

1998

ANNUAL REPORT



CAPITAL TRUST

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Capital Trust, Inc. is a fully integrated, self-managed specialty finance company focused on the commercial real estate industry. As a principal, we combine our broad **real estate experience**, unique **capital markets expertise** and extensive network of contacts to originate, structure, close and manage high yield loans and investments. As an advisor, we execute **sophisticated transactions** and implement **creative strategies** on behalf of clients who include the leading owners and investors in the business. Our mission is to consistently produce **superior returns** for our stockholders and to deliver superior service to our borrowers, partners and clients.

Capital Trust, Inc. is traded on the New York Stock Exchange under the symbol "CT." The company is headquartered in New York City.

TO OUR FELLOW STOCKHOLDERS



Board of Directors:

**Thomas E. Dobrowski • Samuel Zell • John R. Klopp • Craig M. Hatkoff • Sheli Z. Rosenberg • Steven Roth
Gary R. Garrabrant • Martin L. Edelman • Lynne B. Sagalyn • Jeffrey A. Altman**

For Capital Trust, 1998 was two years wrapped into one—before and after the fall. This past autumn’s extraordinary and unprecedented events in the global capital markets negatively impacted what had promised to be an otherwise great year. When the roller coaster stopped, we emerged armed with ready capital and the most experienced team in the business, prepared to take advantage of the new opportunities.

Through mid-August, we originated nearly \$600 million in new loans in 22 separate transactions, all of which exceeded our standards for quality and yield. To fund this growth, we sequentially increased the Company’s committed lines of credit and in July raised an additional \$150 million of capital through a direct placement of Convertible Trust Preferred Securities. This brought us three vitally important strategic investors—Vornado Realty Trust, General Motors Investment Management Corp. and Equity Office Properties Trust—each of which invested \$50 million in Capital Trust. Steven Roth and Tom Dobrowski also joined us as Directors, further enhancing a Board that we firmly believe is the best in the industry. Our advisory business, which had been on a pace to knock the cover off the ball, slowed appreciably but still met its original target of \$10 million in revenues.

Then, seemingly without warning, an unlikely confluence of economic and political shock waves created a chain reaction that led to a near-collapse of the world’s financial markets. The dominoes fell quickly: from the Thai baht to Russian bonds, Long

Term Capital Management to the Clinton impeachment, Malaysia to Brazil to bombing Iraq. Soon, credit spreads on everything had widened far beyond historical levels, Criimi Mae had filed for bankruptcy and Capital Corporation of America was closing its doors. The world faced a liquidity crisis and the domestic mortgage finance business was in the eye of the storm.



In early September, we made what seemed at the time to be a tough call and decided to temporarily suspend all new investment activity. After consulting with the Board, we shut down our pipeline of nearly half a billion dollars of loans that would have closed in the ordinary course by year-end.

As a result of this decision and other risk mitigation measures, our 1998 earnings were negatively impacted and in turn our stock price suffered. The decision to suspend lending was driven by our belief that we are, above all, charged with managing risk, not just meeting quarterly earnings expectations. We believe that our risk management during this extraordinary period, although painful to the bottom line, was effective. We had no defaults, no losses, no margin calls; we hedged our positions more conservatively using interest rate swaps rather than Treasuries; we paid down debt and increased our liquidity. As disappointing as the stock price performance has been, we managed to avoid the land mines that caused heavy casualties for many competitors.

As major stockholders, 1998 was very painful for us. But in spite of 1998's difficulties, we are very excited about the prospects for CT for one simple reason—the opportunities are greater than ever. Our objective for 1999 is also simple—identify the best opportunities to invest the substantial capital with which we have been entrusted.

As we write this letter, the world has settled back to a state of “new normal” (the mortgage finance business, like the rest of the global capital markets, will never really be the same). CT has resumed making new investments, highlighted by our acquisition in February through CT-BB Funding Corp. of a \$246 million portfolio of “BB”-rated commercial mortgage backed securities. Representing, we believe, the largest single subordinate CMBS trade since the fall, the portfolio was purchased at spreads more than double the levels of last June and financed on a non-recourse basis by the seller on extremely attractive terms. We plan to continue to originate mezzanine loans, Capital Trust's traditional focus, and will seek out compelling scale transactions like the “BB” portfolio. We also believe that the sector will consolidate and we will continue to explore merger and acquisition opportunities which add to our platform and diversify our capital sources.

The challenges are great. We are confident in the future and we appreciate your continued support. Stay tuned.

Samuel Zell
Chairman of the Board of Directors

Craig M. Hatkoff
Vice Chairman
Chairman of the Executive Committee

John R. Klopp
Vice Chairman
Chief Executive Officer

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These stories track several transactions that were highlighted in 1997's annual report.

▶ **The BMW Building** Turning \$10 million into \$17 million. First, we seized an undervalued opportunity by committing to purchase a controlling interest in this 950,000 square foot office property in July 1997. Second, we “manufactured” our own \$10 million mezzanine loan by bringing in an equity investor and refinancing the underlying property. Next, as asset manager, we guided a repositioning which featured the installation of BMW as lead tenant. Last, in late 1998 we arranged the sale to a New York City office REIT (who we advised when they went public). Result: over \$7 million of loan, advisory and asset management fees, interest income and profit participation in 18 months. We look forward to more opportunistic “BMW Stories” which combine our real estate and capital markets skills in the future.



▶ **The Kennedy Family** Merchant Advisory. Our involvement started in 1997 with a strategic advisory assignment to assist the Joseph P. Kennedy family in selling their real estate assets and related operating businesses. Along the way, we identified a capital need at their Apparel Center property and quickly committed a \$35 million second mortgage (subsequently syndicated to minimize our overall exposure). The advisory assignment was successfully completed and our loan repaid through a structured sale to Vornado Realty Trust for \$630 million in April 1998. Interest income, loan, syndication and transaction fees totaled over \$5 million, demonstrating the power of combining Capital Trust's advisory business with our ability to commit capital.



▶ **1325 Avenue of the Americas** Full Circle. Our in-depth knowledge of this property and owner started with a previous advisory assignment in the early 1990's. When the opportunity to refinance the original lender arose in late 1997, we arranged for a \$185 million first mortgage from a securitized lender and provided a \$50 million second mortgage. In addition, we subsequently made a highly profitable loan to the borrower's operating company. Just over one year later, both loans were repaid in accordance with our exit strategy.

EXPERIENCE

It's not just putting the money out, it's getting it back, plus a return. Capital Trust has the experience to create opportunities, manage the risk and generate superior returns in all phases of the cycle.



STRENGTH & STABILITY

Diverse Sources of Capital During 1998 Capital Trust accessed more than \$650 million of new debt and equity capital to fuel its growth. We cultivated new funding sources throughout the year and expanded our diverse pool of strategic capital partners. Unlike many other commercial mortgage companies, Capital Trust is a C-corporation which builds its equity capital through retained earnings. In our first full year of operations, the bottom line contributed over \$10 million to our capital base. In 1999, we will continue to build our capital base and expand our capital relationships.

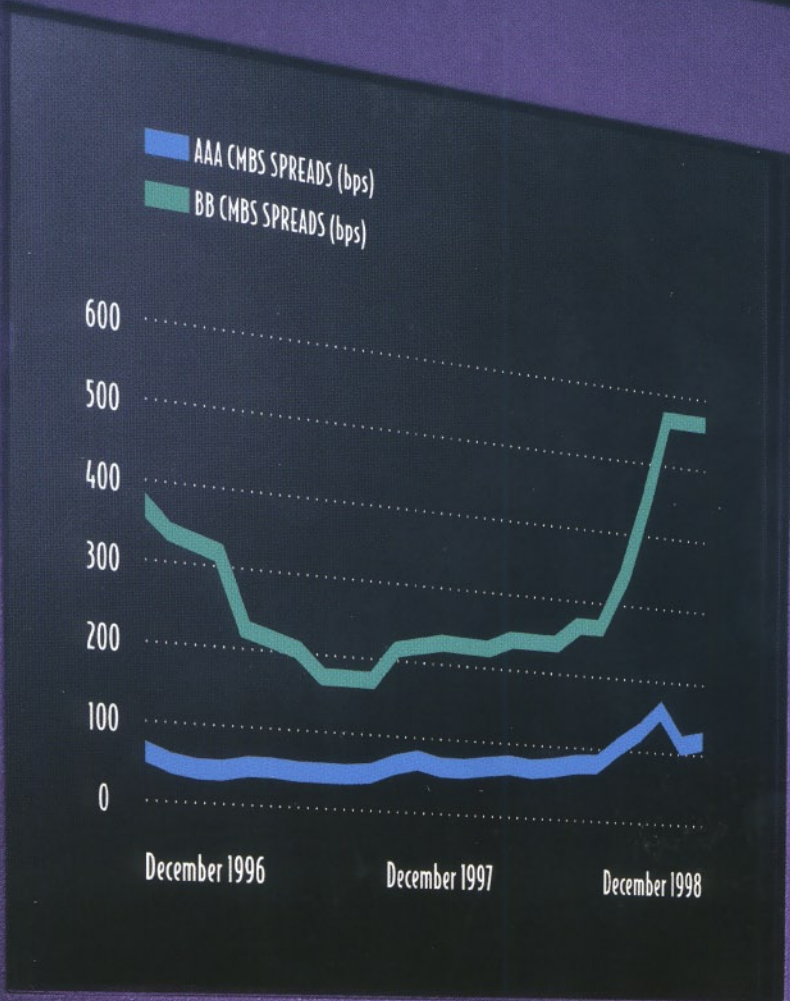
Balance Sheet Management During 1998 we more than doubled our assets to \$766 million and our equity capital base to \$294 million, while significantly increasing our credit facilities. As the business has grown, we have never lost sight of the importance of balance sheet and risk management. Capital Trust's balance sheet is duration and interest rate matched. Our policy is to maintain

ample liquidity, hedge our interest rate exposure through swaps and run a "matched" book. As a result, we experienced no portfolio or hedging losses during September's global debt crisis.



Capital Markets Sophistication When Capital Trust sought additional non-dilutive equity capital this summer, we structured, negotiated and directly placed \$150 million of Convertible Trust Preferred Securities. Not only did this capital fuel the Company's growth, it also brought us important strategic partners. As our book of assets grows, we are exploring new and innovative financing techniques such as Collateralized Loan Obligations (CLOs) and other securitization structures to enhance earnings and maximize our capital efficiency. As we continue to achieve scale, we are able to access a wider range of more cost-effective financing alternatives.

CAPITAL As a provider and consumer, capital is the cornerstone of our business. Our superior access to capital, acute balance sheet management and capital markets sophistication keeps us one step ahead.



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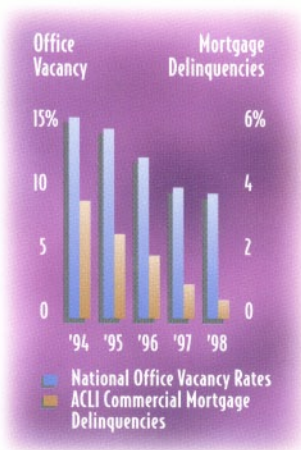
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Market Dislocation Notwithstanding a mature cycle, real estate and commercial mortgage fundamentals are sound. However, lending spreads, particularly in the non-investment grade/mezzanine sector, have not tightened appreciably since significantly increasing in September. This disconnect creates a tremendous opportunity at the “mezzanine” spectrum of the credit curve and ideal market dynamics for Capital Trust. Not only do we have the requisite skill set and real estate know-how to underwrite the opportunity, but we also have the capital to execute.



Reduced Competition By mid-1998, a spate of new mezzanine players had arrived on the real estate scene. From the ill-structured mortgage REITs to the new breed of securitizers, competition was intense. Victims of poor capital structure, asset quality and transaction discipline, most are now gone. This void has created an opportunity for Capital Trust to fill the breach at wider spreads and more attractive terms.

Conviction You need it both to survive and to succeed. In September, we made the tough decision to step to the sidelines in a dislocated market and it proved to be the right call. In early 1999, we stepped to the plate to take down one of the largest subordinate CMBS trades since September demonstrating that we are back. 1999 will see Capital Trust tackle new initiatives and seek to expand its horizons in complementary businesses. Capital Trust will seize the opportunity with conviction and firmly establish itself as the leader in innovative commercial real estate finance.

OPPORTUNITY Experience and capital create

the platform to exploit the opportunities ahead. As a result of the market dislocation and reduced competition, we have a wide-open field to put our capital and experience to work.



MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Prior to July 1997, the Company operated as a REIT, originating, acquiring, operating and holding income-producing real property and mortgage-related investments. Since July 1997, the Company has pursued a new strategic direction operating as a specialty finance company designed primarily to take advantage of high-yielding mezzanine investments and other real estate asset and finance opportunities in commercial real estate. At that time, the Company elected to no longer qualify for treatment as a REIT for federal income tax purposes. Consequently, the information set forth below with regard to historical results of operations for the year ended December 31, 1996 does not reflect any operating results from the Company's specialty finance activities or real estate advisory services nor does it reflect the Company's current loan and other investment portfolio. The results for the year ended December 31, 1997 reflect partial year real estate specialty finance and advisory operations. The results for the year ended December 31, 1998 reflect full year real estate specialty finance and advisory operations.

The Company is successor to Capital Trust (f/k/a California Real Estate Investment Trust), a California business trust (the "Predecessor"), following consummation of the reorganization on January 28, 1999, whereby the Predecessor effectively merged with and into the Company, which thereafter continued as the surviving Maryland corporation (the "Reorganization"). Unless the context otherwise requires, hereinafter references to the business, assets, liabilities, capital structure, operations and affairs of "the Company" include those of "the Predecessor" prior to the Reorganization.

Ownership and Capital Changes

On January 3, 1997, CalREIT Investors Limited Partnership ("CRIL"), an affiliate of Equity Group Investments, Inc. ("EGI") and Samuel Zell, purchased from the Predecessor's former parent 6,959,593 common shares of beneficial interest, \$1.00 par value ("Common Shares") in the Predecessor (representing approximately 76% of the then-outstanding Common Shares) for an aggregate purchase price of \$20,222,011. In July 1997, the Predecessor consummated the sale of 12,267,658 class A 9.5% cumulative convertible preferred shares of beneficial interest, \$1.00 par value ("Class A Preferred Shares"), in the Predecessor, to Veqtor Finance Company, LLC ("Veqtor"), an affiliate of Samuel Zell and the principals of Victor Capital, for an aggregate purchase price of \$33,000,000 (the "Investment"). Concurrently with the foregoing transaction,

Veqtor purchased the 6,959,593 Common Shares (which were reclassified at that time as class A common shares of beneficial interest, \$1.00 par value ("Class A Common Shares")) held by CRIL for an aggregate purchase price of approximately \$21.3 million. Veqtor continues to beneficially own 19,227,251 shares (or approximately 63%) of the outstanding voting stock of the Company.

Concurrently with the foregoing transactions, the Predecessor consummated the acquisition of the real estate services businesses of Victor Capital and appointed a new management team from among the ranks of Victor Capital's professional team and elsewhere. The Predecessor thereafter immediately commenced full implementation of its operations as a finance and advisory company under the direction of its newly elected board of trustees and new management team.

In December 1997, the Predecessor completed a public securities offering (the "Offering") by issuing 9,000,000 new Class A Common Shares in the Company at \$11.00 per share. The Company raised approximately \$91.4 million in net proceeds from the Offering. In July 1998, the Company completed a private placement of 150,000 Convertible Trust Preferred Securities (as hereinafter defined) that are convertible into Class A Common Stock (as hereinafter defined) at a conversion price of \$11.70 per share. The Company raised approximately \$145.2 million in net proceeds from the private placement transaction.

In the Reorganization, the Predecessor merged with and into Captrust Limited Partnership, a Maryland limited partnership ("CTLP"), with CTLP continuing as the surviving entity, and CTLP merged with and into the Company, with the Company continuing as the surviving Maryland corporation. Each outstanding Class A Common Share was converted into one share of class A common stock, par value \$0.01 per share ("Class A Common Stock"), and each outstanding Class A Preferred Share was converted into one share of class A 9.5% cumulative convertible preferred stock, par value \$0.01 per share ("Class A Preferred Stock"), of the Company. As a result, all of the Predecessor's previously issued Class A Common Shares have been reclassified as shares of Class A Common Stock and all of the Predecessor's previously issued Class A Preferred Shares have been reclassified as shares of Class A Preferred Stock.

Overview of Financial Condition

The year ended December 31, 1998 was the Company's first full year of operations as a specialty finance and advisory company. During the year, the Company more than doubled its total asset base to

\$766.4 million at December 31, 1998 from \$317.4 million at December 31, 1997. The Company's growth was primarily the result of originating and funding approximately \$605.3 million of new loan and investment transactions and further borrowings under unfunded commitments. The Company originated or purchased and funded twenty-three new loan and investment transactions and further borrowings under two loans originated in the prior year. The Company funded these assets through cash generated from the Offering, the issuance of the Convertible Trust Preferred Securities (as defined hereafter) and borrowings under the Company's Credit Facilities (as defined hereafter).

Since December 31, 1997, the Company has identified, negotiated and committed to fund or acquire twenty-three loan, certificated mezzanine investment and commercial mortgage-backed securities ("CMBS") investment transactions. These include eleven Mortgage Loan transactions totaling \$234.5 million (of which \$20.9 million remains unfunded at December 31, 1998), nine Mezzanine Loan transactions totaling \$293.4 million, one certificated mezzanine investment for \$32.5 million (of which \$8.5 million remains unfunded at December 31, 1998), and two acquisitions of three classes of subordinated interests issued by a financial asset securitization investment trust totaling \$36.3 million. The Company also funded \$8.4 million of commitments under two loans originated in the prior year. These increases were offset by satisfactions and repayments of \$40.1 million, \$30.3 million, \$500,000 and \$25.5 million on the Mortgage Loans, Mezzanine Loans, Certificated Mezzanine Investments and CMBS, respectively. The Company also sold a CMBS realizing \$24.0 million of proceeds. At December 31, 1998, the Company had outstanding loans, certificated mezzanine investments and investments in commercial mortgage-backed securities of approximately \$702 million and additional commitments for fundings on outstanding loans and certificated mezzanine investments of approximately \$40.3 million as compared to approximately \$251.8 million of such investments and \$26.9 million of additional commitments at December 31, 1997.

The Company believes that the loans and investments originated in 1998 will provide investment yields within the Company's target range of 400 to 600 basis points above LIBOR. The Company maximizes its return on equity by utilizing its existing cash on hand and then employing leverage on its investments. The Company may make loans and investments with yields that fall outside of the investment range set forth above, but that correspond with the level of risk perceived by the Company to be inherent in such investments.

The Company's assets are subject to various risks that can affect results, including the level and volatility of prevailing interest rates and credit spreads, adverse changes in general economic condi-

tions and real estate markets, the deterioration of credit quality of borrowers and the risks associated with the ownership and operation of real estate. Any significant compression of the spreads of the interest rates earned on interest-earning assets over the interest rates paid on interest-bearing liabilities could have a material adverse effect on the Company's operating results as could the availability of desirable loan and investment opportunities and the ability to obtain and maintain targeted levels of leverage and borrowing costs. Adverse changes in national and regional economic conditions can have an effect on real estate values increasing the risk of undercollateralization to the extent that the fair market value of properties serving as collateral security for the Company's assets are reduced. Numerous factors, such as adverse changes in local market conditions, competition, increases in operating expenses and uninsured losses, can affect a property owner's ability to maintain or increase revenues to cover operating expenses and the debt service on the property's financing and, consequently, lead to a deterioration in credit quality or a loan default and reduce the value of the Company's asset. In addition, the yield to maturity on the Company's CMBS assets is subject to the default and loss experience on the underlying mortgage loans, as well as by the rate and timing of payments of principal. If there are realized losses on the underlying loans, the Company may not recover the full amount, or possibly, any of its initial investment in the affected CMBS asset. To the extent there are prepayments on the underlying mortgage loans as a result of refinancing at lower rates, the Company's CMBS assets may be retired substantially earlier than their stated maturities leading to reinvestment in lower yielding assets. There can be no assurance that the Company's assets will not experience any of the foregoing risks or that, as a result of any such experience, the Company will not suffer a reduced return on investment or an investment loss.

As discussed below, the Company has two primary credit facilities, one in the amount of \$355 million with a three-year original term and one in the amount of \$300 million with an 18 month original term.

Effective September 30, 1997, the Company entered into a credit agreement with a commercial lender that provides for a three-year \$150 million line of credit (the "First Credit Facility"). Effective January 1, 1998, pursuant to an amended and restated credit agreement, the Company increased its First Credit Facility with its lender to \$250 million and subsequently further amended the credit agreement to increase the facility to \$300 million effective June 22, 1998 and to \$355 million effective July 23, 1998. The amended and restated agreement expires on December 31, 2001.

On June 8, 1998, the Company entered into an additional credit agreement with another commer-

cial lender that provides for a \$300 million line of credit that expires in December 1999 (the "Second Credit Facility" together with the First Credit Facility, the "Credit Facilities").

The Credit Facilities provide for advances to fund lender-approved loans and investments made by the Company ("Funded Portfolio Assets"). The obligations of the Company under the Credit Facilities are secured by pledges of the Funded Portfolio Assets acquired with advances under the Credit Facilities. Borrowings under the Credit Facilities bear interest at specified rates over LIBOR which rates may fluctuate based upon the credit quality of the Funded Portfolio Assets. Future repayments and redrawdowns of amounts previously subject to the drawdown fee will not require the Company to pay any additional fees. The Credit Facilities provide for margin calls on asset-specific borrowings in the event of asset quality and/or market value deterioration as determined under the Credit Facilities. The Credit Facilities contain customary representations and warranties, covenants and conditions and events of default. The Credit Facilities also contain a covenant obligating the Company to avoid undergoing an ownership change that results in Craig M. Hatkoff, John R. Klopp or Samuel Zell no longer retaining their senior offices and directorships with the Company and practical control of the Company's business and operations.

At December 31, 1998, the Company had \$371.8 million of outstanding borrowings under the Credit Facilities as compared to \$79.9 million at December 31, 1997. The substantial increase was used to fund the new loans and investments.

When possible, in connection with the acquisition of investments, the Company obtains seller financing which can take the form of repurchase agreements. Four of the transactions completed during the year ended December 31, 1998 described above were financed in this manner representing total original repurchase financings of \$41.8 million. These financings are generally completed at discounted terms as compared to those available under the Credit Facilities. Despite these new financings, repurchase obligations decreased modestly from December 31, 1997 to December 31, 1998 due to the repayment on the repurchase obligation associated with the CMBS that was sold in 1998.

On July 28, 1998, the Company privately placed 150,000 8.25% Step Up Convertible Trust Preferred Securities (liquidation amount \$1,000 per security) with an aggregate liquidation amount of \$150 million (the "Convertible Trust Preferred Securities"). The Convertible Trust Preferred Securities were issued by the Company's consolidated statutory trust subsidiary, CT Convertible Trust I (the "Trust"). This private placement transaction was completed concurrently with the related issuance and sale to the Trust of the Company's 8.25% Step Up Convertible Junior Subordinated Debentures in the aggregate

principal amount of \$154,650,000 (the "Convertible Debentures"). Distributions on the Convertible Trust Preferred Securities are payable quarterly in arrears on each calendar quarter-end and correspond to the payments of interest made on the Convertible Debentures, the sole assets of the Trust. Distributions are payable only to the extent payments are made in respect to the Convertible Debentures.

The Company received \$145.2 million in net proceeds, after original issue discount of 3% from the liquidation amount of the Convertible Trust Preferred Securities and transaction expenses, pursuant to the above transactions. The proceeds were used to pay down the Company's Credit Facilities. The Convertible Trust Preferred Securities are convertible at any time by the holders thereof into shares of Class A Common Stock at a per share conversion price of \$11.70. The Convertible Debentures have a 20-year maturity and are non-callable for five years. Upon repayment of the Convertible Debentures at maturity or upon redemption, the proceeds of such repayment or payment shall be simultaneously paid and applied to redeem, among other things, the Convertible Trust Preferred Securities. If the securities have not been redeemed by September 30, 2004, the distribution rate will step up by 0.75% per annum for each annual period thereafter. The 3% (\$4.5 million) discount and \$0.3 million of transaction costs on the issuance will be amortized over the expected life of the Convertible Trust Preferred Securities.

As of December 31, 1998, certain of the Company's loans and other investments have been hedged so that the assets and the corresponding liabilities were matched at floating rates over LIBOR. The Company has entered into interest rate swap agreements for notional amounts totaling approximately \$115.8 million with financial institution counterparties whereby the Company swapped fixed rate instruments, which average approximately 5.95%, for floating rate instruments at the London Interbank Offered Rate ("LIBOR"). The agreements mature at varying times from December 1999 to July 2008.

The Company is exposed to credit loss in the event of non-performance by the counterparties (banks whose securities are rated investment grade) to the interest rate swap and cap agreements, although it does not anticipate such non-performance. The counterparties would bear the interest rate risk of such transactions as market interest rates increase. If an interest rate swap or interest rate cap is sold or terminated and cash is received or paid, the gain or loss is deferred and recognized when the hedged asset is sold or matures.

Recent Market Conditions

In light of the significant volatility in the global capital markets experienced in September 1998, the Company halted its loan origination pace from that

point through year-end. Likewise, the Company's advisory business was also affected as fee producing activity related to real estate acquisitions, dispositions and financings by its clients slowed in reaction to market conditions. The Company ended the year with significant liquidity resources and with the belief that it was positioned to take advantage of portfolio growth opportunities meeting its risk/yield profile which it expected to develop as overall market conditions improved. On March 3, 1999, the Company announced its re-entry into the loan origination and investment market through the acquisition, by its newly formed wholly owned subsidiary, CT-BB Funding Corp., of \$246.0 million of face amount "BB" rated CMBS for a purchase price of \$196.9 million.

Results of Operations for the Years Ended December 31, 1998 and 1997

The Company reported total revenues of \$74.3 million for the year ended December 31, 1998, an increase of \$66.3 million over total revenues of \$8.0 million reported for the year ended December 31, 1997. The Company reported net income allocable to Class A Common Stock of \$10,308,000 for the year ended December 31, 1998, an increase of \$16,336,000 from the net loss allocable to Class A Common Stock of \$6,028,000 for the year ended December 31, 1997. These changes were primarily the result of the full implementation of the Company's operations as a real estate finance and advisory company that generated revenues from loans and other investments and significant advisory and investment banking fees.

Interest and related income from loans and other investments amounted to \$62,316,000 for the year ended December 31, 1998, an increase of \$57,324,000 over the \$4,992,000 for the year ended December 31, 1997. This increase was primarily due to an eleven-fold increase in the average interest earning assets from approximately \$46.8 million for the year ended December 31, 1997 to approximately \$526.3 million for the year ended December 31, 1998. The increase was also enhanced by an increase in the average rate earned on the investments from 10.66% to 11.84%.

Interest and related expenses had a similar percentage change increasing from \$2,223,000 at December 31, 1997 to \$27,252,000 at December 31, 1998. This increase of \$25,029,000 is due to an increase in the average interest bearing liabilities from approximately \$27.5 million for the year ended December 31, 1997 to approximately \$338.3 million for the year ended December 31, 1998. The average rate paid on average interest-bearing liabilities remained constant from year to year at 8.1%.

During the year ended December 31, 1998, other revenues totaled \$11,949,000, an increase of \$8,923,000 over the same period in 1997. The increase for the year ended December 31, 1998 was primarily due to an additional of \$8,613,000 of advi-

sory and investment banking fees generated by Victor Capital and its related subsidiaries over the amount of such fees generated in the prior year and an additional \$185,000 of other interest income being earned in 1998. The Company also experienced a \$307,000 decrease in rental income as the Company sold its remaining rental properties during the first quarter of 1997 for which the Company recorded a loss of \$432,000.

Other expenses increased from \$10,297,000 for the year ended December 31, 1997 to \$21,262,000 for the year ended December 31, 1998. The increase was primarily due to the additional general and administrative expenses necessary for the commencement and continuation of full-scale operations as a specialty finance company, the largest components of such expenses which are employee salaries and related costs, and the provision for possible credit losses. As of December 31, 1998, the Company had 44 full time employees as compared to 29 at December 31, 1997 (who were employed for only five and a half months following the acquisition of Victor Capital on July 15, 1997). The provision for possible credit losses was \$3,555,000 for the year ended December 31, 1998, as the Company provided reserves on its loan and investment portfolio pursuant to its reserve policy. The significant increase from the \$462,000 provision for possible credit loss for the year ended December 31, 1997 was due to the increase in average earning assets outstanding as previously described.

In 1997, the Company did not incur any income tax expense or benefit associated with the loss it incurred due to the uncertainty of realization of net operating loss carryforwards. In the year ended December 31, 1998, the Company accrued \$9,367,000 of income tax expense for federal, state and local income taxes. For federal purposes, the Company utilized net operating loss carryforwards of approximately \$4.9 million to reduce its current tax expense and released approximately \$1.0 million of reserves on deferred tax assets in calculating the accrual for the year ended December 31, 1998. This had the effect of reducing the effective tax rate from the expected rate of 47% to 36%.

As discussed above, the Company issued \$150,000,000 of Convertible Trust Preferred Securities on July 28, 1998. The Company recognized \$2,941,000 of net expenses related to these securities during the year ended December 31, 1998. This amount consisted of distributions to the holders totaling \$5,225,000 and amortization of discount and origination costs totaling \$337,000 that were partially offset by tax benefits of \$2,621,000.

The preferred share dividend and dividend requirement arose in 1997 as a result of the Company's issuance of \$33 million of Class A Preferred Stock on July 15, 1997. Dividends accrue on such stock at a rate of 9.5% per annum on a per share price of \$2.69 for the 12,267,658 shares outstanding.

Results of Operations for the Years Ended December 31, 1997 and 1996

The Company reported a net loss allocable to Class A Common Stock of \$6,028,000 for the year ended December 31, 1997, an increase of \$5,614,000 from the net loss allocable to Class A Common Stock of \$414,000 reported for the year ended December 31, 1996. The significant increase in the loss was a result of the expenses associated with the Company's hiring activity outpacing its income generation pursuant to the acquisition of Victor Capital and initiation of its operations as a real estate finance and advisory company.

Total revenues were \$8,018,000 for 1997, an increase of \$3,794,000 over the \$4,224,000 reported for 1996. The increase in 1997 was due to the implementation of the Company's operations as a finance company in the second half of the year. The Company began to collect interest on loans and investments originated or acquired during this period and began to generate advisory and management fees from its newly acquired subsidiary, Victor Capital, which accounted for \$1,698,000 of the increase. The Company also generated additional interest income from bank deposits over the amount earned the previous year due to significant cash balances on hand from the sale of Class A Preferred Stock in the Investment and Class A Common Stock in the Offering. These increases were offset by a decrease in rental income resulting from the disposition of all rental properties during 1996 and 1997 and the change in the gain or loss on sale of rental properties and investments.

Interest and related income from loans and other investments was \$4,992,000 for the year ended December 31, 1997, an increase of \$4,522,000 over the \$470,000 in 1996. The increase in 1997 was due to the implementation of the Company's business plan in the second half of 1997 when the Company began to collect interest on loans and investments made during this period.

Rental income from the Company's commercial properties was \$307,000 in 1997, a decrease of \$1,712,000 from the \$2,019,000 for 1996. The decrease in 1997 from that received in 1996 was due to the sale of the properties during 1996 and 1997 which were generating the rental income.

Other interest income was \$1,453,000 in 1997, an increase of \$787,000 over the \$666,000 reported for 1996. The increase in 1997 was a result of the Company generating additional interest income from bank deposits due to significant cash balances on hand from the sale of Class A Preferred Stock in the Investment and Class A Common Stock in the Offering.

Net gain or loss on sale of rental properties and investments was a loss of \$432,000 in 1997 versus a gain of \$1,069,000 in 1996. The losses incurred in 1997 were due to the sales of the two remaining rental properties. During 1996, the Company incurred a net loss of \$164,000 from the sale of a

storage facility property, realized a net gain from the sale of a property of \$299,000, and realized a net gain of \$934,000 when the Company sold four of its seven mortgage notes.

Total expenses were \$12,520,000 for the year ended December 31, 1997, an increase of 7,498,000 over the \$4,638,000 reported for the same period in 1996. In 1997, total expenses were up due primarily to a \$7,960,000 increase in general and administrative expenses from the implementation of the operations as a finance company and the related hiring of executive officers and employees, principally from the ranks of Victor Capital, following the acquisition thereof.

Interest and related expense from loans and other investments was \$2,223,000 for 1997, up from the \$86,000 reported for 1996. The increase in 1997 was due to an increase in borrowing under the Company's First Credit Facility and repurchase agreements to fund new loans and investments made in the second half of 1997.

Other interest expense was \$156,000 for 1997, down from \$461,000 for 1996. The decrease in 1997 from the amount reported in 1996 resulted from the elimination of mortgage debt upon sale of the Totem Square property.

General and administrative expenses were \$9,463,000 for the year ended December 31, 1997, up significantly from the \$1,503,000 reported for the same period in 1996. The increase in general and administrative costs in 1997 was due primarily to the addition of the new executive officers and employees hired in 1997 whose salaries and benefits totaled more than \$5 million. The Company also incurred significant non-recurring professional fees (an increase of more than \$2 million over the fees incurred in 1996) in conjunction with the reconstitution of the Company, the termination of its REIT status and the implementation of its operations as a finance company.

Rental property expenses decreased significantly, by \$657,000, for 1997 when the remaining rental properties were sold.

For the year ended December 31, 1997, the Company recorded a provision for possible credit losses of \$462,000. During 1997, the Company had no known assets which were considered impaired and as such no significant additional provisions were necessary. Management believes that the reserve for possible credit losses is adequate.

For the year ended December 31, 1996, the Company reported a provision for possible credit losses of \$1,743,000. By year-end, the Company had reduced the book value of its Sacramento, California shopping center to \$1,215,000 and the book value of its Kirkland, Washington retail property to \$7,370,000. Since these properties were no longer being held for investment, but rather for sale, their book value was reduced to more accurately reflect the then-current market value of the assets. The

decline in the shopping center's value was the result of the Company's relatively short lease term on the land underlying the center, the physical condition of the property and changed market conditions in the Sacramento area. Disposition efforts on behalf of the retail property also indicated the need to reduce this property's book value, as it was no longer being held for investment purposes but actively marketed for sale. Both properties were sold during the first quarter of 1997.

The preferred share dividend and dividend requirement arose in 1997 as a result of the Company issuing \$33 million of Class A Preferred Stock on July 15, 1997. Dividends accrue on such stock at a rate of 9.5% per annum on a per share price of \$2.69.

Liquidity and Capital Resources

At December 31, 1998, the Company had \$46,623,000 in cash. Liquidity in 1999 will be provided primarily by cash on hand, cash generated from operations, principal and interest payments received on investments, loans and securities, and additional borrowings under the Credit Facilities. The Company believes these sources of capital will adequately meet future cash requirements. Consistent with its operations as a finance company, the Company expects that during 1999 it will use a significant amount of its available capital resources to originate and fund loans and other investments. In connection with such investment and loan transactions, the Company intends to employ leverage, up to a maximum 5:1 debt-to-equity ratio, to enhance its return on equity.

The Company experienced a net decrease in cash of approximately \$2.6 million for the year ended December 31, 1998, compared to a net increase in cash of \$44.6 million for the year ended December 31, 1997. For the year ended December 31, 1998, cash provided by operating activities was \$14.8 million, up approximately \$12.3 million from cash provided by operations of \$2.5 million during the same period in 1997. Cash used in investing activities during this same period increased by approximately \$205.2 million to approximately \$447.9 million, up from \$242.7 million, primarily as a result of the increased activity in origination and purchase of loans and other investments. Cash provided by financing activities increased approximately \$145.7 million to approximately \$430.5 million, up from \$284.8 million, primarily from the proceeds of borrowings under the Credit Facilities and net proceeds from the issuance of the Convertible Trust Preferred Securities.

At December 31, 1998, the Company had two outstanding notes payable totaling \$4,247,000, outstanding borrowings on the Credit Facilities of \$371,754,000 and outstanding repurchase obligations of \$79,402,000. At December 31, 1998, the Company had \$283,246,000 of borrowing capacity available under its Credit Facilities.

Impact of Inflation

The Company's operating results depend in part on the difference between the interest income earned on its interest-earning assets and the interest expense incurred in connection with its interest-bearing liabilities. Changes in the general level of interest rates prevailing in the economy in response to changes in the rate of inflation or otherwise can affect the Company's income by affecting the spread between the Company's interest-earning assets and interest-bearing liabilities, as well as, among other things, the value of the Company's interest-earning assets and its ability to realize gains from the sale of assets and the average life of the Company's interest-earning assets. Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations, and other factors beyond the control of the Company. The Company employs the use of correlated hedging strategies to limit the effects of changes in interest rates on its operations, including engaging in interest rate swaps and interest rate caps to minimize its exposure to changes in interest rates. There can be no assurance that the Company will be able to adequately protect against the foregoing risks or that the Company will ultimately realize an economic benefit from any hedging contract into which it enters.

Year 2000 Information

General Description of the Year 2000 Issue and the Nature and Effects of the Year 2000 on Information Technology (IT) and Non-IT Systems

The Year 2000 Issue is the result of computer programs being written using two digits rather than four to define the applicable year. Any of the Company's computer programs or hardware that have date-sensitive software or embedded chips may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in a system failure or miscalculations causing disruptions of operations, including, among other things, a temporary inability to process transactions, send invoices, or engage in similar business activities.

Based upon recent assessments, the Company determined that it was required to replace certain of its software and certain hardware so that those systems will properly utilize dates beyond December 31, 1999. The Company believes that with the replacement of the previously existing software and certain hardware, the Year 2000 Issue can be mitigated. However, if certain replacements are not made, or not completed timely, the Year 2000 Issue could have a material impact on the operations of the Company.

The Company's plan to resolve the Year 2000 Issue involves the following four phases: assessment, remediation, testing and implementation. To date, the Company has completed its assessment of all its in-house systems that could be significantly affected

by the Year 2000. The completed assessment indicated that all of the Company's accounting software could be affected, particularly the general ledger and accounts payable systems. That assessment also included the software included in modeling and evaluating opportunities for new business and the equipment supporting such applications. In addition, the Company will gather information about the Year 2000 compliance status of its significant service providers to monitor their compliance.

Status of Progress in Becoming Year 2000 Compliant, Including Timetable for Completion of Each Remaining Phase

For its information technology exposures, to date the Company believes it is 100% complete on the remediation phase of its in-house IT systems (both software and hardware). Implementation had been completed and the Company began testing of all the software and hardware systems in November 1998. Completion of the testing phase is expected to be completed by March 31, 1999, with 100% completion targeted for September 30, 1999.

Nature and Level of Importance of Third Parties and their Exposure to the Year 2000

The Company's loan servicing function is performed by an independent third party. This service includes the calculation of interest and principal for the Company's loans receivable, the processing of bills to the Company's customers and the maintenance of lock boxes and escrow accounts on behalf of borrowers. The vendor has advised the Company that they will be Year 2000 compliant by June 1999.

The Company will query its significant service providers that do not share information systems with the Company (external agents). To date, the Company is not aware of any external agent with a Year 2000 issue that would materially impact the Company's results of operations, liquidity, or capital

resources. However, the Company has no means of ensuring that any external agents used by the Company will be Year 2000 ready. The inability of external agents to complete their Year 2000 Issue resolution process in a timely manner could materially impact the Company. The effect of non-compliance by external agents is not determinable.

Costs of Year 2000 Compliance

The Company will utilize both internal and external resources to replace, test, and implement the software and operating equipment for Year 2000 modifications. The total cost of the Year 2000 project is \$250,000 and is being funded through operating cash flow. To date, the Company has incurred approximately \$200,000 (\$5,000 expensed and \$195,000 capitalized for new systems and equipment), related to all phases of the Year 2000 project. Of the remaining project costs, approximately \$50,000 is attributable to the testing of equipment and software.

Risks of Year 2000

The Company believes that it has an effective program in place to resolve the Year 2000 Issue in a timely manner. As noted above, the Company has not yet completed all the necessary phases of the Year 2000 program. In the event that the Company does not complete any additional phases, the Company is not certain that the systems would operate correctly, as the systems have not been adequately tested. In addition, disruptions in the economy generally resulting from Year 2000 Issues could materially adversely affect the Company. The amount of potential liability and lost revenue cannot be reasonably estimated at this time.

The Company currently has no contingency plans in the event it does not complete all phases of the Year 2000 program. The Company plans to evaluate the status of completion in the second quarter of 1999 and determine whether such a plan is necessary.

Quantitative and Qualitative Disclosures about Market Risk

The principal objective of the Company's asset/liability management activities is to maximize net interest income, while minimizing levels of interest rate risk. Net interest income and interest expense are subject to the risk of interest rate fluctuations. To mitigate the impact of fluctuations in interest rates, the Company uses interest rate swaps to effectively convert fixed rate assets to variable rate assets for proper matching with variable rate liabilities. Each derivative used as a hedge is matched with an asset or liability with which it has a high correlation. The swap agreements are generally held to maturity and the Company does not use derivative financial instruments for trading purposes. The Company uses interest rate swaps to reduce the Company's exposure to interest rate fluctuations on certain

fixed rate loans and investments and to provide more stable spreads between rates received on loans and investments and the rates paid on their financing sources.

The following table provides information about the Company's financial instruments that are sensitive to changes in interest rates at December 31, 1998. For financial assets and debt obligations, the table presents cash flows and weighted average interest rates based on the contractual maturity dates. For interest rate swaps, the table presents notional amounts and weighted average fixed pay and variable receive interest rates by contractual maturity dates. Notional amounts are used to calculate the contractual cash flows to be exchanged under the contract. Weighted-average variable rates are based on rates in effect as of the reporting date.

| (dollars in thousands) | Expected Maturity Dates | | | | | | Total | Fair Value |
|-----------------------------------------|-------------------------|-----------|-----------|----------|-----------|------------|-----------|------------|
| | 1999 | 2000 | 2001 | 2002 | 2003 | Thereafter | | |
| Assets: | | | | | | | | |
| CMBS | | | | | | | | |
| Variable Rate | — | — | — | — | \$ 31,650 | — | \$ 31,650 | \$ 31,650 |
| Average interest rate | — | — | — | — | 10.62% | — | 10.62% | — |
| Certificated Mezzanine Investments | | | | | | | | |
| Variable Rate | — | \$ 45,480 | — | — | — | — | \$ 45,480 | \$ 45,480 |
| Average interest rate | — | 9.79% | — | — | — | — | 9.79% | — |
| Loans receivable | | | | | | | | |
| Fixed Rate | \$ 29,572 | — | \$ 35,000 | \$13,000 | — | \$ 98,120 | \$175,692 | \$174,790 |
| Average interest rate | 12.25% | — | 12.32% | 12.86% | — | 11.07% | 11.65% | — |
| Variable Rate | \$109,991 | \$130,707 | \$181,986 | — | — | \$ 26,500 | \$449,183 | \$439,687 |
| Average interest rate | 12.05% | 10.36% | 10.53% | — | — | 11.14% | 10.89% | — |
| Liabilities: | | | | | | | | |
| Credit facilities | | | | | | | | |
| Variable Rate | \$ 98,046 | — | \$273,708 | — | — | — | \$371,754 | \$371,754 |
| Average interest rate | 8.58% | — | 8.19% | — | — | — | — | — |
| Repurchase obligations | | | | | | | | |
| Variable Rate | \$ 79,402 | — | — | — | — | — | \$ 79,402 | \$79,402 |
| Average interest rate | 6.74% | — | — | — | — | — | 6.74% | — |
| Convertible Trust Preferred Securities | | | | | | | | |
| Fixed Rate | — | — | — | — | — | \$145,544 | \$145,544 | \$145,544 |
| Average interest rate | — | — | — | — | — | 8.25% | 8.25% | — |
| Interest rate swaps | | | | | | | | |
| Average fixed pay rate | 5.67% | — | 5.79% | 5.98% | 6.04% | 6.04% | 5.95% | — |
| Average variable receive rate | 5.56% | — | 5.55% | 5.55% | 5.55% | 5.55% | 5.55% | — |



REPORT OF INDEPENDENT AUDITORS

The Board of Directors
Capital Trust, Inc. and Subsidiaries

We have audited the consolidated balance sheets of Capital Trust, Inc. and Subsidiaries (the "Company") as of December 31, 1998 and 1997 and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by its management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Board of Directors of Capital Trust, Inc.
(f/k/a California Real Estate Investment Trust):

We have audited the accompanying consolidated statements of operations, cash flows, and changes in stockholders' equity of Capital Trust, Inc. (f/k/a California Real Estate Investment Trust, the predecessor to Capital Trust, Inc.) and Subsidiary (the "Trust") for the year ended December 31, 1996. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, based on our audit, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company at December 31, 1998 and 1997, and the consolidated results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Ernst & Young LLP

Ernst & Young LLP
New York, New York
January 29, 1999, except for Note 25
which is as of March 3, 1999

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated results of operations and cash flows of the Trust for the year ended December 31, 1996, in conformity with generally accepted accounting principles.

Coopers & Lybrand LLP

Coopers & Lybrand LLP
San Francisco, California
February 14, 1997



Capital Trust, Inc. and Subsidiaries
CONSOLIDATED BALANCE SHEETS
 For the Years Ended December 31, 1998 and 1997

(in thousands)

| | 1998 | 1997 |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|------------------|
| Assets: | | |
| Cash and cash equivalents | \$ 46,623 | \$ 49,268 |
| Other available-for-sale securities, at fair value | 3,355 | 11,975 |
| Commercial mortgage-backed securities, available-for-sale and recorded at market value at December 31, 1998, held to maturity and recorded at amortized cost at December 31, 1997. | 31,650 | 49,490 |
| Certificated mezzanine investments available-for-sale, at fair value. | 45,480 | 21,998 |
| Loans receivable, net of \$4,017 and \$462 reserve for possible credit losses at December 31, 1998 and 1997, respectively | 620,858 | 180,324 |
| Excess of purchase price over net tangible assets acquired, net | 308 | 331 |
| Deposits and other receivables | 401 | 284 |
| Accrued interest receivable. | 8,041 | 818 |
| Deferred income taxes | 3,029 | — |
| Prepaid and other assets | 6,693 | 2,878 |
| Total assets | <u>\$766,438</u> | <u>\$317,366</u> |
| Liabilities and Stockholders' Equity | | |
| Liabilities: | | |
| Accounts payable and accrued expenses | \$ 12,356 | \$ 5,718 |
| Notes payable. | 4,247 | 4,953 |
| Credit facilities | 371,754 | 79,864 |
| Repurchase obligations. | 79,402 | 82,173 |
| Deferred origination fees and other revenue | 4,448 | 1,369 |
| Total liabilities | <u>\$472,207</u> | <u>\$174,077</u> |
| Company-obligated, mandatorily redeemable, convertible preferred securities of CT Convertible Trust I, holding solely 8.25% junior subordinated debentures of Capital Trust, Inc. ("Convertible Trust Preferred Securities"). | <u>\$145,544</u> | <u>\$ —</u> |
| Stockholders' equity: | | |
| Class A Convertible Preferred Stock, \$0.01 par value, \$0.26 cumulative annual dividend, 100,000 shares authorized, 12,268 shares issued and outstanding (liquidation preference of \$33,000) | 123 | 123 |
| Class A Common Stock, \$0.01 par value, 100,000 shares authorized, 18,159 and 18,157 shares issued and outstanding at December 31, 1998 and 1997, respectively. | 182 | 182 |
| Restricted Class A Common Stock, \$0.01 par value, 55 shares issued and outstanding at December 31, 1998 | 1 | — |
| Additional paid-in capital | 188,816 | 188,257 |
| Unearned compensation | (418) | — |
| Accumulated other comprehensive income | (4,665) | 387 |
| Accumulated deficit | (35,352) | (45,660) |
| Total stockholders' equity. | <u>148,687</u> | <u>143,289</u> |
| Total liabilities and stockholders' equity | <u>\$766,438</u> | <u>\$317,366</u> |

See accompanying notes to consolidated financial statements.



Capital Trust, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31, 1998, 1997 and 1996

(in thousands, except per share data)

| | 1998 | 1997 | 1996 |
|-----------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|------------------|
| Income from loans and other investments: | | | |
| Interest and related income | \$ 62,316 | \$ 4,992 | \$ 470 |
| Less: Interest and related expenses | <u>27,252</u> | <u>2,223</u> | <u>86</u> |
| Income from loans and other investments, net | <u>35,064</u> | <u>2,769</u> | <u>384</u> |
| Other revenues: | | | |
| Advisory and investment banking fees | 10,311 | 1,698 | — |
| Rental income | — | 307 | 2,019 |
| Other interest income | 1,638 | 1,453 | 666 |
| Gain (loss) on sale of rental properties and investments | <u>—</u> | <u>(432)</u> | <u>1,069</u> |
| Total other revenues | <u>11,949</u> | <u>3,026</u> | <u>3,754</u> |
| Other expenses: | | | |
| General and administrative | 17,045 | 9,463 | 1,503 |
| Other interest expense | 413 | 156 | 461 |
| Rental property expenses | — | 124 | 781 |
| Depreciation and amortization | 249 | 92 | 64 |
| Provision for possible credit losses | <u>3,555</u> | <u>462</u> | <u>1,743</u> |
| Total other expenses | <u>21,262</u> | <u>10,297</u> | <u>4,552</u> |
| Income (loss) before income taxes and distributions and amortization on Convertible Trust Preferred Securities | 25,751 | (4,502) | (414) |
| Provision for income taxes | <u>9,367</u> | <u>55</u> | <u>—</u> |
| Income (loss) before distributions and amortization on Convertible Trust Preferred Securities | 16,384 | (4,557) | (414) |
| Distributions and amortization on Convertible Trust Preferred Securities, net of income tax benefit of \$2,621 | <u>2,941</u> | <u>—</u> | <u>—</u> |
| Net income (loss) | 13,443 | (4,557) | (414) |
| Less: Class A Preferred Stock dividend | 3,135 | 1,341 | — |
| Class A Preferred Stock dividend requirement | <u>—</u> | <u>130</u> | <u>—</u> |
| Net income (loss) allocable to Class A Common Stock | <u>\$ 10,308</u> | <u>\$ (6,028)</u> | <u>\$ (414)</u> |
| Per share information: | | | |
| Net earnings (loss) per share of Class A Common Stock | | | |
| Basic | <u>\$ 0.57</u> | <u>\$ (0.63)</u> | <u>\$ (0.05)</u> |
| Diluted | <u>\$ 0.44</u> | <u>\$ (0.63)</u> | <u>\$ (0.05)</u> |
| Weighted average shares of Class A Common Stock outstanding | | | |
| Basic | <u>18,208,812</u> | <u>9,527,013</u> | <u>9,157,150</u> |
| Diluted | <u>30,625,459</u> | <u>9,527,013</u> | <u>9,157,150</u> |

See accompanying notes to consolidated financial statements.



Capital Trust, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the Years Ended December 31, 1998, 1997 and 1996

(in thousands)

| | Compre- hensive Income (Loss) | Class A Preferred Stock | Class A Common Stock | Restricted Class A Common Stock | Additional Paid-In Capital | Unearned Compensation | Accumulated Other Compre- hensive Income | Accumulated Deficit | Total |
|--------------------------------------------------------------------------------------|----------------------------------------|-------------------------------|----------------------------|------------------------------------------|----------------------------------|--------------------------|------------------------------------------------------|------------------------|------------------|
| Balance at | | | | | | | | | |
| January 1, 1996 | \$ — | \$ — | \$ 92 | \$— | \$ 64,163 | \$ — | \$ — | \$(39,348) | \$ 24,907 |
| Change in unrealized gain (loss) on available-for-sale securities | (22) | — | — | — | — | — | (22) | — | (22) |
| Net loss | (414) | — | — | — | — | — | — | (414) | (414) |
| Balance at | | | | | | | | | |
| December 31, 1996 | <u>\$(436)</u> | — | 92 | — | 64,163 | — | (22) | (39,762) | 24,471 |
| Change in unrealized gain (loss) on available-for-sale securities | 409 | — | — | — | — | — | 409 | — | 409 |
| Issuance of Class A Common Stock | — | — | 90 | — | 91,347 | — | — | — | 91,437 |
| Issuance of Class A Preferred Stock | — | 123 | — | — | 32,747 | — | — | — | 32,870 |
| Class A Preferred Stock Dividend | — | — | — | — | — | — | — | (1,341) | (1,341) |
| Net loss | (4,557) | — | — | — | — | — | — | (4,557) | (4,557) |
| Balance at | | | | | | | | | |
| December 31, 1997 | <u>\$(4,148)</u> | 123 | 182 | — | 188,257 | — | 387 | (45,660) | 143,289 |
| Change in unrealized gain (loss) on available-for-sale securities | (5,052) | — | — | — | — | — | (5,052) | — | (5,052) |
| Issuance of Class A Common Stock under Incentive Stock Plan | — | — | — | — | 10 | — | — | — | 10 |
| Issuance of restricted Class A Common Stock | — | — | — | 1 | 724 | (725) | — | — | — |
| Cancellation of previously issued restricted Class A Common Stock | — | — | — | — | (175) | 156 | — | — | (19) |
| Restricted Class A Common Stock earned | — | — | — | — | — | 151 | — | — | 151 |
| Class A Preferred Stock Dividend | — | — | — | — | — | — | — | (3,135) | (3,135) |
| Net income | 13,443 | — | — | — | — | — | — | 13,443 | 13,443 |
| Balance at | | | | | | | | | |
| December 31, 1998 | <u>\$ 8,391</u> | <u>\$123</u> | <u>\$182</u> | <u>\$ 1</u> | <u>\$188,816</u> | <u>\$(418)</u> | <u>\$(4,665)</u> | <u>\$(35,352)</u> | <u>\$148,687</u> |

See accompanying notes to consolidated financial statements.



Capital Trust, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 1998, 1997 and 1996

| <i>(in thousands)</i> | 1998 | 1997 | 1996 |
|-------------------------------------------------------------------------------------------------|------------------|------------------|-----------------|
| Cash flows from operating activities: | | | |
| Net income (loss) | \$ 13,443 | \$ (4,557) | \$ (414) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | | |
| Deferred income taxes | (3,029) | — | — |
| Provision for credit losses | 3,555 | 462 | 1,743 |
| Depreciation and amortization | 249 | 92 | 64 |
| Restricted Class A Common Stock earned | 151 | — | — |
| Net amortization of premiums and accretion of discounts on loans and investments | 1,250 | — | — |
| Net accretion of discounts and fees on Convertible Trust Preferred Securities | 337 | — | — |
| (Gain) loss on sale of rental properties and investments | — | 432 | (1,069) |
| Expenses reversed on cancellation of restricted stock previously issued | (19) | — | — |
| Changes in assets and liabilities net of effects from subsidiaries purchased: | | | |
| Deposits and other receivables | (117) | 2,707 | (38) |
| Accrued interest receivable | (7,223) | (818) | — |
| Prepaid and other assets | (3,545) | (2,988) | (61) |
| Deferred revenue | 3,079 | 1,369 | — |
| Accounts payable and accrued expenses | 6,638 | 5,857 | 226 |
| Other liabilities | — | (64) | (2) |
| Net cash provided by operating activities | <u>14,769</u> | <u>2,492</u> | <u>449</u> |
| Cash flows from investing activities: | | | |
| Purchases of commercial mortgage-backed securities | (36,334) | (49,524) | — |
| Principal collections and proceeds from sale of commercial mortgage-backed securities | 49,490 | 34 | — |
| Purchases of certificated mezzanine investments | (23,947) | (21,998) | — |
| Principal collections on certificated mezzanine investments | 465 | — | — |
| Origination and purchase of loans receivable | (515,449) | (189,711) | — |
| Principal collections on loans receivable | 70,405 | 9,935 | 35 |
| Purchases of equipment and leasehold improvements | (496) | (479) | — |
| Proceeds from sale of rental properties | — | 8,153 | 13,796 |
| Improvements to rental properties | — | — | (146) |
| Purchases of available-for-sale securities | — | — | (15,849) |
| Principal collections and proceeds from sales of available-for-sale securities | 7,957 | 4,947 | 1,712 |
| Acquisition of Victor Capital Group, L.P., net of cash acquired | — | (4,066) | — |
| Net cash used in investing activities | <u>(447,909)</u> | <u>(242,709)</u> | <u>(452)</u> |
| Cash flows from financing activities: | | | |
| Proceeds from repurchase obligations | 41,837 | 109,458 | — |
| Repayment of repurchase obligations | (44,608) | (27,285) | — |
| Proceeds from credit facilities | 618,686 | 81,864 | — |
| Repayment of credit facilities | (326,796) | (2,000) | — |
| Proceeds from notes payable | 10,000 | 4,001 | — |
| Repayment of notes payable | (10,706) | (4,217) | (77) |
| Net proceeds from issuance of Convertible Trust Preferred Securities | 145,207 | — | — |
| Dividends paid on Class A Preferred Stock | (3,135) | (1,341) | — |
| Net proceeds from issuance of Class A Common Stock under stock Option Plan | 10 | — | — |
| Net proceeds from issuance of Class A Common Stock | — | 91,437 | — |
| Net proceeds from issuance of Class A Preferred Stock | — | 32,870 | — |
| Net cash provided by (used in) financing activities | <u>430,495</u> | <u>284,787</u> | <u>(77)</u> |
| Net increase (decrease) in cash and cash equivalents | <u>(2,645)</u> | <u>44,570</u> | <u>(80)</u> |
| Cash and cash equivalents at beginning of year | <u>49,268</u> | <u>4,698</u> | <u>4,778</u> |
| Cash and cash equivalents at end of year | <u>\$ 46,623</u> | <u>\$ 49,268</u> | <u>\$ 4,698</u> |

See accompanying notes to consolidated financial statements.



Capital Trust, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 1998, 1997 and 1996

1. Organization

Capital Trust, Inc. (the "Company") is a specialty finance company designed to take advantage of high-yielding lending and investment opportunities in commercial real estate and related assets. The Company makes investments in various types of income producing commercial real estate, including senior and junior commercial mortgage loans, preferred equity investments, direct equity investments and subordinate interests in commercial mortgage-backed securities ("CMBS"). The Company also provides real estate investment banking, advisory and asset management services through its wholly owned subsidiary, Victor Capital Group, L.P. ("Victor Capital").

The Company is the successor to Capital Trust (f/k/a California Real Estate Investment Trust), a business trust organized under the laws of the State of California pursuant to a declaration of trust dated September 15, 1966 (the "Predecessor"), following the consummation of the Reorganization (as defined and described below). On December 31, 1996, 76% of the Predecessor's then-outstanding common shares of beneficial interest, \$1.00 par value ("Common Shares") were held by the Predecessor's former parent ("Former Parent"). On January 3, 1997, the Former Parent sold its entire 76% ownership interest in the Predecessor (consisting of 6,959,593 Common Shares) to CalREIT Investors Limited Partnership ("CRIL"), an affiliate of Equity Group Investments, Inc. ("EGI") and Samuel Zell, the Company's current chairman of the board of directors, for an aggregate price of approximately \$20.2 million. Prior to the purchase, which was approved by the Predecessor's then-incumbent board of trustees, EGI and Victor Capital, a then privately held company owned by two of the current directors of the Company, presented to the Predecessor's then-incumbent board of trustees a proposed new business plan in which the Predecessor would cease to be a real estate investment trust ("REIT") and instead become a specialty finance company as discussed above. EGI and Victor Capital also proposed that they provide the Predecessor with a new management team to implement the business plan and invest, through an affiliate, a minimum of \$30 million in a new class of preferred stock to be issued by the Predecessor. In connection with the foregoing, the Predecessor subsequently agreed that, concurrently with the consummation of the proposed preferred equity investment, it would acquire for \$5 million Victor Capital's real estate investment banking, advisory and asset management businesses, including the services of its experienced management team. See Note 2.

On July 15, 1997, the proposed preferred share investment was consummated and 12,267,658 class A 9.5% cumulative convertible preferred shares of beneficial interest, \$1.00 par value ("Class A Preferred Shares"), in the Predecessor were sold to Veqtor Finance Company, LLC ("Veqtor"), an affiliate of Samuel Zell and the principals of Victor Capital for an aggregate purchase price of \$33.0 million. Concurrently with the foregoing transaction, Veqtor purchased from CRIL the 6,959,593 Common Shares held by it for an aggregate purchase price of approximately \$21.3 million (which shares were reclassified on that date as class A common shares of beneficial interest, \$1.00 par value ("Class A Common Shares"), in the Predecessor pursuant to the terms of an amended and restated declaration of trust, dated July 15, 1997, adopted on that date (the "Amended and Restated Declaration of Trust"). See Note 15.

At the Predecessor's 1998 annual meeting of shareholders (held on January 28, 1999), the Predecessor's shareholders approved the reorganization of the Predecessor into a Maryland corporation (the "Reorganization"). In the Reorganization, which was consummated on January 28, 1999, the Predecessor merged with and into Captrust Limited Partnership, a Maryland limited partnership ("CTLP"), with CTLP continuing as the surviving entity, and CTLP merged with and into the Company, with the Company continuing as the surviving Maryland corporation. Each outstanding Class A Common Share was converted into one share of class A common stock, par value \$0.01 per share ("Class A Common Stock"), and each outstanding Class A Preferred Share was converted into one share of class A 9.5% cumulative convertible preferred stock, par value \$0.01 per share ("Class A Preferred Stock"), of the Company. The Company assumed all outstanding obligations to issue shares of Class A Common Stock under the Incentive Stock Plan and Director Stock Plan (as defined and described in Note 18). Unless the context otherwise requires, hereinafter references to the business, assets, liabilities, capital structure, operations and affairs of "the Company" shall include those of "the Predecessor" prior to the Reorganization.

2. Acquisition of Victor Capital

On July 15, 1997, the Company consummated the acquisition of the real estate investment banking, advisory and asset management businesses of Victor Capital and certain affiliated entities including the following wholly-owned subsidiaries: VCG Montreal Management, Inc., Victor Asset Management Partners, L.L.C., VP Metropolis Services, L.L.C., and 970 Management, LLC.

Victor Capital provides services to real estate investors, owners, developers and financial institutions in connection with mortgage financings, securitizations, joint ventures, debt and equity investments, mergers and acquisitions, portfolio evaluations, restructurings and disposition programs. Victor Capital's wholly owned subsidiaries provide asset management and advisory services relating to various mortgage pools and real estate properties. In addition, VCG Montreal Management, Inc. holds a nominal interest in a Canadian real estate venture.

The purchase price in the Victor Capital acquisition was \$5.0 million, which was paid by the Company with the issuance of non-interest bearing acquisition notes, payable in ten semi-annual equal installments of \$500,000. The acquisition notes have been discounted to approximately \$3.9 million based on an imputed interest rate of 9.5%. The acquisition has been accounted for under the purchase method of accounting. The excess of the purchase price of the acquisition in excess of net tangible assets acquired approximated \$342,000.

During the period from July 15, 1997 to December 31, 1997, significant advisory income collected as a result of the Company's acquisition of Victor Capital was applied as a reduction of current accounts receivable and thereby not reflected as revenue.

Had the acquisition occurred on January 1, 1997, pro forma revenues, net loss (after giving effect to the Class A Preferred Stock dividend and dividend requirement) and net loss per common share (basic and diluted) for the year ended December 31, 1997 would have been: \$11,271,000, \$5,347,000 and \$0.56, respectively.

3. Summary of Significant Accounting Policies

Principles of Consolidation

For the year ended December 31, 1996, the Company owned commercial rental property in Sacramento, California through a 59% limited partnership interest in Totem Square L.P., a Washington limited partnership ("Totem"), and an indirect 1% general partnership interest in Totem through its wholly-owned subsidiary Cal-REIT Totem Square, Inc. An unrelated party held the remaining 40% interest. This property was sold during the year ended December 31, 1997 and the Totem Square L.P. and Totem Square, Inc. subsidiaries were liquidated and dissolved.

The consolidated financial statements of the Company include the accounts of the Company, VIC, Inc., which holds Victor Capital and its wholly-owned subsidiaries (included in the consolidated statement of operations since their acquisition on July 15, 1997), Natrest Funding I, Inc. (a single purpose entity holding one Mortgage Loan), CT Convertible Trust I (as described in Note 14) and the results from the disposition of its rental property held by Totem, which was sold on March 4, 1997

prior to commencement of the Company's new business plan (see Note 1). All significant intercompany balances and transactions have been eliminated in consolidation.

Revenue Recognition

Interest income for the Company's mortgage and other loans and investments is recognized over the life of the investment using the interest method and recognized on the accrual basis.

Fees received in connection with loan commitments, net of direct expenses, are deferred until the loan is advanced and are then recognized over the term of the loan as an adjustment to yield. Fees on commitments that expire unused are recognized at expiration.

Income recognition is generally suspended for loans at the earlier of the date at which payments become 90 days past due or when, in the opinion of management, a full recovery of income and principal becomes doubtful. Income recognition is resumed when the loan becomes contractually current and performance is demonstrated to be resumed.

Fees from professional advisory services are generally recognized at the point at which all Company services have been performed and no significant contingencies exist with respect to entitlement to payment. Fees from asset management services are recognized as services are rendered.

Reserve for Possible Credit Losses

The provision for possible credit losses is the charge to income to increase the reserve for possible credit losses to the level that management estimates to be adequate considering delinquencies, loss experience and collateral quality. Other factors considered relate to geographic trends and product diversification, the size of the portfolio and current economic conditions. Based upon these factors, the Company establishes the provision for possible credit losses by category of asset. When it is probable that the Company will be unable to collect all amounts contractually due, the account is considered impaired. Where impairment is indicated, a valuation write-down or write-off is measured based upon the excess of the recorded investment amount over the net fair value of the collateral, as reduced for selling costs. Any deficiency between the carrying amount of an asset and the net sales price of repossessed collateral is charged to the reserve for credit losses.

Cash and Cash Equivalents

The Company classifies highly liquid investments with original maturities of three months or less from the date of purchase as cash equivalents. At December 31, 1998 and 1997, cash equivalents of approximately \$46.4 million and \$48.5 million, respectively, consisted of an investment in a money market fund that invests in Treasury bills. Bank balances in excess of federally insured amounts totaled approximately

\$26,000 and \$1.5 million as of December 31, 1998 and 1997, respectively. The Company has not experienced any losses on demand deposits or money market investments.

Other Available-for-Sale Securities

Other available-for-sale securities are reported on the consolidated balance sheet at fair value with any corresponding change in value reported as an unrealized gain or loss (if assessed to be temporary), as a component of comprehensive income in stockholders' equity, after giving effect to taxes. See Note 5.

Commercial Mortgage-Backed Securities

At December 31, 1997, the Company had the intent and ability to hold its subordinated investment in CMBS until maturity. Consequently, this investment was classified as held to maturity and was carried at amortized cost. During 1998, due to prepayments made on underlying securities that reduced the interest rate/risk profile and maturity of a commercial mortgage-backed security, the Company concluded that it no longer anticipated holding the asset to maturity. Due to the decision to sell this held-to-maturity security, the Company has transferred all of its investments in commercial mortgage-backed securities from held-to-maturity securities to available-for-sale and they are recorded as such at December 31, 1998.

Income from CMBS is recognized based on the effective interest method using the anticipated yield over the expected life of the investments. Changes in yield resulting from prepayments are recognized over the remaining life of the investment. The Company recognizes impairment on its CMBS whenever it determines that the impact of expected future credit losses, as currently projected, exceeds the impact of the expected future credit losses as originally projected. Impairment losses are determined by comparing the current fair value of a CMBS to its existing carrying amount, the difference being recognized as a loss in the current period in the consolidated statements of operations. Reduced estimates of credit losses are recognized as an adjustment to yield over the remaining life of the portfolio.

Certificated Mezzanine Investments

Certificated Mezzanine Investments available-for-sale are reported on the consolidated balance sheets at fair value with any corresponding temporary change in value resulting in an unrealized gain (loss) being reported as a component of comprehensive income in the stockholders' equity section of the balance sheet after giving effect to taxes. See Note 8.

Derivative Financial Instruments

The Company uses interest rate swaps to effectively convert fixed rate assets to variable rate assets for proper matching with variable rate liabilities. The differential to be paid or received on these

agreements is recognized as an adjustment to the interest income related to the earning asset and is recognized on the accrual basis.

The Company also uses interest rate caps to reduce its exposure to interest rate changes on investments. The Company will receive payments on an interest rate cap should the variable rate for which the cap was purchased exceed a specified threshold level and will be recorded as an adjustment to the interest income related to the related earning asset.

Each derivative used as a hedge is matched with an asset or liability with which it has a high correlation. The swap agreements are generally held to maturity and the Company does not use derivative financial instruments for trading purposes.

Rental Properties

Prior to December 31, 1996, rental properties were carried at cost, net of accumulated depreciation and a valuation allowance for possible credit losses. At December 31, 1996 all rental properties were classified as held for sale and valued at net estimated sales prices.

Equipment and Leasehold Improvements, Net

Equipment and leasehold improvements, net, are stated at original cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method based on the estimated lives of the depreciable assets. Amortization is computed over the remaining terms of the related leases.

Expenditures for maintenance and repairs are charged directly to expense at the time incurred. Expenditures determined to represent additions and betterments are capitalized. Cost of assets sold or retired and the related amounts of accumulated depreciation are eliminated from the accounts in the year of sale or retirement. Any resulting profit or loss is reflected in the consolidated statements of operations.

Sales of Real Estate

The Company complies with the provisions of Statement of Financial Accounting Standards No. 66, "Accounting for Sales of Real Estate." Accordingly, the recognition of gains are deferred until such transactions have complied with the criteria for full profit recognition under the Statement. The Company has deferred gains of \$239,000 at December 31, 1998 and 1997.

Deferred Debt Issuance Costs

The Company capitalizes costs incurred related to the issuance of long-term debt. These costs are deferred and amortized on a straight-line basis over the life of the related debt, which approximates the level-yield method, and is recognized as a component of interest expense.

Income Taxes

Prior to commencement of full implementation of operations as a finance company on July 15, 1997, the Company had elected to be taxed as a REIT and, as such, was not taxed on that portion of its taxable income which was distributed to shareholders, provided that at least 95% of its real estate trust taxable income was distributed and that the Company met certain other REIT requirements. At July 15, 1997, the Company elected to not meet the requirements to continue to be taxed as a REIT and was therefore not considered a REIT retroactive to January 1, 1997.

Accordingly, the Company has adopted Financial Accounting Standards Board Statement No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). SFAS No. 109 utilizes the liability method for computing income tax expense. Under the liability method, deferred income taxes are recognized for the tax consequences of "temporary differences" by applying statutory tax rates for future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. Deferred tax assets are recognized for temporary differences that will result in deductible amounts in future years and for carryforwards that are useable in future years. A valuation allowance is recognized if it is more likely than not that some portion of the deferred asset will not be recognized. When evaluating whether a valuation allowance is appropriate, SFAS No. 109 requires a company to consider such factors as previous operating results, future earning potential, tax planning strategies and future reversals of existing temporary differences. The valuation allowance is increased or decreased in future years based on changes in these criteria.

Amortization of the Excess of Purchase Price Over Net Tangible Assets Acquired

The Company recognized the excess of purchase price over net tangible assets acquired in a business combination accounted for as a purchase transaction and is amortizing it on a straight-line basis over a period of 15 years. The carrying value of the excess of purchase price over net tangible assets acquired is analyzed quarterly by the Company based upon the expected revenue and profitability levels of the acquired enterprise to determine whether the value and future benefit may indicate a decline in value. If the Company determines that there has been a decline in the value of the acquired enterprise, the Company will write down the value of the excess of purchase price over net tangible assets acquired to the revised fair value.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Comprehensive Income

Effective January 1, 1998, the Company adopted the Financial Accounting Standards Board's ("FASB") Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" ("SFAS No. 130"). The statement changes the reporting of certain items currently reported in the stockholders' equity section of the balance sheet and establishes standards for reporting of comprehensive income and its components in a full set of general purpose financial statements. Total comprehensive income (loss) was \$8,391,000, \$(4,148,000) and \$(436,000) for the years ended December 31, 1998, 1997 and 1996, respectively. The primary component of comprehensive income other than net income was the unrealized gain (loss) on available-for-sale securities.

Earnings per Share of Class A Common Stock

Earnings per share of Class A Common Stock is presented based on the requirements of Statement of Accounting Standards No. 128 ("SFAS No. 128"). Basic EPS is computed based on the income applicable to Class A Common Stock (which is net income or loss reduced by the dividends on the Class A Preferred Stock) divided by the weighted-average number of shares of Class A Common Stock outstanding during the period. Diluted EPS is based on the net earnings applicable to Class A Common Stock plus dividends on the Class A Preferred Stock, divided by the weighted average number of shares of Class A Common Stock and potentially dilutive shares of Class A Common Stock that were outstanding during the period. At December 31, 1998, potentially dilutive shares of Class A Common Stock include the convertible Class A Preferred Stock and dilutive Class A Common Stock options. At December 31, 1997, the shares of Class A Preferred Stock and Class A Common Stock options were not considered Class A Common Stock equivalents for purposes of calculating Diluted EPS as they were antidilutive. There were no potentially dilutive shares of Class A Common Stock at December 31, 1996. Accordingly, at December 31, 1997 and 1996, there was no difference between Basic EPS and Diluted EPS or weighted average shares of Class A Common Stock outstanding.

Segment Reporting

In 1998, the Company adopted FASB Statement of Financial Accounting Standards No. 131, "Disclosure about Segments of an Enterprise and Related Information" ("SFAS No. 131"). SFAS No. 131 requires disclosures about segments of an enterprise and related information regarding the different types of business activities in which an enterprise engages

and the different economic environments in which it operates. The disclosures required by SFAS No. 131 are presented in Note 23.

The accounting policies of the reportable segments are the same as those described within this summary of significant accounting policies.

Reclassifications

Certain reclassifications have been made in the presentation of the 1997 and 1996 consolidated financial statements to conform to the 1998 presentation.

New Accounting Pronouncements

In June 1998, The FASB issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133") which is required to be adopted in years beginning after June 15, 1999. SFAS No. 133 will require the Company to recognize all derivatives on the balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through income. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value, if any, will be immediately recognized in earnings. The Company plans to adopt SFAS No. 133 effective January 1, 2000. Based upon the Company's derivative positions, which are considered effective hedges at December 31, 1998, the Company estimates that it would have reported a reduction in other comprehensive income of \$4.5 million had the statement been adopted at that time.

4. Interest Rate Risk Management

The Company uses interest rate swaps and interest rate caps to reduce the Company's exposure to inter-

est rate fluctuations on certain loans and investments and to provide more stable spreads between investment yields and the rates on their financing sources. The Company has entered into interest rate swap agreements for notional amounts totaling approximately \$115,810,000 with two investment grade financial institution counterparties whereby the Company swapped fixed rate instruments, which averaged approximately 5.95% at December 31, 1998 and 6.02% for the year then ended, for floating rate instruments equal to the London Interbank Offered Rate ("LIBOR") which averaged approximately 5.55% at December 31, 1998 and 5.56% for the year then ended. Amounts arising from the differential are recognized as an adjustment to interest income related to the earning asset. The agreements mature at varying times from December 1999 to October 2008 with a remaining average term of 72 months.

The Company purchased an interest rate cap with a notional amount of \$18.75 million at a cost of approximately \$71,000. The interest rate cap provides for payments to the Company should LIBOR exceed 11.25% during the period from November 2003 to November 2007.

The Company is exposed to credit loss in the event of non-performance by the counterparties (which are banks whose securities are rated investment grade) to the interest rate swap and cap agreements, although it does not anticipate such non-performance. The counterparties would bear the interest rate risk of such transactions as market interest rates increase.

If an interest rate swap or interest rate cap is sold or terminated and cash is received or paid, the gain or loss is deferred and recognized when the hedged asset is sold or matures.

5. Other Available-for-Sale Securities

At December 31, 1998, the Company's other available-for-sale securities consisted of the following (in thousands):

| | Cost | Gross Unrealized | | Estimated Fair Value |
|------------------------------------------------------------------------------------------------------------------|-----------------|------------------|-------------|----------------------|
| | | Gains | Losses | |
| Federal National Mortgage Association, adjustable rate interest currently at 7.474%, due April 1, 2024 | \$ 1,159 | \$ 17 | \$ — | \$ 1,176 |
| Federal Home Loan Mortgage Association, adjustable rate interest currently at 7.626%, due June 1, 2024 | 425 | 5 | — | 430 |
| Federal National Mortgage Association, adjustable rate interest currently at 7.512%, due May 1, 2025 | 106 | — | — | 106 |
| Federal National Mortgage Association, adjustable rate interest currently at 7.725%, due May 1, 2026 | 463 | 3 | — | 466 |
| Federal National Mortgage Association, adjustable rate interest currently at 7.604%, due June 1, 2026 | 1,139 | 13 | — | 1,152 |
| Norwest Corp. Voting Common Stock, 630 shares | 17 | 8 | — | 25 |
| | <u>\$ 3,309</u> | <u>\$ 46</u> | <u>\$ —</u> | <u>\$ 3,355</u> |

At December 31, 1997, the Company's other available-for-sale securities consisted of the following (in thousands):

| | Cost | Gross Unrealized | | Estimated Fair Value |
|------------------------------------------------------------------------------------------------------------------|-----------------|------------------|---------------|----------------------|
| | | Gains | Losses | |
| Federal National Mortgage Association, adjustable rate interest currently at 7.845%, due April 1, 2024 | \$ 2,176 | \$ — | \$(32) | \$ 2,144 |
| Federal Home Loan Mortgage Association, adjustable rate interest currently at 7.916%, due June 1, 2024 | 752 | — | (10) | 742 |
| Federal National Mortgage Association, adjustable rate interest currently at 7.362%, due May 1, 2025 | 440 | — | (9) | 431 |
| Federal National Mortgage Association, adjustable rate interest currently at 7.965%, due May 1, 2026 | 1,860 | — | (20) | 1,840 |
| Federal National Mortgage Association, adjustable rate interest currently at 7.969%, due June 1, 2026 | 4,545 | 29 | — | 4,574 |
| Norwest Corp. Voting Common Stock, 630 shares | 17 | 7 | — | 24 |
| SL Green Realty Corp. Voting Common Stock, 85,600 shares | 1,798 | 422 | — | 2,220 |
| | <u>\$11,588</u> | <u>\$458</u> | <u>\$(71)</u> | <u>\$11,975</u> |

The maturity dates of debt securities are not necessarily indicative of expected maturities as principal is often prepaid on such instruments.

The 85,600 shares of SL Green Realty Corp. Common Stock were received as partial payment for advisory services rendered by Victor Capital to SL Green Realty Corp. This stock was restricted from sale by the Company for a period of one year from the date of issuance or until August 20, 1998. The stock was sold in December 1998 for \$1,798,000 with no resulting realized gain or loss.

The cost of securities sold is determined using the specific identification method.

6. Rental Properties

At December 31, 1996, the Company's rental property portfolio included a retail and mixed-use property carried at \$8,585,000. This property was sold during 1997.

The Company had established an allowance for valuation losses on rental properties as follows (in thousands):

| | 1998 | 1997 | 1996 |
|------------------------------------------------------------------|-------------|-------------|----------------|
| Beginning balance | \$ — | \$ 6,898 | \$5,863 |
| Provision for valuation losses | — | 1,743 | 1,035 |
| Amounts charged against allowance for valuation losses | — | (8,641) | — |
| Ending balance | <u>\$ —</u> | <u>\$ —</u> | <u>\$6,898</u> |

7. Commercial Mortgage-Backed Securities

The Company pursues rated and unrated investments in public and private subordinated interests ("Subordinated Interests") in commercial mortgage-backed securities ("CMBS").

In 1997, the Company completed an investment

for the entire junior subordinated class of CMBS that provided for both interest payments and principal repayments. The CMBS investment consisted of a security with a face value of \$49,592,000 which was purchased at a discount for \$49,174,000 plus accrued interest. At the time of acquisition, the investment was subordinated to approximately \$351.3 million of senior securities. At December 31, 1997, the CMBS investment (including interest receivable) was \$49,471,000 and had a yield of 8.96%. During 1998, due to prepayments made on underlying securities that reduced the interest rate/risk profile and maturity of this commercial mortgage-backed security, the Company concluded that it no longer anticipated holding this security to maturity. The security was sold during 1998 at a gain of approximately \$100,000. Because of this decision to sell a held-to-maturity security, the Company has transferred all of its investments in commercial mortgage-backed securities from held-to-maturity securities to available-for-sale.

In connection with the CMBS investment above, the Company was named "special servicer" for the entire \$413 million loan portfolio in which capacity the Company earned fee income for management of the collection process when any of the loans became non-performing. During the year ended December 31, 1998, fees totaling \$43,000 were earned relating to the special servicing arrangement. No fees were earned during the year ended December 31, 1997.

During the year ended December 31, 1998, the Company purchased \$36,509,000 face amount of interests in three subordinated commercial mortgage-backed securities issued by a financial asset securitization investment trust for \$36,335,000, which, at December 31, 1998, had an amortized cost of \$36,361,000 and a market value of \$31,650,000. These securities bear interest at floating rates, for

which the weighted average interest rate in effect at December 31, 1998 is 10.62%, and mature in January 2003.

In connection with the aforementioned investments, at December 31, 1998, the Company has deferred acquisition costs of \$67,000 that are being amortized as a reduction of interest income on a basis to realize a level yield over the life of the investment.

8. Certificated Mezzanine Investments

The Company purchases high-yielding mezzanine investments that are subordinate to senior secured loans on commercial real estate. Such investments represent interests in debt service from loans or property cash flow and are issued in certificate form. These certificated investments carry substantially similar terms and risks as the Company's Mezzanine Loans.

The certificated mezzanine investments are floating rate securities that are carried at market value of \$45,480,000 and \$21,998,000 on December 31, 1998 and 1997, respectively. As the market value and amortized cost were the same on December 31, 1998 and 1997, no unrealized gains or losses have been recorded. One of the certificated mezzanine investments is subject to early redemption penalties through October 1999. The certificated mezzanine investments have remaining terms of seventeen to twenty-three months with the security with the seventeen-month maturity having 24 months of additional extensions available. The weighted average interest rate in effect for the two certificated mezzanine investments is 9.79% at December 31, 1998.

In connection with the aforementioned investments, at December 31, 1998, the Company has deferred origination fees, net of direct costs of \$27,000 that are being amortized into interest income on a basis to realize a level yield over the life of the investment.

9. Loans Receivable

The Company currently pursues lending opportunities designed to capitalize on inefficiencies in the real estate capital, mortgage and finance markets. The Company has classified its loans receivable into the following general categories:

- **Mortgage Loans.** The Company originates and funds senior and junior mortgage loans ("Mortgage Loans") to commercial real estate owners and property developers who require interim financing until permanent financing can be obtained. The Company's Mortgage Loans are generally not intended to be permanent in nature, but rather are intended to be of a relatively short-term duration, with extension options as deemed appropriate, and typically require a balloon payment of principal at maturity. The Company may also originate and fund permanent Mortgage Loans in which the

Company intends to sell the senior tranche, thereby creating a Mezzanine Loan (as defined below).

- **Mezzanine Loans.** The Company originates high-yielding loans that are subordinate to first lien mortgage loans on commercial real estate and are secured either by a second lien mortgage or a pledge of the ownership interests in the borrowing property owner. Generally, the Company's Mezzanine Loans have a longer anticipated duration than its Mortgage Loans and are not intended to serve as transitional mortgage financing.
- **Other Mortgage Loans Receivable.** This classification includes loans originated during the Company's prior operations as a REIT and other loans and investments not meeting the above criteria.

At December 31, 1998 and 1997, the Company's loans receivable consisted of the following (in thousands):

| | 1998 | 1997 |
|----------------------------------------------------|------------------|------------------|
| (1) Mortgage Loans | \$305,578 | \$124,349 |
| (2) Mezzanine Loans | 317,278 | 54,375 |
| (3) Other mortgage loans receivable | 2,019 | 2,062 |
| | <u>624,875</u> | <u>180,786</u> |
| Less: reserve for possible credit losses | <u>(4,017)</u> | <u>(462)</u> |
| Total loans | <u>\$620,858</u> | <u>\$180,324</u> |

At December 31, 1998, the weighted average interest rate in effect, after giving effect to interest rate swaps and including amortization of fees and premiums, for the Company's loans receivable was as follows:

| | |
|-----------------------------------------------|--------|
| (1) Mortgage Loans | 10.77% |
| (2) Mezzanine Loans | 11.44% |
| (3) Other mortgage loans receivable | 8.40% |
| Total Loans | 11.10% |

At December 31, 1998, \$449,183,000 (72%) of the aforementioned loans bear interest at floating rates ranging from LIBOR plus 320 basis points to LIBOR plus 700 basis points. The remaining \$175,692,000 (28%) of loans were financed at fixed rates ranging from 8.50% to 12.00%.

The range of maturity dates and weighted average maturity at December 31, 1998 of the Company's loans receivable was as follows:

| | Range of Maturity Dates | Weighted Average Maturity |
|-------------------------------------|---------------------------------|---------------------------------|
| (1) Mortgage Loans | April 1999 to July 2001 | 20 Months |
| (2) Mezzanine Loans | July 1999 to September 2008 | 55 Months |
| (3) Other mortgage loans receivable | February 1999 to August 2017 | 80 Months |
| Total Loans | April 1999 to August 2017 | 38 Months |

In addition, two of the loans totaling \$74,274,000 have borrower extension rights for an additional year.

At December 31, 1998, there are no loans to a single borrower or to related groups of borrowers that exceeded ten percent of total assets. Approximately 44% and 14% of all loans are secured by properties in New York and Texas, respectively, and approximately 57% of all loans are secured by office buildings.

During the year ended December 31, 1998, the Company completed twenty new loan transactions totaling \$527,934,000 and provided \$8,441,000 of additional fundings on two loans originated in the prior year. The Company funded \$507,008,000 of the foregoing loans receivable originated during the year ended December 31, 1998 and has outstanding commitments at December 31, 1998 totaling \$31,761,000.

In connection with the aforementioned loans, at December 31, 1998 and 1997 the Company has deferred origination fees, net of direct costs of \$4,460,000 and \$1,262,000, respectively, that are being amortized into income over the life of the loan. At December 31, 1998 and 1997, the Company has also recorded \$1,243,000 and \$22,000, respectively, of exit fees which will be collected at the loan pay-off. These fees are recorded as interest income on a basis to realize a level yield over the life of the loans.

As of December 31, 1998, loans totaling \$584,849,000 are pledged as collateral for borrowings on the Credit Facilities and Repurchase Obligations.

As of December 31, 1996, the Company was in the process of monetizing its assets and accordingly, recorded such assets at the lower of cost or current market value, less estimated selling costs. The Company has established an allowance for valuation losses on loans receivable as follows (in thousands):

| | 1998 | 1997 | 1996 |
|------------------------------------------------------------------|----------------|--------------|-------------|
| Beginning balance . . . | \$ 462 | \$ — | \$9,151 |
| Provision for valuation losses | 3,555 | 462 | — |
| Amounts charged against allowance for valuation losses | — | — | (9,151) |
| Ending balance | <u>\$4,017</u> | <u>\$462</u> | <u>\$ —</u> |

10. Risk Factors

The Company's assets are subject to various risks that can affect results, including the level and volatility of prevailing interest rates and credit spreads, adverse changes in general economic conditions and real estate markets, the deterioration of credit quality of borrowers and the risks associated with the ownership and operation of real estate. Any significant compression of the spreads of the interest rates earned on interest-earning assets over the interest rates paid on interest-bearing liabilities could have a material adverse effect on the Company's operating

results as could the availability of desirable loan and investment opportunities and the ability to obtain and maintain targeted levels of leverage and borrowing costs. Adverse changes in national and regional economic conditions can have an effect on real estate values increasing the risk of undercollateralization to the extent that the fair market value of properties serving as collateral security for the Company's assets are reduced. Numerous factors, such as adverse changes in local market conditions, competition, increases in operating expenses and uninsured losses, can affect a property owner's ability to maintain or increase revenues to cover operating expenses and the debt service on the property's financing and, consequently, lead to a deterioration in credit quality or a loan default and reduce the value of the Company's assets. In addition, the yield to maturity on the Company's CMBS assets are subject to the default and loss experience on the underlying mortgage loans, as well as by the rate and timing of payments of principal. If there are realized losses on the underlying loans, the Company may not recover the full amount, or possibly, any of its initial investment in the affected CMBS asset. To the extent there are prepayments on the underlying mortgage loans as a result of refinancing at lower rates, the Company's CMBS assets may be retired substantially earlier than their stated maturities leading to reinvestment in lower yielding assets. There can be no assurance that the Company's assets will not experience any of the foregoing risks or that, as a result of any such experience, the Company will not suffer a reduced return on investment or an investment loss.

11. Equipment and Leasehold Improvements

At December 31, 1998 and 1997, equipment and leasehold improvements, net, are summarized as follows (in thousands):

| | Period of Depreciation or Amortization | 1998 | 1997 |
|------------------------------------------|----------------------------------------------|--------------|--------------|
| Office equipment | 3 to 7 years | \$715 | \$307 |
| Leasehold improvements | Term of leases | <u>232</u> | <u>143</u> |
| | | 947 | 450 |
| Less: accumulated depreciation | | <u>(320)</u> | <u>(93)</u> |
| | | <u>\$627</u> | <u>\$357</u> |

Depreciation and amortization expense on equipment and leasehold improvements totaled \$227,000, \$64,000 and \$19,000 for the years ended December 31, 1998, 1997 and 1996, respectively. Equipment and leasehold improvements are included in prepaid and other assets in the consolidated balance sheets.

12. Notes Payable

At December 31, 1998 and 1997, the Company has notes payable aggregating \$4,247,000 and \$4,953,000, respectively.

In connection with the acquisition of Victor Capital and affiliated entities, the Company issued \$5.0 million of non-interest bearing unsecured notes ("Acquisition Notes") to the sellers, payable in ten semi-annual payments of \$500,000. The Acquisition Notes were originally discounted to \$3,908,000 based on an imputed interest rate of 9.5%. At December 31, 1998 and 1997, the net present value of the remaining payments on the Acquisition Notes amounted to \$3,419,000 and \$4,094,000, respectively.

The Company is also indebted under a note payable due to a life insurance company. This note is secured by the property that was sold in 1997. The note bears interest at 9.50% per annum with principal and interest payable monthly until August 7, 2017 when the entire unpaid principal balance and any unpaid interest is due. The life insurance company has the right to call the entire note due and payable upon ninety days prior written notice. At December 31, 1998 and 1997, the balance of the note payable amounted to \$828,000 and \$859,000, respectively.

13. Long-Term Debt

Credit Facilities

Effective September 30, 1997, the Company entered into a credit agreement with a commercial lender that provided for a three-year \$150 million line of credit (the "First Credit Facility"). Effective January 1, 1998, pursuant to an amended and restated credit agreement, the Company increased its First Credit Facility with its lender to \$250 million and subsequently further amended the credit agreement to increase the facility to \$300 million effective June 22, 1998 and \$355 million effective July 23, 1998. The Company incurred an initial commitment fee upon the signing of the credit agreement and the credit agreement calls for additional commitment fees when the total borrowing under the Credit Facility exceeds \$75 million, \$150 million, \$250 million and \$300 million. The amended and restated agreement expires on December 31, 2001.

On June 8, 1998, the Company entered into an additional credit agreement with another commercial lender that provides for a \$300 million line of credit that expires in December 1999 (the "Second Credit Facility" together with the First Credit Facility, the "Credit Facilities"). The Company incurred an initial commitment fee upon the signing of the Second Credit Facility and will pay an additional commitment fee when borrowings exceed \$250 million.

The Credit Facilities provide for advances to fund lender-approved loans and investments made by the Company ("Funded Portfolio Assets"). The obligations of the Company under the Credit Facilities are secured by pledges of the Funded Portfolio Assets acquired with advances under the Credit Facilities. Borrowings under the Credit Facilities bear interest at specified rates over LIBOR which rates may fluctuate based upon the credit quality of the Funded Portfolio Assets. Future repayments and

redrawdowns of amounts previously subject to the drawdown fee will not require the Company to pay any additional fees. The Credit Facilities provide for margin calls on asset-specific borrowings in the event of asset quality and/or market value deterioration as determined under the Credit Facilities. The Credit Facilities contain customary representations and warranties, covenants and conditions and events of default. The Credit Facilities also contain a covenant obligating the Company to avoid undergoing an ownership change that results in Craig M. Hatkoff, John R. Klopp or Samuel Zell no longer retaining their senior offices and directorships with the Company and practical control of the Company's business and operations.

At December 31, 1998, the Company has borrowed \$273,708,000 against the First Credit Facility at an average borrowing rate (including amortization of fees incurred and capitalized) of 8.19%. The Company has pledged assets of \$411,052,000 as collateral for the borrowing against the First Credit Facility.

At December 31, 1998, the Company has borrowed \$98,046,000 against the Second Credit Facility at an average borrowing rate (including amortization of fees incurred and capitalized) of 8.58%. The Company has pledged assets of \$147,274,000 as collateral for the borrowing against the Second Credit Facility.

On December 31, 1998, the unused amounts available under the Credit Facilities were \$283,246,000.

Repurchase Obligations

The Company has entered into seven repurchase agreements at December 31, 1998.

Four of the repurchase agreements, with a securities dealer, arose in connection with the purchase of a Certificated Mezzanine Investment, a Mortgage Loan and two Mezzanine Loans. At December 31, 1998, the Company has sold such assets totaling \$71,469,000, which approximates market value, and has a liability to repurchase these assets for \$53,704,000. The liability balance bears interest at specified rates over LIBOR and the agreements generally have a one-year term with extensions available by mutual consent. These agreements mature at various dates between March 1999 and August 1999.

One of the repurchase agreements, with another securities dealer, arose in connection with the purchase of a Certificated Mezzanine Investment. At December 31, 1998, the Company has sold such asset with a book value of \$23,641,000, which approximates market value, and has a liability to repurchase this asset for \$14,918,000. The liability balance bears interest at specified rates over LIBOR and matures in May 1999.

The Company also has entered into a repurchase agreement with a securities broker in conjunction with the purchase of one of the classes of subordinated CMBS issued by a financial asset securitization investment trust. At December 31, 1998,

the Company has sold such securities with a cost of \$10,000,000 (market value \$8,543,750) and has a liability to repurchase these assets for \$7,642,000. The liability balance bears interest at specified rates over LIBOR and matures in March 1999.

The Company also has entered into a repurchase agreement with a securities broker in conjunction with the financing of all of its FNMA and FHLMC securities. At December 31, 1998, the Company has sold such securities with a book value totaling \$3,292,000 (market value \$3,330,000) and has a liability to repurchase these assets for \$3,137,000.

The average interest rate in effect for all variable rate repurchase obligations at December 31, 1998 is 6.74%.

At December 31, 1997, the Company had entered into four repurchase agreements.

Three of the repurchase agreements, with a securities dealer, arose in connection with the purchase of a CMBS investment, a Certificated Mezzanine Investment and a Mezzanine Loan. At December 31, 1997, the Company had sold such assets totaling \$97,265,000, which approximated market value, and had a liability to repurchase these assets for \$72,712,000. The liability balance bore interest at specified rates over LIBOR (weighted average of 6.75% at December 31, 1997) and generally had a one year term with extensions available by mutual consent.

The Company also had entered into a repurchase agreement with a securities broker in conjunction with the financing of all of its FNMA and FHLMC securities. At December 31, 1997, the Company had sold such securities with a book value totaling \$9,773,000 (market value \$9,731,000) and had a liability to repurchase these assets for \$9,461,000. The liability balance bore interest at 6.40%.

14. Convertible Trust Preferred Securities

On July 28, 1998, the Company privately placed 150,000 8.25% Step Up Convertible Trust Preferred Securities (liquidation amount \$1,000 per security) with an aggregate liquidation amount of \$150 million (the "Convertible Trust Preferred Securities"). The Convertible Trust Preferred Securities were issued by the Company's consolidated statutory trust subsidiary, CT Convertible Trust I (the "Trust"). The Convertible Trust Preferred Securities represent an undivided beneficial interest in the assets of the Trust which consist solely of the Company's Convertible Debentures (as hereafter defined). This private placement transaction was completed concurrently with the related issuance and sale to the Trust of the Company's 8.25% Step Up Convertible Junior Subordinated Debentures in the aggregate principal amount of \$154,650,000 (the "Convertible Debentures"). Distributions on the Convertible Trust Preferred Securities are payable quarterly in arrears on each calendar quarter-end and correspond to the

payments of interest made on the Convertible Debentures, the sole assets of the Trust. Distributions are payable only to the extent payments are made in respect to the Convertible Debentures.

The Company received \$145,207,000 in net proceeds, after original issue discount of 3% from the liquidation amount of the Convertible Trust Preferred Securities and transaction expenses, pursuant to the above transactions. The proceeds were used to pay down the Company's Credit Facilities. The Convertible Trust Preferred Securities are convertible into shares of Class A Common Stock, at the direction of the holders of the Convertible Trust Preferred Securities made to the conversion agent to exchange such Convertible Trust Preferred Securities for a portion of the Convertible Debentures held by the Trust on the basis of one security for each \$1,000 principal amount of Convertible Debentures, and immediately convert such amount of Convertible Debentures into Class A Common Stock at an initial rate of 85.47 shares of Class A Common Stock per \$1,000 principal amount of the Convertible Debentures (which is equivalent to a conversion price of \$11.70 per share of Class A Common Stock). The Convertible Debentures have a 20-year maturity and are non-callable for five years. Upon repayment of the Convertible Debentures at maturity or upon redemption, the proceeds of such repayment or payment shall be simultaneously paid and applied to redeem, among other things, the Convertible Trust Preferred Securities. If the securities have not been redeemed by September 30, 2004, the distribution rate will step up by 0.75% per annum for each annual period thereafter. The 3% (\$4,500,000) discount and transaction fees on the issuance will be amortized over the expected life of the Convertible Trust Preferred Securities.

For financial reporting purposes, the Trust is treated as a subsidiary of the Company and, accordingly, the accounts of the Trust are included in the consolidated financial statements of the Company. Intercompany transactions between the Trust and the Company, including the Junior Subordinated Debentures, are eliminated in the consolidated financial statements of the Company. The Convertible Trust Preferred Securities are presented as a separate caption between liabilities and stockholders' equity in the consolidated balance sheet of the Company as "Company-obligated, mandatorily redeemable, convertible preferred securities of CT Convertible Trust I, holding solely 8.25% junior subordinated debentures of Capital Trust, Inc. ("Convertible Trust Preferred Securities)". Distributions on the Convertible Trust Preferred Securities are recorded, net of the tax benefit, in a separate caption immediately following the provision for income taxes in the consolidated statement of operations of the Company.

15. Stockholders' Equity

Authorized Capital

Upon consummation of the Reorganization (see Note 1), each outstanding Class A Common Share of the Predecessor was converted into one share of Class A Common Stock of the Company, and each outstanding Class A Preferred Share of the Predecessor was converted into one share of Class A Preferred Stock of the Company. As a result, all of the Predecessor's previously issued Class A Common Shares have been reclassified as shares of Class A Common Stock and all of the Predecessor's previously issued Class A Preferred Shares have been reclassified as shares of Class A Preferred Stock.

The Company has the authority to issue up to 300,000,000 shares of stock, consisting of (i) 100,000,000 shares of Class A Common Stock, (ii) 100,000,000 shares of class B common stock, \$0.01 par value ("Class B Common Stock" and together with the Class A Common Stock, the "Common Stock"), and (iii) 100,000,000 shares of preferred stock, \$0.01 par value ("Preferred Stock"). As of December 31, 1998, there were 12,267,658 shares of Class A Preferred Stock issued and outstanding, no shares of Class B Preferred Stock (as defined below) were issued and outstanding, 18,158,816 shares of Class A Common Stock were issued and outstanding and no shares of Class B Common Stock issued and outstanding. The board of directors is generally authorized to issue additional shares of authorized stock without stockholders' approval.

Common Stock

Except as described herein or as required by law, all shares of Class A Common Stock and shares of Class B Common Stock are identical and entitled to the same dividend, distribution, liquidation and other rights. The Class A Common Stock are voting shares entitled to vote on all matters presented to a vote of stockholders, except as provided by law or subject to the voting rights of any outstanding Preferred Stock. The shares of Class B Common Stock do not have voting rights and are not counted in determining the presence of a quorum for the transaction of business at any meeting of the stockholders of the Company. Holders of record of shares of Class A Common Stock and shares of Class B Common Stock on the record date fixed by the Company's board of directors are entitled to receive such dividends as may be declared by the board of directors subject to the rights of the holders of any series of Preferred Stock.

Each share of Class A Common Stock is convertible at the option of the holder thereof into one share of Class B Common Stock and, subject to certain conditions, each share of Class B Common Stock is convertible at the option of the holder thereof into one share of Class A Common Stock.

The Company is restricted from declaring or paying any dividends on its Class A Common Stock or Class B Common Stock unless all accrued and unpaid dividends with respect to the Preferred Stock have been paid in full.

Preferred Stock

There are 100,000,000 shares of Preferred Stock authorized. In connection with the Reorganization, the Company created two classes of Preferred Stock, the Class A Preferred Stock and the class B 9.5% cumulative convertible preferred stock, \$0.01 par value ("Class B Preferred Stock" together with the Class A Preferred Stock, the "Authorized Preferred Stock"). As described above, upon consummation of the Reorganization, the Predecessor's outstanding Class A Preferred Shares were converted into shares of the Company's Class A Preferred Stock. The Predecessor's 12,267,658 outstanding Class A Preferred Shares were originally issued and purchased by Veqtor on July 15, 1997 for an aggregate purchase price of approximately \$33 million (see Note 1).

Except as described herein or as required by law, both classes of Authorized Preferred Stock are identical and entitled to the same dividend, distribution, liquidation and other rights. The holders of the Class A Preferred Stock are entitled to vote together with the holders of the Class A Common Stock as a single class on all matters submitted to a vote of stockholders. Each share of Class A Preferred Stock entitles the holder thereof to a number of votes per share equal to the number of shares of Class A Common Stock into which such shares of Class A Preferred Stock is then convertible. Except as described herein, the holders of Class B Preferred Stock do not have voting rights and are not counted in determining the presence of a quorum for the transaction of business at a stockholders' meeting. The affirmative vote of the stockholders of a majority of the outstanding Authorized Preferred Stock, voting together as a separate single class, except in certain circumstances, have the right to approve any merger, consolidation or transfer of all or substantially all of the assets of the Company. Holders of the Authorized Preferred Stock are entitled to receive, when and as declared by the board of directors, cash dividends per share at the rate of 9.5% per annum on a per share price of \$2.69. Such dividends shall accrue (whether or not declared) and, to the extent not paid for any dividend period, will be cumulative. Dividends on the Authorized Preferred Stock are payable, when and as declared, semi-annually, in arrears, on December 26 and June 25 of each year.

Each share of Class A Preferred Stock is convertible at the option of the holder thereof into an equal number of shares of Class B Preferred Stock, or into a number of shares Class A Common Stock equal to the ratio of (x) \$2.69 plus an amount equal to all dividends per share accrued and unpaid thereon as of the date of such conversion to (y) the conversion price in effect as of the date of such conversion. Each share of Class B Preferred Stock is convertible at the option of the holder thereof, subject to certain conditions, into an equal number of shares of Class A Preferred Stock or into a number of shares of Class B Common Stock equal to the ratio of (x) \$2.69 plus an amount equal to all

dividends per share accrued and unpaid thereon as of the date of such conversion to (y) the conversion price in effect as of the date of such conversion. The conversion price in effect as of December 31, 1998 is \$2.69 and therefore the outstanding shares of Class A Preferred Stock are convertible into an equal number of shares of Class A Common Stock.

16. General and Administrative Expenses

General and administrative expenses for the years ended December 31, 1998, 1997 and 1996 consist of (in thousands):

| | 1998 | 1997 | 1996 |
|---------------------------------|-----------------|----------------|----------------|
| Salaries and Benefits | \$11,311 | \$5,035 | \$ — |
| Professional services | 3,138 | 2,311 | 295 |
| Other | 2,596 | 2,117 | 1,208 |
| Total | <u>\$17,045</u> | <u>\$9,463</u> | <u>\$1,503</u> |

The Company incurred significant non-recurring fees for professional services in 1997 (an increase of more than \$2,000,000 over 1996) in conjunction with the reconstitution of the Company, the termination of its REIT status and the implementation of its operations as a finance company.

17. Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return. The provision for income taxes for the years ended December 31, 1998 and 1997 is comprised as follows (in thousands):

| | 1998 | 1997 |
|--------------------------------------|----------------|--------------|
| Current | | |
| Federal | \$7,226 | \$ — |
| State | 2,740 | — |
| Local | 2,480 | 55 |
| Deferred | | |
| Federal | (2,282) | — |
| State | (419) | — |
| Local | (378) | — |
| Provision for income taxes | <u>\$9,367</u> | <u>\$ 55</u> |

The Company has federal net operating loss carryforwards ("NOLs") as of December 31, 1998 of approximately \$13.0 million. Such NOLs expire through 2012. The Company also has a federal capital loss carryover of approximately \$1.6 million that can be used to offset future capital gains. Due to CRIL's purchase of 6,959,593 Common Shares from the Predecessor's Former Parent in January 1997 and another prior ownership change, a substantial portion of the NOLs are limited for federal income tax purposes to approximately \$1.4 million annually. Any unused portion of such annual limitation can be carried forward to future periods.

The reconciliation of income tax computed at the U.S. federal statutory tax rate (35% for the year ended December 31, 1998 and 34% for the year ended December 31, 1997) to the effective income tax rate for the years ended December 31, 1998 and 1997 are as follows (in thousands):

| | 1998 | | 1997 | |
|----------------------------------------------------------------------|----------------|--------------|--------------|-------------|
| | \$ | % | \$ | % |
| Federal income tax at statutory rate | \$9,013 | 35.0% | \$(1,531) | (34.0)% |
| State and local taxes, net of federal tax benefit | 2,919 | 11.3% | 36 | 0.1% |
| Tax benefit of net operating loss not currently recognized | — | —% | 1,536 | 34.0% |
| Utilization of net operating loss carry-forwards | (2,755) | (10.7)% | — | —% |
| Compensation in excess of deductible limits | 221 | 0.9% | — | —% |
| Other | (31) | (0.1)% | 14 | 0.0% |
| | <u>\$9,367</u> | <u>36.4%</u> | <u>\$ 55</u> | <u>0.1%</u> |

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax reporting purposes.

The components of the net deferred tax assets are as follows (in thousands):

| | December 31, | |
|-------------------------------------------------------------------|-----------------|-------------|
| | 1998 | 1997 |
| Net operating loss carryforward | \$ 4,559 | \$ 9,090 |
| Reserves on other assets and for possible credit losses | 4,621 | 3,326 |
| Deferred revenue | — | 616 |
| Reserve for uncollectible accounts | — | 208 |
| Other | 119 | — |
| Deferred tax assets | 9,299 | 13,240 |
| Valuation allowance | (6,270) | (13,240) |
| | <u>\$ 3,029</u> | <u>\$ —</u> |

The Company recorded a valuation allowance to reserve a portion of its net deferred assets in accordance with SFAS No. 109. Under SFAS No. 109, this valuation allowance will be adjusted in future years, as appropriate. However, the timing and extent of such future adjustments can not presently be determined.

18. Employee Benefit Plans

1997 Long-Term Incentive Stock Plan

In May 1997, the board of trustees of the Predecessor adopted the original 1997 long-term incentive share plan, which was approved by the Predecessor's shareholders and thereafter amended to reflect the Predecessor's name change in July 1997. In May 1998, the Predecessor's board of trustees originally adopted, subject to shareholder approval, the original form of an amended and restated 1997 long-term incentive share plan which was subsequently approved at the Predecessor's 1998 annual meeting of shareholders on January 28, 1999 (the "1998 Annual Meeting"). Upon consummation of the Reorganization, the Company succeeded to and assumed the amended and restated plan which has been amended to reflect the succession of the Company (the plan is hereinafter referred to as the "Incentive Stock Plan"). The Incentive Stock Plan permits the grant of nonqualified stock option ("NQSO"), incentive stock option ("ISO"), restricted stock, stock appreciation right ("SAR"), performance unit, performance stock and stock unit awards. A maximum of 2,674,388 shares of Class A Common Stock may be issued during the fiscal year 1999 pursuant to awards under the Incentive Stock Plan and the Director Stock Plan (as defined below) in addition to the options outstanding under the two plans at December 31, 1998. The maximum number of shares that may be subject to awards to any employee during the term of the plan may not exceed 500,000 shares and the maximum amount payable in cash to any employee with respect to any performance period pursuant to any performance unit or performance stock award is \$1.0 million.

The ISOs shall be exercisable no more than ten years after their date of grant and five years after the grant in the case of a 10% stockholder and vest over a period of three years with one-third vesting at each anniversary date. Payment of an option may be made with cash, with previously owned Class A Common Stock, by foregoing compensation in accordance with performance compensation committee or compensation committee rules or by a combination of these.

Restricted stock may be granted under the Incentive Stock Plan with performance goals and periods of restriction as the board of directors may designate. The performance goals may be based on the attainment of certain objective and/or subjective measures. The Company issued 72,500 shares of restricted stock in 1998 of which 17,500 shares were canceled upon the resignation of a former employee. The shares of restricted stock outstanding vest one-third on each of the following dates: January 30, 2001, January 30, 2002 and January 30, 2003. The Incentive Stock Plan also authorizes the grant of stock units at any time and from time to time on such terms as shall be determined by the board of directors or administering compensation committee. Stock units shall be payable in Class A Common Stock upon the occurrence of certain trigger events. The terms and condi-

tions of the trigger events may vary by stock unit award, by the participant, or both.

SFAS No. 123, "Accounting for Stock-Based Compensation" was issued by the FASB in October 1996. SFAS No. 123 encourages the adoption of a new fair-value based accounting method for employee stock-based compensation plans. SFAS No. 123 also permits companies to continue accounting for stock-based compensation plans as prescribed by APB Opinion No. 25. However, companies electing to continue accounting for stock-based compensation plans under APB Opinion No. 25, must make pro forma disclosures as if the company adopted the cost recognition requirements under SFAS No. 123. The Company has continued to account for stock-based compensation under APB Opinion No. 25. Accordingly, no compensation cost has been recognized for the Incentive Stock Plan or the Director Stock Plan in the accompanying consolidated statements of operations as the exercise price of the stock options granted thereunder equaled the market price of the underlying stock on the date of the Grant.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 1998 and 1997: (1) dividend yield of zero, (2) expected volatility of 40%, (3) risk-free interest rate of 5.25% and 5.71%, respectively and (4) an expected life of five years. The weighted average fair value of each stock option granted during the year ended December 31, 1998 and 1997 was \$4.44 and \$2.63, respectively.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in the Company's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. For the year ended December 31, 1998, pro forma net income, after giving effect to the Class A Preferred Stock dividend requirement, and basic and diluted earnings per share, after giving effect to the fair value of the grants would be \$12.2 million, \$0.50 and \$0.40, respectively. For the year ended December 31, 1997, pro forma net loss, after giving effect to the Class A Preferred Stock dividend requirement, and basic and diluted loss per share, after giving effect to the fair value of the grants would be \$5.0 million and \$0.52, respectively.

The pro forma information presented above is not representative of the effect stock options will have on pro forma net income or earnings per share for future years.

The following table summarizes the activity under the Incentive Stock Plan for the years ended December 31, 1998 and 1997:

| | Options Outstanding | Exercise Price per Share | Weighted Average Exercise Price per Share |
|--------------------------------------------|---------------------|--------------------------|-------------------------------------------|
| Outstanding at January 1, 1997 . . . | — | \$ — | \$ — |
| Granted in 1997 | <u>607,000</u> | \$6.00 | <u>6.00</u> |
| Outstanding at December 31, 1997 | 607,000 | \$6.00 | 6.00 |
| Granted in 1998 | 1,112,250 | \$9.00 - \$11.38 | 9.93 |
| Exercised in 1998 | (1,666) | \$6.00 | 6.00 |
| Canceled in 1998 | <u>(193,500)</u> | \$6.00 - \$10.00 | <u>7.81</u> |
| Outstanding at December 31, 1998 | <u>1,524,084</u> | \$6.00 - \$11.38 | <u>\$8.46</u> |

272,834 of the options are exercisable at December 31, 1998 and none of the options were exercisable at December 31, 1997. At December 31, 1998, the outstanding options have various remaining contractual lives ranging from 8½ to 9½ years with a weighted average life of 8.95 years.

1997 Non-Employee Director Stock Plan

In May 1997, the board of trustees of the Predecessor adopted the original 1997 non-employee trustee share plan, which was approved by the Predecessor's shareholders, and thereafter amended to reflect the Predecessor's name change, in July 1997. In May 1998, the Predecessor's board of trustees originally adopted, subject to shareholder approval, the original form of an amended and restated 1997 non-employee trustee share plan which was subsequently approved at the Predecessor's 1998 Annual Meeting. Upon consummation of the Reorganization, the Company succeeded to and assumed the amended and restated plan, which has been amended to reflect the succession of the Company (the plan is hereinafter referred to as the "Director Stock Plan"). The Director Stock Plan permits the grant of NQSO, restricted stock, SAR, performance unit, stock and stock unit awards. A maximum of 2,674,388 shares of Class A Common Stock may be issued during the fiscal year 1999 pursuant to awards under the Director Stock Plan and the Incentive Stock Plan, in addition to the options outstanding under the two plans at December 31, 1998.

The board of directors shall determine the purchase price per Class A Common Stock covered by a NQSO granted under the Director Stock Plan. Pay-

ment of a NQSO may be made with cash, with previously owned shares of Class A Common Stock, by foregoing compensation in accordance with board rules or by a combination of these payment methods. SARs may be granted under the plan in lieu of NQSOs, in addition to NQSOs, independent of NQSOs or as a combination of the foregoing. A holder of a SAR is entitled upon exercise to receive shares of Class A Common Stock, or cash or a combination of both, as the board of directors may determine, equal in value on the date of exercise to the amount by which the fair market value of one share of Class A Common Stock on the date of exercise exceeds the exercise price fixed by the board on the date of grant (which price shall not be less than 100% of the market price of a share of Class A Common Stock on the date of grant) multiplied by the number of shares in respect to which the SARs are exercised.

Restricted stock may be granted under the Director Stock Plan with performance goals and periods of restriction as the board of directors may designate. The performance goals may be based on the attainment of certain objective and/or subjective measures. The Director Stock Plan also authorizes the grant of stock units at any time and from time to time on such terms as shall be determined by the board of directors. Stock units shall be payable in shares of Class A Common Stock upon the occurrence of certain trigger events. The terms and conditions of the trigger events may vary by stock unit award, by the participant, or both.

The following table summarizes the activity under the Director Stock Plan for the years ended December 31, 1998 and 1997:

| | Options Outstanding | Exercise Price per Share | Weighted Average Exercise Price per Share |
|--------------------------------------------|---------------------|--------------------------|-------------------------------------------|
| Outstanding at January 1, 1997 . . . | — | \$ — | \$ — |
| Granted in 1997 | <u>50,000</u> | \$ 6.00 | <u>6.00</u> |
| Outstanding at December 31, 1997 | 50,000 | \$ 6.00 | 6.00 |
| Granted in 1998 | <u>205,000</u> | \$10.00 | <u>10.00</u> |
| Outstanding at December 31, 1998 | <u>255,000</u> | \$6.00 - \$10.00 | <u>\$ 9.22</u> |

16,666 of the options are exercisable at December 31, 1998 and none of the options were exercisable at December 31, 1997. At December 31, 1998, the outstanding options have a remaining contractual life of 8½ years to 9½ years with a weighted average life of 8.98 years.

19. Fair Values of Financial Instruments

SFAS No. 107, "Disclosures about Fair Value of Financial Instruments," requires disclosure of fair value information about financial instruments, whether or not recognized in the statement of financial condition, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based upon estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and the estimated future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. SFAS No. 107 excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts do not represent the underlying value of the Company.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and cash equivalents: The carrying amount of cash on hand and money market funds is considered to be a reasonable estimate of fair value.

Other available-for-sale securities: The fair value was determined based upon the market value of the securities.

Commercial mortgage-backed securities: The fair value was obtained by obtaining quotes from a market maker in the security.

Certificated mezzanine investments: The fair value was obtained by obtaining quotes from a market maker in the security.

Loans receivable, net: The fair values were estimated by using current institutional purchaser yield requirements for loans with similar credit characteristics.

Interest rate cap agreement: The fair value was estimated based upon the amount at which similar financial instruments would be valued.

Credit Facilities: The Credit Facilities are at floating rates of interest which are similar to those in the market currently. Therefore, the carrying value is a reasonable estimate of fair value.

Repurchase obligation: The repurchase obligations, which are generally short term in nature, bear interest at a floating rate and the book value is a reasonable estimate of fair value.

Convertible Trust Preferred Securities: The fair value was estimated based upon the amount at which similar privately placed financial instruments would be valued.

Interest rate swap agreements: The fair value was estimated based upon the amount at which similar financial instruments would be valued.

The carrying amounts of all assets and liabilities approximate the fair value except as follows (in thousands):

| | December 31, 1998 | | December 31, 1997 | |
|----------------------------------------|-------------------|------------|-------------------|------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial Assets: | | | | |
| Loans receivable, net | 620,858 | 614,477 | 180,324 | 181,198 |
| Interest rate cap agreement | 60 | 6 | 71 | 70 |
| Unrecognized Financial Instruments: | | | | |
| Interest Rate Swap Agreement | — | (4,521) | — | (874) |

20. Supplemental Schedule of Non-Cash and Financing Activities

The following is a summary of the significant non-cash investing and financing activities during the year ended December 31, 1997 (in thousands):

Stock received as partial compensation for advisory services \$1,798

In connection with the sale of properties and notes receivable, the Company entered into various non-cash transactions as follows during the year ended December 31, 1997 (in thousands):

| | |
|------------------------------------------|----------------|
| Sales price less selling costs | \$8,396 |
| Amount due from buyer | (1,090) |
| Net cash received | <u>\$7,306</u> |

Interest paid on the Company's outstanding debt for 1998, 1997 and 1996 was \$25,184,000, \$1,877,000 and \$550,000, respectively. Income taxes paid by the Company in 1998 were \$7,866,000. No income taxes were paid in 1997 or 1996.

21. Transactions with Related Parties

The Company entered into a consulting agreement, dated as of July 15, 1997, with a director of the Company. The consulting agreement had an initial term of one year that was extended to December 31, 1998. Pursuant to the agreement, the director provides consulting services for the Company including strategic planning, identifying and negotiating mergers, acquisitions, joint ventures and strategic alliances, and advising as to capital structure matters. During the years ended December 31, 1998 and 1997, the

Company has incurred expenses of \$165,000 and \$300,000, respectively, in connection with this agreement.

The Company entered into a consulting agreement, dated as of January 1, 1998, with another director of the Company. The consulting agreement had an initial term of one year. Pursuant to the agreement, the director provides consulting services for the Company including new business identification, strategic planning and identifying and negotiating mergers, acquisitions, joint ventures and strategic alliances. During the year ended December 31, 1998, the Company has incurred expenses of \$96,000 in connection with this agreement.

The Company pays EGI, an affiliate under common control of the chairman of the board of directors, for certain corporate services provided to the Company. These services include consulting on legal matters, tax matters, risk management, investor relations and investment banking. During the years ended December 31, 1998 and 1997, the Company has incurred \$216,000 and \$134,000, respectively, of expenses in connection with these services.

During 1996, the Company shared certain personnel and other costs with the Former Parent. The Company reimbursed Former Parent pursuant to a cost allocation agreement based on each Company's respective asset values (real property and notes receivable) that was subject to annual negotiation. During 1996, reimbursable costs charged to the Company by Former Parent approximated \$258,000.

At December 31, 1996, the Company owed \$31,000 to the Former Parent pursuant to the cost allocation agreement. The cost allocation agreement between the Company and the Former Parent was terminated on January 7, 1997. At December 31, 1998 and 1997, the Company had no amounts due to the Former Parent pursuant to the cost allocation arrangement.

During the year ended December 31, 1998, the Company, through two of its acquired subsidiaries, earned asset management fees pursuant to agreements with entities in which two of the executive officers and directors of the Company have an equity interest and serve as officers, members or as a general partner thereof. During the year ended December 31, 1998 and 1997, the Company earned \$1,682,000 and \$327,000, respectively, from such agreements, which have been included in the consolidated statements of operations.

22. Commitments and Contingencies

Leases

The Company leases premises and equipment under operating leases with various expiration dates. Minimum annual rental payments at December 31, 1998 are as follows (in thousands):

Years ending December 31:

| | |
|---------------|---------------|
| 1999. | \$ 533 |
| 2000. | 203 |
| 2001. | 23 |
| 2002. | 23 |
| | <u>\$ 782</u> |

Rent expense for office space and equipment amounted to \$530,000, \$310,000 and \$40,000 for the years ended December 31, 1998, 1997 and 1996, respectively.

Litigation

In the normal course of business, the Company is subject to various legal proceedings and claims, the resolution of which, in management's opinion, will not have a material adverse effect on the consolidated financial position or the results of operations of the company.

Employment Agreements

The Company has employment agreements with four of its executive officers.

The employment agreements with two of the executive officers provide for five-year terms of employment commencing as of July 15, 1997. Such agreements contain extension options that extend such agreements automatically unless terminated by notice, as defined, by either party. The employment agreements provide for base annual salaries of \$500,000, which has been increased to \$600,000, and will be increased each calendar year to reflect increases in the cost of living and will otherwise be subject to increase at the discretion of the board of directors. Such executive officers are also entitled to annual incentive cash bonuses to be determined by the board of directors based on individual performance and the profitability of the Company and are participants in the Incentive Stock Plan and other employee benefit plans of the Company.

The employment agreement with one executive officer provides for a term of employment commencing as of August 15, 1998 and expiring on January 2, 2002, which shall be automatically extended until December 31, 2002 unless, prior to April 7, 2001, either party shall have delivered to the other a non-renewal notice. The employment agreement provides for a base annual salary of \$350,000, which will be increased each calendar year to reflect increases in the cost of living and may otherwise be further increased at the discretion of the board of directors. The employment agreement also provides for annual incentive cash bonuses for calendar years 1999 through 2001 to be determined by the board of directors based on individual performance and the profitability of the Company, provided that the minimum of each of said three annual incentive bonuses shall be no less than \$750,000. In addition to the base salary and incentive bonus, the executive will receive during calendar year 1999 only, a special cash payment of \$1,200,000 of which \$850,000 was expensed

in 1998. The executive is entitled to participate in employee benefit plans of the Company at levels determined by the board of directors and commensurate with his position and receives Company provided life and disability insurance. In accordance with the agreement, the executive was granted, pursuant to the Incentive Stock Plan, options to purchase 100,000 shares of Class A Common Stock with an exercise price of \$9.00 immediately vested and exercisable as of the date of the agreement. The Company also agreed to grant, pursuant to the Incentive Stock Plan, fully vested shares of Class A Common Stock, 50,000 shares on January 1, 1999 and 100,000 shares on each of the three successive anniversaries thereof.

The employment agreement with another executive officer provides for a two-year employment term which began July 15, 1997. Such agreement contains extension options that extend the agreement automatically unless terminated by notice by either party. The employment agreement provides for base annual salary of \$300,000, annual bonuses, as specified, at the end of 1997 and 1998, and participation in the Incentive Stock Plan and other employee benefit plans of the Company. Such executive officer is also entitled to an annual incentive cash bonus to be determined by the board of

directors based on individual performance and the profitability of the Company.

23. Segment Reporting

The Company has adopted a new accounting pronouncement requiring disclosure about the Company's segments based on a management approach. The Company has an internal information system that produces performance data for its two segments along service lines.

The Lending and Investment segment includes all of the Company's activities related to the loan and investment portfolio and the financing thereof.

The Advisory segment includes all of the Company's activities related to fee services provided to real estate investors, owners, developers and financial institutions in connection with mortgage financings, securitizations, joint ventures, debt and equity investments, mergers and acquisitions, portfolio evaluations, restructurings and disposition programs. The segment also provides asset management and advisory services relating to various mortgage pools and real estate properties.

The following table details the identified segment's contribution to the Company's overall profitability for the year ended December 31, 1998 (in thousands):

| | Lending and Investment | Advisory | Total |
|--------------------------------------------------------------------------------------------------------------------------------|---------------------------|----------|------------|
| Income from loans and other investments: | | | |
| Interest and related income | \$ 62,316 | \$ — | \$ 62,316 |
| Less: Interest and related expenses | 27,252 | — | 27,252 |
| Income from loans and other investments, net | 35,064 | — | 35,064 |
| Other revenues: | | | |
| Advisory and asset management fees | — | 10,311 | 10,311 |
| Other interest income | 1,638 | — | 1,638 |
| Total other revenues | 1,638 | 10,311 | 11,949 |
| Other expenses: | | | |
| General and administrative | 11,507 | 5,538 | 17,045 |
| Other interest expense | 413 | — | 413 |
| Depreciation and amortization | 181 | 68 | 249 |
| Provision for possible credit losses | 3,555 | — | 3,555 |
| Total other expenses | 15,656 | 5,606 | 21,262 |
| Income before income taxes and distributions and amortization on Convertible Trust Preferred Securities | 21,046 | 4,705 | 25,751 |
| Provision for income taxes | 7,150 | 2,217 | 9,367 |
| Income before distributions and amortization on Convertible Trust Preferred Securities | 13,896 | 2,488 | 16,384 |
| Distributions and amortization on Convertible Trust Preferred Securities, net of income tax benefit of \$2,621 | 2,941 | — | 2,941 |
| Net income | 10,955 | 2,488 | 13,443 |
| Less: Class A Preferred Stock dividend | 3,135 | — | 3,135 |
| Net income allocable to Class A Common Stock | \$ 7,820 | \$ 2,488 | \$ 10,308 |
| Total Assets | \$ 763,791 | \$ 2,647 | \$ 766,438 |

All revenues were generated from external sources within the United States with the exception of \$74,000 that was received as dividends from an investment in Canada. There were no transactions between the two segments during the year ended December 31, 1998.

24. Summary of Quarterly Results of Operations (Unaudited)

The following is a summary of the unaudited quarterly results of operations for the years ended December 31, 1998 and 1997 (in thousands, except per share data):

| | <u>March 31</u> | <u>June 30</u> | <u>September 30</u> | <u>December 31</u> |
|----------------------------------------------|-----------------|----------------|---------------------|--------------------|
| 1998 | | | | |
| Revenues | \$ 11,207 | \$ 20,166 | \$ 21,872 | \$ 21,020 |
| Net income | \$ 2,673 | \$ 5,024 | \$ 3,144 | \$ 2,602 |
| Class A Preferred Stock dividends | \$ 784 | \$ 784 | \$ 783 | \$ 784 |
| Net income per share of | | | | |
| Class A Common Stock: | | | | |
| Basic | \$ 0.10 | \$ 0.24 | \$ 0.13 | \$ 0.10 |
| Diluted | \$ 0.09 | \$ 0.16 | \$ 0.10 | \$ 0.09 |
| 1997 | | | | |
| Revenues | \$ 613 | \$ 371 | \$ 2,729 | \$ 4,737 |
| Net loss | \$ (508) | \$ (352) | \$ (1,593) | \$ (2,104) |
| Class A Preferred Stock | | | | |
| dividends and dividend requirement | \$ — | \$ — | \$ 679 | \$ 792 |
| Net loss per share of | | | | |
| Class A Common Stock: | | | | |
| Basic and Diluted | \$ (0.06) | \$ (0.04) | \$ (0.25) | \$ (0.27) |

25. Subsequent Event

On March 3, 1999, the Company, through its newly formed wholly owned subsidiary, CT-BB Funding Corp., acquired a portfolio of "BB" rated commercial mortgage backed securities from an affiliate of the Company's credit provider under the First Credit Facility. The portfolio, which is comprised of 11 separate issues with an aggregate face amount of \$246.0 million, was purchased for \$196.9 million (approximately 80% of par value) for which the blended yield to maturity was 10.65% on the date of

acquisition (533 basis points over the comparable maturity Treasuries). In connection with the transaction, an affiliate of the seller provided three-year term financing for 70% of the purchase price at a floating rate above LIBOR and provided an interest rate swap for the full duration of the securities in order to hedge interest rate exposure. Concurrent with the transaction, the First Credit Facility's maturity was extended to February 28, 2002 with an automatic one-year amortizing extension option, if not otherwise extended.



CORPORATE DATA

Board of Directors and Executive Officers

Board of Directors

Samuel Zell

*Chairman of the Board of the Company
and Chairman of the Board of Equity Group
Investments, L.L.C.*

Jeffrey A. Altman

*Senior Vice President of Franklin Mutual
Advisors, Inc.*

Thomas E. Dobrowski

*Managing Director of Real Estate and
Alternative Investments of General Motors Investment
Management Corporation*

Martin L. Edelman

Of Counsel to Battle Fowler LLP

Gary R. Garrabrant

*Managing Director and Chief Investment Officer of
Equity International Properties, Ltd.*

Craig M. Hatkoff

John R. Klopp

Sheli Z. Rosenberg

*President and Chief Executive Officer of
Equity Group Investments, L.L.C.*

Steven Roth

*Chairman of the Board of Trustees and
Chief Executive Officer of Vornado Realty Trust*

Lynne B. Sagalyn

*Professor and Coordinator of the
MBA Real Estate Program at the Columbia University
Graduate School of Business*

Executive Officers

Samuel Zell

Chairman of the Board

John R. Klopp

Vice Chairman and Chief Executive Officer

Craig M. Hatkoff

*Vice Chairman and Chairman of the Executive
Committee of the Board of Directors*

Stephen D. Plavin

Chief Operating Officer

Edward L. Shugrue III

*Chief Financial Officer, Managing Director and
Assistant Secretary*

Donald J. Meyer

Chief Investment Officer and Managing Director

Headquarters Office

Capital Trust, Inc.

605 Third Avenue, 26th Floor

New York, NY 10016

Phone: 212-655-0220

Fax: 212-655-0044

E-Mail: info@ctnyse.com

Common Stock Market Prices and Dividends

The Company's Class A Common Stock is listed on the New York Stock Exchange, ticker symbol CT. The Company does not pay dividends on its Class A Common Stock.

The high and low sales prices for 1998 on the NYSE were as follows:

| | 1997 | | 1998 | |
|----------------|-------|--------|-------|-------|
| | High | Low | High | Low |
| First Quarter | 67/8 | 21/2 | 111/4 | 9 |
| Second Quarter | 61/8 | 41/2 | 117/8 | 91/16 |
| Third Quarter | 113/8 | 55/8 | 99/16 | 47/16 |
| Fourth Quarter | 151/8 | 913/16 | 73/8 | 43/8 |

Transfer Agent

American Stock Transfer & Trust Co.

40 Wall Street

New York, NY 10005

Phone: 800-937-5449

Auditors

Ernst & Young LLP

New York, NY

Stockholders

There were approximately 1,500 registered holders of Class A Common Stock as of December 31, 1998.

Form 10-K Availability

Requests for a copy of the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission provided free of charge, and any other investor inquiries from individuals and institutional investors should be directed to:

Cynthia H. McHugh

Investor Relations

Capital Trust, Inc.

Two North Riverside Plaza

Chicago, IL 60606

Phone: 312-928-1905

The Commission also maintains a Web site that contains reports, proxy information and statements, and other information regarding registrants that file electronically with the Commission. The Web site address is <http://www.sec.gov>. The Company files electronically.