PMC CAPITAL INC
Form 10-Q
November 15, 2002

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10 Q

(Mark One)

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

For the quarterly period ended **September 30, 2002**

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 1-09589

PMC CAPITAL, INC.

(Exact name of registrant as specified in its charter)

FLORIDA	59-2338439
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
18111 Preston Road, Suite 600, Dallas, TX 75252	(972) 349-3200
(Address of principal executive offices)	(Registrant s telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES __X__ NO ______

As of October 31, 2002, Registrant had outstanding 11,853,516 shares of Common Stock, par value $.01 per share.

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PART I

Financial Information

ITEM I.

Financial Statements

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PMC CAPITAL, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)

	September 30, 2002	December 31, 2001
	(Unaudited)	
ASSETS		
Investments at value:		
Loans receivable, net	$ 72,508	$ 107,392
Retained interests in transferred assets	39,465	33,537
Cash equivalents	30,931	16,989
Assets acquired in liquidation	2,762	329
Mortgage-backed security of affiliate	1,449	1,701
Investment in unconsolidated subsidiaries	356	67
Restricted investments	187	95
Total investments at value	147,658	160,110
Other assets:		
Due from affiliates	538	607
Cash	285	329
Accrued interest receivable	235	462
Property and equipment, net	111	133
Receivable for loans sold		184
Deferred charges, deposits and other assets	791	873
Total other assets	1,960	2,588
Total assets	$ 149,618	$ 162,698
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes and debentures payable	$ 64,820	$ 76,310
Dividends payable	1,485	2,434
Borrower advances	1,117	798
Accounts payable	898	753
Accrued interest payable	667	1,193
Due to affiliates	277	189
Other liabilities	1,156	1,113
Total liabilities	70,420	82,790
Commitments and contingencies		
Cumulative preferred stock of subsidiary	7,000	7,000
Shareholders equity:		
Common stock, authorized 30,000,000 shares of $0.01 par value, 11,853,516 shares issued and outstanding at September 30, 2002 and December 31, 2001	119	119
Additional paid-in capital	71,508	71,508
Dividends in excess of earnings	(1,587)	(340)
Net unrealized appreciation (depreciation) on investments	2,158	1,621

	72,198	72,908
Total liabilities and shareholders equity	$ 149,618	$ 162,698
Net asset value per common share	$ 6.09	$ 6.15

The accompanying notes are an integral part of these consolidated financial statements.

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PMC CAPITAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2002	2001	2002	2001
		(Unaudited)		
Investment income:				
Interest	$ 5,790	$ 9,066	$ 1,533	$ 2,567
Income from retained interests in transferred assets	3,799	3,814	1,281	1,355
Premium income	317	390	46	45
Other investment income, net	719	547	212	205
Total investment income	10,625	13,817	3,072	4,172
Advisory fee income	1,435	1,329	480	374
Equity in income of unconsolidated subsidiaries, net	287	304	92	117
Other income, net	110	221	60	173
Total income	12,457	15,671	3,704	4,836
Expenses:				
Interest	3,496	4,144	1,119	1,347
Salaries and related benefits	2,928	3,219	964	997
General and administrative	605	625	178	154
Legal and accounting	253	213	57	79
Rent	249	242	81	60
Profit sharing plan	158	182	83	34
Small Business Administration fees	152	82	93	21
Directors and shareholders expense	58	44	18	12
Total expenses	7,899	8,751	2,593	2,704
Income from continuing operations	4,558	6,920	1,111	2,132
Discontinued operations:				
Loss from operations of assets held for sale	(277)		(170)	
Net operating income	4,281	6,920	941	2,132
Realized and unrealized gain (loss) on investments:				
Investments written-off	(1,588)	(1,616)	(1,123)	(597)
Sale of assets	1,463	2,732		
Change in unrealized appreciation (depreciation) on investments	537	840	731	355
Total realized and unrealized gain (loss) on investments	412	1,956	(392)	(242)
Net operating income and realized and unrealized gain (loss) on investments	$ 4,693	$ 8,876	$ 549	$ 1,890

Preferred dividends	$ 187	$ 187	$ 63	$ 62
Basic weighted average common shares outstanding	11,854	11,854	11,854	11,854
Diluted weighted average common shares outstanding	11,854	11,855	11,854	11,854
Basic and diluted earnings per common share	$ 0.38	$ 0.73	$ 0.04	$ 0.15

The accompanying notes are an integral part of these consolidated financial statements.

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PMC CAPITAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Nine Months Ended September 30,	
	2002	**2001**
	(Unaudited)	
Cash flows from operating activities:		
Net operating income and realized and unrealized gain (loss) on investments	$ 4,693	$ 8,876
Adjustments to reconcile net operating income and realized and unrealized gain (loss) on investments to net cash provided by operating activities:		
Loans funded, held for sale	(4,205)	(5,880)
Proceeds from sale of guaranteed loans	3,962	6,311
Realized and unrealized (gain) loss on investments	(412)	(1,956)
Unrealized premium (income) expense, net	10	(15)
Depreciation and amortization	190	121
Accretion of loan discount and deferred fees	(114)	(55)
Equity in income of unconsolidated subsidiaries, net	(287)	(304)
Other operating assets and liabilities	100	(815)
Net cash provided by operating activities	3,937	6,283
Cash flows from investing activities:		
Loans funded	(23,489)	(52,501)
Principal collected	12,722	6,682
Proceeds from retained interests in transferred assets	3,661	2,509
Proceeds from mortgage-backed security of affiliate	246	123
Purchase of property and equipment and other assets	(373)	(33)
Investment in retained interests in transferred assets	(2,933)	(2,127)
Investment in restricted cash	(91)	(299)
Advances (to) from affiliates, net	158	(104)
Net cash used in investing activities	(10,099)	(45,750)
Cash flows from financing activities:		
Proceeds from structured loan sale transactions, net	37,901	44,511
Proceeds from issuance of notes payable		3,333
Repayment of SBA debentures	(11,490)	
Payment of dividends on common stock	(6,164)	(8,297)
Payment of dividends on preferred stock	(187)	(187)
Net cash provided by financing activities	20,060	39,360
Net increase (decrease) in cash and cash equivalents	13,898	(107)
Cash and cash equivalents, beginning of year	17,318	21,909
Cash and cash equivalents, end of period	$ 31,216	$ 21,802
Supplemental disclosures:		
	$ 4,022	$ 4,546

Interest paid	

The accompanying notes are an integral part of these consolidated financial statements.

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PMC CAPITAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Interim Financial Statements:

The accompanying consolidated balance sheet of PMC Capital, Inc. (PMC Capital) and its wholly-owned regulated investment company subsidiaries (collectively, we , us or our) as of September 30, 2002 and the consolidated statements of income for the three and nine months ended September 30, 2002 and 2001 and cash flows for the nine months ended September 30, 2002 and 2001 have not been audited by independent accountants. In the opinion of our management, the financial statements reflect all adjustments necessary to present fairly the financial position at September 30, 2002 and the results of operations for the three and nine months ended September 30, 2002 and 2001. These adjustments are of a normal recurring nature.

Certain notes and other information have been omitted from the interim financial statements presented in this Quarterly Report on Form 10-Q. Therefore, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended December 31, 2001.

The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect (i) the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and (ii) the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Our most sensitive estimates involve valuing and recording income on our retained interests in transferred assets and in determining the value of our loans receivable and assets acquired in liquidation.

The results for the three and nine months ended September 30, 2002 are not necessarily indicative of future financial results.

Note 2. Reclassifications:

Certain prior period amounts have been reclassified to conform to the current year presentation.

Note 3. Business and Consolidation:

Business

PMC Capital is a diversified closed-end management investment company that operates as a business development company under the Investment Company Act of 1940, as amended (the 1940 Act). Our common stock is traded on the American Stock Exchange under the symbol PMC.

We are primarily engaged in the business of originating loans to small businesses either directly or through our three principal lending subsidiaries: First Western SBLC, Inc. (First Western), PMC Investment Corporation (PMCIC) and Western Financial Capital Corporation (Western Financial).

First Western, PMCIC and Western Financial are registered under the 1940 Act as diversified closed-end management investment companies. First Western is licensed as a small business lending company that originates loans through the SBA s 7(a) guaranteed loan program. PMCIC is a licensed specialized small business investment companies under the Small Business Investment Act of 1958, as amended. Western Financial is a licensed small business investment company under the Small Business Act of 1958, as amended. In addition, PMC Capital is either directly or indirectly the sole shareholder or partner of several non-investment company act subsidiaries. These are: PMC Advisers, Ltd. and its subsidiary (PMC Advisers); PMC Funding Corp. and its subsidiary (PMC Funding); PMC Capital, L.P. 1998-1 (the 1998 Partnership) and PMC Capital, L.P. 1999-1 (the 1999 Partnership).

In addition, at September 30, 2002, PMC Capital owned approximately 28% of PMC Joint Venture, L.P. 2000 (the 2000 Joint Venture), 61% of PMC Joint Venture, L.P. 2001 (the 2001 Joint Venture) and 61% of PMC Joint Venture, L.P. 2002-1 (the 2002 Joint Venture, and together with the 1998 Partnership, the 1999 Partnership, the 2000 Joint Venture and the 2001 Joint Venture, the SPEs). PMC Commercial Trust (PMC

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(Unaudited)

Commercial), our affiliate through common management, owns the remaining interests in the 2000 Joint Venture, the 2001 Joint Venture and the 2002 Joint Venture (together, the Joint Ventures).

Consolidation

The consolidated financial statements include the accounts of PMC Capital and its wholly-owned regulated investment company subsidiaries, First Western, PMCIC and Western Financial. All material intercompany balances and transactions have been eliminated.

PMC Advisers, which acts as the investment adviser for PMC Commercial, and PMC Funding, which holds assets on our behalf, are accounted for using the equity method of accounting in conformity with Federal securities laws. Our ownership interests in the SPEs are accounted for as retained interests in transferred assets (Retained Interests) in accordance with Statement of Financial Accounting Standards (SFAS) No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (SFAS No. 140).

Note 4. Retained Interests in Transferred Assets:

In our structured loan sale transactions, we contributed loans receivable to an SPE in exchange for an ownership interest in that entity. The SPE issued notes payable (the Structured Notes) (usually through a private placement) to third parties (Structured Noteholders). The SPE then distributed a portion of the proceeds from the Structured Notes to us. The Structured Notes are collateralized solely by the assets of the SPE which means that should the SPE fail to make payments on the Structured Notes, the Structured Noteholders have no recourse to us. Upon the completion of our structured loan sale transactions, we recorded the transfer of loans receivable as a sale and the SPE meets the definition of a qualifying SPE as outlined in SFAS No. 140. As a result, the loans receivable contributed to the SPE, the Structured Notes issued by the SPE, and the operating results of the SPE are not included in our consolidated financial statements. The difference between (i) the carrying value of the loans receivable sold and (ii) the sum of (a) the cash received and (b) the present value of the estimated future cash flows from the Retained Interests constituted the gain or loss on sale. Retained Interests are carried at fair value (determined as described below), with realized and unrealized gains and losses included in our consolidated statements of income.

We completed a structured loan sale transaction on April 12, 2002. Information pertaining to the transaction (as of the date completed) was as follows. Amounts represent PMC Capital s share of the 2002 Joint Venture.

	2002 Joint Venture
	(Dollars in thousands)
Principal amount of sold loans	$ 43,218
Structured Notes issued	$ 38,897
Funding of reserve	$ 1,729
Interest rate on the Structured Notes	6.67%
Structured Notes rating(1)	"Aaa"
Weighted average interest rate on loans	9.53%
Weighted average remaining life of loans(2)	5.05 years
Aggregate losses assumed(3)	2.71%
Prepayment rate assumption(4)	9.00%
Discount rate assumptions(5)	8.2% to 12.9%
Net gain recorded	$ 1,463
Value of Retained Interests	$ 8,772

(1) Structured Notes issued by the SPE were rated by Moody s Investors Service, Inc.

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PMC CAPITAL, INC. AND SUBSIDIARIES
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(Unaudited)

(2) *The weighted average remaining life of loans was calculated by summing the product of (i) the sum of the principal collections expected in each future period multiplied by (ii) the number of periods until collection, and then dividing that total by (iii) the initial principal balance.*

(3) *This percentage represents aggregate estimated losses as a percentage of the principal outstanding based upon per annum losses that ranged from 0.5% to 0.8%.*

(4) *The prepayment rate was based on anticipated principal payments considering the loans sold and other similar loans.*

(5) *The initial discount rates utilized were (i) 8.2% for our required overcollateralization, (ii) 9.9% for our reserve fund and (iii) 12.9% for our interest-only strip receivable.*

Information pertaining to our structured loan sale transactions as of September 30, 2002 was as follows. Balances represent PMC Capital s share of the respective Joint Ventures.

	1998 Partnership	1999 Partnership	2000 Joint Venture	2001 Joint Venture	2002 Joint Venture
			(Dollars in thousands)		
Principal outstanding on sold loans	$ 27,468	$ 40,959	$ 24,901	$ 46,873	$ 42,518
Structured Notes balance outstanding	$ 26,081	$ 39,251	$ 22,142	$ 43,005	$ 38,263
Cash in the collection account	$ 323	$ 2,341	$ 207	$ 441	$ 404
Cash in the reserve account	$ 2,211	$ 2,574	$ 1,495	$ 2,821	$ 2,559
Weighted average interest rate on loans	Prime + 1.22%	9.45%	9.26%	9.74%	9.54%
Discount rate assumptions(1)	4.8% to 11.8%	7.2% to 12.0%	7.8% to 12.6%	6.9% to 11.7%	7.2% to 12.0%
Prepayment rate assumption(2)	11.00%	10.00%	9.00%	9.00%	9.00%
Weighted average remaining life of loans(3)	3.63 years	3.75 years	3.74 years	5.07 years	4.94 years
Aggregate losses assumed(4)	2.64%	1.99%	5.63%	3.08%	2.86%
Aggregate losses to date	%	%	%	%	%

(1) *The discount rates utilized were (i) 4.8% to 7.8% for our required overcollateralization, (ii) 8.7% to 9.6% for our reserve funds and (iii) 11.7% to 12.6% for our interest-only strip receivables; however, the interest-only strip receivable of the 2000 Joint Venture was written down to zero.*

(2) *The prepayment rate was based on the actual performance of the loan pools, adjusted for anticipated principal payments considering other similar loans.*

(3) *The weighted average remaining life of loans was calculated by summing the product of (i) the sum of the principal collections expected in each future period multiplied by (ii) the number of periods until collection, and then dividing that total by (iii) the remaining principal balance.*

(4) *Represents aggregate estimated losses as a percentage of the principal outstanding based upon per annum estimated losses that ranged from 0.3% to 0.8%. In addition, to the extent we have identified loans on which recovery of the underlying principal is in doubt, we reduce expected future cash flows by the anticipated shortfall.*

The value of our Retained Interests is based on an estimate of the discounted future cash flows we will receive. In determining the present value of expected future cash flows, estimates are made in determining (i) the amount and timing of those cash flows and (ii) the discount rates. The amount and timing of cash flows is generally determined based on our estimates of loan losses and anticipated prepayment speeds relating to the loans receivable contributed to the SPE. Actual loan losses and prepayments may vary significantly from our assumptions. The discount rates that we utilize in computing the net present value of future cash flows are based upon our estimate of the inherent risks associated with each cash flow stream. Due to the limited number of entities that conduct transactions with similar assets, the relatively small size of our Retained Interests and the limited number of buyers for such assets, no readily ascertainable market exists. Therefore, if we were forced to immediately liquidate some or all of our Retained Interests, the proceeds of such liquidation may be significantly less than the current value of such Retained Interests.

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In determining the fair value of our Retained Interests related to First Western for our SBA 7(a) transactions, our assumptions at September 30, 2002 included prepayment speeds ranging from 20% to 30% per annum, loss rates ranging from 0.3% to 0.6% per annum and discount rates ranging from 6.0% to 11.9%.

The components of our Retained Interests are as follows:

(1) Our required overcollateralization which consists of the cash flows associated with the portion of the principal and interest collected by the SPE from the subordinated portion of the loans receivable sold (the OC Piece). The OC Piece represents the excess of the loans receivable contributed to the SPE over the notes payable issued by the SPE and serves as additional collateral for the Structured Noteholders.

(2) The Reserve Fund and the interest earned thereon. The Reserve Fund represents cash that is required to be kept in a liquid cash account by the SPE as collateral for the Structured Noteholders, a portion of which was contributed by us to the SPE upon formation, and a portion of which is built up over time by the SPE from the cash flows of the underlying loans receivable.

(3) The interest-only strip receivable (the IO Receivable). The IO Receivable is comprised of the cash flows that will be received by us in the future after payment by the SPE of (a) all interest and principal due to the Structured Noteholders, (b) all principal and interest on the OC Piece, (c) any required funding of the Reserve Fund and (d) on-going costs of the transaction.

Our Retained Interests consisted of the following:

	September 30, 2002				
	Value				
	OC Piece	Reserve Fund	IO Receivable	Total	Cost
			(In thousands)		
First Western	$	$ 845	$ 1,926	$ 2,771	$ 2,321
1998 Partnership	1,594	1,757	932	4,283	3,755
1999 Partnership	4,117	2,090	2,228	8,435	7,977
2000 Joint Venture	2,948	786		3,734	3,533
2001 Joint Venture	4,752	2,253	3,654	10,659	9,505
2002 Joint Venture	5,078	2,019	2,486	9,583	9,048
	$ 18,489	$ 9,750	$ 11,226	$ 39,465	$ 36,139

	December 31, 2001				
	Value				
	OC Piece	Reserve Fund	IO Receivable	Total	Cost
			(In thousands)		
First Western	$	$ 743	$ 2,238	$ 2,981	$ 2,587
1998 Partnership	1,871	2,048	1,150	5,069	4,686
1999 Partnership	4,428	2,441	3,149	10,018	9,532

2000 Joint Venture	3,083	1,238	989	5,310	5,091
2001 Joint Venture	4,397	1,825	3,937	10,159	9,656
	$13,779	$ 8,295	$11,463	$33,537	$31,552

The 2000 Joint Venture has $3.9 million of non-accrual loans receivable currently in the process of liquidation. Due to anticipated reductions in future cash flows related to these loans, our IO Receivable for the 2000 Joint Venture was written down to zero and the value of the Reserve Fund was also reduced. These value reductions caused realized losses of $1,394,000 which were recorded during the nine months ended September 30, 2002.

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PMC CAPITAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

The following is a sensitivity analysis of our Retained Interests as of September 30, 2002 to highlight the volatility that results when prepayments, losses and discount rates are different than our assumptions:

Changed Assumption	Pro-Forma Value	Asset Change
Losses increase by 50 basis points per annum(1)	$36,593,000	($2,872,000)
Losses increase by 100 basis points per annum(1)	$33,808,000	($5,657,000)
Rate of prepayment increases by 5% per annum(2)	$37,823,000	($1,642,000)
Rate of prepayment increases by 10% per annum(2)	$36,663,000	($2,802,000)
Discount rates increase by 100 basis points	$37,821,000	($1,644,000)
Discount rates increase by 200 basis points	$36,281,000	($3,184,000)

(1) If we experience losses in excess of anticipated losses, the effect on our Retained Interests would first be to reduce the value of the IO Receivables. To the extent the IO Receivables could not fully absorb the losses, the effect would then be to reduce the value of our Reserve Funds and then the value of our OC Pieces.

(2) For example, an 8% assumed rate of prepayment would be increased to 13% or 18% based on increases of 5% or 10% per annum, respectively.

These sensitivities are hypothetical and should be used with caution. Pro-forma values based on changes in these assumptions generally cannot be extrapolated since the relationship of the change in assumption to the change in fair value may not be linear. The effect of a variation in a particular assumption on the fair value of our Retained Interests is calculated without changing any other assumption. In reality, changes in one factor are not isolated from changes in another which might magnify or counteract the sensitivities.

The following information summarizes the financial position of the SPEs at September 30, 2002 and December 31, 2001. We own 100% of the 1998 Partnership and the 1999 Partnership. At September 30, 2002, we owned approximately 28% of the 2000 Joint Venture, 61% of the 2001 Joint Venture and 61% of the 2002 Joint Venture. At December 31, 2001, we owned approximately 33% of the 2000 Joint Venture and 60% of the 2001 Joint Venture. Balances for the Joint Ventures represent 100% of the limited partnership interests.

Summary of Financial Position:

	1998 Partnership		1999 Partnership	
	September 30, 2002	December 31, 2001	September 30, 2002	December 31, 2001
	(In thousands)			
Loans Receivable, Net	$27,209	$29,817	$40,959	$47,909
Total Assets	$29,870	$35,438	$46,115	$55,761
Notes Payable	$26,081	$30,663	$39,251	$47,560
Total Liabilities	$26,163	$30,792	$39,468	$47,823
Partners Capital	$ 3,707	$ 4,646	$ 6,647	$ 7,938

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PMC CAPITAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	2000 Joint Venture		2001 Joint Venture		2002 Joint Venture
	September 30, 2002	December 31, 2001	September 30, 2002	December 31, 2001	September 30, 2002
			(In thousands)		
Loans Receivable, Net	$74,342	$79,695	$75,972	$78,177	$69,493
Total Assets	$79,974	$85,716	$81,655	$83,600	$74,669
Notes Payable	$67,038	$71,100	$69,539	$71,768	$62,528
Total Liabilities	$67,241	$71,316	$69,724	$71,958	$62,702
Partners Capital	$12,733	$14,400	$11,931	$11,642	$11,967

The following information summarizes the results of operations of our SPEs. Amounts represent 100% of the limited partnership interests for the Joint Ventures.

Summary of Operations:

	Nine Months Ended September 30,			
	1998 Partnership		1999 Partnership	
	2002	2001	2002	2001
	(In thousands)			
Interest Income	$1,354	$2,459	$3,200	$3,984
Total Revenues	$1,391	$2,528	$3,519	$4,171
Interest Expense	$ 765	$1,704	$2,072	$2,467
Total Expenses	$ 969	$1,791	$2,187	$2,602
Net Income	$ 422	$ 737	$1,332	$1,569

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PMC CAPITAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	Nine Months Ended September 30,				
	2000 Joint Venture		2001 Joint Venture		2002 Joint Venture
	2002	2001	2002	2001(1)	2002(2)
	(In thousands)				
Interest Income	$5,370	$6,033	$5,638	$2,066	$3,187
Total Revenues	$5,615	$6,256	$5,707	$2,223	$3,216
Interest Expense	$3,794	$3,979	$3,361	$1,228	$1,959
Total Expenses	$4,889	$4,163	$3,546	$1,285	$2,057
Net Income	$ 726	$2,093	$2,161	$ 938	$1,159

(1) There were no operations prior to June 27, 2001.
(2) There were no operations prior to April 12, 2002.

Our ownership of the Joint Ventures is based on our share of the capital of the respective Joint Ventures. Our share of the cash flows from the Joint Ventures is based upon the remaining principal balance of the underlying loans receivable contributed by us to the respective Joint Ventures.

Our limited partnership allocation of the assets, liabilities and partners capital of the Joint Ventures was as follows:

	September 30, 2002			December 31, 2001	
	2000 Joint Venture	2001 Joint Venture	2002 Joint Venture	2000 Joint Venture	2001 Joint Venture
	(In thousands)				
Loans Receivable, Net	$23,995	$46,873	$42,518	$26,612	$48,648
Assets	$25,808	$50,374	$45,689	$28,589	$51,922
Liabilities	$22,209	$43,119	$38,370	$23,810	$44,933
Partners Capital	$ 3,599	$ 7,255	$ 7,319	$ 4,779	$ 6,989

Our limited partnership allocation of the net income of the Joint Ventures was as follows:

	2002		2001	
	Nine Months Ended September 30, 2002	Period From April 12 (Inception) to September 30, 2002	Nine Months Ended September 30, 2001	Period From June 27 (Inception) to to September 30, 2001

	2000 Joint Venture	2001 Joint Venture	2002 Joint Venture	2000 Joint Venture	2001 Joint Venture
			(In thousands)		
Net Income (Loss)	$(633)	$1,294	$664	$504	$ 484

In accordance with SFAS No. 140, our consolidated financial statements do not include the SPE assets, liabilities, partners capital, revenues or expenses. As a result, at September 30, 2002 and December 31, 2001 our consolidated balance sheets do not include the $197.9 million and $171.7 million of assets, respectively, and

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PMC CAPITAL, INC. AND SUBSIDIARIES
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$169.3 million and $147.4 million of liabilities, respectively, related to our structured loan sale transactions recorded by the SPEs. Our Retained Interests related to these structured loan sale transactions were $36.7 million and $30.6 million at September 30, 2002 and December 31, 2001, respectively.

The net unrealized appreciation on our Retained Interests at September 30, 2002 and December 31, 2001 was $3.3 million and $2.0 million, respectively. The net increase of $1.3 million primarily resulted from a decrease in the discount rates used to value our Retained Interests resulting from the lower interest rate environment at September 30, 2002 compared to December 31, 2001. Any appreciation (depreciation) of our Retained Interests is included in the accompanying statements of income as either realized loss (if there is a reduction in expected future cash flows) or unrealized gain (loss) on investments.

The income from our Retained Interests is comprised of the yield earned on our Retained Interests which is determined based on our estimates of future cash flows. We update our cash flow assumptions on a quarterly basis and any changes to cash flow assumptions affect the yield on our Retained Interests. The annualized yield on our Retained Interests was as follows:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2002	2001	2002	2001
Annualized Yield	13.6%	14.4%	12.9%	13.2%

We are the servicer for all loans held by the SPEs. Servicing fee income for the three months ended September 30, 2002 and 2001 related to loans receivable held by the SPEs was approximately $141,000 and $117,000, respectively. Servicing fee income for the nine months ended September 30, 2002 and 2001 related to loans receivable held by the SPEs was approximately $392,000 and $363,000, respectively. Servicing fee income is included in other investment income, net in our consolidated statements of income. We have not established a servicing asset or liability as our servicing fees are considered adequate compensation.

Pursuant to the trust indentures related to the Structured Notes, we received approximately $7.4 million and $6.3 million in cash distributions from our SPEs during the nine months ended September 30, 2002 and 2001, respectively.

Note 5. Notes and Debentures Payable:

We repaid $11,490,000 in debentures due the SBA during September 2002. Debentures outstanding at September 30, 2002 and December 31, 2001 were $19.8 million and $31.3 million, respectively.

We have a $10 million uncollateralized revolving credit facility, as amended, which expires March 2003. Advances pursuant to the credit facility bear interest at our option of the bank s prime rate less 50 basis points or LIBOR plus 175 basis points. As of September 30, 2002 and December 31, 2001, we had no borrowings outstanding under this facility. The credit facility requires us to meet certain covenants (terms as defined in the agreement), the most restrictive of which requires that (i) the ratio of net charge-offs to net loans receivable not exceed 2%, (ii) the ratio of assets to debt may not fall below 110% for PMC Capital and 135% including our consolidated subsidiaries and (iii) the problem loans percentage cannot exceed 10% of our serviced loan portfolio. At September 30, 2002, we were in compliance with all covenants of this facility.

Our uncollateralized notes payable outstanding at both September 30, 2002 and December 31, 2001 were $45.0 million. The notes mature from December 2002 to July 2006 with a weighted average interest rate of 5.2% at September 30, 2002. These notes payable require us to meet certain covenants, the most restrictive of which require (i) that net loans receivable exceed 150% of funded debt, (ii) loan losses for any 12-month period must not exceed 3% of net loans receivable and (iii) our consolidated earnings plus interest expense must exceed 150% of interest expense. At September 30, 2002, we were in compliance with all covenants of these notes.

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Note 6. Discontinued Operations:

At September 30, 2002 and December 31, 2001, the aggregate value of our assets acquired in liquidation, as reduced for anticipated selling costs, was estimated to be approximately $2,762,000 and $329,000, respectively. Our assets acquired in liquidation at September 30, 2002 consist primarily of three hotel properties. We are currently marketing these assets.

The discontinued operations of our assets acquired in liquidation consisted of the following:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2002	2001	2002	2001
	(In thousands)			
Room revenue	$ 97	$	$ 48	$
Salaries and wages	(103)		(66)	
Other operating expenses	(271)		(152)	
Loss from operations of assets held for sale	$ (277)	$	$ (170)	$

None of our assets acquired in liquidation held at September 30, 2001 were operating during the three or nine months ended September 30, 2001.

Note 7. Net Unrealized Appreciation (Depreciation) on Investments and Realized and Unrealized Gain (Loss) on Investments:

Net unrealized appreciation (depreciation) on investments was comprised of the following:

	September 30, 2002	December 31, 2001
	(In thousands)	
Loans receivable	$ (674)	$ (443)
Retained Interests	3,326	1,985
Mortgage-backed security of affiliate	69	79
Assets acquired in liquidation	(563)	
Net unrealized appreciation (depreciation) on investments	$ 2,158	$ 1,621

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Realized and unrealized gain (loss) on investments was as follows:

	Nine Months Ended September 30, 2002			
	Retained Interests(1)	Assets Acquired in Liquidation	Loans Receivable	Total
Investments written-off	$(1,425,000)	$	$ (163,000)	$(1,588,000)
Sale of assets			1,463,000	1,463,000
Change in unrealized appreciation (depreciation) on investments	1,331,000	(563,000)	(231,000)	537,000
Total realized and unrealized gain (loss) on investments	$ (94,000)	$(563,000)	$1,069,000	$ 412,000

(1) *Includes the mortgage-backed security of our affiliate.*

	Three Months Ended September 30, 2002			
	Retained Interests(1)	Assets Acquired in Liquidation	Loans Receivable	Total
Investments written-off	$(1,123,000)	$	$	$(1,123,000)
Change in unrealized appreciation (depreciation) on investments	981,000	(103,000)	(147,000)	731,000
Total realized and unrealized gain (loss) on investments	$ (142,000)	$(103,000)	$(147,000)	$ (392,000)

(1) *Includes the mortgage-backed security of our affiliate.*

	Nine Months Ended September 30, 2001			
	Retained Interests(1)	Assets Acquired in Liquidation	Loans Receivable	Total
Investments written-off	$(1,241,000)	$	$ (375,000)	$(1,616,000)
Sale of assets			2,732,000	2,732,000
Change in unrealized appreciation (depreciation) on investments	997,000		(157,000)	840,000
Total realized and unrealized gain (loss) on investments	$ (244,000)	$	$2,200,000	$ 1,956,000

(1) Includes the mortgage-backed security of our affiliate.

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	Three Months Ended September 30, 2001			
	Retained Interests(1)	Assets Acquired in Liquidation	Loans Receivable	Total
Investments written-off	$(536,000)	$	$ (61,000)	$(597,000)
Change in unrealized appreciation (depreciation) on investments	510,000		(155,000)	355,000
Total realized and unrealized gain (loss) on investments	$ (26,000)	$	$(216,000)	$(242,000)

(1) Includes the mortgage-backed security of our affiliate.

Note 8. Earnings Per Common Share Computations:

The computations of basic earnings per common share are based on our weighted average shares outstanding. The weighted average shares outstanding were 11,854,000 for the three and nine months ended September 30, 2002 and 2001. For purposes of calculating diluted earnings per share, the weighted average shares outstanding were increased by approximately 1,000 shares for the nine months ended September 30, 2001. There was no change in the weighted average shares outstanding for the effect of stock options during the three months ended September 30, 2002 and 2001 and the nine months ended September 30, 2002 since the stock options were anti-dilutive.

Earnings are defined as net operating income and realized and unrealized gain (loss) on investments and are reduced by the preferred stock dividend requirements of PMCIC.

Note 9. Dividends Paid and Declared:

In January, April and July 2002, we paid quarterly dividends of $0.20, $0.16 and $0.16 per share, respectively, to common shareholders of record on December 31, 2001, March 28, 2002, and June 28, 2002, respectively. The Board of Directors declared a dividend of $0.12 per share to common shareholders of record on September 30, 2002, which was paid on October 7, 2002. Dividends declared for the nine months ended September 30, 2002 and 2001 were $0.44 per share and $0.65 per share, respectively.

Note 10. Recently Issued Accounting Pronouncements:

In April 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections. The statement, which was effective for financial statements issued for fiscal years beginning after May 15, 2002 and encourages early application, updates, clarifies and simplifies existing accounting pronouncements. Specifically, the statement rescinds SFAS No. 4, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of the related income tax effect. As a result of this rescission, the criteria in APB Opinion No. 30 will now be used to determine the classification of gains and losses resulting from the extinguishment of debt. The statement also amends SFAS No. 13 to require that when a capital lease is modified in such a way that the change in the lease provisions establishes a new lease which is classified as an operating lease, the asset and lease obligation under the capital lease should be removed, a gain or loss for the difference should be recorded and the new lease should be accounted for as an operating lease. The impact from the implementation of this statement, which we believe will not have a material impact on our consolidated financial statements, will be dependent upon (i) any future debt extinguishments and (ii) whether we enter into capital leases and make subsequent modifications to those leases.

In June 2002, SFAS No. 146, Accounting for Exit or Disposal Activities was issued. SFAS No. 146 addresses significant issues regarding the recognition, measurement and reporting of cost associated with exit and disposal

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activities, including restructuring activities that are currently accounted for pursuant to the guidance that the Emerging Issues Task Force has set forth in Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). The scope of SFAS No. 146 also includes (i) costs related to terminating a contract that is not a capital lease and (ii) termination benefits that employees who are involuntarily terminated receive under the terms of a one-time benefit arrangement that is not an ongoing benefit arrangement or an individual deferred compensation contract. SFAS No. 146 will be effective for financial statements issued for fiscal years beginning after December 15, 2002. We have not yet determined the impact, if any, of SFAS No. 146 on our results of operations and financial condition.

Note 11. Commitments and Contingencies:

Loan commitments and approvals outstanding at September 30, 2002, including the unfunded portion of projects in the construction phase, amounted to approximately $40.6 million. Of these commitments, $8.0 million are for loans to be originated by First Western, a portion of which we expect to be sold into the secondary market. Approximately 97% of these commitments are for variable-rate loans based on the prime rate or LIBOR at spreads over prime and LIBOR ranging from 1.00% to 2.75% and 3.25% to 4.50%, respectively. Commitments generally have fixed expiration dates and require payment of a fee to us. Since some commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

PMC Capital and PMC Commercial have entered into indemnification agreements regarding the performance of their respective loans receivable sold to the Joint Ventures. To the extent that poor performance by either PMC Capital or PMC Commercial s sold loans receivable (the Underperforming Company) is pervasive enough to cause the other company (the Performing Company) to not receive cash flow that it otherwise would have received, then the Underperforming Company must make the Performing Company whole. If the cash flow reduction is considered to be temporary, then interest will be paid as compensation to the Performing Company. In general, when a loan is liquidated, it may cause a deferral of cash flow to the Performing Company and, as a result, interest would be charged to the Underperforming Company until the cash flow from the Joint Venture repays the Performing Company. The 2000 Joint Venture has $3.9 million of non-accrual loans receivable (contributed by PMC Capital) currently in the process of liquidation. We expect that there will be losses incurred upon liquidation of these loans. When these loans are liquidated, they will cause a deferral of cash flow to PMC Commercial and, as a result, interest would be charged until the cash flow from the Joint Venture repays PMC Commercial. If the reduction of cash flows is deemed permanent, (*i.e.,* to the extent that the Underperforming Company will not be able to satisfy the shortfall with the assets they have contributed to the related structured loan sale transaction), the reduction in cash flows must be paid to the Performing Company by the Underperforming Company. At September 30, 2002, our maximum exposure under these indemnification agreements was approximately $23.8 million which represents the value of the Retained Interests reflected on PMC Commercial s consolidated balance sheet. Based on our present cash flow assumptions, including stress test analyses of increasing the anticipated losses on each of the loan pools, it does not appear that the loans receivable sold by us will cause any permanent cash flow reductions to PMC Commercial nor will the loans receivable sold by PMC Commercial cause any permanent cash flow reductions to us. If the performance of our sold loans receivable deteriorates, it may be necessary for us to perform under these indemnification agreements.

When our structured loan sale transactions were completed, the SPE entered into credit enhancement agreements that governed the assets and the flow of funds in and out of the SPE formed as part of the structured loan sale transactions. Generally, the credit enhancement agreements contain specified limits on the delinquency, default and loss rates on loans receivable included in each SPE. If, at any measurement date, the delinquency, default or loss rate with respect to any SPE were to exceed the specified limits, provisions of the credit enhancement agreements would automatically increase the level of credit enhancement requirements for that SPE. During the period in which the specified delinquency, default or loss rate was exceeded, excess cash flow from the SPE, if any, would be used to fund the increased credit enhancement levels instead of being distributed, which would delay or reduce our distribution. As a result of the problem loans in the 2000 Joint Venture (described above), a credit enhancement event will be triggered effective November 15, 2002. As a consequence, some of our cash

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flows relating to this transaction will be deferred to periods later than previously anticipated. The valuation of our Retained Interests at September 30, 2002 reflects this change in anticipated cash flows.

In the normal course of business, including the operation of our assets acquired in liquidation, we are subject to various proceedings and claims, the resolution of which will not, in management s opinion, have a material adverse effect on our consolidated financial position or results of operations.

Note 12. Subsequent Event:

On October 1, 2002, our affiliate PMC Funding, acquired two assisted care living facilities that are subject to mortgages held by PMC Capital. PMC Funding is operating one of the two facilities while the other facility is vacant. PMC Funding has applied for, but does not currently have, professional malpractice liability insurance for the operating assisted care living facility. It is possible that PMC Funding will not be able to obtain or maintain such insurance on acceptable terms or that any insurance obtained will provide adequate coverage against potential liabilities. A malpractice claim related to the operating assisted care living facility could have a material adverse effect on our results of operations. As of September 30, 2002, the underlying loans receivable held by PMC Capital related to these facilities were valued at approximately $816,000 and a $50,000 unrealized valuation loss was recorded during the three and nine months ended September 30, 2002. Management believes that the net proceeds from the sale of the facilities will equal or exceed the value of the loans receivable.

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PART I
Financial Information

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

INTRODUCTION

We are a national small business lender. Our operations include originating, servicing and selling commercial loans. We primarily originate loans to individuals and small businesses in the limited service sector of the hospitality industry. We sell certain of our loans receivable through privately-placed structured loan transactions and sell the government guaranteed portion of our loans originated under the Small Business Administration (the SBA) 7(a) program. Historically, we have retained servicing rights and residual interests in all loans sold. Servicing rights include the right to collect payments on behalf of the loan purchaser, monitor the loan receivable for any defaults and address any problems in collecting the required principal and interest payments. We retain a residual interest in the sold loans receivable either directly or through our ownership in the special purpose entities (the SPEs) created in conjunction with our structured loan sale transactions. In addition, we operate as an investment manager to evaluate loans receivable and properties and to service loans receivable and lease contracts pursuant to fee arrangements with our affiliate, PMC Commercial Trust (PMC Commercial).

The following discussion of our financial condition at September 30, 2002 and results of operations for the three and nine months ended September 30, 2002 and 2001 should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2001.

OVERVIEW

Our results of operations during the first nine months of 2002 were negatively impacted by a combination of factors including: the low interest rate environment, investment losses, diminished loan origination volume, general economic conditions, lower earnings on our variable-rate loans compared to fixed-rate loans, the costs of operating foreclosed properties and reduced income on the cash and cash equivalents remaining to be invested from our April 2002 structured loan sale transaction. See Results of Operations for a detailed discussion of our operations during the three and nine months ended September 30, 2002 compared to 2001.

Prior to 2001, other than loans originated under the SBA 7(a) program, we primarily originated fixed-rate loans. Commencing in the latter half of 2001, our ability to compete for fixed-rate lending opportunities declined. Interest rates have remained at historically low levels for a prolonged period of time providing the banking industry with the ability to offer fixed-rate mini-perm loans (*i.e.,* five-year maturity, 20-year amortization) based on these low short-term rates. In contrast, the interest rates on our fixed-rate loan products are based on a longer term (10-year U.S. Treasuries) which remained at disproportionately higher levels than shorter term financial indices. As a result, our fixed interest rates offered were higher than the banks and our lending opportunities decreased. However, we have been able to compete more effectively by offering a LIBOR based variable-rate loan product. See Economic Factors.

As of September 30, 2002, our variable-rate loans receivable were $57.6 million (79%) of our loans receivable, an increase of $19.1 million (50%) from December 31, 2001. The rise in variable-rate loans receivable at September 30, 2002 is a result of our variable-rate loan originations and the sale of fixed-rate loans receivable in our April 2002 structured loan sale transaction. At September 30, 2002, approximately 97% of our outstanding commitments were for variable-rate loans, and given the current interest rate market, we expect to continue to originate primarily variable-rate loans.

As of September 30, 2002, our commitments to fund loans of approximately $40.6 million were greater than commitments of $18.2 million at September 30, 2001 and $18.7 million at June 30, 2002. Commitments have fixed expiration dates and require payment of a fee to us. Based upon current economic conditions, we anticipate that the loan origination volume for the fourth quarter of 2002 will range from $18 million to $23 million and that the loan origination volume for 2003 will range from $50 million to $60 million. However, there can be no assurance of the accuracy of these estimates. See Economic Factors.

We primarily fund our commitments through structured loan sale transactions (Structured Loan Sales). The proceeds that we receive from the completion of Structured Loan Sales and prepayments are invested initially in temporary investments which generate less interest income and, as a result of the declining interest rate environment, have generally been re-loaned or committed to be re-loaned initially at lower interest rates. To the extent the prime rate or LIBOR increases (decreases), we would receive the benefit (reduction) from this increase (decrease) in variable interest rates. In addition, due to our decreased loan originations during the first nine months of 2002, the funds from our most recent transaction have been invested for a longer period of time than the proceeds from our prior Structured Loan Sales and our interest income, cash flows and financial condition have been, and will continue to be, negatively impacted until the proceeds are fully reinvested. See Liquidity and Capital Resources Uses of Funds Loan Originations. The proceeds from our April 2002 Structured Loan Sale, plus our previously available cash and cash equivalents, provided us with approximately $50.4 million in available funds to be reinvested. As of September 30, 2002, we had approximately $31.2 million of available cash and cash equivalents remaining to be invested. Based on current projections of our net cash requirements, we anticipate that these funds will not be fully invested until the first or second quarter of 2003.

Economic Factors

LIBOR-Based Loan Program: Prior to 2001 we primarily originated fixed-rate loans. During 2001 we commenced marketing and selling a variable-rate loan product based on LIBOR which provides a lower cost variable interest rate alternative to our borrowers. We commenced the LIBOR-based loan program as a result of market conditions and recently this program has gained increased borrower acceptance. Most of our current commitments are based on LIBOR.

Interest Income and Rates: The decreased loan origination volume during the first half of 2002 affected our interest income. Interest income will continue to be reduced if (i) principal payments on outstanding loans receivable exceed our loan originations, (ii) interest rates continue to decrease, or (iii) problem loans increase. As a result of our dependence on variable-rate loans, the continued prolonged low interest rate environment caused our interest income to be reduced. To the extent that rates remain at these historically low levels, or the prime rate or LIBOR decreases from current levels, we will earn less interest income. Alternatively, when rates rise in the future, the interest we earn on our performing variable-rate loans will increase. Effective November 7, 2002, the prime rate was decreased to 4.25% and LIBOR decreased to 1.40%.

Interest Rate Spreads: Our net interest margin is dependent upon the difference between the cost of our borrowed funds and the rate at which we invest these funds (the spread differential). A significant reduction in the spread differential may have a material adverse effect on our results of operations. Over the past few years the spread differential has been reduced causing decreased income from continuing operations. There can be no assurance that the spread differential will not continue to decrease. We believe that our LIBOR-based loan program will provide us with a spread differential that is greater than the spread differential we have historically received on our fixed-rate transactions due to the perception of a more efficient market for LIBOR-based structured loan sale transactions compared to fixed-rate structured loan sale transactions.

Loan Origination Trend: During the first half of 2002, we experienced decreases in lending opportunities, loans funded and loan commitments compared to the prior year due to competition resulting from the interest rate environment and the economic uncertainty which specifically had an impact on the hospitality sector. As a result of the continuation of low short-term interest rates, banks continue to offer their mini-perm short-term loans at rates considerably lower than our long-term fixed-rate loans and often with less down payment requirements. In addition, as a result of the economic uncertainty following the tragic events of September 11th, fewer hospitality properties were marketed; therefore, fewer property sales required financing. However, during the third quarter of 2002, we perceived a change in the economic environment for limited service hospitality properties. More property owners were willing to refinance into variable-rate loans and more properties were

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being sold. As a result of our borrowers acceptance of our LIBOR-based lending program and other changes in the market, our loan commitments and lending opportunities increased.

Competition: Our primary competition has come from banks, financial institutions and other finance companies. Many of these competitors have greater financial and larger managerial resources than us and are able to provide services that we are not able to provide (*i.e.,* depository services). In general, we believe that we compete effectively with such entities on the basis of the variety of our lending programs offered, interest rates, our long-term maturities and payment schedules, the quality of our service, our reputation as a lender, timely credit analysis and greater responsiveness to renewal and refinancing requests from borrowers. In addition, the variety and flexibility of our lending programs enhances our ability to react to current market conditions.

Hospitality Industry Factors: During 2001, there were reductions in business and discretionary travel causing a moderation in demand for hotel rooms and a slowdown in construction of hospitality properties (including limited service hospitality properties). Although the Federal Reserve lowered interest rates during 2001 to aid in stimulating the economy and to provide liquidity, consumer and business confidence declined. This lack of confidence, which continued into 2002, caused a significant strain on the travel and hotel industries as well as numerous other industries in the United States. However, the limited service segment of the hospitality industry has been less impacted and has continued to outperform the luxury and upscale sectors which experienced the weakest performance.

Another factor which affects the limited service sector of the hospitality industry is a significant rise in gasoline prices within a short period of time. As seen in the past, when gas prices sharply increase, occupancy rates decrease.

Fluctuations in Quarterly Results

Our quarterly operating results will fluctuate based on a number of factors, including, among others:

- The completion of a Structured Loan Sale in a particular period;
- The spread between interest rates on the securities issued in connection with our structured loan transactions and the interest rates on the underlying loans receivable;
- Interest rate changes;
- The volume and timing of loan originations and the volume and timing of prepayments of our loans receivable;
- Changes in the cash flows and/or assumptions underlying the valuation of our retained interests in transferred assets;
- The recognition of gains or losses on investments;
- The level of competition in our markets; and,
- General economic conditions, especially those which affect the hospitality sector.

As a result of these factors, quarterly results should not be relied upon as being indicative of performance in future quarters.

In addition, to the extent a Structured Loan Sale is completed (i) our interest income on loans receivable in future periods will be reduced until the proceeds received are reinvested in new loan originations, (ii) interest expense will be reduced if we repay outstanding debt with the proceeds and (iii) we will earn income from our ownership of a retained interest in the loans sold. Until the proceeds are fully reinvested, the net impact of a Structured Loan Sale on future operating periods is a reduction in interest income, net of interest expense.

PORTFOLIO INFORMATION

Lending Activities

General

The recorded value of our loans receivable was $72.5 million and $107.4 million at September 30, 2002 and December 31, 2001, respectively. During the nine months ended September 30, 2002 and 2001, we originated loans totaling $27.7 million and $58.4 million and received repayments, including proceeds from the sale of our guaranteed SBA 7(a) program loans, of $16.7 million (of which approximately $9.5 million represented prepayments) and $13.0 million (of which approximately $1.1 million represented prepayments), respectively. During the year ended December 31, 2001, we originated $66.0 million of loans. Our commitments to fund new loans increased to $40.6 million at September 30, 2002 from $19.5 million at December 31, 2001 and $18.7 million at June 30, 2002. See Liquidity and Capital Resources. Our serviced loan portfolio (which includes our loans receivable which have been sold through Structured Loan Sales and the sold government guaranteed portion of loans originated under the SBA 7(a) program (together, our Sold Loans) decreased by $13.7 million (4%) to $308.1 million at September 30, 2002 from $321.8 million at December 31, 2001.

Effective October 1, 2002, the SBA temporarily changed its policy on origination of loans to limit the maximum loan amount to $500,000. While our SBA 7(a) loan origination volume has not been significant, the effect of this change will likely be to reduce our SBA 7(a) lending in future periods and reduce our proceeds from the sale of SBA 7(a) loans to the secondary market and consequently our premium income.

At September 30, 2002 and December 31, 2001, approximately $57.6 million and $38.5 million, respectively, of our loans receivable had a variable interest rate (reset on a quarterly basis) based upon either the prime rate or LIBOR. The spread that we charge over the prime rate generally ranges from 1.0% to 2.5%. The spread that we charge over LIBOR generally ranges from 3.50% to 4.50%. The prime rate and LIBOR used in determining interest rates charged to our borrowers for the fourth quarter of 2002 were 4.75% and 1.76%, respectively. To the extent the prime rate or LIBOR changes, we will have changes in interest income from our variable-rate loans receivable. Effective November 7, 2002, the prime rate was decreased to 4.25% and LIBOR decreased to 1.40%.

Prepayment Activity

We experienced increased prepayment activity on our loans receivable as a result of the interest rate environment (the prime rate and yield on treasury notes decreased substantially during 2001 and 2002), and we believe that we may continue to experience prepayment activity at high levels, particularly in relation to our fixed-rate loans receivable, to the extent that interest rates remain at these low levels. Many of our prepayment charges for our fixed-rate loans receivable are based upon a yield maintenance premium which provides for greater fees as interest rates decrease. In addition, certain of our loans receivable have a prohibition on prepayment during their initial years. Our SBA 7(a) loans receivable did not have any prepayment charges for loans originated prior to January 2001 in accordance with SBA policy. The SBA changed its policy on prepayment charges to allow the SBA to collect a 5% fee for loans prepaid in the first year, 3% in the second year and 1% in the third year. This change in SBA policy may lessen the amount of prepayments received during the first three years after the closing of an SBA guaranteed loan.

The timing and volume of our prepayment activity for both our variable and fixed-rate loans receivable fluctuate and are impacted by numerous factors including the following:

- The competitive lending environment (*i.e.,* availability of alternative financing);
- The anticipated interest rate environment (*i.e.,* if interest rates are expected to rise or decline);
- The amount of the prepayment charge; and,
- The interest rate on the loan receivable.

When retained loans receivable are paid-off prior to their maturity we generally receive prepayment charges. Prepayment charges result in one-time increases in our income. The proceeds from the prepayments we receive are invested initially in temporary investments and are generally re-loaned or committed to be re-loaned at lower

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interest rates than the prepaid loans receivable. These lower interest rates have had an adverse effect on our interest income, and depending upon the rate of future prepayments, may further impact our interest income. It is difficult for us to accurately predict the volume or timing of prepayments since the factors listed above are not all-inclusive and changes in one factor are not isolated from changes in others which might magnify or counteract the rate or volume of prepayment activity.

Problem Loans

Problem loans (Problem Loans) are loans receivable which are not complying with their contractual terms, the collection of the balance of the principal is considered impaired and on which its fair value is less than the remaining unamortized principal balance. Problem Loans do not include those loans receivable that we expect a full recovery of the principal balance through either collection efforts or liquidation of collateral (Special Mention Loans). However, there can be no assurance that Special Mention Loans will not become Problem Loans in the future if there is deterioration of the value of the collateral. The value of our loans receivable at September 30, 2002 has been reduced by unrealized losses of $674,000. During 2001 and 2002, we experienced an increase in Problem Loans and, as a result, an increase in unrealized and realized losses. This trend in Problem Loans is primarily a result of current economic conditions (see Economic Factors). In addition, our increased unrealized and realized losses are partially a result of the reduced value of distressed properties in the limited service hospitality industry. Due to the increased number of properties being marketed, the value of the collateral for our Problem Loans has decreased.

Our Problem Loans and Special Mention Loans were as follows:

	September 30, 2002	December 31, 2001
	(Dollars in thousands)	
Problem Loans:		
Loans receivable	$2,838	$ 6,152
Sold loans	6,520	1,799
	$9,358	$ 7,951
Special Mention Loans:		
Loans receivable	$ 908	$ 1,433
Sold loans	697	6,456
	$1,605	$ 7,889
Percentage Problem Loans:		
Loans receivable	3.9%	5.7%
Sold loans	3.5%	1.1%
Percentage Special Mention Loans:		
Loans receivable	1.3%	1.4%
Sold loans	0.4%	4.1%

In addition, we had approximately $2.4 million of retained loans which are not considered either Problem Loans or Special Mention Loans whose value has been reduced by approximately $214,000 at September 30, 2002.

Our retained Problem Loans as of December 31, 2001 included two limited service hospitality properties we acquired through foreclosure during the first quarter of 2002. The aggregate value of these properties, as reduced for anticipated selling costs, was estimated to be $2.1 million. See Assets Acquired in Liquidation. Our sold Problem Loans as of September 30, 2002 include $3.9 million of non-accrual loans currently in the process of liquidation. At December 31, 2001, these sold loans were classified as Special Mention Loans.

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Retained Interests in Transferred Assets (Retained Interests)

At September 30, 2002 and December 31, 2001 the recorded value of our Retained Interests was $39.5 million and $33.5 million, respectively. Retained Interests represents our ownership interest in loans receivable that have been contributed to SPEs and have been recorded as sold. The components of our Retained Interests are the required overcollateralization, the cash reserves and an interest-only strip receivable.

The fair value of our Retained Interests is determined based on the present value of future cash flows we expect to receive from the SPEs. The future cash flows are based in part upon our estimates of prepayment speeds, loan losses and discount rates. We estimate prepayment speeds and loan losses based on the current and anticipated interest rate environment, the current and anticipated competitive environment and our historical experience with these and similar loans receivable. The discount rates utilized are determined for each of the components of Retained Interests as estimates of market rates based on interest rate levels considering the risks inherent in the transaction. Changes in any of our assumptions, or actu