898 and $150,149 held at fair value)	168,056	177,173
Residential real estate, net		749,214
Non-performing residential loans		215,371
Investment in unconsolidated entities	104,520	122,954
Goodwill	140,437	140,437
Derivative assets	4,617	7,769
Accrued interest receivable	34,515	37,630
Other assets	111,223	95,813
Variable interest entity (VIE) assets, at fair value	118,451,518	103,151,624
Total Assets	**$ 125,172,361**	**$ 110,770,575**
Liabilities and Equity		
Liabilities:		
Accounts payable, accrued expenses and other liabilities	$ 137,831	$ 225,374
Related-party payable	29,458	17,793
Dividends payable	95,424	90,171
Derivative liabilities	18,057	24,192
Secured financing agreements, net	2,601,062	2,257,560
Convertible senior notes, net	1,000,839	997,851
Secured borrowings on transferred loans	143,038	181,238
VIE liabilities, at fair value	117,931,005	102,649,263
Total Liabilities	**121,956,714**	**106,443,442**
Commitments and contingencies (Note 21)		
Equity:		
Starwood Property Trust, Inc. Stockholders Equity:		
Preferred stock, $0.01 per share, 100,000,000 shares authorized, no shares issued and outstanding		
	1,967	1,961

Common stock, $0.01 per share, 500,000,000 shares authorized, 196,711,522 issued and 196,085,672 outstanding as of March 31, 2014 and 196,139,045 issued and 195,513,195 outstanding as of December 31, 2013				
Additional paid-in capital		3,192,245		4,300,479
Treasury stock (625,850 shares)		(10,642)		(10,642)
Accumulated other comprehensive income		80,115		75,449
Accumulated deficit		(59,542)		(84,719)
Total Starwood Property Trust, Inc. Stockholders Equity		3,204,143		4,282,528
Non-controlling interests in consolidated subsidiaries		11,504		44,605
Total Equity		**3,215,647**		**4,327,133**
Total Liabilities and Equity	**$**	**125,172,361**	**$**	**110,770,575**

See notes to condensed consolidated financial statements.

Table of Contents

Starwood Property Trust, Inc. and Subsidiaries

Condensed Consolidated Statements of Operations

(Unaudited, amounts in thousands, except per share data)

	For the Three Months Ended March 31, 2014		For the Three Months Ended March 31, 2013	
Revenues:				
Interest income from loans	$	104,910	$	67,690
Interest income from investment securities		29,454		16,240
Servicing fees		34,211		
Other revenues		3,404		79
Total revenues		**171,979**		**84,009**
Costs and expenses:				
Management fees		27,821		15,069
Interest expense		37,831		17,426
General and administrative		46,101		4,038
Business combination costs				4,196
Acquisition and investment pursuit costs		394		81
Depreciation and amortization		4,636		
Loan loss allowance		497		30
Other expense		1,689		33
Total costs and expenses		**118,969**		**40,873**
Income before other income, income taxes and non-controlling interests		**53,010**		**43,136**
Other income:				
Income of consolidated VIEs, net		56,004		
Change in fair value of servicing rights		(5,251)		
Change in fair value of investment securities, net		8,361		405
Change in fair value of mortgage loans held-for-sale, net		20,893		
Earnings from unconsolidated entities		64		741
Gain on sale of investments, net		1,555		13,524
(Loss) gain on derivative financial instruments, net		(7,866)		16,228
Foreign currency gain (loss), net		1,477		(7,665)
Total other-than-temporary impairment (OTTI)		(1,192)		(527)
Noncredit portion of OTTI recognized in other comprehensive income (loss)		979		485
Net impairment losses recognized in earnings		(213)		(42)
Other income, net		18		
Total other income		**75,042**		**23,191**
Income from continuing operations before income taxes		**128,052**		**66,327**
Income tax provision		(5,620)		(615)
Income from continuing operations		**122,432**		**65,712**
Loss from discontinued operations, net of tax (Note 3)		(1,551)		(2,288)
Net income		**120,881**		**63,424**
Net income attributable to non-controlling interests		(280)		(1,181)
Net income attributable to Starwood Property Trust, Inc.	**$**	**120,601**	**$**	**62,243**
Per share data:				
Basic earnings per share data:				
Income from continuing operations attributable to Starwood Property Trust, Inc.	$	0.62	$	0.47

Loss from discontinued operations attributable to Starwood Property Trust, Inc.		(0.01)		(0.01)
Net income attributable to Starwood Property Trust, Inc.	$	0.61	$	0.46
Diluted earnings per share data:				
Income from continuing operations attributable to Starwood Property Trust, Inc.	$	0.61	$	0.47
Loss from discontinued operations attributable to Starwood Property Trust, Inc.		(0.01)		(0.01)
Net income attributable to Starwood Property Trust, Inc.	$	0.60	$	0.46
Dividends declared per common share	$	0.48	$	0.44

See notes to condensed consolidated financial statements.

Table of Contents

Starwood Property Trust, Inc. and Subsidiaries

Condensed Consolidated Statements of Comprehensive Income

(Unaudited, amounts in thousands)

	For the Three Months Ended March 31,	
	2014	2013
Net income	**$ 120,881**	**$ 63,424**
Other comprehensive income (loss) (net change by component):		
Cash flow hedges	122	279
Available-for-sale securities	3,498	(2,349)
Foreign currency remeasurement	1,046	(7,061)
Other comprehensive income (loss)	4,666	(9,131)
Comprehensive income	**125,547**	**54,293**
Less: Comprehensive income attributable to non-controlling interests	(280)	(1,181)
Comprehensive income attributable to Starwood Property Trust, Inc.	**$ 125,267**	**$ 53,112**

See notes to condensed consolidated financial statements.

Table of Contents

Starwood Property Trust, Inc. and Subsidiaries

Condensed Consolidated Statements of Equity

(Unaudited, amounts in thousands, except share data)

	Common stock Shares	Common stock Par Value	Additional Paid-In Capital	Treasury Stock Shares	Treasury Stock Amount	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Starwood Property Trust, Inc. Stockholders Equity	Non-Controlling Interests	Total Equity
Balance, January 1, 2014	**196,139,045**	**$ 1,961**	**$ 4,300,479**	**625,850**	**$ (10,642)**	**$ (84,719)**	**$ 75,449**	**$ 4,282,528**	**$ 44,605**	**$ 4,327,133**
Stock-based compensation	434,189	4	7,203					7,207		7,207
Manager incentive fee paid in stock	138,288	2	3,306					3,308		3,308
Net income						120,601		120,601	280	120,881
Dividends declared, $0.48 per share						(95,424)		(95,424)		(95,424)
Spin-off of Starwood Waypoint Residential Trust			(1,118,743)					(1,118,743)	(1,594)	(1,120,337)
Other comprehensive income, net							4,666	4,666		4,666
Distribution to non-controlling interests									(31,787)	(31,787)
Balance, March 31, 2014	**196,711,522**	**$ 1,967**	**$ 3,192,245**	**625,850**	**$ (10,642)**	**$ (59,542)**	**$ 80,115**	**$ 3,204,143**	**$ 11,504**	**$ 3,215,647**
Balance, January 1, 2013	**136,125,356**	**$ 1,361**	**$ 2,721,353**	**625,850**	**$ (10,642)**	**$ (72,401)**	**$ 79,675**	**$ 2,719,346**	**$ 77,859**	**$ 2,797,205**
Convertible senior notes			28,118					28,118		28,118
Stock-based compensation	187,501	2	4,654					4,656		4,656
Manager incentive fee paid in stock	13,188		366					366		366
Net income						62,243		62,243	1,181	63,424
Dividends declared, $0.44 per share						(60,147)		(60,147)		(60,147)
Other comprehensive loss, net							(9,131)	(9,131)		(9,131)
Contributions from non-controlling interests									6	6
Distribution to non-controlling interests									(44,098)	(44,098)
Balance, March 31, 2013	**136,326,045**	**$ 1,363**	**$ 2,754,491**	**625,850**	**$ (10,642)**	**$ (70,305)**	**$ 70,544**	**$ 2,745,451**	**$ 34,948**	**$ 2,780,399**

See notes to condensed consolidated financial statements.

Table of Contents

Starwood Property Trust, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(Unaudited, amounts in thousands)

	For the Three Months Ended March 31, 2014	2013
Cash Flows from Operating Activities:		
Net income	$ 120,881	$ 63,424
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of deferred financing costs	2,895	3,193
Amortization of convertible debt discount and deferred fees	2,988	841
Accretion of net discount on investment securities	(7,398)	(9,180)
Accretion of net deferred loan fees and discounts	(1,806)	(7,856)
Amortization of premium from secured borrowings on transferred loans	(787)	(374)
Share-based compensation	7,207	4,656
Share-based component of incentive fees	3,308	366
Change in fair value of fair value option investment securities	(8,361)	
Change in fair value of consolidated VIEs	(21,877)	
Change in fair value of servicing rights	5,251	
Change in fair value of loans held-for-sale	(20,893)	
Change in fair value of derivatives	7,110	(16,318)
Foreign currency (gain) loss, net	(1,492)	7,390
Gain on non-performing loans and sale of investments	(2,498)	(15,004)
Other-than-temporary impairment of investment securities	213	42
Loan loss allowance	497	30
Depreciation and amortization	5,786	713
Earnings from unconsolidated entities	(64)	
Distributions of earnings from unconsolidated entities	956	
Changes in operating assets and liabilities:		
Related-party payable, net	11,665	9,307
Accrued interest receivable, less purchased interest	3,063	1,802
Other assets	(20,474)	5,839
Accounts payable, accrued expenses and other liabilities	(22,574)	35,984
Originations of loans held-for-sale, net of principal collections	(261,733)	
Proceeds from sale of loans held-for-sale	302,461	
Net cash provided by operating activities	**104,324**	**84,855**
Cash Flows from Investing Activities:		
Spin-off of Starwood Waypoint Residential Trust	(111,960)	
Purchase of investment securities	(9,890)	(37,175)
Proceeds from sales of investment securities	27,883	19,480
Proceeds from principal collections on investment securities	8,227	21,726
Origination and purchase of loans held-for-investment	(728,594)	(129,817)
Proceeds from principal collections on loans	316,428	93,651
Proceeds from loans sold	146,400	44,631
Acquisition and improvement of single family homes	(61,901)	(114,925)
Proceeds from sale of single family homes	1,784	3,360
Purchase of non-performing loans		(104,142)
Proceeds from sale of non-performing loans	1,153	

Distribution of capital from unconsolidated entities	17,834	150
Payments for purchase or termination of derivatives	(11,274)	
Proceeds from termination of derivatives	799	
Return of investment basis in purchased derivative asset	407	518
Deposit on purchase of LNR		(40,665)
Decrease (increase) in restricted cash, net	234	(38,040)
Net cash used in investing activities	**(402,470)**	**(281,248)**

See notes to condensed consolidated financial statements.

Table of Contents

Starwood Property Trust, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Continued)

(Unaudited, amounts in thousands)

	For the Three Months Ended March 31, 2014	For the Three Months Ended March 31, 2013
Cash Flows from Financing Activities:		
Borrowings under financing agreements	$ 997,767	$ 347,521
Proceeds from issuance of convertible senior notes		587,700
Principal repayments on borrowings	(656,573)	(625,513)
Payment of deferred financing costs	(7,418)	(24)
Payment of dividends	(90,171)	(73,796)
Contributions from non-controlling interests		6
Distributions to non-controlling interests	(31,788)	(44,098)
Issuance of debt of consolidated VIEs	45,761	
Repayment of debt of consolidated VIEs	(53,385)	
Distributions of cash from consolidated VIEs	2,740	
Net cash provided by financing activities	**206,933**	**191,796**
Net decrease in cash and cash equivalents	(91,213)	(4,597)
Cash and cash equivalents, beginning of period	317,627	177,671
Effect of exchange rate changes on cash	57	
Cash and cash equivalents, end of period	$ 226,471	$ 173,074
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 44,638	$ 10,536
Income taxes paid	2,725	327
Supplemental disclosure of non-cash investing and financing activities:		
Net assets distributed in spin-off of Starwood Waypoint Residential Trust	$ 1,008,377	$
Dividends declared, but not yet paid	95,424	60,147
Unsettled trade receivable		206,608
Consolidation of VIEs (VIE asset/liability additions)	20,236,513	
Deconsolidation of VIEs (VIE asset/liability reductions)	1,289,569	
Conversion of non-performing residential loans to residential real estate	3,590	

See notes to condensed consolidated financial statements.

Table of Contents

Starwood Property Trust, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

As of March 31, 2014

(Unaudited)

1. Business and Organization

Starwood Property Trust, Inc. (STWD together with its subsidiaries, we or the Company) is a Maryland corporation that commenced operations in August 2009, upon the completion of our initial public offering (IPO). We are focused primarily on originating, acquiring, financing and managing commercial mortgage loans and other commercial real estate debt investments, commercial mortgage-backed securities (CMBS), and other commercial real estate-related debt investments in both the U.S. and Europe. We refer to the following as our target assets:

- commercial real estate mortgage loans, including preferred equity interests;

- CMBS; and

- other commercial real estate-related debt investments.

We may also invest in residential mortgage-backed securities (RMBS), certain residential mortgage loans, distressed or non-performing commercial loans, commercial properties subject to net leases and commercial real estate owned. As market conditions change over time, we may adjust our strategy to take advantage of changes in interest rates and credit spreads as well as economic and credit conditions.

We have three reportable business segments which include:

- Real estate investment lending (the Lending Segment) includes all business activities of the Company, excluding the single family residential and LNR businesses, which generally represents investments in real estate related loans and securities that are held-for-investment.

- LNR includes all business activities of the acquired LNR Property LLC (LNR) business excluding the consolidation of securitization VIEs.

- Single family residential (SFR) includes the business activities associated with our investments in single-family residential properties and non-performing single-family residential mortgage loans. This segment was spun off on January 31, 2014 as discussed below and in Note 3 herein.

On April 19, 2013, we acquired the equity of LNR and certain of its subsidiaries for an initial agreed upon purchase price of approximately $859 million, which was reduced for transaction expenses and distributions occurring after September 30, 2012, resulting in cash consideration of approximately $730 million. Immediately prior to the acquisition, an affiliate of the Company acquired the remaining equity comprising LNR s commercial property division for a purchase price of $194 million. The portion of the LNR business acquired by us includes the following: (i) servicing businesses in both the U.S. and Europe that manage and work out problem assets, (ii) a finance business that is focused on selectively acquiring and managing real estate finance investments, including unrated, investment grade and non-investment grade rated CMBS, including subordinated interests of securitization and resecuritization transactions, and high yielding real estate loans; and (iii) a mortgage loan business which originates conduit loans for the primary purpose of selling these loans into securitization transactions.

On January 31, 2014, we completed the spin-off of our SFR segment to our stockholders. The newly-formed real estate investment trust, Starwood Waypoint Residential Trust (SWAY), is listed on the New York Stock Exchange (NYSE) and trades under the ticker symbol SWAY. Our stockholders received one common share of SWAY for every five shares of our common stock held at the close of business on January 24, 2014. As part of the spin-off, we contributed $100 million to the unlevered balance sheet of SWAY to fund its growth and operations. As of January 31, 2014, SWAY held net assets of $1.1 billion. The net assets of SWAY consisted of approximately 7,200 units of single-family homes and residential non-performing mortgage loans as of January 31, 2014. In connection with the spin-off, 40.1 million shares of SWAY were issued. Refer to Note 3 herein for additional information regarding SFR segment financial information.

We are organized and conduct our operations to qualify as a real estate investment trust (REIT) under the Internal Revenue Code of 1986, as amended (the Code). As such, we will generally not be subject to U.S. federal corporate income tax on that portion

Table of Contents

of our net income that is distributed to stockholders if we distribute at least 90% of our taxable income to our stockholders by prescribed dates and comply with various other requirements.

In connection with the LNR acquisition, we established additional taxable REIT subsidiaries (TRSs). TRSs permit us to participate in certain activities from which REITs are generally precluded, as long as these activities meet specific criteria, are conducted within the parameters of certain limitations established by the Code, and are conducted in entities which elect to be treated as taxable subsidiaries under the Code. To the extent these criteria are met, we will continue to maintain our qualification as a REIT.

These TRSs engage in various real estate related operations, including special servicing of commercial real estate, originating and securitizing commercial mortgage loans, and investing in entities which engage in real estate related operations. As of March 31, 2014, $799.8 million of the LNR assets were owned by TRS entities. Our TRSs are not consolidated for federal income tax purposes, but are instead taxed as corporations. For financial reporting purposes, a provision for current and deferred taxes is established for the portion of earnings recognized by us with respect to our interest in TRSs.

We are organized as a holding company and conduct our business primarily through our various wholly-owned subsidiaries. We are externally managed and advised by SPT Management, LLC (our Manager) pursuant to the terms of a management agreement. Our Manager is controlled by Barry Sternlicht, our Chairman and Chief Executive Officer. Our Manager is an affiliate of Starwood Capital Group, a privately-held private equity firm founded and controlled by Mr. Sternlicht.

2. Summary of Significant Accounting Policies

Balance Sheet Presentation of LNR Variable Interest Entities

The acquisition of LNR substantially changed the presentation of our financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP). As noted above, LNR operates a finance business that acquires unrated, investment grade and non-investment grade rated CMBS. These securities represent interests in securitization structures (commonly referred to as special purpose entities, or SPEs). These SPEs are structured as pass through entities that receive principal and interest on the underlying collateral and distribute those payments to the certificate holders. Under GAAP, SPEs typically qualify as variable interest entities (VIEs). These are entities that, by design, either (1) lack sufficient equity to permit the entity to finance its activities without additional subordinated financial support from other parties, or (2) have equity investors that do not have the ability to make significant decisions relating to the entity s operations through voting rights, or do not have the obligation to absorb the expected losses, or do not have the right to receive the residual returns of the entity.

Because LNR often serves as the special servicer of the trusts in which it invests, consolidation of these structures is required pursuant to GAAP as outlined in detail below. This results in a consolidated balance sheet which presents the gross assets and liabilities of the SPEs. The assets and other instruments held by these SPEs are restricted and can only be used to fulfill the obligations of the entity. Additionally, the obligations of the SPEs do not have any recourse to the general credit of any other consolidated entities, nor to us as the consolidator of these SPEs.

The SPE liabilities initially represent investment securities on our balance sheet (pre-consolidation). Upon consolidation of these VIEs, our associated investment securities are eliminated, as is the interest income related to those securities. Similarly, the fees we earn in our roles as special servicer of the bonds issued by the consolidated VIEs or as collateral administrator of the consolidated VIEs are also eliminated. Finally, an allocable portion of the identified servicing intangible associated with the eliminated fee streams is eliminated in consolidation.

Please refer to the segment presentation in Note 22 herein for a presentation of the LNR business without consolidation of these VIEs.

Basis of Accounting and Principles of Consolidation

The accompanying condensed consolidated financial statements include our accounts and those of our consolidated subsidiaries and VIEs. Intercompany amounts have been eliminated in consolidation. In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations, and cash flows have been included.

These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 (the Form 10-K), as filed with the Securities and Exchange Commission (SEC). The results of operations for the three months ended March 31, 2014 are not necessarily indicative of the operating results for the full year.

Table of Contents

Refer to our Form 10-K for a description of our recurring accounting policies. We have included disclosure in this Note 2 regarding principles of consolidation and other accounting policies that are required either (i) to be disclosed quarterly, (ii) that we view as critical, or (iii) became significant since December 31, 2013 due to a corporate action or increase in the significance of the underlying business activity.

Variable Interest Entities

We evaluate all of our interests in VIEs for consolidation. When our interests are determined to be variable interests, we assess whether we are deemed to be the primary beneficiary of the VIE. The primary beneficiary of a VIE is required to consolidate the VIE. ASC 810, *Consolidation*, defines the primary beneficiary as the party that has both (i) the power to direct the activities of the VIE that most significantly impact its economic performance, and (ii) the obligation to absorb losses and the right to receive benefits from the VIE which could be potentially significant. We consider our variable interests as well as any variable interests of our related parties in making this determination. Where both of these factors are present, we are deemed to be the primary beneficiary and we consolidate the VIE. Where either one of these factors is not present, we are not the primary beneficiary and do not consolidate the VIE.

To assess whether we have the power to direct the activities of a VIE that most significantly impact the VIE s economic performance, we consider all facts and circumstances, including our role in establishing the VIE and our ongoing rights and responsibilities. This assessment includes first, identifying the activities that most significantly impact the VIE s economic performance; and second, identifying which party, if any, has power over those activities. In general, the parties that make the most significant decisions affecting the VIE or have the right to unilaterally remove those decision makers are deemed to have the power to direct the activities of a VIE.

To assess whether we have the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE, we consider all of our economic interests, including debt and equity investments, servicing fees, and other arrangements deemed to be variable interests in the VIE. This assessment requires that we apply judgment in determining whether these interests, in the aggregate, are considered potentially significant to the VIE. Factors considered in assessing significance include: the design of the VIE, including its capitalization structure; subordination of interests; payment priority; relative share of interests held across various classes within the VIE s capital structure; and the reasons why the interests are held by us.

Our purchased investment securities include CMBS which are unrated and non-investment grade rated securities issued by CMBS trusts. In certain cases, we may contract to provide special servicing activities for these CMBS trusts, or, as holder of the controlling class, we may have the right to name and remove the special servicer for these trusts. In our role as special servicer, we provide services on defaulted loans within the trusts, such as foreclosure or work-out procedures, as permitted by the underlying contractual agreements. In exchange for these services, we receive a fee. These rights give us the ability to direct activities that could significantly impact the trust s economic performance. However, in those instances where an unrelated third party has the right to unilaterally remove us as special servicer, we do not have the power to direct activities that most significantly impact the trust s economic performance. We evaluated all of our positions in such investments for consolidation.

For VIEs in which we are determined to be the primary beneficiary, all of the underlying assets, liabilities and equity of the structures are recorded on our books, and the initial investment, along with any associated unrealized holding gains and losses, are eliminated in consolidation. Similarly, the interest income earned from these structures, as well as the fees paid by these trusts to us in our capacity as special servicer, are eliminated in consolidation. Further, an allocable portion of the identified servicing intangible asset associated with the servicing fee streams, and the corresponding allocable amortization or change in fair value of the servicing intangible asset, are also eliminated in consolidation.

We perform ongoing reassessments of: (1) whether any entities previously evaluated under the majority voting interest framework have become VIEs, based on certain events, and therefore subject to the VIE consolidation framework, and (2) whether changes in the facts and circumstances regarding our involvement with a VIE causes our consolidation conclusion regarding the VIE to change.

We have elected the fair value option in measuring the assets and liabilities of any VIEs we consolidate. Fluctuations in the fair values of the VIE assets and liabilities, along with trust interest income and trust interest and administrative expenses, are presented net in income of consolidated VIEs in our consolidated statements of operations.

Table of Contents

Discontinued Operations

On January 31, 2014, we completed the spin-off of our SFR segment to our stockholders as discussed in Note 1. In accordance with Accounting Standards Codification (ASC) Topic 205, *Presentation of Financial Statements,* the results of the SFR segment are presented within discontinued operations in our condensed consolidated statements of operations for the three months ended March 31, 2014 and 2013.

Fair Value Option

The guidance in ASC 825, *Financial Instruments*, provides a fair value option election that allows entities to make an irrevocable election of fair value as the initial and subsequent measurement attribute for certain eligible financial assets and liabilities. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. The decision to elect the fair value option is determined on an instrument by instrument basis and must be applied to an entire instrument and is irrevocable once elected. Assets and liabilities measured at fair value pursuant to this guidance are required to be reported separately in our consolidated balance sheets from those instruments using another accounting method.

We have elected the fair value option for eligible financial assets and liabilities of our consolidated VIEs, loans held-for-sale originated by LNR s conduit platform, purchased CMBS issued by VIEs we could consolidate in the future and certain investments in marketable equity securities. The fair value elections for VIE and securitization related items were made in order to mitigate accounting mismatches between the carrying value of the instruments and the related assets and liabilities that we consolidate at fair value. The fair value elections for mortgage loans held-for-sale originated by LNR s conduit platform were made due to the short-term nature of these instruments. The fair value elections for investments in marketable equity securities were made because the shares are listed on an exchange, which allows us to determine the fair value using a quoted price from an active market.

Loans Receivable and Provision for Loan Losses

In our Lending Segment we purchase and originate commercial real estate debt and related instruments generally to be held as long-term investments at amortized cost. We are required to periodically evaluate each of these loans for possible impairment. Impairment is indicated when it is deemed probable that we will not be able to collect all amounts due according to the contractual terms of the loan. If a loan is determined to be impaired, we write down the loan through a charge to the provision for loan losses. Actual losses, if any, could ultimately differ from these estimates.

We perform a quarterly review of our portfolio of loans. In connection with this review, we assess the performance of each loan and assign a risk rating based on several factors including risk of loss, loan-to-value ratio, or LTV, collateral performance, structure, exit plan, and sponsorship. Loans are rated 1 through 5 , from less risk to greater risk in connection with this review.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. The most significant and subjective estimate that we make is the projection of cash flows we expect to receive on our loans, investment securities and intangible assets, which has a significant impact on the amounts of interest income, credit losses (if any), and fair values that we record and/or disclose. In addition, the fair value of financial assets and liabilities that are estimated using a discounted cash flows method is significantly impacted by the rates at which we estimate market participants would discount the expected cash flows.

Reclassifications

As a result of the LNR acquisition, certain items in our condensed consolidated statements of operations and cash flows for the three months ended March 31, 2013 have been reclassified or combined to conform to the current period s presentation. We removed the Net interest margin subtotal from our condensed consolidated statements of operations, with interest income now included in a new Revenues subtotal, and interest expense now included within the new Costs and expenses subtotal. Additionally, the results from our SFR segment have been reclassified as discontinued operations as a result of the spin-off. The reclassifications and combinations related to our condensed consolidated statement of cash flows for the three months ended March 31, 2013 had no effect on previously reported totals or subtotals.

Table of Contents

Recent Accounting Developments

On April 10, 2014 the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*, which requires only those disposals which represent a strategic shift that has or will have a major impact on an entity s operations or financial results be presented as discontinued operations. The ASU is effective for annual periods beginning on or after December 15, 2014, and interim periods within those annual periods, and requires prospective application. We do not expect the application of this ASU to materially impact the Company.

3. Acquisitions and Divestitures

SFR Spin-off

As described in Note 1, on January 31, 2014, we completed the spin-off of our SFR segment to our stockholders. The results of operations for the SFR segment are presented within discontinued operations in our condensed consolidated statements of operations for all periods presented. We have no continuing involvement with the SFR segment following the spin-off. Subsequent to the spin-off, SWAY entered into a management agreement with an affiliate of our Manager. The following table presents the summarized consolidated results of operations for the SFR segment prior to the spin-off, excluding segment allocations (in thousands):

	For the Three Months Ended March 31,			
		2014		**2013**
Total revenues	$	3,876	$	1,164
Total costs and expenses		6,369		3,625
Loss before other income and income taxes		**(2,493)**		**(2,461)**
Total other income		942		335
Loss before income taxes		**(1,551)**		**(2,126)**
Income tax provision				(162)
Net loss	**$**	**(1,551)**	**$**	**(2,288)**

The following table presents the summarized consolidated balance sheet of the SFR segment as of January 31, 2014, the date of spin-off (in thousands):

		January 31, 2014
Assets:		
Cash and cash equivalents	$	111,960
Restricted cash		189
Residential real estate, net		812,017
Non-performing residential loans		211,019
Other assets		9,498
Total Assets	**$**	**1,144,683**

Liabilities and Equity		
Liabilities:		
Accounts payable, accrued expenses and other liabilities	$	24,346
Equity:		
Additional paid-in capital		1,130,405
Accumulated deficit		(11,662)
Total Stockholders Equity		1,118,743
Non-controlling interests in consolidated subsidiaries		1,594
Total Equity		**1,120,337**
Total Liabilities and Equity	**$**	**1,144,683**

Table of Contents

LNR Acquisition

As described in Note 1, on April 19, 2013, we acquired the equity of LNR for an initial agreed upon purchase price of $859 million, which was reduced for transaction expenses and distributions occurring after September 30, 2012, resulting in cash consideration of approximately $730 million. We applied the provisions of ASC 805 in accounting for our acquisition of LNR. Refer to Note 3 of our Form 10-K for further discussion of the LNR acquisition including the final purchase price allocation.

4. Loans

Our loans held-for-investment are accounted for at amortized cost and our loans held-for-sale are accounted for at the lower of cost or fair value, unless we have elected the fair value option. The following tables summarize our investments in mortgages and loans by subordination class as of March 31, 2014 and December 31, 2013 (amounts in thousands):

March 31, 2014		**Carrying Value**		**Face Amount**	**Weighted Average Coupon**	**Weighted Average Life (WAL) (years)(2)**
First mortgages	$	2,810,468	$	2,866,252	5.8%	4.2
Subordinated mortgages(1)		501,222		536,714	8.3%	4.0
Mezzanine loans		1,327,714		1,336,832	11.2%	3.3
Total loans held-for-investment		4,639,404		4,739,798		
Loans held-for-sale, fair value option elected		186,837		181,450	5.1%	9.5
Loans transferred as secured borrowings		143,042		143,069	5.5%	3.0
Total gross loans		4,969,283		5,064,317		
Loan loss allowance (loans held-for-investment)		(4,481)				
Total net loans	$	4,964,802	$	5,064,317		

December 31, 2013		**Carrying Value**		**Face Amount**	**Weighted Average Coupon**	**Weighted Average Life (WAL) (years)(2)**
First mortgages	$	2,616,441	$	2,666,875	5.6%	4.3
Subordinated mortgages(1)		505,533		541,817	8.7%	4.2
Mezzanine loans		1,245,728		1,246,841	12.2%	3.7
Total loans held-for-investment		4,367,702		4,455,533		
Loans held-for-sale, fair value option elected		206,672		209,099	5.3%	9.6
Loans transferred as secured borrowings		180,414		180,483	5.4%	2.9
Total gross loans		4,754,788		4,845,115		
Loan loss allowance (loans held-for-investment)		(3,984)				
Total net loans	$	4,750,804	$	4,845,115		

(1) Subordinated mortgages include (i) subordinated mortgages that we retain after having sold first mortgage positions related to the same collateral and (ii) B-Notes.

(2) Represents the WAL of each respective group of loans as of the respective balance sheet date. The WAL of each individual loan is calculated as a fraction, the numerator of which is the sum of the timing (in years) of each expected future principal payment multiplied by the balance of the respective payment, and with a denominator equal to the sum of the expected principal payments using the contractually extended maturity dates of the assets. Assumptions for the calculation of the WAL are adjusted as necessary for changes in projected principal repayments and/or maturity dates of the loan.

Table of Contents

As of March 31, 2014, approximately $3.6 billion, or 71.8%, of the loans were variable rate and paid interest principally at LIBOR plus a weighted-average spread of 5.18%. The following table summarizes our investments in floating rate loans (amounts in thousands):

	March 31, 2014		December 31, 2013	
Index	Base Rate	Carrying Value	Base Rate	Carrying Value
1 Month LIBOR	0.1520%	$ 630,005	0.1677%	$ 590,444
LIBOR Floor	0.19% - 3.00%(1)	2,937,015	0.19% - 3.00%(1)	2,641,162
U.S. Prime Rate	3.25%	2,197	3.25%	2,226
Total		$ 3,569,217		$ 3,233,832

(1) The weighted-average LIBOR Floor was 0.41% and 0.49% as of March 31, 2014 and December 31, 2013, respectively.

As of March 31, 2014, the risk ratings for loans subject to our rating system, which is described in our Form 10-K and excludes loans on the cost recovery method and loans for which the fair value option has been elected, by class of loan were as follows (amounts in thousands):

	Balance Sheet Classification						
	Loans Held-For-Investment						
Risk Rating Category	First Mortgages	Subordinated Mortgages	Mezzanine Loans	Cost Recovery Loans	Loans Held-For-Sale	Loans Transferred As Secured Borrowings	Total
1	$	$	$	$	$	$	$
2	100,691	104,092	226,689			12,994	444,466
3	2,552,430	360,398	986,067			130,048	4,028,943
4	147,063	36,732	114,958				298,753
5							
N/A	2,219			8,065	186,837		197,121
	$ 2,802,403	$ 501,222	$ 1,327,714	$ 8,065	$ 186,837	$ 143,042	$ 4,969,283

As of December 31, 2013, the risk ratings for loans subject to our rating system by class of loan were as follows (amounts in thousands):

	Balance Sheet Classification						
	Loans Held-For-Investment						
Risk Rating Category	First Mortgages	Subordinated Mortgages	Mezzanine Loans	Cost Recovery Loans	Loans Held-For-Sale	Loans Transferred As Secured Borrowings	Total
1	$	$	$	$	$	$	$
2	94,981	103,369	153,119			13,022	364,491
3	2,354,692	370,446	1,012,674			167,392	3,905,204
4	153,987	31,718	79,935				265,640
5							
N/A				12,781	206,672		219,453
	$ 2,603,660	$ 505,533	$ 1,245,728	$ 12,781	$ 206,672	$ 180,414	$ 4,754,788

After completing our impairment evaluation process as described in our Form 10-K, we concluded that no impairment charges were required on any individual loans held-for-investment as of March 31, 2014 or December 31, 2013. As of March 31, 2014, approximately $57.8 million of our loans held-for-investment were in default, approximately $8.0 million of which are within the LNR Segment and were acquired as non-performing loans prior to the April 19, 2013 acquisition. The remaining $49.8 million of the defaulted loan balance is comprised of a single mezzanine loan within the Lending Segment. The senior loan was in technical default as of March 31, 2014 due to a covenant breach, which caused our mezzanine loan to be in default. The loan is in the process of being refinanced, with a substantial equity investment by the borrower. No lender concessions are expected to be granted in connection with the refinancing. Additionally, none of our held-for-sale loans where we have elected the fair value option was 90 days or more past due or on nonaccrual status.

Table of Contents

In accordance with our policies, we record an allowance for loan losses equal to (i) 1.5% of the aggregate carrying amount of loans rated as a 4, plus (ii) 5% of the aggregate carrying amount of loans rated as a 5. These groups accounted for 6.0% and 5.6% of our loan portfolio as of March 31, 2014 and December 31, 2013, respectively. The following table presents the activity in our allowance for loan losses (amounts in thousands):

	For the Three Months Ended March 31, 2014	2013
Allowance for loan losses at January 1	$ 3,984	$ 2,061
Provision for loan losses	497	30
Charge-offs		
Recoveries		
Allowance for loan losses at March 31	$ 4,481	$ 2,091
Recorded investment in loans related to the allowance for loan loss	$ 298,753	$ 112,573

The activity in our loan portfolio was as follows (amounts in thousands):

	For the Three Months Ended March 31, 2014	2013
Balance at January 1	$ 4,750,804	$ 3,000,335
Acquisitions/originations/additional funding	981,762	129,817
Capitalized interest(1)	8,656	1,611
Basis of loans sold(2)	(448,317)	(44,631)
Loan maturities/principal repayments	(353,934)	(93,651)
Discount accretion/premium amortization	1,806	7,632
Changes in fair value	20,893	
Unrealized foreign currency remeasurement gain (loss)	3,629	(6,141)
Loan loss allowance	(497)	(30)
Balance at March 31	$ 4,964,802	$ 2,994,942

(1) Represents accrued interest income on loans whose terms do not require current payment of interest.

(2) See Note 10 for additional disclosure on these transactions.

5. Investment Securities

Investment securities were comprised of the following as of March 31, 2014 and December 31, 2013 (amounts in thousands):

	Carrying Value as of March 31, 2014	December 31, 2013

RMBS, available-for-sale	$	291,217	$	296,236
Single-borrower CMBS, available-for-sale		113,477		114,346
CMBS, fair value option (1)		564,818		550,282
Held-to-maturity (HTM) securities		369,152		368,318
Equity security, fair value option		15,115		15,247
Subtotal - Investment securities		1,353,779		1,344,429
VIE eliminations (1)		(430,694)		(409,322)
Total investment securities	$	923,085	$	935,107

(1) Certain fair value option CMBS are eliminated in consolidation against VIE liabilities pursuant to ASC 810.

Table of Contents

Purchases, sales and principal collections for all investment securities were as follows (amounts in thousands):

	Available-for-sale RMBS	Available-for-sale CMBS	CMBS, fair value option	HTM Securities	Equity Security	Total
Three Months ended March 31, 2014						
Purchases	$	$	$ 9,890	$	$	$ 9,890
Sales	9,309		18,574			27,883
Principal collections	7,819	408				8,227
Three Months ended March 31, 2013						
Purchases				37,190		37,190
Sales	12,711	206,608(1)			6,769	226,088
Principal collections	16,868	4,858				21,726

(1) Settlement occurred subsequent to March 31, 2013. We account for all investment securities transactions on a trade date basis.

RMBS and Single-borrower CMBS, Available-for-Sale

With the exception of one CMBS classified as HTM, the Company classified all of its RMBS and CMBS investments where the fair value option has not been elected as available-for-sale as of March 31, 2014 and December 31, 2013. These RMBS and CMBS are reported at fair value in the balance sheet with changes in fair value recorded in accumulated other comprehensive income (AOCI).

The tables below summarize various attributes of our investments in available-for-sale RMBS and single-borrower CMBS where the fair value option has not been elected as of March 31, 2014 and December 31, 2013 (amounts in thousands):

	Purchase Amortized Cost	Credit OTTI	Recorded Amortized Cost	Non-Credit OTTI	Unrealized Gains or (Losses) Recognized in AOCI: Gross Unrealized Gains	Unrealized Gains or (Losses) Recognized in AOCI: Gross Unrealized Losses	Net Fair Value Adjustment	Fair Value
March 31, 2014								
RMBS	$ 243,354	$ (10,342)	$ 233,012	$ (979)	$ 59,419	$ (235)	$ 58,205	$ 291,217
Single-borrower CMBS	100,980		100,980		12,497		12,497	113,477
Total	$ 344,334	$ (10,342)	$ 333,992	$ (979)	$ 71,916	$ (235)	$ 70,702	$ 404,694
December 31, 2013								
RMBS	$ 253,912	$ (11,134)	$ 242,778	$ (55)	$ 55,154	$ (1,641)	$ 53,458	$ 296,236
Single-borrower CMBS	100,687		100,687		13,659		13,659	114,346
Total	$ 354,599	$ (11,134)	$ 343,465	$ (55)	$ 68,813	$ (1,641)	$ 67,117	$ 410,582

	Weighted Average Coupon(1)	Weighted Average Rating (Standard & Poor s)	WAL (Years)(3)
March 31, 2014			
RMBS	1.0%	B-	7.8
Single-borrower CMBS	11.5%	BB+(2)	4.0
December 31, 2013			
RMBS	1.0%	B-	