

CAPITAL TRUST INC  
Form 10-Q  
October 28, 2008

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2008

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 1-14788

Capital Trust, Inc.  
(Exact name of registrant as specified in its charter)

Maryland  
(State or other jurisdiction of incorporation or organization)

94-6181186  
(I.R.S. Employer Identification No.)

410 Park Avenue, 14th Floor, New York, NY  
(Address of principal executive offices)

10022  
(Zip Code)

Registrant's telephone number, including area code: (212) 655-0220

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

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

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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The number of outstanding shares of the registrant's class A common stock, par value \$0.01 per share, as of October 28, 2008 was 22,095,499.

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CAPITAL TRUST, INC.  
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Capital Trust, Inc. and Subsidiaries  
Consolidated Balance Sheets  
September 30, 2008 and December 31, 2007  
(in thousands, except per share data)

Assets	September 30, 2008 (unaudited)	December 31, 2007 (audited)
Cash and cash equivalents	\$ 115,240	\$ 25,829
Restricted cash	18,231	5,696
Commercial mortgage backed securities	851,371	876,864
Loans receivable, net	2,044,408	2,257,563
Equity investment in unconsolidated subsidiaries	3,822	977
Deposits and other receivables	790	3,927
Accrued interest receivable	12,065	15,091
Interest rate hedge assets	13	—
Deferred income taxes	4,160	3,659
Prepaid and other assets	17,619	21,876
Total assets	\$ 3,067,719	\$ 3,211,482
Liabilities & Shareholders' Equity		
Liabilities:		
Accounts payable and accrued expenses	\$ 26,783	\$ 65,682
Repurchase obligations and secured debt	816,208	911,857
Collateralized debt obligations	1,158,787	1,192,299
Senior unsecured credit facility	100,000	75,000
Junior subordinated debentures	128,875	128,875
Participations sold	337,015	408,351
Interest rate hedge liabilities	19,932	18,686
Deferred origination fees and other revenue	1,639	2,495
Total liabilities	2,589,239	2,803,245
Shareholders' equity:		
Class A common stock \$0.01 par value 100,000 shares authorized, 21,730 and 17,166 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively ("class A common stock")	217	172
Restricted class A common stock \$0.01 par value, 360 and 424 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively ("restricted class A common stock" and together with class A common stock, "common stock")	4	4
Additional paid-in capital	554,454	426,113
Accumulated other comprehensive loss	(12,152)	(8,684)
Accumulated deficit	(64,043)	(9,368)
Total shareholders' equity	478,480	408,237
Total liabilities and shareholders' equity	\$ 3,067,719	\$ 3,211,482

See accompanying notes to consolidated financial statements.

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Capital Trust, Inc. and Subsidiaries  
Consolidated Statements of Income  
Three and Nine Months Ended September 30, 2008 and 2007  
(in thousands, except share and per share data)  
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Income from loans and other investments:				
Interest and related income	\$ 44,141	\$ 64,712	\$ 149,725	\$ 190,959
Less: Interest and related expenses	28,175	43,716	98,918	120,008
Income from loans and other investments, net	15,966	20,996	50,807	70,951
Other revenues:				
Management fees	3,477	1,115	9,827	2,446
Incentive management fees	—	—	—	962
Servicing fees	116	173	337	285
Other interest income	483	173	1,307	754
Total other revenues	4,076	1,461	11,471	4,447
Other expenses:				
General and administrative	5,711	6,840	18,819	21,483
Depreciation and amortization	13	61	140	1,450
Total other expenses	5,724	6,901	18,959	22,933
Gain on extinguishment of debt	—	—	6,000	—
(Provision for)/recovery of losses on loan impairment	—	—	(56,000)	4,000
Gain on sale of investments	—	—	374	—
Loss from equity investments	(625)	(109)	(549)	(1,042)
Income (loss) before income taxes	13,693	15,447	(6,856)	55,423
Income tax provision (benefit)	26	(50)	(475)	(304)
Net income (loss)	\$ 13,667	\$ 15,497	\$ (6,381)	\$ 55,727
Per share information:				
Net income (loss) earnings per share of common stock:				
Basic	\$ 0.61	\$ 0.88	\$ (0.31)	\$ 3.17
Diluted	\$ 0.61	\$ 0.87	\$ (0.31)	\$ 3.14
Weighted average shares of common stock outstanding:				
Basic	22,247,042	17,594,047	20,707,262	17,555,724

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Diluted	22,250,631	17,717,282	20,707,262	17,719,881
Dividends declared per share of common stock	\$ 0.60	\$ 0.80	\$ 2.20	\$ 2.40

See accompanying notes to consolidated financial statements.

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Capital Trust, Inc. and Subsidiaries  
Consolidated Statements of Changes in Shareholders' Equity  
For the Nine Months Ended September 30, 2008 and 2007  
(in thousands)  
(unaudited)

	Comprehensive Income (Loss)	Class A Common Stock	Restricted Class A Common Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Income/(Loss)	Accumulated Deficit	Total
Balance at January 1, 2007		\$ 169	\$ 5	\$ 417,641	\$ 12,717	\$ (4,260)	\$ 426,272
Net income	\$ 55,727	—	—	—	—	55,727	55,727
Unrealized loss on derivative financial instruments	(4,158)	—	—	—	(4,158)	—	(4,158)
Unrealized gain on available for sale security	108	—	—	—	108	—	108
Amortization of unrealized gain on securities	(1,259)	—	—	—	(1,259)	—	(1,259)
Currency translation adjustments	810	—	—	—	810	—	810
Issuance of stock relating to asset purchase	—	—	—	707	—	—	707
Amortization of deferred gains and losses on settlement of swaps	—	—	—	—	(353)	—	(353)
Sale of shares of class A common stock under stock option agreement	—	—	—	952	—	—	952
Restricted class A common stock earned	—	2	(1)	3,570	—	—	3,571
Dividends declared on common stock	—	—	—	—	—	(41,983)	(41,983)
Balance at September 30, 2007	\$ 51,228	\$ 171	\$ 4	\$ 422,870	\$ 7,865	\$ 9,484	\$ 440,394
Balance at January 1, 2008		\$ 172	\$ 4	\$ 426,113	\$ (8,684)	\$ (9,368)	\$ 408,237
Net loss	\$ (6,381)					(6,381)	(6,381)
Unrealized loss on derivative financial instruments	(1,233)	—	—	—	(1,233)	—	(1,233)
Unrealized gain on available for sale security	277	—	—	—	277	—	277
Reclassification to gain on sale of investments	(482)	—	—	—	(482)	—	(482)

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Amortization of unrealized gain on securities	(1,278)	—	—	—	(1,278)	—	(1,278)
Deferred loss on settlement of swap	(612)	—	—	—	(612)	—	(612)
Amortization of deferred gains and losses on settlement of swaps	(140)	—	—	—	(140)	—	(140)
Shares of class A common stock issued in public offering	—	40	—	112,567	—	—	112,607
Shares of class A common stock issued under dividend reinvestment plan and stock purchase plan	—	5	—	12,835	—	—	12,840
Sale of shares of class A common stock under stock option agreement	—	—	—	180	—	—	180
Restricted class A common stock earned	—	—	—	2,759	—	—	2,759
Dividends declared on common stock	—	—	—	—	—	(48,294)	(48,294)
Balance at September 30, 2008	\$ (9,849)	\$ 217	\$ 4	\$ 554,454	\$ (12,152)	\$ (64,043)	\$ 478,480

See accompanying notes to consolidated financial statements.

Capital Trust, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
For the Nine Months Ended September 30, 2008 and 2007  
(in thousands)  
(unaudited)

	Nine Months Ended September 30,	
	2008	2007
Cash flows from operating activities:		
Net (loss) income	\$ (6,381)	\$ 55,727
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	140	1,450
Gain on extinguishment of debt	(6,000)	—
Provision for losses	56,000	—
Gain on sale of investment	(374)	—
Loss from equity investments	549	1,042
Distributions of income from equity investments in unconsolidated subsidiaries	—	425
Restricted class A common stock earned	2,759	3,570
Amortization of premiums and discounts on loans/CMBS, and debt, net and deferred interest on loans	(8,050)	(1,542)
Amortization of deferred gains and losses on settlement of swaps	(140)	(200)
Amortization of finance costs	4,003	4,134
Changes in assets and liabilities, net:		
Deposits and other receivables	3,442	1,909
Accrued interest receivable	3,026	(383)
Prepaid and other assets	544	(404)
Deferred income taxes	(501)	(50)
Deferred origination fees and other revenue	(1,047)	(1,897)
Accounts payable and accrued expenses	(4,662)	3,701
Net cash provided by operating activities	43,308	67,482
Cash flows from investing activities:		
Purchases of CMBS	(660)	(110,550)
Principal collections on and proceeds from CMBS	27,896	37,089
Origination, purchase and fundings of loans receivable	(115,344)	(869,623)
Principal collections on and proceeds from loans receivable	206,008	620,189
Equity investments in unconsolidated subsidiaries	(3,473)	(9,122)
Return of capital from equity investments in unconsolidated subsidiaries	—	1,616
Proceeds from total return swaps	—	1,815
Purchase of equipment and leasehold improvements	(43)	(546)
Payments for business purchased	—	(1,853)
Payment of capitalized costs	—	(115)
Increase in restricted cash	(12,535)	(2,034)
Net cash provided by (used in) investing activities	101,849	(333,134)
Cash flows from financing activities:		
Proceeds from repurchase obligations and secured debt	184,025	1,307,512
Repayment of repurchase obligations and secured debt	(273,674)	(1,123,078)

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Proceeds from credit facilities	25,000	125,000
Repayment of credit facilities	—	(50,000)
Issuance of junior subordinated debentures	—	77,325
Purchase of common equity in CT Preferred Trust I & CT Preferred Trust II	—	(2,325)
Repayment of collateralized debt obligations	(33,274)	(17,017)
Settlement of interest rate hedges	(612)	(153)
Payment of financing costs	(306)	(2,474)
Sale of class A common stock upon stock option exercise	180	952
Dividends paid on common stock	(82,532)	(52,355)
Proceeds from sale of shares of class A common stock	123,108	—
Proceeds from dividend reinvestment plan	2,339	—
Net cash (used in) provided by financing activities	(55,746)	263,387
Net increase (decrease) in cash and cash equivalents	89,411	(2,265)
Cash and cash equivalents at beginning of year	25,829	26,142
Cash and cash equivalents at end of period	\$ 115,240	\$ 23,877

See accompanying notes to consolidated financial statements.

Capital Trust, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
(unaudited)

1. Organization

References herein to “we,” “us” or “our” refer to Capital Trust, Inc. and its subsidiaries unless the context specifically requires otherwise.

We are a fully integrated, self-managed finance and investment management company that specializes in credit-sensitive structured financial products. To date, our investment programs have focused on loans and securities backed by commercial real estate assets. We invest for our own account directly on our balance sheet and for third parties through a series of investment management vehicles. From the commencement of our finance business in 1997 through September 30, 2008, we have completed over \$11.0 billion of investments in the commercial real estate debt arena. We conduct our operations as a real estate investment trust, or REIT, for federal income tax purposes and we are headquartered in New York City.

2. Summary of Significant Accounting Policies

The accompanying unaudited consolidated interim financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. The accompanying unaudited consolidated interim financial statements should be read in conjunction with the financial statements and the related management’s discussion and analysis of financial condition and results of operations filed with our Annual Report on Form 10-K for the fiscal year ended December 31, 2007. In our opinion, all material adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. The results of operations for the nine months ended September 30, 2008 are not necessarily indicative of results that may be expected for the entire year ending December 31, 2008. Our accounting and reporting policies conform in all material respects to generally accepted accounting principles, or GAAP, in the United States.

Principles of Consolidation

The accompanying unaudited consolidated interim financial statements include, on a consolidated basis, our accounts, the accounts of our wholly-owned subsidiaries and our interests in variable interest entities in which we are the primary beneficiary. All significant intercompany balances and transactions have been eliminated in consolidation. Our interests in CT Preferred Trust I and CT Preferred Trust II, the issuers of trust securities backed by our junior subordinated debentures, are accounted for using the equity method and their assets and liabilities are not consolidated into our financial statements due to our determination that CT Preferred Trust I and CT Preferred Trust II are variable interest entities in which we are not the primary beneficiary under Financial Accounting Standards Board, or FASB, Interpretation No. 46(R) “Consolidation of Variable Interest Entities”, or FIN 46R. We account for our co-investment interest in the private equity funds we manage, CT Mezzanine Partners III, Inc., or Fund III, and CT Opportunity Partners I, LP, or CTOPI, under the equity method of accounting. We also accounted for our investment in Bracor Inmobiliarios Ltda., or Bracor, under the equity method of accounting until we sold our investment in December 2007. As such, we report a percentage of the earnings or losses of the companies in which we have such investments equal to our ownership percentage on a single line item in the consolidated statement of income as income from equity investments. CTOPI is an investment company (under the American Institute of Certified Public Accountants Investment Company Guide) and therefore it maintains its financial records on a fair value basis. We have applied such accounting relative to our investment in CTOPI pursuant to the Emerging Issues Task Force, or EITF, Issue No. 85-12 “Retention of Specialized Accounting for Investments in Consolidation.”

#### Revenue Recognition

Interest income from our loans receivable is recognized over the life of the investment using the effective interest method and is recorded on the accrual basis. Fees, premiums, discounts and direct costs in connection with these investments 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. For loans where we have unfunded commitments, we amortize the appropriate items on a straight line basis. 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 special servicing and asset management services are recognized as services are rendered. We account for incentive fees we earn from our investment management business in accordance with Method 1 of EITF D-96, "Accounting for Management Fees Based on a Formula". Under Method 1, no incentive income is recorded until all contingencies have been eliminated.

Capital Trust, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (continued)  
(unaudited)

Cash and Cash Equivalents

We classify highly liquid investments with original maturities of three months or less from the date of purchase as cash equivalents. At September 30, 2008 and December 31, 2007, a majority of the cash and cash equivalents consisted of overnight deposits in demand deposit and money market accounts. As of, and for the periods ended, September 30, 2008 and December 31, 2007, we had bank balances in excess of federally insured amounts. We have not experienced any losses on our demand deposits, commercial paper or money market investments.

Restricted Cash

Restricted cash at September 30, 2008 was comprised of \$18.2 million that is on deposit with the trustee for our collateralized debt obligations, or CDOs, and is expected to be used to pay contractual interest and principal and to purchase replacement collateral for our reinvesting CDOs during their respective reinvestment periods. Restricted cash at December 31, 2007 was \$5.7 million.

Commercial Mortgage Backed Securities

We classify our commercial mortgage backed securities, or CMBS, pursuant to FASB Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities", or FAS 115, on the date of acquisition of the investment. On August 4, 2005, we decided to change the accounting classification of our CMBS investments from available-for-sale to held-to-maturity. Held-to-maturity investments are stated at cost adjusted for the amortization of any premiums or discounts and any premiums or discounts are amortized through the consolidated statements of income using the effective interest method. Other than in the instance of impairment, these held-to-maturity investments are shown in our financial statements at their adjusted values pursuant to the methodology described above.

We may also invest in CMBS and certain other securities which may be classified as available-for-sale. Available-for-sale securities are carried at estimated fair value with the net unrealized gains or losses reported as a component of accumulated other comprehensive income/(loss) in shareholders' equity. Many of these investments are relatively illiquid and management must estimate their values. In making these estimates, management utilizes market prices provided by dealers who make markets in these securities, but may, under certain circumstances, adjust these valuations based on management's judgment. Changes in the valuations do not affect our reported income or cash flows, but impact shareholders' equity and, accordingly, book value per share.

Income on these securities is recognized based upon a number of assumptions that are subject to uncertainties and contingencies. Examples include, among other things, the rate and timing of principal payments, including prepayments, repurchases, defaults and liquidations, the pass-through or coupon rate and interest rates. Additional factors that may affect our reported interest income on our mortgage backed securities include interest payment shortfalls due to delinquencies on the underlying mortgage loans and the timing and magnitude of credit losses on the mortgage loans underlying the securities that are impacted by, among other things, the general condition of the real estate market, including competition for tenants and their related credit quality, and changes in market rental rates. These uncertainties and contingencies are difficult to predict and are subject to future events that may alter the assumptions.

We account for CMBS under EITF 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets", or EITF 99-20. Under EITF 99-20, when significant changes in estimated cash flows from the cash flows previously estimated occur due to actual prepayment and credit loss experience and the present value of the revised cash flows using the current expected yield is less than the present value of the previously estimated remaining cash flows, adjusted for cash receipts during the intervening period, an

other than temporary impairment is deemed to have occurred. Accordingly, the security is written down to fair value with the resulting charge being included in income and a new cost basis established with the original discount or premium written off when the new cost basis is established. In accordance with this guidance, on a quarterly basis, when significant changes in estimated cash flows from the cash flows previously estimated occur due to actual prepayment and credit loss experience, we calculate a revised yield based upon the current amortized cost of the investment, including any other than temporary impairments recognized to date, and the revised cash flows. The revised yield is then applied prospectively to recognize interest income. Management must also assess whether unrealized losses on securities reflect a decline in value that is other than temporary, and, accordingly, write down the impaired security to its fair value, through a charge to income. Significant judgment of management is required in this analysis that includes, but is not limited to, making assumptions regarding the collectability of the principal and interest, net of related expenses, on the underlying loans.



Capital Trust, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (continued)  
(unaudited)

During the fourth quarter of 2004, we concluded that two of our CMBS investments had incurred other-than-temporary impairment and we incurred a charge of \$5.9 million through the income statement. At September 30, 2008, we believe there has not been any adverse change in estimated cash flows relating to existing CMBS investments; therefore we did not recognize any additional other than temporary impairment on any CMBS investments. Significant judgment of management is required in this analysis that includes, but is not limited to, making assumptions regarding the collectability of the principal and interest, net of related expenses, on the underlying loans.

From time to time we purchase CMBS and other investments in which we have a level of control over the issuing entity; we refer to these investments as controlling class investments. The presentation of controlling class investments in our financial statements is governed in part by FIN 46R. FIN 46R could require that certain controlling class investments be presented on a consolidated basis. Based upon the specific circumstances of certain of our CMBS investments that are controlling class investments and our interpretation of FIN 46R, specifically the exemption for qualifying special purpose entities as defined under FASB Statements of Financial Accounting Standard No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities", or FAS 140, we have concluded that the entities that have issued the controlling class investments should not be presented on a consolidated basis. We are aware that FAS 140 is currently under review by standard setters and that, as a result of this review, our current interpretation of FIN 46R and FAS 140 may change.

#### Loans Receivable and Reserve for Possible Credit Losses

We purchase and originate commercial real estate debt and related instruments, or Loans, to be held as long-term investments at amortized cost. Management must periodically evaluate each of these Loans for possible impairment. Impairment is indicated when it is deemed probable that we will not be able to collect all amounts due according to the contractual terms of the Loan. If a Loan were determined to be permanently impaired, we would write down the Loan through a charge to the reserve for possible credit losses. Given the nature of our Loan portfolio and the underlying commercial real estate collateral, significant judgment on the part of management is required in determining permanent impairment and the resulting charge to the reserve, which includes but is not limited to making assumptions regarding the value of the real estate that secures the loan. Each Loan in our portfolio is evaluated at least quarterly using our loan risk rating system which considers loan-to-value, debt yield, cash flow stability, exit plan, loan sponsorship, loan structure and other factors deemed necessary by management to assess the likelihood of delinquency or default. If we believe that there is a potential for delinquency or default, a downside analysis is prepared to estimate the value of the collateral underlying our Loan, and this potential loss is multiplied by the default likelihood to determine the size of the reserve. Actual losses, if any, could ultimately differ from these estimates.

#### Deferred Financing Costs

The deferred financing costs which are included in prepaid and other assets on our consolidated balance sheets include issuance costs related to our debt and are amortized using the effective interest method or a method that approximates the effective interest method.

#### Repurchase Obligations

In certain circumstances, we have financed the purchase of investments from a counterparty through a repurchase agreement with that same counterparty. We currently record these investments in the same manner as other investments financed with repurchase agreements, with the investment recorded as an asset and the related borrowing under any repurchase agreement as a liability on our consolidated balance sheets. Interest income earned on the investments and interest expense incurred on the repurchase obligations are reported separately on the consolidated statements of income. In February 2008, the FASB issued FASB Staff Position 140-3, "Accounting for Transfers of

Financial Assets and Repurchase Financing Transactions, or FSP 140-3, which provides guidance on accounting for transfers of financial assets and repurchase financings. FSP 140-3 presumes that an initial transfer of a financial asset and a repurchase financing shall not be evaluated as a linked transaction and shall be evaluated separately under FAS 140. If the linked transaction does not meet the requirements for sale accounting, the linked transaction shall generally be accounted for as a forward contract, as opposed to the current presentation, where the purchased asset and the repurchase liability are reflected separately on the balance sheet.

FSP 140-3 is effective on a prospective basis for fiscal years beginning after November 15, 2008, with earlier application not permitted. Given that FSP 140-3 is to be applied prospectively, we do not expect that the adoption of FSP 140-3 will have a material impact on our financial statements with respect to our existing transactions. New transactions entered into after December 31, 2008, that are subject to FSP 140-3 may be presented differently on our financial statements.

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Capital Trust, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (continued)  
(unaudited)

#### Interest Rate Derivative Financial Instruments

In the normal course of business, we use interest rate derivative financial instruments to manage, or hedge, cash flow variability caused by interest rate fluctuations. Specifically, we currently use interest rate swaps to effectively convert variable rate liabilities, that are financing fixed rate assets, to fixed rate liabilities. The differential to be paid or received on these agreements is recognized on the accrual basis as an adjustment to the interest expense related to the attendant liability. The interest rate swap agreements are generally accounted for on a held-to-maturity basis, and, in cases where they are terminated early, any gain or loss is generally amortized over the remaining life of the hedged item. These swap agreements must be effective in reducing the variability of cash flows of the hedged items in order to qualify for the aforementioned hedge accounting treatment. Changes in value of effective cash flow hedges are reflected in our financial statements through accumulated other comprehensive income/(loss) and do not affect our net income. To the extent a derivative does not qualify for hedge accounting, and is deemed a non-hedge derivative, the changes in its value are included in net income.

To determine the fair value of derivative instruments, we use third parties to periodically value our interests.

#### Income Taxes

Our financial results generally do not reflect provisions for current or deferred income taxes on our REIT taxable income. Management believes that we operate in a manner that will continue to allow us to be taxed as a REIT and, as a result, do not expect to pay substantial corporate level taxes (other than taxes payable by our taxable REIT subsidiaries which are accounted for in accordance with FASB Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes", or FAS 109). Many of these requirements, however, are highly technical and complex. If we were to fail to meet these requirements, we may be subject to federal, state and local income tax on current and past income, and we may also be subject to penalties.

In September 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109", or FIN 48. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FAS 109. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This interpretation was effective January 1, 2007. The adoption of FIN 48 did not have a material impact on our financial results.

#### Accounting for Stock-Based Compensation

We account for stock-based compensation in accordance with FASB Statement of Financial Accounting Standards No. 123(R) "Share Based Payment," or FAS 123(R). Upon adoption of FAS 123(R), as of January 1, 2006, we have elected to utilize the modified prospective method, and there was no impact from this adoption. Compensation expense for the time vesting of stock based compensation grants is recognized on the accelerated attribution method and compensation expense for performance vesting of stock based compensation grants is recognized on a straight line basis. Compensation expense relating to stock-based compensation is recognized in net income using a fair value measurement method.

#### Comprehensive Income

We comply with the provisions of the FASB Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income", or FAS 130, in reporting comprehensive income and its components in the full set of general purpose financial statements. Total comprehensive (loss)/income was (\$9.8) million and \$51.2 million, for the periods ended September 30, 2008 and 2007, respectively. The primary components of comprehensive income other than net

loss for the nine months ended September 30, 2008 were the unrealized gain/(loss) on derivative financial instruments and CMBS. At September 30, 2008, accumulated other comprehensive loss was \$12.2 million, comprised of unrealized gains on CMBS of \$7.0 million, unrealized losses on cash flow swaps of \$19.9 million, and \$736,000 of deferred realized gains on the settlement of cash flow swaps.

#### Earnings per Share of Common Stock

Earnings per share of common stock are presented based on the requirements of the FASB Statement of Financial Accounting Standards No. 128, "Earnings per Share", or FAS 128. Basic EPS is computed based on the net earnings applicable to common stock and stock units divided by weighted average number of shares of common stock and stock units outstanding during the period. Diluted EPS is based on the net earnings allocable to common stock and stock units, divided by weighted average number of shares of common stock and stock units and potentially dilutive common stock options.

Capital Trust, Inc. and Subsidiaries  
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(unaudited)

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 may ultimately differ from those estimates.

Reclassifications

Certain reclassifications have been made in the presentation of the prior periods consolidated financial statements to conform to the September 30, 2008 presentation.

Segment Reporting

We operate in two reportable segments. We have an internal information system that produces performance and asset data for the two segments along service lines.

The “Balance Sheet Investment” segment includes our portfolio of interest earning assets (including our co-investments in investment management vehicles) and the financing thereof.

The “Investment Management” segment includes the activities of our wholly-owned investment management subsidiary, CT Investment Management Co. LLC, or CTIMCO, and its subsidiaries. CTIMCO is a taxable REIT subsidiary and serves as the investment manager of Capital Trust, Inc., all of our investment management vehicles and all of our CDOs and serves as senior servicer and special servicer on certain of our investments and for third parties. In addition, CTIMCO owns certain of our assets.

Business Combination

On June 15, 2007, we purchased a healthcare loan origination platform, located in Birmingham, Alabama. We paid a \$2.6 million initial purchase price (\$1.9 million in cash and \$707,000 in common stock), and we have a contingent obligation to pay up to an additional \$1.8 million (\$1.1 million in cash and \$700,000 in common stock) on March 15, 2009, if the acquired business meets certain performance criteria. We have recorded \$2.1 million of goodwill associated with the initial purchase price.

Goodwill

Goodwill represents the excess of acquisition costs over the fair value of net assets of businesses acquired. Goodwill is reviewed annually in the fourth quarter to determine if there is impairment at a reporting unit level or more frequently if an indication of impairment exists. No impairment charges for goodwill were recorded during the nine months ended September 30, 2008.

New Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, “Fair Value Measurements”, or FAS 157. FAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. FAS 157 applies to reporting periods beginning after November 15, 2007. As discussed above, we report the changes in the value of effective cash flow hedges and our available for sale securities through accumulated other comprehensive income/(loss). We adopted FAS 157 as of January 1, 2008. As a result of the adoption of FAS 157, the fair value of our interest rate hedge liabilities decreased by \$961,000 due to the valuation adjustment related to our credit.



Capital Trust, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (continued)  
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The table below details the fair value measurements at September 30, 2008 (in millions):

Description	Fair Value Measurements at Reporting Date Using			
	Fair Value at September 30, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Interest rate hedge assets	\$ —	\$ —	\$ —	\$ —
Interest rate hedge liabilities	(19.9)	—	(19.9)	—
Total	\$ (19.9)	\$ —	\$ (19.9)	\$ —

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities”, or FAS 159. FAS 159 permits entities to choose to measure many financial instruments, and certain other items, at fair value. FAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. FAS 159 applies to reporting periods beginning after November 15, 2007. We adopted FAS 159 as of January 1, 2008. Adoption of FAS 159 had no impact on the consolidated financial statements as we did not elect to measure any financial instruments at fair value.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, “Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133”, or FAS 161. The use and complexity of derivative instruments and hedging activities have increased significantly over the past several years. Constituents have expressed concerns that the existing disclosure requirements in FASB Statement No. 133, “Accounting for Derivative Instruments and Hedging Activities”, do not provide adequate information about how derivative and hedging activities affect an entity’s financial position, financial performance, and cash flows. Accordingly, FAS 161 requires enhanced disclosures about an entity’s derivative and hedging activities and thereby improves the transparency of financial reporting. FAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. FAS 161 encourages, but does not require, comparative disclosures for earlier periods at initial adoption. We are currently evaluating the potential effect of the adoption of FAS 161 on our consolidated financial statements.

Capital Trust, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements (continued)  
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3. Commercial Mortgage Backed Securities

Activity relating to our CMBS investments for the nine months ended September 30, 2008 was as follows (\$ values in thousands):

Asset Type	Face Value	Book Value	Number of Securities	Number of Issues	Rating (1)	Weighted Average		Maturity (Years)(3)
						Coupon(2)	Yield(2)	
December 31, 2007								
Floating Rate	\$ 171,620	\$ 170,543	14	11	BB	8.16%	8.19%	2.6
Fixed Rate	744,790	706,321	65	45	BB+	6.69%	7.14%	7.5
Total/Weighted Average	916,410	876,864	79	56	BB+	6.97%	7.35%	6.5
Originations								
Floating Rate	3,300	660	1	—	BB+	8.93%	43.92%	8.8
Fixed Rate	—	—	—	—	—	—	—	—
Total/Weighted Average	3,300	660	1	—	BB+	8.93%	43.92%	8.8
Repayments & Other (4)								
Floating Rate	121	(301)	—	—	N/A	N/A	N/A	