

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10 – K

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Fiscal Year Ended December 31, 2004

- 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: 1-13610

PMC COMMERCIAL TRUST

(Exact name of registrant as specified in its charter)

Texas

(State or other jurisdiction
of incorporation or organization)

75-6446078

(I.R.S. Employer Identification No.)

17950 Preston Road, Suite 600, Dallas, TX 75252

(Address of principal executive offices)

(972) 349-3200

(Registrant's telephone number)

Securities registered pursuant to Section 12(b) of the Act:
Common Shares of beneficial interest, \$.01 par value

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2).

YES NO

The aggregate market value of the voting stock held by non-affiliates of the Registrant, based upon the closing sale price of the Common Shares of Beneficial Interest on June 30, 2004 as reported on the American Stock Exchange, was approximately \$141 million. Common Shares of Beneficial Interest held by each officer and trust manager and by each person who owns 10% or more of the outstanding Common Shares of Beneficial Interest have been excluded because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of March 7, 2005, Registrant had outstanding 10,876,961 Common Shares of Beneficial Interest.

DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the Registrant's Proxy Statement to be filed with the Securities and Exchange Commission within 120 days after the year covered by this Form 10-K with respect to the Annual Meeting of Shareholders are incorporated by reference into Part III.

PMC COMMERCIAL TRUST

Form 10-K

For the Year Ended December 31, 2004

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Forward-Looking Statements

This Form 10-K contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created thereby. These statements include the plans and objectives of management for future operations, including plans and objectives relating to future growth of our loans receivable and availability of funds. Such forward-looking statements can be identified by the use of forward-looking terminology such as “may,” “will,” “expect,” “intend,” “believe,” “anticipate,” “estimate,” or “continue,” or the negative thereof or other variations or similar words or phrases. The forward-looking statements included herein are based on current expectations that involve numerous risks and uncertainties identified in this Form 10-K, including, without limitation, the risks identified under the caption “Item 1. Business – Risk Factors.” Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Form 10-K will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved. Readers are cautioned not to place undue reliance on forward-looking statements. Forward-looking statements speak only as of the date they are made. We do not undertake to update them to reflect changes that occur after the date they are made.

PART I

Item 1. BUSINESS

INTRODUCTION

PMC Commercial Trust (“PMC Commercial” and together with its wholly-owned subsidiaries, the “Company,” “our” or “we”) is a real estate investment trust (“REIT”) that primarily originates loans to small businesses collateralized by first liens on the real estate of the related business. Our loans are primarily to borrowers in the limited service hospitality industry. We also originate loans for commercial real estate primarily in the service, retail, multi-family and manufacturing industries. In addition, our investments include the ownership of commercial properties in the hospitality industry. Our common shares are traded on the American Stock Exchange under the symbol “PCC.”

On February 29, 2004, PMC Capital, Inc. (“PMC Capital”), our affiliate through common management, merged with and into PMC Commercial. Primarily as a result of the merger, beneficiaries’ equity increased from approximately \$92.1 million at December 31, 2003 to approximately \$161.3 million at December 31, 2004 and total assets increased from approximately \$131.7 million at December 31, 2003 to approximately \$253.8 million at December 31, 2004. We believe that the merger has provided, and will continue to provide, more stability in income available for distribution through the larger, more diversified asset base. The merger resulted in a substantial increase in revenues and expenses. Revenues increased as a result of the income generated by the assets acquired from PMC Capital. Prior to the merger, we had no employees and most of our overhead was paid through an advisory relationship with PMC Capital. Subsequent to the merger, we are internally managed, have 43 employees and overhead of the combined larger entity is now our responsibility.

We generate revenue from the yield earned on our investments, rental income from property ownership and other fee income from our lending activities. Our operations are centralized in Dallas, Texas and include originating, servicing and selling commercial loans and oversight of our property ownership. During the years ended December 31, 2004 and 2003, our total revenues were approximately \$25.4 million and \$14.1 million, respectively, and our net income was approximately \$24.8 million and \$8.2 million, respectively. Our 2004 net income includes an extraordinary gain of approximately \$11.6 million from negative goodwill resulting from the merger.

A substantial part of PMC Capital’s activities were undertaken by its wholly-owned subsidiaries: First Western SBLC, Inc. (“First Western”), PMC Investment Corporation (“PMIC”) and Western Financial Capital Corporation (“Western Financial”). PMIC and Western Financial are small business investment companies (“SBICs”). Each of these subsidiaries is now wholly-owned by PMC Commercial.

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As a result of the acquisition of First Western, we are now able to originate loans under the Small Business Administration's ("SBA") 7(a) Guaranteed Loan Program. First Western is currently a "Preferred Lender," as designated by the SBA, in Dallas, Texas and originates, sells and services small business loans throughout the continental United States. As a non-bank SBA 7(a) Guaranteed Loan Program lender, First Western is able to originate loans on which a substantial portion of the loan (generally 75%) is guaranteed as to payment of principal and interest by the SBA. A market exists for the sale of the guaranteed portion of First Western's loans and we receive premiums at the time of sale that approximate up to 10% of the principal amount of the loan sold. To the extent we were to increase our volume of loans originated by First Western, there should be a corresponding increase in premiums received. In addition, due to the existence of the SBA guarantee, we are able to originate loans in industries that we would typically not lend to due to the profitability of the loan including the premium received. See "Lending Activities – SBA Programs."

We seek to maximize shareholder value through long-term growth in dividends paid to our shareholders. As a REIT, we must distribute at least 90% of our REIT taxable income to shareholders. See "Tax Status." We pay dividends from the cash flow generated from our operations.

Our ability to generate interest income, as well as other loan related fees, is dependent upon economic, regulatory and competitive factors that influence interest rates and loan originations, and our ability to source financing for our investment activities. The amount of other income earned will vary based on volume of loans funded, the timing and amount of financings, the volume of loans receivable which prepay and the resultant applicable prepayment fees, if any, the mix of loans (construction versus non-construction), the rate on loans originated as well as the general level of interest rates.

Generally, in order to fund new loans or real estate investments, we need to issue new equity, borrow funds or sell loans. Since 1996, our primary source of funds has been structured loan transactions. In a structured loan transaction, we contribute loans receivable to a special purpose entity ("SPE") in exchange for a subordinate financial interest in that entity. We account for structured loan sale transactions as sales of our loans receivable and the SPE meets the definition of a qualifying special purpose entity ("QSPE"); as a result, neither the loans receivable contributed to the QSPE nor the notes payable issued by the QSPE are included in our consolidated financial statements. See "Structured Loan Transactions."

We operate in two reportable segments: (i) the lending division, which originates loans to small businesses primarily in the hospitality industry and (ii) the property division, which owns hotel properties. See detailed financial information regarding our segments in "Item 8. Consolidated Financial Statements and Supplementary Data."

LENDING ACTIVITIES

Overview

Our lending division originates loans to small businesses, primarily in the hospitality industry. For the year ended December 31, 2004, total revenues and income from continuing operations for our lending division were approximately \$19.9 million (78% of our total revenues) and \$10.5 million (86% of our total income from continuing operations), respectively. Total assets allocated to the lending division were approximately \$214.2 million (84% of our total assets) at December 31, 2004.

We are a national lender that focuses our lending activities on businesses in the southeast and southwest regions of the United States. We primarily originate small business loans in the limited service sector of the hospitality industry. With the addition of the lending operations of PMC Capital, we expect to increase our loan originations to the convenience store and gas station, restaurant, service, retail and commercial real estate industries. In addition to first liens on real estate of the related business, our loans are generally personally guaranteed by the principals of the entities obligated on the loans. In addition to our historical underwriting criteria, as a result of the merger, we are now originating loans using PMC Capital's underwriting criteria which generally has higher loan-to-value ratios than we had prior to the merger. See "Risk Factors."

We identify loan origination opportunities through personal contacts, internet referrals, attendance at trade shows and meetings, correspondence with local chambers of commerce, direct mailings, advertisements in trade publications and other marketing methods. In addition, we have generated most of our loans through referrals from lawyers, accountants, real estate and loan brokers and existing borrowers. We may make payments to non-affiliated

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individuals who assist in generating loan applications, with such payments generally not exceeding 1% of the principal amount of the originated loan.

Limited Service Hospitality Industry

Our loans in the hospitality industry are generally collateralized by first liens on limited service hospitality properties and are generally made to owner-operated facilities operating under national franchises. We believe that franchise operations offer attractive lending opportunities because such businesses generally employ proven business concepts, have national reservation systems, have consistent product quality, are screened and monitored by franchisors and generally have a higher rate of success when compared to other independently operated hospitality businesses.

The prevailing lodging industry perception for 2005 is more optimistic than 2004. Lodging demand in the United States appears to correlate to changes in the United States Gross Domestic Product ("U.S. GDP") growth, with typically a two to three quarter lag. Therefore, given the relatively strong U.S. GDP growth in the past year and the positive projections for the remainder of 2005, an improvement in 2005 and 2006 lodging demand is predicted by industry analysts. Such improvement will be dependent upon several factors including: the strength of the economy, the correlation of hotel demand to new hotel supply and the impact of global or domestic events on travel and the hotel industry. Industry analysts with PricewaterhouseCoopers LLP have published reports that predict the industry's results will improve in 2005 and 2006.

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. Most of the limited service hospitality properties collateralizing our loans are located on interstate highways. As seen in the past, when gas prices sharply increase, occupancy rates decrease for properties located on interstate highways.

While occupancy increased slightly for the overall hospitality industry, average room rates showed a slight decline in 2004 based on published industry statistics. We anticipate that lodging demand will increase in 2005 and 2006 as the lodging industry follows the economy. We believe improving economic trends in the lodging industry will generate an increase in competition among lenders, especially those lenders offering alternatives such as fixed-rate and "mini-perm" loans.

Loan Originations and Underwriting

We originate mortgage loans to small businesses primarily collateralized by commercial real estate. We believe that we successfully compete in the commercial real estate finance market due to our understanding of our borrowers' businesses, the flexible loan terms that we offer and our responsive customer service. Our approach to assessing new commercial mortgage loans requires an analysis of the replacement cost of the collateral, its liquidation value and an analysis of local market conditions.

We also consider the underlying cash flow of the tenant or owner-occupant as well as more traditional real estate underwriting criteria such as:

- The components and value of the borrower's collateral (primarily real estate);
- The ease with which the collateral can be liquidated;
- The industry and competitive environment in which the borrower operates;
- The financial strength of the guarantors;
- The existence of any secondary repayment sources; and
- The existence of a franchise relationship.

Upon receipt of a completed loan application, our credit department conducts: (i) a detailed analysis of the loan, which typically includes an appraisal and a valuation by our credit department of the property that will collateralize the loan to ensure compliance with loan-to-value percentages, (ii) a site inspection for real estate collateralized loans, (iii) a review of the borrower's business experience, (iv) a review of the borrower's credit history, and (v) an analysis of the borrower's debt-service-coverage and debt-to-equity ratios. All appraisals must be performed by an approved, licensed third party appraiser and based on the market value, replacement cost and cash flow value approaches. We generally utilize nationwide independent appraisal firms and seek local market economic information to the extent available.

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Our typical loan is distinguished from those of some of our competitors by the following characteristics:

- *Substantial down payments are required.* We usually require an initial down payment of not less than 20% of the value of the property which is collateral for the loan at the time of such loan. Our experience has shown that the likelihood of full repayment of a loan increases if the owner/operator is required to make an initial and substantial financial commitment to the property which is collateral for the loan.
- *“Cash outs” are typically not permitted.* Generally, we will not make a loan in an amount greater than either the replacement cost of the property which is collateral for the loan or the current appraised value of the property which is collateral for the loan. For example, a hotel property may have been originally constructed for a cost of \$2,000,000, with the owner/operator borrowing \$1,600,000 of that amount. At the time of the borrower’s loan refinancing request, the property securing the loan is appraised at \$4,000,000. Some of our competitors might loan from 70% to 90% or more of the new - -appraised value of the property and permit the owner/operator to receive a cash distribution from the proceeds. Generally, we would not permit this type of “cash-out” distribution.
- *The obligor is personally liable for the loan.* We generally require the principals of the borrower to personally guarantee the loan.

We are currently originating primarily variable-rate loans. Our variable-rate loans are based on LIBOR, or the prime rate (primarily SBA 7(a) lending). While we have originated fixed-rate loans, we do not expect to originate a significant amount of additional fixed-rate loans in the near future since our sources of funds are primarily variable-rate and due to competitors with a lower cost of funds. Management continually evaluates potential sources of capital with a fixed-rate cost to determine if a fixed-rate loan product would be feasible. Due to the current level of interest rates for smaller companies like ours, it does not appear that a significant amount of capital with a fixed interest cost is available to us that would allow us to generate appropriate spreads to compensate us for the commensurate risk of the loans that would be originated. We will continue to monitor the leverage market for possible fixed-rate sources of capital and to the extent we identify an appropriate source, we may establish a fixed-rate lending product. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Current Operating Overview and Economic Factors – Lending Division.”

General information on our loans receivable, net, was as follows:

	At December 31,					
	2004			2003		
	Loans Receivable		Weighted Average Interest Rate	Loans Receivable		Weighted Average Interest Rate
Amount	%		Amount	%		
<i>(Dollars in thousands)</i>						
Fixed rate	\$ 28,100	21.9%	9.7%	\$29,331	58.0%	10.1%
Variable rate - prime	15,445	12.0%	6.6%	—	—	—
Variable rate - LIBOR	84,689	66.1%	6.4%	21,203	42.0%	5.4%
	<u>\$128,234</u>	<u>100.0%</u>	7.1%	<u>\$50,534</u>	<u>100.0%</u>	8.1%

Our variable-rate loans receivable generally require monthly payments of principal and interest, reset on a quarterly basis, to amortize the principal over ten to 20 years. Fixed-rate loans receivable generally require level monthly payments of principal and interest calculated to amortize the principal over ten to 25 years.

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Loan Activity

The following table details our loan activity for the years indicated:

	Years Ended December 31,				
	2004	2003	2002	2001	2000
	<i>(In thousands)</i>				
Loans receivable, net — beginning of year	\$ 50,534	\$ 71,992	\$ 78,486	\$ 65,645	\$ 115,265
Loans originated	53,659	31,320	32,776	51,683	22,508
Loans acquired in the merger (1)	55,144	—	—	—	—
Principal collections (2)	(23,196)	(5,655)	(11,637)	(4,965)	(15,135)
Repayments of SBA 504 program loans	(1,621)	(1,963)	(631)	(970)	(973)
Loans sold (3)	(6,222)	—	—	—	—
Loans transferred to AAL (4)	(2,115)	—	—	—	(1,181)
Structured loan sales (5)	—	(45,456)	(27,286)	(32,662)	(55,675)
Loan deemed to be repurchased from QSPE (6)	2,126	—	—	—	—
Other adjustments (7)	(75)	296	284	(245)	836
Loans receivable, net — end of year	<u>\$ 128,234</u>	<u>\$ 50,534</u>	<u>\$ 71,992</u>	<u>\$ 78,486</u>	<u>\$ 65,645</u>

(1) Represents the estimated fair value of loans acquired from PMC Capital in the merger.

(2) Represents scheduled principal payments and prepayments.

(3) First Western sells the guaranteed portion of its loans through private placements to either dealers in government guaranteed loans or institutional investors.

(4) Loans receivable on which the collateral was foreclosed upon and the assets were classified as assets acquired in liquidation ("AAL").

(5) Loans receivable which were sold as part of structured loan sale transactions.

(6) Represents a loan receivable at its estimated fair value deemed to be repurchased from one of our QSPEs as a result of a delinquent loan on which we initiated foreclosure and were contractually allowed to repurchase from our QSPE.

(7) Represents the change in loan loss reserves, discounts and deferred commitment fees.

Quarterly Loan Originations

The following table is a breakdown of loans originated on a quarterly basis during the years indicated:

	Years Ended December 31,				
	2004	2003	2002	2001	2000
	<i>(In thousands)</i>				
First Quarter	\$ 6,609	\$ 9,009	\$ 6,346	\$ 9,761	\$ 301
Second Quarter	17,255	12,103	6,506	22,567	3,924
Third Quarter	14,998	5,557	10,044	10,097	7,340
Fourth Quarter	14,797	4,651	9,880	9,258	10,943
Total	<u>\$53,659</u>	<u>\$31,320</u>	<u>\$32,776</u>	<u>\$51,683</u>	<u>\$22,508</u>

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Loan Portfolio Statistics

Information on our loans receivable, loans which have been sold and on which we have retained interests (the “Sold Loans”) and our loans receivable combined with our Sold Loans (the “Aggregate Portfolio”) was as follows:

	At December 31,					
	2004			2003		
	Aggregate Portfolio	Sold Loans (1)	Loans Receivable	Aggregate Portfolio	Sold Loans	Loans Receivable
	<i>(Dollars in thousands, except footnotes)</i>					
Portfolio outstanding (2)	\$ 468,158	\$ 339,301	\$ 128,857	\$ 197,437	\$ 146,001	\$ 51,436
Weighted average interest rate	7.8%	8.0%	7.1%	8.2%	8.2%	8.1%
Annualized average yield (3)	9.1%	8.9%	9.1%	8.4%	9.2%	7.2%
Weighted average contractual maturity (in years)	15.5	15.1	16.5	15.2	16.2	12.4
Delinquent and problem loans (4)	\$ 6,861	\$ 3,150	\$ 3,711	\$ 3,105	\$ 1,357	\$ 1,748
Lodging industry concentration %	91.0%	89.5%	94.7%	96.6%	95.4%	100.0%
Texas concentration % (5)	24.7%	28.7%	14.3%	19.8%	22.5%	12.1%

(1) In addition to loans of the QSPEs, includes SBA 7(a) Guaranteed Loan Program loans of First Western.

(2) Portfolio outstanding before loan loss reserves and deferred commitment fees. Includes the principal balance remaining on underlying loans receivable in our 1998 structured loan financing transaction of \$12.9 million and \$26.0 million at December 31, 2004 and 2003, respectively.

(3) The calculation of annualized average yield divides our interest income, prepayment fees and other loan related fees, adjusted by the provision for (reduction of) loan losses, by the weighted average outstanding portfolio.

(4) Includes loans which are either past due greater than 60 days or the collection of the balance of principal and interest is considered unlikely and on which the fair value of the collateral is less than the remaining unamortized principal balance (“Problem Loans”). The balance does not include the principal balance of loans which have been identified as potential problem loans for which it is expected that a full recovery of the principal balance will be received through either collection efforts or liquidation of collateral (“Special Mention Loans”).

(5) We also had a concentration of approximately 12% of loans receivable in Virginia at December 31, 2004. No other concentrations greater than 10% existed at December 31, 2004 for our loans receivable, Sold Loans or Aggregate Portfolio.

Industry Concentration

The distribution of our loan portfolio by industry was as follows at December 31, 2004:

	Loans Receivable			Aggregate Portfolio		
	Number of Loans	Cost (1)	%	Number of Loans	Cost (1)	%
	<i>(Dollars in thousands)</i>					
Hotels and motels	129	\$121,997	94.7%	360	\$425,764	90.9%
Gasoline/service stations	18	2,964	2.3%	27	12,082	2.6%
Services	17	669	0.5%	30	5,985	1.3%
Restaurants.	12	591	0.4%	18	3,690	0.8%
Retail, other.	12	749	0.6%	16	5,716	1.2%
Apartments	1	509	0.4%	8	8,564	1.8%
Other	19	1,378	1.1%	27	6,357	1.4%
	<u>208</u>	<u>\$128,857</u>	<u>100.0%</u>	<u>486</u>	<u>\$468,158</u>	<u>100.0%</u>

(1) Loan portfolio outstanding before loan loss reserves and deferred commitment fees.

SBA Programs

General

We participate as a private lender in the SBA 504 Program which allows us to originate first mortgage loans with lower loan-to-value ratios. In addition, the businesses acquired from PMC Capital operate under several licenses from the SBA. First Western is a licensed small business lending company (“SBLC”) that originates loans through the SBA’s 7(a) Guaranteed Loan Program (“SBA 7(a) Loan Program”). PMIC is a licensed specialized small business investment company (“SBIC”) under the Small Business Investment Act of 1958, as amended (“SBIA”). PMIC uses long-term funds provided by the SBA, together with its own capital, to provide long-term collateralized loans to eligible small businesses owned by “disadvantaged” persons, as defined under SBA regulations. Western Financial is a licensed SBIC under the SBIA that provides loans to borrowers whether or not they qualify as “disadvantaged.”

First Western, PMIC and Western Financial are periodically examined and audited by the SBA to determine compliance with SBA regulations.

Section 504

The SBA 504 Program assists small businesses in obtaining subordinated, long-term financing by guaranteeing debentures available through certified development companies for the purpose of acquiring land, building, machinery and equipment and for modernizing, renovating or restoring existing facilities and sites. A typical finance structure for an SBA 504 Program project would include a first mortgage covering 50% of the project cost from a private lender, a second mortgage obtained through the SBA 504 Program covering up to 40% of the project cost and a contribution of at least 10% of the project cost by the principals of the small businesses being assisted. We typically require at least 20% of the equity in a project to be contributed by the principals of the borrower. The SBA does not guarantee the first mortgage. Although the total sizes of projects utilizing the SBA 504 Program guarantees are unlimited, currently the maximum amount of subordinated debt in any individual project generally is \$1.5 million (or \$2 million for certain projects). Typical project costs range in size from \$500,000 to \$4 million.

SBA 7(a) Loan Program

First Western is licensed to operate as an SBLC. The SBA guarantees 75% of qualified loans over \$150,000 with such individual guarantees not exceeding \$1.5 million. While the eligibility requirements of the SBA 7(a) Loan Program vary by the industry of the borrower and other factors, the general eligibility requirements are that: (i) gross sales of the borrower cannot presently exceed \$6 million, (ii) liquid assets of the borrower and affiliates cannot exceed specified limits, and (iii) the maximum aggregate SBA loan guarantees to a borrower cannot exceed \$1.5 million. Maximum maturities for SBA 7(a) loans are 25 years for real estate and between seven and 15 years for the purchase of machinery, furniture, fixtures and/or equipment. In order to operate as an SBLC, a licensee is required to maintain a minimum net worth (as defined by SBA regulations) of the greater of (i) 10% of the outstanding loans receivable of First Western or (ii) \$1.0 million, as well as certain other regulatory restrictions such as change in control provisions. See “Risk Factors.”

SBIC Program

SBICs are intended to stimulate the flow of private equity capital to eligible small businesses. Under present SBA regulations, eligible small businesses include businesses that have a net worth not exceeding \$18 million and have average annual fully taxable net income not exceeding \$6 million for the most recent two fiscal years. According to SBA regulations, SBICs may make long-term loans to small businesses and invest in the equity securities of such businesses. Under SBA regulations, an SBIC can issue debentures whose principal and interest is guaranteed to be paid in the event of non-payment by the SBIC. As a result, the debentures’ costs of funds are usually advantageous compared to alternative fixed-rate sources of funds available to us.

PROPERTY OWNERSHIP

During the year ended December 31, 2004, total revenues and income from continuing operations for our property division were approximately \$5.5 million (22% of our total revenues) and \$1.7 million (14% of our total income from continuing operations), respectively. Total assets allocated to the property division were approximately \$39.6 million (16% of total assets) at December 31, 2004.

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At December 31, 2004, we owned 19 limited service hospitality properties (the “Hotel Properties”) that we purchased in 1998 and 1999 through a sale/leaseback agreement with Arlington Hospitality, Inc. (“Arlington”). Arlington, through its wholly-owned subsidiary, is the operator of our properties through an amended master lease agreement that provides for base rent (currently \$3.9 million per year) and percentage rent equal to 4% of the gross room revenues generated by the Hotel Properties. The master lease agreement, as amended, and the underlying individual property leases, as amended, expire in June 2008, but each can be extended by either Arlington or us for one five-year period, and thereafter by Arlington for a five-year period and a subsequent two-year period. If fully extended, the term of the master lease agreement, as amended, would continue until September 2020. Arlington operates our Hotel Properties as “Amerihost Inns” which is a brand name franchised by Cendant Corporation, the largest franchisor of limited service hospitality properties.

Effective October 1, 2004, we amended the master lease agreement (the “Master Lease Agreement”) and the individual lease agreements to provide incentive for, among other things, the disposition of the Hotel Properties prior to October 1, 2008. Also, the current base rent was reduced from approximately 10.5% to 8.5% of the Stated Value established for the Hotel Properties. The Stated Value of each Hotel Property (currently an aggregate of \$46.1 million) is the value attributed to each Hotel Property at inception of the lease agreement for purposes of determining the lease payment. The Master Lease Agreement stipulates increases in base rent to approximately 10.5% or 15% unless, on a cumulative basis, at least five of the Hotel Properties are sold over each of the next four years.

To the extent we approve sales of our Hotel Properties, certain of our Hotel Properties could be deemed impaired and impairment losses that result, if any, could be material. Our Hotel Properties are reviewed for impairment whenever events or circumstances indicate that the carrying amount of the Hotel Property may not be recoverable, but in no event less than on a quarterly basis. Based on the Master Lease Agreement, if impairment losses were to occur, we would receive shortfall notes receivable from Arlington. See “Item 7. Management’s Discussion and Analysis – Current Operating Overview and Economic Factors – Property Division.”

STRUCTURED LOAN TRANSACTIONS

General

Structured loan transactions have historically been our primary method of obtaining funds for new loan originations. In a structured loan transaction, we contribute loans receivable to an SPE in exchange for a subordinate financial interest in that entity and obtain an opinion of counsel that the contribution of the loans receivable to the SPE constitutes a “true sale” of the loans receivable. The SPE issues notes payable (usually through a private placement) to third parties and then distributes a portion of the notes payable proceeds to us. The notes payable are collateralized solely by the assets of the SPE. We account for structured loan sale transactions as sales of our loans receivable and the SPE meets the definition of a QSPE; as a result, neither the loans receivable contributed to the QSPE nor the notes payable issued by the QSPE are included in our consolidated financial statements. The terms of the notes payable issued by the QSPEs provide that the partners of these QSPEs are not liable for any payment on the notes. Accordingly, if the QSPEs fail to pay the principal or interest due on the notes, the sole recourse of the holders of the notes is against the assets of the QSPEs. We have no obligation to pay the notes, nor do the holders of the notes have any recourse against our assets. We are the servicer of the loans pursuant to the transaction documents and are paid a fee of 30 basis points per year based on the principal outstanding.

When a structured loan sale transaction is completed: (1) our ownership interests in the QSPEs are accounted for as retained interests in transferred assets (“Retained Interests”) and are recorded at the present value of the estimated future cash flows to be received from the QSPE and (2) the difference between (i) the carrying value of the loans receivable sold and (ii) the sum of (a) the cash received and (b) the relative fair value of our Retained Interests, constitutes the gain or loss on sale. Gains or losses on these sales may represent a material portion of our net income in the period in which the transactions occur.

A structured loan financing is similar to a structured loan sale, with the exception that the transaction is not treated as a sale for financial reporting purposes. Therefore, the loans receivable contributed to the SPE and the notes payable issued by the SPE are included in our consolidated financial statements and as a result, the ownership interest in the SPE is not accounted for as a retained interest. Even though the loans receivable and the notes payable are included on our balance sheets from the structured loan financing transaction completed by PMC Commercial in 1998, PMC Commercial has no obligation to pay the notes, nor do the holders of the notes have any recourse against PMC Commercial’s assets. The terms of the notes payable issued by the SPE provide that PMC

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Commercial is not liable for payment on the notes. Accordingly, even though the loans receivable and the notes payable of the SPE are included in our consolidated financial statements, if the SPE fails to pay the principal or interest on the notes, the sole recourse of the holders of the notes is against the loans receivable and any other assets of the SPE.

Our structured loan sale transactions and structured loan financing transactions receive opinions from outside counsel that opine to the legal sale of the loans to the legal entity formed in connection with the securitization. Each of our completed securitization transactions (both structured loan sale transactions and structured loan financing transactions) provides a clean-up call. A clean-up call is an option allowed by the transaction documents to repurchase the transferred assets when the amount of the outstanding assets (or corresponding notes payable outstanding) falls to a level at which the cost of servicing those assets becomes burdensome. The clean-up call option regarding a loan in a QSPE or SPE is exercised by the party that contributed the loan to the QSPE or SPE. As a result of the characteristics underlying the structured loan transaction not satisfying the requirements of off-balance sheet accounting treatment, the 1998 securitization originated by PMC Commercial was considered a structured loan financing transaction.

Since we have historically relied on structured loan transactions as our primary source of operating capital to fund new loan originations, any adverse changes in our ability to complete this type of transaction, including any negative impact on the asset-backed securities market for the type of product we generate, could have a detrimental effect on our ability to generate funds to originate loans. See “Risk Factors.”

Structured Loan Sale Transactions

General

As of December 31, 2004, the QSPEs consisted of:

- PMC Capital, L.P. 1998-1 (the “1998 Partnership”) and its related general partner;
- PMC Capital, L.P. 1999-1 (the “1999 Partnership”) and its related general partner;
- PMC Joint Venture, L.P. 2000 (the “2000 Joint Venture”) and its related general partner;
- PMC Joint Venture, L.P. 2001 (the “2001 Joint Venture”) and its related general partner;
- PMC Joint Venture, L.P. 2002-1 (the “2002 Joint Venture”) and its related general partner; and,
- PMC Joint Venture, L.P. 2003-1 (the “2003 Joint Venture,” and together with the 2000 Joint Venture, the 2001 Joint Venture and the 2002 Joint Venture, the “Joint Ventures”) and its related general partner.

As a result of the merger, we acquired PMC Capital’s subordinate interests in the Joint Ventures and 100% of the subordinate interests in the 1998 Partnership and the 1999 Partnership (collectively, the “Acquired Structured Loan Sale Transactions”). The remaining subordinate interests of the Joint Ventures were 32% of the 2000 Joint Venture, 58% of the 2001 Joint Venture, 61% of the 2002 Joint Venture and 56% of the 2003 Joint Venture. We previously owned the remaining subordinate interests in the Joint Ventures (the “Originated Structured Loan Sale Transactions”).

Even though we now own 100% of the subordinate interest in each of the Joint Ventures, since a portion was obtained through acquisition (via merger with PMC Capital), we have recorded these investments separately. At the date of acquisition, the fair value of the Acquired Structured Loan Sale Transactions became our cost.

In addition, First Western has Retained Interests related to the sale of loans originated pursuant to the SBA 7(a) Loan Program. First Western sold the unguaranteed portion of its loans through a private placement in 1997 (“First Western 1997”) and has retained the right to service these loans. We acquired 100% of First Western 1997 in the merger.

2002 and 2003 Structured Loan Sale Transactions

On October 7, 2003, we completed a structured loan sale transaction of a pool of variable-rate loans receivable. PMC Commercial and PMC Capital contributed loans receivable of \$45.4 million and \$57.8 million, respectively, to the 2003 Joint Venture. The 2003 Joint Venture issued, through a private placement, approximately \$92.9 million of its 2003 Loan-Backed Floating Rate Notes (the “2003 L.P. Notes”) of which approximately \$40.9 million was allocated to us based on our ownership percentage in the 2003 Joint Venture. The 2003 L.P. Notes, issued at par, have a stated maturity in 2023, bear interest, reset on a quarterly basis, at the 90-day LIBOR plus 1.25%, and are collateralized by the loans receivable contributed by us and PMC Capital to the 2003 Joint Venture. We accounted for this transaction as a sale, recorded a gain of \$711,000 and recorded our Retained Interests at an

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initial amount of \$8,698,000 during 2003. At inception of the 2003 Joint Venture, we had a subordinate interest of 44% in the limited partnership based on our share of the capital.

On April 12, 2002, we completed a structured loan sale transaction of a pool of primarily fixed-rate loans receivable. PMC Commercial and PMC Capital contributed loans receivable of \$27.3 million and \$43.2 million, respectively, to the 2002 Joint Venture. The 2002 Joint Venture issued, through a private placement, approximately \$63.5 million of its 2002 Loan-Backed Fixed Rate Notes (the "2002 L.P. Notes") of which approximately \$24.6 million was allocated to us based on our ownership percentage in the 2002 Joint Venture. The 2002 L.P. Notes, issued at par, have a stated maturity in 2023, bear interest at 6.67% and are collateralized by the loans receivable contributed by us and PMC Capital to the 2002 Joint Venture. We accounted for this transaction as a sale, recorded a gain of \$562,000 and recorded our Retained Interests at an initial amount of \$5,293,000 during 2002. At inception of the 2002 Joint Venture, we had a subordinate interest of 39% in the limited partnership based on our share of the capital.

The terms of the notes issued in conjunction with the 2000 Joint Venture, the 2001 Joint Venture, the 2002 Joint Venture and the 2003 Joint Venture (collectively the "JV Notes") provide that the partners of the respective Joint Ventures are not liable for any payments on the JV Notes. Accordingly, if the Joint Ventures fail to pay the JV Notes, the sole recourse of the holders of the JV Notes is against the assets of the respective Joint Venture. Accordingly, we have no obligation to pay the JV Notes, nor do the holders of the JV Notes have any recourse against our assets.

Information on Originated Structured Loan Sale Transactions

Information relating to our Originated Structured Loan Sale Transactions was as follows:

	2000 Joint Venture	2001 Joint Venture	2002 Joint Venture	2003 Joint Venture
	<i>(Dollars in thousands)</i>			
Transaction date	12/18/00	06/27/01	04/12/02	10/07/03
Principal amount of loans sold:				
At time of sale	\$ 55,675	\$ 32,662	\$ 27,286	\$ 45,456
At December 31, 2004	\$ 37,526	\$ 27,337	\$ 25,362	\$ 37,985
Structured notes:				
At time of sale	\$ 49,550	\$ 30,063	\$ 24,557	\$ 40,910
At December 31, 2004	\$ 33,255	\$ 24,778	\$ 22,704	\$ 33,543
Weighted average interest rate on loans (1):				
At time of sale	9.63%	9.62%	9.23%	L+4.02%
At December 31, 2004	9.49%	9.59%	9.24%	L+4.02%
Required overcollateralization:				
At time of sale (2)	11.0%	8.0%	10.0%	10.0%
At December 31, 2004 (3)	14.8%	9.6%	10.8%	12.0%
Interest rate on the structured notes payable (1)	7.28%	6.36%	6.67%	L+1.25%
Rating of structured notes (4)	"Aaa"	"Aaa"	"Aaa"	"Aaa"
Cash reserve requirement	6.0%	6.0%	6.0%	6.0%

(1) Variable interest rates are denoted by the spread over the 90-day LIBOR ("L").

(2) The required overcollateralization percentage at time of sale represents the portion of our Sold Loans retained by the QSPes whose value is included in Retained Interests.

(3) The required overcollateralization percentage at December 31, 2004 was larger than the required overcollateralization percentage at time of sale since all principal payments received on the underlying loans receivable are paid to the noteholders.

(4) Structured notes issued by the QSPes were rated by Moody's Investors Service, Inc.

Information on Acquired Structured Loan Sale Transactions and First Western 1997

Information relating to our Acquired Structured Loan Sale Transactions and First Western 1997 (purchased on February 29, 2004) was as follows:

	First Western 1997 (1)	1998 Partnership	1999 Partnership	2000 Joint Venture	2001 Joint Venture	2002 Joint Venture	2003 Joint Venture
<i>(Dollars in thousands)</i>							
Principal amount of loans sold:							
At February 29, 2004	\$ 2,683	\$ 21,702	\$ 29,800	\$ 17,345	\$ 37,191	\$ 36,102	\$ 56,424
At December 31, 2004	\$ 2,339	\$ 19,427	\$ 23,264	\$ 15,014	\$ 31,588	\$ 27,031	\$ 49,654
Structured notes/certificates:							
At February 29, 2004	\$ 2,683	\$ 21,221	\$ 26,394	\$ 15,636	\$ 33,324	\$ 32,932	\$ 50,774
At December 31, 2004	\$ 2,339	\$ 18,770	\$ 22,814	\$ 12,349	\$ 27,662	\$ 22,785	\$ 44,043
Weighted average interest rate on loans (2):							
At February 29, 2004	P+2.32%	P+1.22%	9.40%	9.20%	9.64%	9.58%	L+4.02%
At December 31, 2004	P+2.27%	P+1.22%	9.13%	9.12%	9.60%	9.63%	L+4.02%
Required overcollateralization (3) (4):							
At February 29, 2004	—	10.5%	12.0%	15.7%	10.6%	12.0%	10.2%
At December 31, 2004	—	10.5%	15.4%	18.2%	12.5%	16.0%	11.6%
Mortgage-backed security (5)							
	—	5.0%	—	—	—	—	—
Interest rate on structured notes/certificates (2)							
	P-1.90%	P-1.00%	6.60%	7.28%	6.36%	6.67%	L+1.25%
Rating of structured notes/certificates (6)							
	“Aaa”/“A”	“Aaa”	“Aaa”	“Aaa”	“Aaa”	“Aaa”	“Aaa”
Cash reserve requirement/minimum (7)							
	\$ 912	8.0%	6.0%	6.0%	6.0%	6.0%	6.0%

- (1) The transaction has both the primary and a subordinated portion of the transaction rated and sold.
- (2) Variable interest rates are denoted by the spread over (under) the prime rate (“P”) or the 90-day LIBOR (“L”). The interest rate for the “A” rated subordinated certificates of First Western 1997 is P-1.55%.
- (3) The required overcollateralization percentage at February 29, 2004 represents the portion of our Sold Loans retained by the QSPEs whose value is included in Retained Interests.
- (4) For the majority of the Acquired Structured Loan Sale Transactions, the required overcollateralization percentage at December 31, 2004 was larger than the required overcollateralization percentage at February 29, 2004 since all principal payments received on the underlying loans receivable are paid to the noteholders.
- (5) Owned by PMC Commercial.
- (6) Structured notes issued by the QSPEs were rated by Moody’s Investors Service, Inc.
- (7) Transactions all have minimum reserve requirements of 2% of the principal balance sold at the time of the sale. First Western 1997 is currently at its minimum requirement.

Retained Interests

Retained Interests represent our residual interest in the loans sold to the QSPE. When we securitize loans, we are required to recognize Retained Interests, which represent our right to receive net future cash flows, at their fair value. Our Retained Interests consist of (i) the required overcollateralization, which is the retention of a portion of each of the Sold Loans, (ii) the reserve fund, which represents the required cash balance owned by the QSPE and (iii) the interest-only strip receivable, which represents the future excess funds to be generated by the QSPE after payment of all obligations of the QSPE. Our Retained Interests are subject to credit, prepayment and interest rate risks. The estimated fair value of our Retained Interests is determined based on the present value of estimated future cash flows that we will receive from the QSPEs. The estimated future cash flows are calculated based on assumptions concerning, among other things, loan losses and prepayment speeds. On a quarterly basis, we measure the fair value of, and record income relating to, the Retained Interests based upon the future anticipated cash flows discounted based on an estimate of market interest rates for investments of this type. Any appreciation of the Retained Interests is included in our balance sheet in beneficiaries’ equity. Any depreciation of Retained Interests is either included in our statement of income as either a realized loss (if there is a reduction in expected future cash flows) or on the balance sheet in beneficiaries’ equity as an unrealized loss.

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We retain a portion of the default and prepayment risk associated with the underlying loans of our Retained Interests. Actual defaults and prepayments, with respect to estimating future cash flows for purposes of valuing our Retained Interests will vary from our assumptions, possibly to a material degree, and slower (faster) than anticipated prepayments of principal or lower (higher) than anticipated loan losses will increase (decrease) the fair value of our Retained Interests and related cash flows. We regularly measure our loan loss, prepayment and other assumptions against the actual performance of the loans sold. Although we believe that assumptions made as to the future cash flows are reasonable, actual rates of loss or prepayments will vary from those assumed and the assumptions may be revised based upon changes in facts or circumstances. See “Risk Factors – There is volatility in the valuation of our Retained Interests.”

TAX STATUS

PMC Commercial has elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended (the “Code”). As a REIT, PMC Commercial is generally not subject to Federal income tax (including any applicable alternative minimum tax) to the extent that it distributes at least 90% of its REIT taxable income to shareholders. First Western and PMCIIC have elected to be treated as taxable REIT subsidiaries; thus, their earnings are subject to U.S. Federal income tax. To the extent our taxable REIT subsidiaries retain their earnings and profits, these earnings and profits will be unavailable for distribution to our shareholders.

PMC Commercial may, however, be subject to certain Federal excise taxes and state and local taxes on its income and property. If PMC Commercial fails to qualify as a REIT in any taxable year, it will be subject to Federal income taxes at regular corporate rates (including any applicable alternative minimum tax) and will not be able to qualify as a REIT for four subsequent taxable years. REITs are subject to a number of organizational and operational requirements under the Code. See “Risk Factors” for additional tax status information.

RISK FACTORS

Management has identified the following important factors that could cause actual results to differ materially from those reflected in forward-looking statements or from our historical results. These factors, which are not all-inclusive, could have a material impact on our asset valuations, results of operations or financial condition. In addition, these factors could impair our ability to maintain dividend distributions at current levels.

We have a concentration of investments in the hospitality industry and in certain states, which may negatively impact the market price of our shares.

Substantially all of our revenue is generated from lending to hospitality properties and the ownership of Hotel Properties. Our loans receivable were approximately 95% concentrated in the hospitality industry at December 31, 2004. In addition, approximately 90% of the loans receivable underlying our Retained Interests were concentrated in the hospitality industry as of December 31, 2004. Any economic factors that negatively impact the hospitality industry, including terrorism, travel restrictions, bankruptcies or other political or geopolitical events, could have a material adverse effect on our financial condition and results of operations.

At December 31, 2004, approximately 14% of our loans receivable were collateralized by properties in Texas and approximately 12% were collateralized by properties in Virginia. Approximately 29% of the loans receivable underlying our Retained Interests were collateralized by properties in Texas. No other state had a concentration of 10% or greater of our loans receivable, Sold Loans or Aggregate Portfolio at December 31, 2004. See “Properties” in Item 2 of this Form 10-K for information on state concentrations related to our Hotel Properties. A decline in economic conditions in any state in which we have a concentration of investments could have a material adverse effect on our financial condition and results of operations.

We are dependent on third party management for the operation and sale of our Hotel Properties.

We are currently dependent upon Arlington to operate and manage our Hotel Properties under the Master Lease Agreement. The operating results of our Hotel Properties are subject to a variety of risks which could negatively impact the cash flow from our Hotel Properties to support the payment obligations under the Master Lease Agreement. Arlington announced in its Annual Report on Form 10-K for the year ended December 31, 2003, that the aggregate cash flow from the operations in 2003 of the Hotel Properties that we own and lease to one of Arlington’s subsidiaries was not sufficient to pay the lease obligations and ongoing capital expenditures related to these Hotel Properties as required by the amended individual lease agreements. To the extent the cash flows from

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our Hotel Properties are less than the lease payments, the shortfall is paid by Arlington from its other operations since Arlington has guaranteed the lease payments.

Per the Master Lease Agreement, Arlington is responsible for identifying and marketing our Hotel Properties for sale. There can be no assurance that the Hotel Properties will be sold at the best price or that buyers will be identified for our Hotel Properties. The Master Lease Agreement provides for incentives to sell the Hotel Properties in specific time frames. Arlington's ability to meet those deadlines will allow the continuation of the reduced base rent.

In the event Arlington defaults on the Master Lease Agreement, there can be no assurance that we would be able to find a new operator for our Hotel Properties, negotiate to receive the same amount of lease income or that we would be able to collect on the guarantee of Arlington. In addition, in the event Arlington defaults, we would incur costs including holding costs, legal fees and costs to re-franchise the properties.

The market for structured loan transactions may decline, which would decrease the availability of, and increase the cost of, working capital and negatively affect the potential for growth.

We will continue to need capital to fund loans. Our long-term ability to continue to grow depends, to a large extent, on our ability to sell our asset-backed securities through structured loan transactions. In certain economic markets the availability of funds may be diminished or the "spread" charged for funds may increase causing us to delay a structured loan transaction. In addition, terrorist attacks or political or geopolitical events could impact the availability and cost of our capital.

A number of factors could impair our ability, or alter our decision, to complete a structured loan transaction. These factors include, but are not limited to:

- As a result of certain economic conditions, investors in the type of asset-backed securities that we place may increase our cost of capital by widening the "spreads" (over a benchmark such as LIBOR or treasury rates) they require in order to purchase the asset-backed securities or cease acquiring our type of asset-backed security;
- A deterioration in the performance of our loans receivable or the loans receivable of our prior transactions (for example, higher than expected loan losses or delinquencies) may deter potential investors from purchasing our asset-backed securities;
- A deterioration in the operations or market perception of the limited service sector of the hospitality industry may deter potential investors from purchasing our asset-backed securities or lower the available rating from the rating agencies; and
- A change in the underlying criteria utilized by the rating agencies may cause transactions to receive lower ratings than previously issued thereby increasing the cost of capital on our transactions.

Significant changes in any of these criteria may result in us temporarily suspending our use of structured loan transactions and we may seek other sources of financing. A reduction in the availability or an increased cost of this source of funds could have a material adverse effect on our financial condition and results of operations since working capital may not be available or available at acceptable "spreads" to fund our future loan originations or to acquire real estate.

Economic slowdowns, negative political events and changes in the competitive environment could adversely affect operating results.

Several factors may impact the hospitality industry. Many of the businesses to which we have made, or will make, loans and Arlington may be susceptible to economic slowdowns or recessions. Terrorism, bankruptcies or other political or geopolitical events could affect our borrowers. Our non-performing assets are likely to increase during these periods. These conditions could lead to losses in our portfolio and a decrease in our interest income, net income and assets. During economic downturns, there may be reductions in business travel and consumers generally take fewer vacations. 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. Most of the limited service hospitality properties collateralizing our loans are located on interstate highways. As seen in the past, when gas prices sharply increase, occupancy rates for properties located on interstate highways decrease. These factors may cause a reduction in revenue per available room ("RevPAR"). If RevPAR for the limited service sector of the hospitality industry were to experience significant sustained reductions, the ability of our borrowers to meet their obligations could be impaired and loan losses could increase and the ability of Arlington to meet its obligations could be impaired.

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Many of our competitors have greater financial and managerial resources than us and are able to provide services we are not able to provide (*i.e.*, depository services). As a result of these competitors' greater financial resources, they may be better able to withstand the impact of economic downturns than we are.

As a result of the merger with PMC Capital, we now originate riskier loans and loan losses could increase.

As a result of the merger with PMC Capital, we acquired loans that either were impaired loans at the time of the merger or have become impaired loans subsequent to the merger. In addition, the loan origination platform that we acquired from PMC Capital (including lending through the SBA 7(a) Loan Program) generally is for loans which are more susceptible to loss and which may have higher loan-to-value ratios than we had previously originated. As a result, our loans may incur losses in future periods in greater amounts than had historically been realized.

Our operating results could be negatively impacted by our inability to access certain financial markets.

We rely upon access to capital markets as a source of liquidity to satisfy our working capital needs, grow and invest in loans. Although we believe that we maintain sufficient access to these financial markets, adverse changes in the economy, the overall health of the limited service hospitality industry and increased loan losses could limit access to these markets and restrict us from continuing our current operating strategy or implementing new operating strategies.

Competition might prevent us from originating loans at favorable yields, which would harm our results of operations and our ability to continue paying dividends at current levels.

Our net income depends on our ability to originate loans at favorable spreads over our borrowing costs. In originating loans, we compete with other specialty commercial lenders, banks, other REITs, savings and loan associations, insurance companies and other entities that originate loans, many of which have greater financial resources than us. As a result, we may not be able to originate sufficient mortgage loans at favorable spreads over our borrowing costs, which would harm our results of operations and consequently, our ability to continue paying dividends at current levels.

There is volatility in the valuation of our Retained Interests.

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 for our Retained Interests. Therefore, our estimate of the fair value may vary significantly from what a willing buyer would pay for these assets. 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 estimated fair value of such Retained Interests.

The estimated fair value of our Retained Interests is determined based on certain assumptions including, but not limited to, anticipated defaults, prepayment speeds and discount rates. We retain a portion of the default and prepayment risk associated with the underlying transferred loans of our Retained Interests. As more fully described below, actual defaults and prepayments with respect to estimating future cash flows for purposes of valuing the Retained Interests may vary from our assumptions, possibly to a material degree, and slower (faster) than anticipated prepayments of principal or lower (higher) than anticipated loan losses will increase (decrease) the fair value of our Retained Interests and the related estimated cash flows. The discount rates utilized are determined for each of the assets comprising the Retained Interests based upon an estimate of the inherent risks associated with each asset.

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The following is a sensitivity analysis of our Retained Interests as of December 31, 2004 to highlight the volatility that results when prepayments, loan losses and discount rates are different than our assumptions:

Changed Assumption	Value	Asset Change (1)
		<i>(In thousands)</i>
Losses increase by 50 basis points per annum (2)	\$ 66,766	(\$3,757)
Losses increase by 100 basis points per annum(2)	\$ 63,099	(\$7,424)
Rate of prepayment increases by 5% per annum(3)	\$ 69,235	(\$1,288)
Rate of prepayment increases by 10% per annum(3)	\$ 68,261	(\$2,262)
Discount rates increase by 100 basis points	\$ 67,761	(\$2,762)
Discount rates increase by 200 basis points	\$ 65,159	(\$5,364)

- (1) Any depreciation of our Retained Interests is either included in the accompanying statement of income as a realized loss (if there is a reduction in expected future cash flows) or on our balance sheet in beneficiaries' equity as an unrealized loss.
- (2) If we experience significant losses (i.e., in excess of anticipated losses), the effect on our Retained Interests would first be to reduce the value of the interest-only strip receivables. To the extent the interest-only strip 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 required overcollateralization.
- (3) 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. Values based on changes in these assumptions generally cannot be extrapolated since the relationship of the change in assumptions to the change in value may not be linear. The effect of a variation in a particular assumption on the estimated 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.

Changes in any of these assumptions or actual results which deviate from assumptions will affect the estimated fair value of our Retained Interests, possibly to a material degree. There can be no assurance as to the accuracy of these estimates.

We are leveraged.

We have borrowed funds and intend to obtain additional funds through advances under our revolving credit facility and conduit warehouse facility, completion of junior subordinated debt and/or preferred stock or SBA debentures, if available. As a result, we use leverage to fund our capital needs. Private lenders and the SBA have fixed dollar claims on our assets superior to the claims of the holders of our common shares. Leverage magnifies the effect that rising or falling interest rates have on our earnings. Any increase in the interest rate earned by us on investments in excess of the interest rate on the funds obtained from borrowings would cause our net income and earnings per share to increase more than they would without leverage, while any decrease in the interest rate earned by us on investments would cause net income and earnings per share to decline by a greater amount than they would without leverage. Leverage is thus generally considered a speculative investment technique. In order for us to repay indebtedness on a timely basis, we may be required to dispose of assets when we would not otherwise do so and at prices which may be below the net book value of such assets. Dispositions of assets could have a material adverse effect on our financial condition and results of operations.

There are significant risks in lending to small businesses.

Our loans receivable consist primarily of loans to small, privately-owned businesses. There is no publicly available information about these businesses; therefore, we must rely on our own due diligence to obtain information in connection with our investment decisions. Our borrowers may not meet net income, cash flow and other coverage tests typically imposed by banks. A borrower's ability to repay its loan may be adversely impacted by numerous factors, including a downturn in its industry or other negative economic conditions. Deterioration in a borrower's financial condition and prospects may be accompanied by deterioration in the collateral for the loan. In addition, small businesses typically depend on the management talents and efforts of one person or a small group of people for their success. The loss of services of one or more of these persons could have an adverse impact on the operations of the small business. Small companies are typically more vulnerable to customer preferences, market conditions and economic downturns and often need additional capital to expand or compete. These factors may have an impact on the ultimate recovery of our loans receivable from such businesses. Loans to small businesses,

therefore, involve a high degree of business and financial risk, which can result in substantial losses and accordingly should be considered speculative.

There is volatility in the valuation of our loans receivable.

There is typically no public market or established trading market for the loans we originate. The illiquid nature of our loans may adversely affect our ability to dispose of such loans at times when it may be advantageous for us to liquidate such investments.

To the extent one or several of our borrowers experience significant operating difficulties and we are forced to liquidate the loan, future losses may be substantial. The determination of whether significant doubt exists and whether a loan loss reserve is necessary for each loan requires judgment and consideration of the facts and circumstances existing at the evaluation date. Changes to the facts and circumstances of the borrower and/or the physical condition of the collateral underlying the loan, the hospitality industry and the economy may require the establishment of significant additional loan loss reserves.

We have an ongoing need for additional capital since earnings are required to be paid as dividends.

We will continue to need capital to fund loans. Historically, we have sold loans receivable as part of structured loan transactions, borrowed from financial institutions and issued equity securities to raise capital. A reduction in the availability of funds from financial institutions or the asset-backed securities market could have a material adverse effect on our financial condition and our results of operations. We must distribute at least 90% of our REIT taxable income to our shareholders to maintain our REIT status under the Code. As a result, that income will not be available to fund loan originations or acquire real estate. We expect to be able to borrow from financial institutions and sell loans receivable in the asset-backed securities market in the future.

We are subject to prepayment risk on our Retained Interests and loans receivable which could result in losses or reduced earnings and negatively affect our cash available for distribution to shareholders.

Prepayments of fixed-rate loans generally increase during times of declining interest rates. Conversely, prepayments of variable-rate loans may increase during times of increasing interest rates and are more susceptible to prepayment as a result of lower prepayment fees. The proceeds from the prepayments we receive are either used to repay debt or invested initially in temporary investments and for prepayments of our fixed-rate loans have generally been re-loaned or committed to be re-loaned at lower interest rates than the prepaid loans receivable. The lower interest rates we receive on these new loans receivable have had an adverse effect on our results of operations and depending upon the rate of future prepayments may further impact our results of operations. The impact of the lower lending rates on our net income may be partially offset by the reduced cost of our variable-rate borrowings in a lower interest rate environment. In addition, when loans receivable are repaid prior to their maturity, we often receive prepayment fees.

Prepayments of loans of the QSPEs may have a negative impact on our financial condition or results of operations. Prepayments of loans receivable with higher interest rates negatively impact the fair value of our Retained Interests to a greater extent than prepayments of loans receivable with lower interest rates. Prepayments in excess of assumptions will cause a decline in the fair value of our Retained Interests primarily relating to a reduction in the excess funds (our interest-only strip receivable) expected from our structured loan sale transactions. For example, if a \$1.0 million loan with an interest rate of 10% prepays and the “all-in cost” of that QSPE’s structured notes was 7%, we would lose the 3% spread we had expected to receive on that loan in future periods. Our “all-in costs” include interest, servicing, trustee and other ongoing costs. The “spread” that is lost may be offset in part or in whole by the prepayment fee that we collect.

First Western, our SBA guaranteed lending company, sells the guaranteed portion of most of its originated loans through private placements (“Secondary Market Sales”). These sales are especially sensitive to prepayments. Our Retained Interests in these loan sales consists only of the spread between the interest First Western collects from the borrower and the interest paid to the purchaser of the guaranteed portion of the loan. Therefore, to the extent the prepayments of these loans exceed estimates, there is a significant impact on the estimated fair value of the associated Retained Interests.

Changes in interest rates could negatively affect lending operations, which could result in reduced earnings.

The net income of our lending operations is materially dependent upon the “spread” between the rate at

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which we borrow funds (historically either short-term at variable rates or longer term at fixed rates) and the rate at which we loan these funds. During periods of changing interest rates, interest rate mismatches could negatively impact our net income, dividend yield, and the market price of our common shares.

At the present time, we primarily originate variable-rate loans and have debt which is long-term and at fixed interest rates and preferred stock which is long-term with a fixed dividend yield. If the yield on loans originated with funds obtained from fixed-rate borrowings or preferred stock fails to cover the cost of such funds, our cash flow will be reduced.

As a result of our dependence on variable-rate loans (all of our current commitments are for variable-rate loans), our interest income has been reduced (excluding the impact of loans acquired in the merger) during this low interest rate environment. In addition, to the extent that rates remain at these historically low levels, or if LIBOR or the prime rate decreases from current levels, interest income on our currently outstanding loans receivable will decline.

Changes in interest rates do not have an immediate impact on the interest income of our fixed-rate loans receivable. Our interest rate risk on our fixed-rate loans receivable is primarily due to loan prepayments and maturities. The average maturity of our loan portfolio is less than their average contractual terms because of prepayments. The average life of mortgage loans receivable tends to increase when the current mortgage rates are substantially higher than rates on existing mortgage loans receivable and, conversely, decrease when the current mortgage rates are substantially lower than rates on existing mortgage loans receivable (due to refinancings of fixed-rate loans receivable at lower rates).

Our Board of Trust Managers may change operating policies and strategies without shareholder approval or prior notice and such change could harm our business and results of operations and the value of our stock.

Our Board of Trust Managers has the authority to modify or waive our current operating policies and strategies, including PMC Commercial's election to operate as a REIT, without prior notice and without shareholder approval. We cannot predict the effect any changes to our current operating policies and strategies would have on our business, operating results and value of our stock; however, the effect could be adverse.

We depend on the accuracy and completeness of information about potential borrowers and guarantors.

In deciding whether or not to extend credit or enter into transactions with potential borrowers and/or their guarantors, we may rely on information furnished to us by or on behalf of potential borrowers and/or guarantors, including financial statements, construction invoices and other financial information. We may also rely on representations of potential borrowers and/or guarantors as to the accuracy and completeness of that information. Our financial condition and results of operations could be negatively impacted to the extent we rely on financial statements that are materially misleading.

There may be significant fluctuations in our quarterly results.

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

- The completion of a structured loan sale transaction in a particular period;
- Interest rate changes;
- The volume and timing of loan originations and prepayments of our loans receivable;
- 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 industry.

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

To the extent a structured loan sale transaction 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 transaction on future operating periods should be a reduction in interest income, net of interest expense.

We depend on our key personnel, and the loss of any of our key personnel could adversely affect our operations.

We depend on the diligence, experience and skill of our key personnel (executive officers) who provide management services to us for the selection, acquisition, structuring, monitoring and sale of our portfolio assets and the borrowings used to acquire these assets. We have entered into employment agreements with the majority of our executive officers who devote all of their business time to our business. The loss of any executive officer could harm our business, financial condition, cash flow and results of operations.

Failure to qualify as a REIT would subject us to U.S. Federal income tax.

If a company meets certain income and asset diversification and income distribution requirements under the Code, it can qualify as a REIT and be entitled to pass-through tax treatment. We would cease to qualify for pass-through tax treatment if we were unable to comply with these requirements. PMC Commercial is also subject to a non-deductible 4% excise tax (and, in certain cases, corporate level income tax) if we fail to make certain distributions. Failure to qualify as a REIT would subject us to Federal income tax as if we were an ordinary corporation, resulting in a substantial reduction in both our net assets and the amount of income available for distribution to our shareholders.

We believe that we have operated in a manner that allows us to qualify as a REIT under the Code and intend to continue to so operate. Although we believe that we are organized and operate as a REIT, no assurance can be given that we will continue to remain qualified as a REIT. Qualification as a REIT involves the application of technical and complex provisions of the Code for which there are limited judicial or administrative interpretations and involves the determination of various factual matters and circumstances not entirely within our control. In addition, no assurance can be given that new legislation, regulations, administrative interpretations or court decisions will not significantly change the tax laws with respect to qualification as a REIT or the Federal income tax consequences of such qualification.

If the combined company fails to qualify as a REIT, we may, among other things:

- not be allowed a deduction for distributions to our shareholders in computing our taxable income;
- be subject to U.S. Federal income tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates;
- be subject to increased state and local taxes; and,
- unless entitled to relief under certain statutory provisions, be disqualified from treatment as a REIT for the taxable year in which we lost our qualification and the four taxable years following the year during which we lost our qualification.

As a result of these factors, our failure to qualify as a REIT also could impair our ability to expand our business and raise capital, substantially reduce the funds available for distribution to our shareholders and may reduce the market price of our common shares.

Ownership limitation may restrict change of control or business combination opportunities.

In order for us to qualify as a REIT, no more than 50% in value of our outstanding capital shares may be owned, directly or indirectly, by five or fewer individuals during the last half of any calendar year. "Individuals" include natural persons, private foundations, some employee benefit plans and trusts, and some charitable trusts.

In order to preserve our REIT status, our declaration of trust generally prohibits any shareholder from directly or indirectly owning more than 9.8% of any class or series of our outstanding common shares or preferred shares. The ownership limitation could have the effect of discouraging a takeover or other transaction in which holders of our common shares might receive a premium for their shares over the then prevailing market price or which holders might believe to be otherwise in their best interests.

U.S. Federal income tax requirements may restrict our operations which could restrict our ability to take advantage of attractive investment opportunities.

We believe we have operated, and will continue to operate, in a manner that is intended to qualify as a REIT for U.S. Federal income tax purposes. However, the U.S. Federal income tax laws governing REITs are extremely complex, and interpretations of the U.S. Federal income tax laws governing qualification as a REIT are

limited. Qualifying as a REIT will require us to meet various tests regarding the nature of our assets and our income, the ownership of our outstanding shares and the amount of distributions we make on an ongoing basis.

At any time, new laws, interpretations, or court decisions may change the federal tax laws regarding, or the U.S. Federal income tax consequences of, qualification as a REIT. In addition, compliance with the REIT qualification tests could restrict our ability to take advantage of attractive investment opportunities in non-qualifying assets, which would negatively affect the cash available for distribution to our shareholders.

Failure to make required distributions would subject us to tax.

In order to qualify as a REIT, an entity generally must distribute to its shareholders, each taxable year, at least 90% of its taxable income, other than any net capital gain and excluding the non-distributed taxable income of taxable REIT subsidiaries. As a result, our shareholders receive periodic distributions from us. Such distributions are taxable as ordinary income to the extent that they are made out of current or accumulated earnings and profits. To the extent that a REIT satisfies the 90% distribution requirement, but distributes less than 100% of its taxable income, it will be subject to federal corporate income tax on its undistributed income. In addition, the REIT will incur a 4% nondeductible excise tax on the amount, if any, by which its distributions in any calendar year are less than the sum of:

- 85% of its ordinary income for that year;
- 95% of its capital gain net income for that year; and
- 100% of its undistributed taxable income from prior years.

We have paid out, and intend to continue to pay out, our REIT taxable income to our shareholders in a manner intended to satisfy the 90% distribution requirement and to avoid both Federal corporate income tax and the 4% excise tax.

Our taxable income may substantially exceed our net income as determined based on generally accepted accounting principles (“GAAP”) because, for example, capital losses will be deducted in determining GAAP income, but may not be deductible in computing taxable income. In addition, we may invest in assets that generate taxable income in excess of economic income or in advance of the corresponding cash flow from the assets, referred to as excess non-cash income. Although some types of non-cash income are excluded in determining the 90% distribution requirement, we will incur federal corporate income tax and the 4% excise tax with respect to any non-cash income items if we do not distribute those items on an annual basis. As a result of the foregoing, we may generate less cash flow than taxable income in a particular year. In that event, we may be required to use cash reserves, incur debt, or liquidate non-cash assets at rates or times that we regard as unfavorable in order to satisfy the distribution requirement and to avoid federal corporate income tax and the 4% excise tax in that year.

Our ownership of and relation with our taxable REIT subsidiaries will be limited, and a failure to comply with the limits would jeopardize our REIT status and may result in the application of a 100% excise tax.

Subject to certain restrictions, a REIT may own up to 100% of the stock of one or more taxable REIT subsidiaries. A taxable REIT subsidiary may earn income that would not be qualifying income if earned directly by the parent REIT. Both the subsidiary and the REIT must jointly elect to treat the subsidiary as a taxable REIT subsidiary. A corporation of which a taxable REIT subsidiary directly or indirectly owns more than 35% of the voting power or value of the stock will automatically be treated as a taxable REIT subsidiary. Overall, no more than 20% of the value of a REIT’s assets may consist of stock or securities of one or more taxable REIT subsidiaries. A taxable REIT subsidiary generally will pay income tax at regular corporate rates on any taxable income that it earns. In addition, the taxable REIT subsidiary rules limit the deductibility of interest paid or accrued by a taxable REIT subsidiary to its parent REIT to assure that the taxable REIT subsidiary is subject to an appropriate level of corporate taxation. The rules also impose a 100% excise tax on certain transactions between a taxable REIT subsidiary and its parent REIT that are not conducted on an arm’s-length basis.

Our taxable REIT subsidiaries are PMCID, First Western and PMC Funding Corp. PMC Funding Corp. holds assets on our behalf. Our taxable REIT subsidiaries are subject to normal corporate income taxes. We will monitor at all times the value of our investments in taxable REIT subsidiaries for the purpose of ensuring compliance with the rule that no more than 20% of the value of our assets may consist of taxable REIT subsidiary stock and securities (which is applied at the end of each calendar quarter). The aggregate value of our taxable REIT subsidiary stock and securities is less than 20% of the value of our total assets (including our taxable REIT subsidiary stock and securities). In addition, we will scrutinize all of our transactions with our taxable REIT

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subsidiaries for the purpose of ensuring that they are entered into on arm's-length terms in order to avoid incurring the 100% excise tax described above. There are no distribution requirements applicable to the taxable REIT subsidiaries and after-tax earnings may be retained. There can be no assurance, however, that we will be able to comply with the 20% limitation on ownership of taxable REIT subsidiary stock and securities on an ongoing basis so as to maintain REIT status or to avoid application of the 100% excise tax imposed on certain non-arm's-length transactions.

We operate in a highly regulated environment.

Changes in the laws or regulations governing REITs may significantly affect our business. As a company whose common shares are publicly traded, we are subject to the rules and regulations of the Securities and Exchange Commission. In addition, we are regulated by the SBA. Changes in laws that govern our entities may significantly affect our business. Laws and regulations may be changed from time to time, and the interpretations of the relevant laws and regulations are also subject to change. Any change in the laws or regulations governing our business could have a material impact on our financial condition or results of operations.

At any time, U.S. Federal income tax laws governing REITs or the administrative interpretations of those laws may be amended. Any of those new laws or interpretations thereof may take effect retroactively and could adversely affect us. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the tax rate on both dividends and long-term capital gains for most non-corporate taxpayers to 15% until 2008. This reduced maximum tax rate generally does not apply to ordinary REIT dividends, which continue to be subject to tax at the higher tax rates applicable to ordinary income (a maximum rate of 35%). However, the 15% maximum tax rate does apply to certain REIT distributions. This legislation may cause shares in non-REIT corporations to be a more attractive investment to individual investors than shares in REITs and may adversely affect the market price of our common shares.

To the extent a loan becomes a problem loan, we will deliver a default notice and begin foreclosure and liquidation proceedings when we determine that pursuit of these remedies is the most appropriate course of action. Foreclosure and bankruptcy are complex processes that are subject to federal and state laws and regulations, as well as various guidelines imposed by mortgage investors.

In conjunction with the operations of our assets acquired in liquidation, we are subject to numerous Federal, state and local laws and government regulations including environmental, occupational health and safety, state and local taxes and laws relating to access for disabled persons.

Under various Federal, state and local laws, ordinances and regulations, a current or former owner or operator of real estate may be considered liable for the costs of remediating or removing hazardous substances found on its property, regardless of whether or not the property owner or operator was responsible for its presence. Such liability may be imposed by the Environmental Protection Agency or any state or local government authority regardless of fault. The ultimate costs under environmental laws and the timing of these costs are difficult to predict, and the liability under some environmental laws related to contaminated sites can be imposed retroactively, may be on a joint and several basis and could be material to our financial statements or results of operations.

We are subject to the Americans with Disabilities Act.

The Americans with Disabilities Act of 1990 ("ADA") requires all public accommodations and commercial facilities to meet federal requirements related to access and use by disabled persons. Compliance with the ADA requirements could require removal of access barriers, and noncompliance could result in imposition of fines by the U.S. Government or an award of damages to private litigants. Although we believe that the properties that we own or finance are substantially in compliance with these requirements, a determination that the properties are not in compliance with the ADA could result in the imposition of fines or an award of damages to private litigants. Pursuant to the Master Lease Agreement relating to the Hotel Properties, costs and fines associated with the ADA are the responsibility of the tenant. However, a substantial expense may affect the borrowers' or tenants' ability to pay their obligations, and consequently, our cash flow and the amounts available for distributions to shareholders may be adversely affected.

EMPLOYEES

We employed 43 individuals including marketing professionals, investment professionals, operations professionals and administrative staff as of December 31, 2004. In addition, we have employment agreements with

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the majority of our executive officers. Annual base salary during the terms of the contracts does not exceed \$350,000 for any one individual. Our operations are conducted from our Dallas, Texas office. Management believes the relationship with its employees is good.

COMPETITION

Our primary competition for lending opportunities has come from banks, financial institutions and other lending companies. Many of these competitors have greater financial and managerial resources than us and are able to provide services we are not able to provide (*i.e.*, depository services). As a result of these competitors' greater financial resources, they may be better able to withstand the impact of economic downturns than we are.

Our net income primarily depends on our ability to originate loans at favorable spreads over our borrowing costs. In originating loans we compete with other specialty commercial lenders, banks, other REITs, savings and loan associations, insurance companies and other entities that originate loans, many of which have greater financial resources than us. As a result, we may not be able to originate sufficient mortgage loans at favorable spreads over our borrowing costs, which would harm our results of operations and consequently, our ability to continue paying dividends at current levels.

In conjunction with our variable-rate loan product, we believe we compete effectively on the basis of 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 variable-rate lending programs enhances our ability to react to current market conditions.

While we have originated fixed-rate loans, we do not expect to originate a significant amount of additional fixed-rate loans in the near future since our sources of funds are primarily variable-rate and due to competitors with a lower cost of funds.

CUSTOMERS

In relation to our lending division, we are not dependent upon a single borrower, or a few borrowers, whose loss would have a material adverse effect on us. In addition, we have not loaned more than 10% of our assets to any single borrower.

Our property division is currently dependent upon Arlington to operate the Hotel Properties. Lease income from Arlington represents 100% of the revenue in this segment. The loss of Arlington as operator of our properties could have a material adverse effect on us. As a REIT, we would be required to find another operator for our Hotel Properties and lease payments could be substantially less than we currently receive. Until such time as a new lease could be entered into, we would incur holding costs, legal fees and costs to re-franchise the properties.

AVAILABLE INFORMATION

We file annual, quarterly, current and special reports and other information with the Securities and Exchange Commission (the "SEC"). All documents may be located at the SEC's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549 or you may obtain information on the operation of the Public Reference Room by calling 1-800-SEC-0330. Our SEC filings are also available to the public, free of charge, at our internet site www.pmctrust.com, as soon as reasonably practicable after the reports are filed with, or furnished to, the SEC or at the SEC's internet site at www.sec.gov.

Item 2. PROPERTIES

We lease office space for our corporate headquarters in Dallas, Texas under an operating lease which expires in October of 2011.

At December 31, 2004, we owned 19 Hotel Properties. The Hotel Properties are leased to a wholly-owned subsidiary of Arlington pursuant to individual property leases, as amended, which are subject to the terms of a Master Lease Agreement. The Master Lease Agreement and the underlying individual property leases, as amended, expire in June 2008, but each can be extended by either Arlington or us for one five-year period, and thereafter by Arlington for a five-year period and a subsequent two-year period. If fully extended, the term of the Master Lease Agreement would continue until September 2020. Arlington guarantees the payment of the rent due under the terms of the Master Lease Agreement and the amended individual property leases. If Arlington defaults under the Master Lease Agreement, we have the right to, among other things, terminate the Master Lease Agreement and litigate to receive damages pursuant to the guarantee as a result of the default. Lease income represented approximately 22% of our total revenues during 2004. See "Property Ownership."

The following table describes the location, number of rooms, year built and annual current base rent for 2005 relating to our Hotel Properties:

City	State	Number of Rooms in Hotel	Year Built	Annual Base Rent (1)
Eagles Landing (2)	Georgia	60	1995	\$ 195,500
Rochelle	Illinois	61	1997	204,000
Macomb	Illinois	60	1995	221,000
Sycamore	Illinois	60	1996	221,000
Plainfield	Indiana	60	1992	204,000
Mt. Pleasant	Iowa	63	1997	187,000
Storm Lake	Iowa	61	1997	178,500
Coopersville	Michigan	60	1996	204,000
Grand Rapids North	Michigan	60	1995	229,500
Grand Rapids South	Michigan	61	1997	229,500
Monroe	Michigan	63	1997	212,500
Tupelo	Mississippi	61	1997	195,500
Ashland	Ohio	62	1996	255,000
Marysville	Ohio	79	1990	272,000
Wooster East	Ohio	58	1994	170,000
Wooster North	Ohio	60	1995	170,000
Jackson	Tennessee	61	1998	212,500
McKinney	Texas	61	1997	212,500
Mosinee	Wisconsin	53	1993	144,500
		1,164		\$3,918,500

(1) Assumes current base rent remains at 8.5% during 2005. If property sales do not occur in accordance with the Master Lease Agreement, base rent would increase to approximately 10.5%.

(2) Represents our real estate investment held for sale at December 31, 2004.

Item 3. LEGAL PROCEEDINGS

In the normal course of business, including our assets acquired in liquidation and the QSPEs, we are periodically party to certain legal actions and proceedings involving matters that are generally incidental to our business (*i.e.*, collection of loans receivable). In management's opinion, the resolution of these legal actions and proceedings will not have a material adverse effect on our consolidated financial statements.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of security holders during the fourth quarter of 2004.

PART II**Item 5. MARKET PRICE OF AND DIVIDENDS ON THE REGISTRANT'S COMMON STOCK AND RELATED SHAREHOLDER MATTERS**

The Common Shares are traded on the American Stock Exchange (the "AMEX") under the symbol "PCC." The following table sets forth, for the periods indicated, the high and low sales prices as reported on the AMEX and the regular and special dividends per share declared by us for each such period.

Quarter Ended	High	Low	Regular Dividends Per Share	Special Dividends Per Share
December 31, 2004	\$ 15.98	\$ 14.40	\$ 0.340	—
September 30, 2004	\$ 15.44	\$ 14.00	\$ 0.340	—
June 30, 2004	\$ 15.55	\$ 13.03	\$ 0.340	—
March 31, 2004	\$ 17.20	\$ 14.77	\$ 0.380	—
December 31, 2003	\$ 15.94	\$ 13.53	\$ 0.380	—
September 30, 2003	\$ 14.09	\$ 13.00	\$ 0.380	—
June 30, 2003	\$ 14.45	\$ 11.25	\$ 0.380	—
March 31, 2003	\$ 13.59	\$ 12.44	\$ 0.400	—
December 31, 2002	\$ 13.67	\$ 11.25	\$ 0.400	\$ 0.020
September 30, 2002	\$ 15.10	\$ 12.80	\$ 0.400	—
June 30, 2002	\$ 15.50	\$ 14.05	\$ 0.400	—
March 31, 2002	\$ 14.75	\$ 12.85	\$ 0.400	—

On March 7, 2005, there were approximately 1380 holders of record of Common Shares and the last reported sales price of the Common Shares was \$15.38.

Our shareholders are entitled to receive dividends when and as declared by our Board of Trust Managers (the "Board"). Our Board considers many factors including, but not limited to, expectations for future earnings, REIT taxable income, the interest rate environment, competition, our ability to obtain leverage and our loan portfolio activity in determining dividend policy. The Board also uses REIT taxable income plus tax depreciation, less the collection of percentage rents set aside for future capital expenditures in determining the amount of dividends declared. In addition, as a REIT we are required to pay out 90% of taxable income. Consequently, the dividend rate on a quarterly basis will not necessarily correlate directly to any single factor such as REIT taxable income or earnings expectations.

We have certain covenants within our debt facilities that limit our ability to pay out returns of capital as part of our dividends. These restrictions have not historically limited the amount of dividends we have paid and management does not believe that they will restrict future dividend payments. Additional information concerning dividends may be found in "Selected Financial Data" in Item 6 and in Item 8.

See Item 12 for information regarding our equity compensation plans.

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Item 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following is a summary of our Selected Consolidated Financial Data as of and for the five years in the period ended December 31, 2004. The following data should be read in conjunction with our consolidated financial statements and the notes thereto and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” appearing elsewhere in this Form 10-K. The selected financial data presented below has been derived from our consolidated financial statements.

	Years Ended December 31,				
	2004 (1)	2003	2002	2001	2000
	<i>(In thousands, except per share information)</i>				
Total revenues	\$ 25,359	\$ 14,081	\$ 15,247	\$ 15,628	\$ 18,297
Income from continuing operations	\$ 12,253	\$ 6,521	\$ 7,903	\$ 7,685	\$ 7,011
Discontinued operations (2)	\$ 935	\$ 942	\$ 1,471	\$ 967	\$ 933
Gain on sale of loans receivable	\$ —	\$ 711	\$ 562	\$ 1,433	\$ 1,117
Gain on sale of real estate investments (2)	\$ —	\$ —	\$ —	\$ 1,350	\$ 304
Extraordinary item: negative goodwill	\$ 11,593	\$ —	\$ —	\$ —	\$ —
Net income	\$ 24,781	\$ 8,174	\$ 9,936	\$ 11,435	\$ 9,365
Basic weighted average common shares outstanding	10,134	6,448	6,444	6,431	6,520
Basic and diluted earnings per common share:					
Income from continuing operations and gain on sale of loans receivable and real estate investments (2)	\$ 1.21	\$ 1.12	\$ 1.31	\$ 1.63	\$ 1.29
Extraordinary item: negative goodwill	\$ 1.14	\$ —	\$ —	\$ —	\$ —
Net income	\$ 2.44	\$ 1.27	\$ 1.54	\$ 1.78	\$ 1.44
Dividends declared, common	\$ 14,140	\$ 9,932	\$ 10,440	\$ 9,789	\$ 11,367
Dividends per common share	\$ 1.40	\$ 1.54	\$ 1.62	\$ 1.52	\$ 1.75
	At December 31,				
	2004 (1)	2003	2002	2001	2000
	<i>(In thousands)</i>				
Loans receivable, net	\$ 128,234	\$ 50,534	\$ 71,992	\$ 78,486	\$ 65,645
Real estate investments, net	\$ 36,223	\$ 41,205	\$ 44,928	\$ 52,718	\$ 65,674
Real estate investments, held for sale, net	\$ 1,859	\$ 2,134	\$ 1,877	\$ —	\$ —
Retained Interests	\$ 70,523	\$ 30,798	\$ 23,532	\$ 17,766	\$ 11,203
Total assets	\$ 253,840	\$ 131,736	\$ 149,698	\$ 156,347	\$ 151,399
Revolving credit facility	\$ 14,600	\$ —	\$ 7,300	\$ 8,700	\$ —
Redeemable preferred stock of subsidiary	\$ 3,488	\$ —	\$ —	\$ —	\$ —
Notes and debentures payable	\$ 60,749	\$ 33,380	\$ 41,191	\$ 48,370	\$ 53,235
Beneficiaries’ equity	\$ 161,304	\$ 92,091	\$ 93,929	\$ 92,771	\$ 89,785
Total liabilities and beneficiaries’ equity	\$ 253,840	\$ 131,736	\$ 149,698	\$ 156,347	\$ 151,399

- (1) On February 29, 2004, we merged with PMC Capital. Primarily as a result of the merger, total beneficiaries’ equity and total assets increased. The merger also resulted in a substantial increase in revenues and expenses. Revenues increased as a result of the income generated by the assets acquired from PMC Capital. Prior to the merger, we had no employees and most of our overhead was paid through an advisory relationship with PMC Capital. Subsequent to the merger, we are internally managed. Overhead, previously paid by PMC Capital, is now our responsibility.
- (2) Effective January 1, 2002, we adopted SFAS No. 144, “Accounting for the Impairment of or Disposal of Long-Lived Assets” (“SFAS No. 144”). In accordance with SFAS No. 144, gains and losses on property sales are classified within discontinued operations subsequent to the adoption. In addition, the operations of our Hotel Properties either sold during 2002, 2003 or 2004 or held for sale at December 31, 2004 have been reflected as discontinued operations in our accompanying statements of income and the prior period financial statements have been reclassified to reflect the operations of these properties as discontinued operations during all periods presented above.

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our Consolidated Financial Statements and the related notes that appear elsewhere in this document.

BUSINESS

Our mission is to derive income primarily from the origination of collateralized loans and from ownership in income producing real estate. Through conservative underwriting and exceptional service, we strive to provide our shareholders with the highest dividend, consistent with the focus on preservation of investment capital. We are committed to remain one of the nation's leading lenders to the limited service hospitality industry.

We are primarily a commercial lender that originates loans to small businesses that are principally collateralized by first liens on the real estate of the related business. We then sell certain of our loans receivable through privately-placed structured loan sale transactions. Historically, we have retained residual interests in all loans receivable sold through our subordinate financial interest in the related qualifying special purpose entities ("QSPEs").

Our revenues include the following:

- Interest earned on loans receivable including the effect of commitment fees collected at the inception of the loan;
- Lease income on our Hotel Properties;
- Income on our Retained Interests;
- Interest earned on temporary (short-term) investments; and
- Other related loan fees, including late fees, prepayment fees and construction monitoring fees.

Our ability to generate interest income, as well as other revenue sources, is dependent on economic, regulatory and competitive factors that influence interest rates and loan originations, and our ability to secure financing for our investment activities. The amount of other income earned will vary based on volume of loans funded, the timing and amount of financings, the volume of loans receivable which prepay, the mix of loans (construction versus non-construction), the rate and type of loans originated (whether fixed or variable) as well as the general level of interest rates. For a more detailed description of the risks affecting our financial condition and results of operations, see "Risk Factors" in Item 1 of this Form 10-K.

RECENT DEVELOPMENTS

Conduit Warehouse Facility

On February 7, 2005, we entered into a \$100.0 million conduit warehouse facility (the "Conduit Facility") with a concurrent reduction in our revolving credit facility from \$40.0 million at December 31, 2004 to \$20.0 million. In conjunction with the Conduit Facility, we created a new subsidiary, PMC Conduit, L.P., which will hold the assets and liabilities of the Conduit Facility.

The Conduit Facility operates as a revolving line of credit, collateralized by loans originated by us, which have been or will be sold and/or contributed to PMC Conduit, L.P. While PMC Commercial has not guaranteed the repayment of the Conduit Facility, PMC Commercial must repurchase the loans securing the Conduit Facility if certain of the representations and warranties made by PMC Commercial in connection with the Conduit Facility are breached. Approximately \$24.4 million of our loans were contributed to PMC Conduit, L.P. who immediately advanced \$15.0 million under the Conduit Facility which was used to repay a portion of the balance outstanding on our revolving credit facility at February 7, 2005. Interest payments on the advances are payable by PMC Conduit, L.P., on a monthly basis, and PMC Conduit L.P.'s principal repayment obligations are expected to be financed through future securitizations of the loans collateralizing advances under the Conduit Facility. We anticipate that future advances under the Conduit Facility will be used to further invest in loans. The Conduit Facility allows for advances based on the amount of eligible collateral contributed to the Conduit Facility and has several financial covenants, the most restrictive of which are maximum delinquency ratios for our contributed loans and serviced portfolio, as defined in the transaction documents. The ability to make advances under the Conduit Facility expires February 6, 2008.

The Conduit Facility is a short-term capital source that is an intermediary to our long-term source of capital which is currently the securitization of our loan portfolio. The Conduit Facility should allow us to build a larger pool of loans which will then be sold as part of a securitization.

Junior Subordinated Debt

On March 15, 2005, PMC Commercial issued notes payable (the "Junior Subordinated Notes") of approximately \$27.1 million due March 15, 2035 to a special purpose subsidiary, PMC Preferred Capital Trust-A, a Delaware statutory trust (the "Preferred Trust"). The Junior Subordinated Notes are subordinated to PMC Commercial's existing debt. The Preferred Trust issued shares of its preferred beneficial interest (the "Preferred Securities") to an unaffiliated party in exchange for approximately \$26.3 million and issued shares of common beneficial interest to PMC Commercial for \$820,000. The Junior Subordinated Notes and the Preferred Securities each bear interest at a floating rate which resets on a quarterly basis at the 90-day LIBOR plus 3.25% (approximately 6.25% as of March 15, 2005) and generally may not be redeemed prior to March 15, 2010. After payment of costs associated with the issuance of approximately \$800,000, the proceeds from the sale of the Preferred Securities were approximately \$25.5 million. The net proceeds were used to prepay, without penalty, the \$20 million of uncollateralized notes payable and the remainder was used to repay a portion of the outstanding balance on our Conduit Facility.

CURRENT OPERATING OVERVIEW AND ECONOMIC FACTORS

The following provides a summary of our current operating overview and significant economic factors that may have an impact on our financial condition and results of operations. The factors described below could impact the volume of loan originations, the income we earn on our assets, our ability to complete a securitization, the performance of our loans, the operations of our properties and/or the performance of the QSPEs.

General

We completed the merger with PMC Capital on February 29, 2004. Primarily as a result of the merger, beneficiaries' equity increased from approximately \$92.1 million at December 31, 2003 to approximately \$161.3 million at December 31, 2004, and total assets increased from approximately \$131.7 million at December 31, 2003 to approximately \$253.8 million at December 31, 2004. We believe that the merger has provided, and will continue to provide, more stability in income available for distribution through the larger, more diversified asset base. The merger resulted in a substantial increase in revenues and expenses. Revenues increased as a result of the income generated by the assets acquired from PMC Capital. Prior to the merger, we had no employees and most of our overhead was paid through an advisory relationship with PMC Capital. Subsequent to the merger, we are internally managed and overhead of the combined larger entity is now our responsibility. Our overhead also increased due to costs associated with the Sarbanes-Oxley Act of 2002 (the "Act"). We incurred consulting fees and costs related to external consultants and our external auditors' performance of procedures relating to the Act. These costs are significant, totaling approximately \$400,000 during 2004. Significant costs related to the Act are expected to continue in future periods.

The increased equity provided by the merger has assisted us in restructuring our leverage. In addition to the \$100.0 million Conduit Facility, which provided us with increased availability of funds, we completed the issuance of the Junior Subordinated Notes.

Lending Division

Loans originated during 2004 were \$53.7 million which is greater than the \$31.3 million of loans we originated during 2003. On a pro forma basis with PMC Capital, loans originated would have been \$68.1 million during 2003. We currently anticipate loan originations to be between \$60 million and \$80 million during 2005. Several key concerns have caused us to re-evaluate our estimates of loan originations as detailed below:

- our inability to originate fixed-rate loans at the same time that the market for variable-rate loans is decreasing;
- borrowers looking to fix their cost of capital in anticipation of rising interest rates;
- uncertainty as to the cost of funds we will pay when we securitize our loans; and
- local banks, with a substantially lower cost of capital than us, lending to operators in the limited hospitality industry.

In order to effectively compete for variable-rate loans, we are currently reducing the interest rate spreads that we historically charged by approximately 25 basis points. We believe that the spread reduction will still provide us with appropriate rewards for the risk related to the types of loans that we are originating but such loans will not be as profitable as in prior years.

At December 31, 2004 and 2003, our outstanding commitments to fund new loans were approximately \$30.3 million and \$7.7 million, respectively. Our pipeline has increased but not to the level we had at December 31, 2002 of approximately \$40.9 million. However, we have seen an increase in activity as the economic expansion gains traction and our renewed marketing efforts gain momentum.

Prior to 2003, we had primarily been a fixed-rate lender. During 2002, with interest rates falling and short-term rates at historical lows, borrowers were looking to take advantage of the market by either entering into "mini-perm" fixed-rate loans with banks or variable-rate loans. We could not effectively compete with the low fixed interest rates offered through the "mini-perm" products of the banks due to the relatively higher cost of our capital. Therefore, we introduced a variable-rate loan product based on LIBOR. With the continued low interest rate environment in 2003 and 2004, we became solely dependent on variable-rate loans.

Now that the market is changing so that borrowers are looking for fixed-rate loans, we are still constrained by the local bank competition that offers a five-year fixed-rate loan whose rate is well below the interest rate of the long-term interest rate that we can offer. Historically, the rate for our fixed-rate product needed to be around 4%

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over the 10-year treasury in order to provide us with what management believed was a reasonable spread. With the 10-year treasury at approximately 4.3%, the rate we needed to obtain is approximately 8.3% for a quality loan with a 20-year amortization and maturity. The local banks offer a five-year maturity, 20-year amortization loan at approximately 3% over 5-year treasuries (currently approximately 4.0%) which provides for an interest rate of approximately 7.0%. Management believes that the difference between the bank's rate and ours is causing borrowers to take on the refinancing risk that rates won't rise by more than 1.3% in the next five years and they are therefore taking the "mini-perm" bank loan.

Even if we were to originate fixed-rate loans, the securitization market cost of funds may cause us to have a lower spread than we historically have achieved on our fixed-rate securitizations. In addition, during the period between when we make loans with fixed interest rates and when we complete a fixed-rate structured loan transaction, if rates were to rise, our spreads would narrow. Therefore, until interest rate markets and competition revert back to conditions in 2002 and prior, we expect continued strong competition and therefore limited originations of fixed-rate loans.

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 "net interest spread"). A significant reduction in net interest spread may have a material adverse effect on our results of operations and may cause us to re-evaluate our lending focus. Over the past few years the spread has been reduced causing decreased income from continuing operations (excluding the increase from loans acquired in the merger) and there can be no assurance that it will not continue to decrease. We believe that our LIBOR-based loan program allows us to compete more effectively with variable-rate products of our competitors, provides us with a more attractive securitization product and provides us with a net interest spread that is less susceptible to interest rate fluctuations than our fixed-rate loan programs.

Most of our loans are to borrowers operating properties in the limited service sector of the hospitality industry. The limited service sector of the hospitality industry, as a subset of the hospitality industry, does not always react to economic conditions in the same manner as the rest of the hospitality industry. Economic conditions that impact the limited service sector of the hospitality industry and, to a lesser degree, the hospitality industry in general, have a significant impact on our loans to, and investments in, hospitality properties, and our future lending operations.

Property Division

We own 19 limited service hospitality properties. As a REIT, we cannot operate these properties. As a result, we are dependent upon Arlington to operate and manage our Hotel Properties. Arlington's operating results, including the operations of our Hotel Properties, are subject to a variety of risks which could affect Arlington's ability to generate sufficient cash flow to support the payment obligations under the amended master lease agreement (the "Master Lease Agreement"). In the event Arlington defaults on the Master Lease Agreement, there is no assurance that we would be able to find a new operator for our hotel properties, negotiate to receive the same amount of lease income or collect on the guarantee of Arlington. In addition, in the event Arlington defaults, we may incur costs, including holding costs, legal fees and costs to re-franchise the properties.

Effective October 1, 2004, the Master Lease Agreement with Arlington provides incentive for, among other things, the disposition of all Hotel Properties prior to October 1, 2008. Also, the current base rent was reduced through September 30, 2006 from approximately 10.5% to 8.5% of the Stated Value established for the Hotel Properties. The Stated Value of each Hotel Property (currently an aggregate of \$46.1 million) is the value attributed to each Hotel Property at the inception of the lease agreement for purposes of determining the lease payment. The continuation of the reduced base rent will continue unless, on a cumulative basis, at least five of the Hotel Properties are not sold over each of the next four years.

While current payments for rent have been reduced, these rent payment reductions will cease and increased rent payments will occur if Arlington does not either purchase from us, or have a third party purchase from us, the Hotel Properties at their Stated Value. The aggregate Stated Value of the properties of \$46.1 million is greater than our book value of \$38.1 million. In addition, based on discussions with Arlington and real estate brokers in the markets in which our Hotel Properties are located, the market value of the Hotel Properties in aggregate approximates the aggregate book value of the Hotel Properties. As a result, Arlington must provide additional rent over the remaining term of the lease either in shortfall notes at the time of a sale or through increased monthly rent payments. In the event the conditions as stipulated in the Master Lease Agreement are not met, the Master Lease Agreement provides for an increase in base rent to the prior contractual rate (approximately 10.5% of the Stated Value) or 15% of the Stated Value depending on the type of default. Commencing October 1, 2004, we are

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recognizing straight-line rent based on the estimated future cash flows from Arlington over the remaining term of the Master Lease Agreement.

In addition, as a result of the lease amendment:

- When a Hotel Property is classified as held for sale, we will incur impairment losses if the price to be paid by the third party purchaser is less than the net book value of the Hotel Property, as adjusted for selling and other costs;
- If a Hotel Property is sold below the Stated Value, Arlington will compensate us for the shortfall by entering into a promissory note with us. The value of the note receivable from Arlington will be recorded as an asset and a corresponding deferred liability (the "Rent Deferral");
- If the aggregate shortfall exceeds \$4.0 million, Arlington is immediately required to pay the excess. Any sales proceeds received in excess of the Stated Value of the Hotel Property sold will be applied against any shortfall. To the extent there is no remaining shortfall, any excess will be allocated to reduce the Stated Value on remaining Hotel Properties to be sold and will further reduce Arlington's lease obligation;
- Under the lease amendment, a fee is due from Arlington from each property sale equal to approximately 25% of the trailing twelve-month revenues for the Hotel Property sold. If principal payments are made on the shortfall note receivable such that the face amount of the note receivable is less than the Rent Deferral for that Hotel Property, lease income will be recorded; and
- Once the final amount of rent due from Arlington has been determined, which will occur no later than upon the sale of the last Hotel Property, the Rent Deferral would be recognized as income.

Effective October 1, 2004, we estimated that our cash received for rent (assuming no properties were sold) would be reduced, on an annual basis, by approximately \$1.0 million. Our lease payments will be further reduced as a result of property sales; however, we would earn income on any investments which we acquire with the proceeds from the property sale and/or repayment of any shortfall notes.

To the extent we approve sales of our Hotel Properties, certain of our Hotel Properties could be deemed impaired and impairment losses that result, if any, could be material. Our Hotel Properties are reviewed for impairment whenever events or circumstances indicate that the carrying amount of the property may not be recoverable, but in no event less than on a quarterly basis. To the extent Hotel Properties are sold, we will receive the net proceeds, after payment of any mortgage debt related to individual properties (currently we have mortgage debt of approximately \$14.2 million on eleven of the properties).

Lodging Industry

The prevailing lodging industry perception for 2005 is more optimistic than 2004. Lodging demand in the United States appears to correlate to changes in U.S. GDP growth, with typically a two to three quarter lag. Therefore, given the relatively strong U.S. GDP growth in the past year and the positive projections for the remainder of 2005, an improvement in 2005 and 2006 lodging demand is predicted by industry analysts. Such improvement will be dependent upon several factors including: the strength of the economy, the correlation of hotel demand to new hotel supply and the impact of global or domestic events on travel and the hotel industry. Industry analysts with PricewaterhouseCoopers LLP have published reports that predict the industry's results will improve in 2005 and 2006.

In 2004, occupancy increased slightly for the overall hospitality industry and average room rates showed a slight decline based on published industry statistics. We anticipate that lodging demand will increase in 2005 and 2006 as the lodging industry follows the economy. We believe improving economic trends in the lodging industry will generate an increase in competition among lenders, especially those lenders offering alternatives such as fixed-rate and "mini-perm" loans. We anticipate an improvement in volume but continued net interest spread pressure.

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. Most of the limited service hospitality properties collateralizing our loans are located on interstate highways. Historically, when gas prices sharply increase, occupancy rates decrease for properties located on interstate highways.

PORTFOLIO INFORMATION

Lending Activities

General

Our lending activities consist primarily of originating loans to borrowers who operate in the hospitality industry. Our net loans receivable were \$128.2 million and \$50.5 million at December 31, 2004 and 2003, respectively. During 2004 and 2003, we originated loans totaling \$53.7 million and \$31.3 million and received principal repayments of \$31.0 million (of which approximately \$13.7 million represented prepayments and \$5.3 million represented balloon maturities or repayments of SBA 504 program loans) and \$7.6 million (of which approximately \$2.6 million represented prepayments and \$2.4 million represented balloon maturities), respectively. Loans originated and principal payments during 2004 of \$53.7 million and \$31.0 million, respectively, include SBA 7(a) guaranteed loans originated of \$6.6 million and proceeds from the sale of SBA 7(a) guaranteed loans of \$6.2 million.

When originating a loan, we charge a commitment fee. During 2004 and 2003, we collected commitment fees of \$379,000 and \$110,000, respectively. The increase during 2004 is primarily due to the merger. Commitment fees are collected when the prospective borrower accepts our proposed terms and are deferred and recognized as an adjustment of yield over the life of the related loan receivable.

At December 31, 2004, approximately \$100.1 million of our loans receivable had a variable interest rate (reset on a quarterly basis) based primarily on the 90-day LIBOR, or the prime rate (primarily related to our SBA 7(a) Guaranteed Loan Program) with a weighted average interest rate of approximately 6.4%. The spread that we charge over LIBOR generally ranges from 3.5% to 4.5% and the spread we charge over the prime rate generally ranges from 1.75% to 2.75%. The LIBOR rate used in determining interest rates during the first quarter of 2005 (set on January 1, 2005) was 2.56%. The prime rate used in determining interest rates to be charged to our borrowers during the first quarter of 2005 (set on January 1, 2005) was 5.25%. To the extent LIBOR or the prime rate changes, we will have changes in interest income from our variable-rate loans receivable. In addition, at December 31, 2004, approximately \$28.1 million of our loans receivable had a fixed interest rate with a weighted average interest rate of approximately 9.7%. See Item 7A. "Quantitative and Qualitative Disclosures About Market Risk."

Prepayment Activity

Prepayment activity on our fixed-rate loans receivable has remained at high levels as a result of the continued low interest rate environment. We believe that we will continue to see prepayment activity at these higher levels in 2005. Many of our prepayment fees for our fixed-rate loans receivable are based upon a yield maintenance premium which provides for greater prepayment fees as interest rates decrease. In addition, certain loans receivable have prepayment prohibitions of up to five years.

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 current and anticipated interest rate environment (*i.e.*, if interest rates are expected to rise or fall);
- The market for limited service hospitality property sales; and
- The amount of the prepayment fee and the length of prepayment prohibition.

When our loans receivable are repaid prior to their maturity, we generally receive prepayment fees. Prepayment fees result in one-time increases in our income. The proceeds from the prepayments we receive are either used to repay debt or invested initially in temporary investments and for prepayments of our fixed-rate loans have generally been re-loaned or committed to be re-loaned at lower 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 another which might magnify or counteract the rate or volume of prepayment activity.

Prepayments of loans receivable of the QSPEs will also have an impact on our financial condition and results of operations. Prepayments of Sold Loans with higher interest rates negatively impact the value of our Retained Interests to a greater extent than prepayments of Sold Loans with lower interest rates. Prepayments in excess of our assumptions will cause a decline in the value of our Retained Interests primarily relating to a reduction

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in the excess funds (our interest-only strip receivable) expected from our structured loan sale transactions. The “spread” that is lost may be offset in part or in whole by the prepayment fee that we collect.

First Western, our SBA guaranteed lending company, sells the guaranteed portion of most of its originated loans through private placements. These sales are especially sensitive to prepayments. Our Retained Interests in these loan sales consist only of the spread between the interest First Western collects from the borrower and the interest paid to the purchaser of the guaranteed portion of the loan. Therefore, to the extent the prepayments of these loans exceed estimates, there is a significant impact on the value of the associated Retained Interests.

Impaired Loans

Our policy with respect to loans receivable which are in arrears as to interest payments for a period in excess of 60 days is generally to discontinue the accrual of interest income. To the extent a loan becomes a Problem Loan (as defined below), we will deliver a default notice and begin foreclosure and liquidation proceedings when we determine that pursuit of these remedies is the most appropriate course of action.

Senior management closely monitors our impaired loans which are classified into two categories: Problem Loans and Special Mention Loans (together, “Impaired Loans”). Our Problem Loans are loans which are not complying with their contractual terms, the collection of the balance of the principal is considered impaired and on which the fair value of the collateral is less than the remaining unamortized principal balance. Our Special Mention Loans are those loans receivable that are either not complying or had previously not complied with their contractual terms but we expect a full recovery of the principal balance through either collection efforts or liquidation of collateral.

Historically, we have not had a significant amount of Impaired Loans or delinquent loans nor have we had a significant amount of charged-off loans. Our Impaired Loans were as follows:

	At December 31,	
	2004 (1)	2003
	<i>(Dollars in thousands)</i>	
Problem Loans:		
Loans receivable	\$ 3,711	\$ 1,748
Sold loans of QSPEs	3,150	1,357
	<u>\$ 6,861</u>	<u>\$ 3,105</u>
Special Mention Loans:		
Loans receivable	\$ 1,376	\$ 249
Sold loans of QSPEs	—	—
	<u>\$ 1,376</u>	<u>\$ 249</u>
Percentage Problem Loans:		
Loans receivable	2.9%	3.4%
Sold loans of QSPEs	1.1%	0.9%
Percentage Special Mention Loans:		
Loans receivable	1.1%	0.5%
Sold loans of QSPEs	—	—

(1) Secondary Market Sales are excluded from sold loans of QSPEs as the SBA has guaranteed payment of principal on these loans.

Our provision for loan losses (excluding reductions of loan losses during 2004) as a percentage of our weighted average outstanding loans receivable was 0.42% and 0.40% during 2004 and 2003, respectively. During 2004, we reversed \$675,000 of previously recorded loan loss reserves due to the reduction in the expected loss on a loan collateralized by a limited service hospitality property due to repayment of all principal on the loan. We recorded loan loss reserves of \$422,000 during 2004 primarily related to two limited service hospitality properties on which significant doubt exists as to the ultimate realization of the loan.

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At December 31, 2004 and 2003, we had reserves in the amount of \$164,000 and \$675,000, respectively, against loans receivable that we have deemed to be Impaired Loans. Our aggregate Impaired Loans increased from \$3.4 million at December 31, 2003 to \$8.2 million at December 31, 2004 primarily as a result of our larger portfolio including the loans acquired in connection with the merger and the change in our underwriting. As a result of the merger, we acquired, and are originating loans which can be considered riskier (*i.e.*, higher loan-to-value ratio) than PMC Commercial originated prior to the merger.

Retained Interests

At December 31, 2004 and 2003, the estimated fair value of our Retained Interests was \$70.5 million and \$30.8 million, respectively. We acquired Retained Interests with an estimated value of \$43.6 million in connection with the merger. This estimated value became our cost through purchase accounting. Retained Interests represents the subordinate interest in loans receivable that have been contributed to QSPEs and have been recorded as sold. When we securitize loans receivable, we are required to recognize Retained Interests, which represents our right to receive net future cash flows, at their estimated fair value. Our Retained Interests consist of (i) the retention of a portion of each of the Sold Loans (the "required overcollateralization"), (ii) contractually required cash balances owned by the QSPE (the "reserve fund") and (iii) future excess funds to be generated by the QSPE after payment of all obligations of the QSPE (the "interest-only strip receivable"). Retained Interests are subject to credit, prepayment and interest rate risks.

The estimated fair value of our Retained Interests is based on estimates of the present value of future cash flows we expect to receive from the QSPEs. Estimated future cash flows are based in part upon estimates of prepayment speeds and loan losses. Prepayment speeds and loan losses are estimated based on the current and anticipated interest rate and competitive environments 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 actual results which deviate from our assumptions, may materially affect the value of our Retained Interests.

The net unrealized appreciation on our Retained Interests at December 31, 2004 and 2003 was approximately \$5.1 million and \$3.6 million, respectively. Any appreciation of our Retained Interests is included in the accompanying balance sheet in beneficiaries' equity. Any depreciation of our Retained Interests is either included in the accompanying statement of income as a realized loss (if there is a reduction in expected future cash flows) or on our balance sheet in beneficiaries' equity as an unrealized loss. Reductions in expected future cash flows generally occur as a result of decreases in expected yields, increases in anticipated loan losses or increases in prepayment speed assumptions. Our acquired Retained Interests are more susceptible to incurring realized losses. When acquired from PMC Capital, the estimated fair value at February 29, 2004 for each of the components of Retained Interests was recorded as our cost. As a result, during any period that (i) the value of any of the components of our Retained Interests is below the cost and (ii) the estimated cash flow from the particular component has been reduced, realized losses would result. Once realized losses occur, we recognize subsequent appreciation of our Retained Interests as income over the estimated remaining life of the Retained Interests through a higher effective yield.

Assets Acquired in Liquidation

We have not historically had a significant amount of assets acquired in liquidation. However, we anticipate that we will acquire assets through liquidation of the collateral underlying certain of our Problem Loans over the next twelve to eighteen months. Currently, we have \$6.9 million in aggregate Problem Loans, including \$3.2 million of Problem Loans of the QSPEs which may be repurchased by us if they become "charged-off" loans per the transaction documents.

With regard to properties acquired through foreclosure, deferred maintenance issues may have to be addressed as part of the operation of the property or it may not be economically justifiable to operate the property prior to its sale. To the extent keeping the property in operation is deemed to assist in attaining a higher value upon sale, we will take steps to do so including hiring third party management companies to operate the property.

In connection with the sale of our assets acquired in liquidation to third parties, we may finance a portion of the purchase price of the property. These loans will typically bear market rates of interest. While these loans are evaluated using the same methodology as our loans receivable, certain lending criteria may not be able to be achieved.

Property Ownership Data

Our Hotel Properties are operated by Arlington pursuant to our Master Lease Agreement.

The following table summarizes statistical data regarding the underlying operations of our 19 Hotel Properties (1):

	Years Ended December 31,		
	2004	2003	2002
Occupancy	56.37%	57.54%	58.83%
ADR (2)	\$ 54.67	\$ 54.61	\$ 55.62
RevPAR (3)	\$ 30.82	\$ 31.42	\$ 32.72
Room revenue	\$13,065,542	\$13,282,772	\$13,846,484
Rooms rented	238,985	243,214	248,964
Rooms available	423,971	422,698	423,202

(1) Arlington has provided all data (only includes properties owned as of December 31, 2004).

(2) "ADR" is defined as the average daily room rate.

(3) "RevPAR" is defined as room revenue per available room and is determined by dividing room revenue by available rooms for the applicable period.

Our income related to the Hotel Properties is from lease payments and the recording of straight-line rent adjustments. Our lease is a "triple net" lease; therefore, all expenses of operation including insurance and real estate taxes are the obligation of Arlington. The data provided above is for informational purposes only. All revenues and expenses from operation of the properties belong to Arlington.

A summary of financial information for the lessee of our properties, Arlington, (which has been derived from their latest available public filings as of our filing date) as of September 30, 2004 and December 31, 2003, and for the nine months ended September 30, 2004 and the years ended December 31, 2003 and 2002 is as follows:

ARLINGTON HOSPITALITY, INC.

	September 30, 2004	December 31, 2003		
	<i>(In thousands)</i>			
BALANCE SHEET DATA:				
Investment in hotel assets	\$ 59,403	\$ 81,629		
Cash and short term investments	3,304	3,624		
Total assets	76,436	99,713		
Total liabilities	66,466	87,926		
Shareholder's equity	9,970	11,787		
	<u>Nine months ended September 30,</u>	<u>Years ended December 31,</u>		
	2004	2003	2003	2002
	<i>(In thousands)</i>			
INCOME STATEMENT DATA:				
Total revenue	\$ 50,374	\$ 56,094	\$ 72,517	\$ 68,172
Operating income (loss)	757	(314)	(2,449)	2,921
Net loss	(2,047)	(3,759)	(5,619)	(1,710)

Arlington is a public entity that files periodic reports with the SEC. Additional information about Arlington, including December 31, 2004 financial information when available, can be obtained from the SEC's website at www.sec.gov.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and our results of operations is based upon our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. Our management has discussed the development and selection of these critical accounting policies and estimates with the audit committee of our Board of Trust Managers (the "Board"), and the audit committee has reviewed the disclosures relating to these policies and estimates included in this annual report.

We believe the following critical accounting considerations and significant accounting policies represent our more significant judgments and estimates used in the preparation of our consolidated financial statements.

Valuation of Loans Receivable

Loan loss reserves are established based on a determination, through an evaluation of the recoverability of individual loans receivable, that significant doubt exists as to the ultimate realization of the loan receivable. We monitor the loan portfolio on an ongoing basis and evaluate the adequacy of our loan loss reserves. In our analysis, we review various factors, including the value of the collateral securing the loan receivable and the borrower's payment history. The determination of whether significant doubt exists and whether a loan loss reserve is necessary for each loan requires judgment and consideration of the facts and circumstances existing at the evaluation date. Changes to the facts and circumstances of the borrower, the hospitality industry and the economy may require the establishment of significant additional loan loss reserves. If a determination is made that significant doubt exists as to the ultimate collection of our loans receivable, the effect on our results of operations may be material.

At December 31, 2004 and 2003, we had reserves in the amount of \$164,000 and \$675,000, respectively, against loans receivable that we have deemed to be Impaired Loans. Our provision for loan losses (excluding reductions of loan losses during 2004) as a percentage of our weighted average outstanding loans receivable was 0.42% and 0.40% during 2004 and 2003, respectively. During 2004, we reversed \$675,000 of previously recorded loan loss reserves due to the reduction in the expected loss on a loan collateralized by a limited service hospitality property due to repayment of all principal on the loan. We recorded loan loss reserves of \$422,000 during 2004 primarily related to two limited service hospitality properties on which significant doubt exists as to the ultimate realization of the loan. To the extent one or several of our loans experience significant operating difficulties and we are forced to liquidate the loans, future losses may be substantial.

Valuation of Retained Interests

Due to the limited number of entities that conduct structured loan sale 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 for our Retained Interests. Therefore, our estimate of fair value may vary significantly from what a willing buyer would pay for these assets.

The valuation of our Retained Interests is our most volatile critical accounting estimate because the valuation is dependent upon estimates of future cash flows that are dependent upon the performance of the underlying loans receivable and estimates of discount rates. Prepayments or losses in excess of estimates will cause unrealized depreciation and ultimately realized losses. The estimated fair value of our Retained Interests is determined based on the present value of estimated future cash flows from the QSPEs. The estimated future cash flows are calculated based on assumptions including, among other things, prepayment speeds and loan losses. We regularly measure loan loss and prepayment assumptions against the actual performance of the loans receivable sold and to the extent adjustments to our assumptions are deemed necessary, they are made on a quarterly basis. If prepayment speeds occur at a faster rate than anticipated, or future loan losses either occur quicker, or in amounts greater than expected, the fair value of the Retained Interests will decline and total income in future periods would be reduced. For example, if a \$1.0 million loan with an interest rate of 10% prepays and the "all-in cost" of that QSPE's structured notes was 7%, we would lose the 3% spread we had expected to receive on that loan in future periods. The "spread" that is lost may be offset in part or in whole by the prepayment fee that we collect. If prepayments occur slower than anticipated, or future loan losses are either slower than or less than expected, cash flows would exceed estimated amounts, the estimated fair value of our Retained Interests would increase and total income in future periods would be enhanced. Although we believe that assumptions as to the future cash flows of the structured loan sale transactions are reasonable, actual rates of loss or prepayments may vary significantly from those assumed and other assumptions may be revised based upon anticipated future events. These assumptions are

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updated on a quarterly basis. Over the past three years, there has been no significant change in the methodology employed in valuing these assets. The discount rates utilized in computing the net present value of future cash flows are based on an estimate of the inherent risks associated with each cash flow stream. Purchasers of these types of investments may utilize different discount rates in determining the fair value of the estimated future cash flows.

As a result of the merger, we acquired PMC Capital's subordinate interests in the Joint Ventures and 100% of the subordinate interests in the 1998 Partnership and the 1999 Partnership (collectively, the "Acquired Structured Loan Sale Transactions"). The remaining subordinate interests of the Joint Ventures were 32% of the 2000 Joint Venture, 58% of the 2001 Joint Venture, 61% of the 2002 Joint Venture and 56% of the 2003 Joint Venture. We previously owned the remaining subordinate interests in the Joint Ventures (the "Originated Structured Loan Sale Transactions").

Significant estimates related to the Originated Structured Loan Sale Transactions were as follows at December 31, 2004:

	Constant Prepayment Rate (1)	Aggregate Losses Assumed (2)	Range of Discount Rates
2000 Joint Venture	11.00%	3.54%	6.5% to 11.2%
2001 Joint Venture	10.75%	2.74%	6.5% to 11.2%
2002 Joint Venture	10.75%	3.82%	6.5% to 11.2%
2003 Joint Venture	11.00%	3.73%	7.7% to 11.2%

(1) Based on the actual performance of the loan pool, adjusted for anticipated principal prepayments considering other similar loans.

(2) Represents aggregate estimated future losses as a percentage of the principal outstanding of the underlying loans receivable as of December 31, 2004 based upon per annum losses that ranged from 0.0% to 2.2%. To the extent loans are likely to be liquidated in the next twelve months, estimated losses were assumed to occur during the year ending December 31, 2005. No losses are assumed for the year ending December 31, 2005 for those structured loan sale transactions with no current potential Impaired Loans.

Significant estimates related to our Acquired Structured Loan Sale Transactions and First Western 1997 were as follows at December 31, 2004:

	Constant Prepayment Rate (1)	Aggregate Losses Assumed (2)	Range of Discount Rates
Secondary Market (3)	20.0%	—	11.20%
First Western 1997	30.0%	0.02%	4.0% to 11.2%
1998 Partnership	12.0%	3.35%	6.4% to 11.2%
1999 Partnership	15.0%	2.54%	6.5% to 11.2%
2000 Joint Venture	15.0%	3.33%	6.9% to 11.6%
2001 Joint Venture	11.0%	2.88%	6.8% to 11.5%
2002 Joint Venture	11.0%	5.82%	6.8% to 11.5%
2003 Joint Venture	11.0%	3.52%	7.7% to 11.2%

(1) Based on the actual performance of the loan pool, adjusted for anticipated principal prepayments considering other similar loans.

(2) Represents aggregate estimated future losses as a percentage of the principal outstanding of the underlying loans receivable as of December 31, 2004 based upon per annum losses that ranged from 0.0% to 2.4%. To the extent loans are likely to be liquidated in the next twelve months, estimated losses were assumed to occur during the year ending December 31, 2005. No losses are assumed for the year ending December 31, 2005 for those structured loan sale transactions with no current potential Impaired Loans.

(3) There are no losses assumed on Secondary Market Sales as the SBA has guaranteed payment of principal on these loans.

At December 31, 2004, we have identified two sold loans (\$3.2 million) that we consider Problem Loans. If we had to liquidate these loans, the losses could exceed estimates and the estimated fair value of our Retained Interests would decline.

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The following is a sensitivity analysis of our Retained Interests as of December 31, 2004 to highlight the volatility that results when prepayments, loan losses and discount rates are different than our assumptions:

Changed Assumption	Value	Change (1)
	<i>(In thousands)</i>	
Losses increase by 50 basis points per annum (2)	\$ 66,766	(\$3,757)
Losses increase by 100 basis points per annum (2)	\$ 63,099	(\$7,424)
Rate of prepayment increases by 5% per annum (3)	\$ 69,235	(\$1,288)
Rate of prepayment increases by 10% per annum (3)	\$ 68,261	(\$2,262)
Discount rates increase by 100 basis points	\$ 67,761	(\$2,762)
Discount rates increase by 200 basis points	\$ 65,159	(\$5,364)

- (1) Any depreciation of our Retained Interests is either included in the accompanying statement of income as a realized loss (if there is a reduction in expected future cash flows) or on our balance sheet in beneficiaries' equity as an unrealized loss.
- (2) If we experience significant losses (i.e., in excess of anticipated losses), the effect on our Retained Interests would first reduce the value of the interest-only strip receivables. To the extent the interest-only strip 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 required overcollateralization.
- (3) 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. Values based on changes in these assumptions generally cannot be extrapolated since the relationship of the change in assumptions to the change in value may not be linear. The effect of a variation in a particular assumption on the estimated 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.

Valuation of Real Estate Investments

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," ("SFAS No. 144") our Hotel Properties are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable.

We consider each individual Hotel Property to be an identifiable component of our business. In accordance with SFAS No. 144, we do not consider hotels as "held for sale" until it is probable that the sale will be completed within one year. We consider a Hotel Property as "held for sale" once we have (i) executed a contract for sale, (ii) allowed the potential buyer to substantially complete their due diligence review and (iii) received a substantial non-refundable deposit. In addition, the determination of "held for sale" status is assessed based on all facts and circumstances, including management's intent and ability to eliminate the cash flows of the property from the Company's operations and management's intent and ability not to have significant continuing involvement in the operations of the property.

We discontinue depreciation on Hotel Properties if they are classified as "held for sale." Upon designation of a Hotel Property as "held for sale," we compare the carrying value of the Hotel Property to its estimated fair value, less costs to sell. We will reclassify the Hotel Property to real estate investment held for sale in our consolidated balance sheet at the lesser of its carrying value or its estimated fair value, less costs to sell. Any adjustment to the carrying value of a Hotel Property classified as "held for sale" is reflected in discontinued operations in our consolidated statements of income. In addition, the operating results of those properties classified as "held for sale" or that have been sold are included in discontinued operations.

For assets to be held and used, we perform a recoverability test to determine if the future undiscounted cash flows over our expected holding period for the property exceed the carrying amount of the property. If the recoverability test is not met, estimated fair value is determined by comparing the carrying value of the property to its future undiscounted cash flows using a risk-adjusted discount rate. Future cash flows are based on estimated future rent payments to be received on the Hotel Properties.

Revenue Recognition Policies

Interest Income

Interest income includes interest earned on loans and our short-term investments and includes the amortization of net loan origination fees and discounts. Interest income on loans is accrued as earned with the accrual of interest generally suspended when the related loan becomes a non-accrual loan. A loan receivable is generally classified as non-accrual (a "Non-Accrual Loan") if (i) it is past due as to payment of principal or interest for a period of more than 60 days, (ii) any portion of the loan is classified as doubtful or is charged-off or (iii) if the repayment in full of the principal and/or interest is in doubt. Generally, loans are charged off when management determines that we will be unable to collect any remaining amounts due under the loan agreement, either through liquidation of collateral or other means. Interest income on a Non-Accrual Loan is recognized on either the cash basis or the cost recovery basis.

When originating a loan receivable, we charge a commitment fee. These fees, net of costs, are deferred and recognized as an adjustment of yield over the life of the related loan receivable using a method which approximates the interest method.

For purchased loans, we may have discounts representing the difference between the unamortized principal balance of the loan and its estimated fair value at the date of purchase. These discounts are recognized as an adjustment of yield over the life of the related loan receivable using a method which approximates the interest method.

For loans originated under the SBA 7(a) Loan Program, when we sell the SBA guaranteed portion of the loans, a portion of the sale proceeds representing the difference in the face amount of the unguaranteed portion of the loans and the value of the loans (the "Retained Loan Discount") is recorded as a reduction in basis of the retained portion of the loan rather than premium income. The Retained Loan Discount is amortized to interest income over the life of the underlying loan using the interest method unless the underlying loan receivable is prepaid or sold.

Income from Retained Interests

The income from our Retained Interests represents the accretion (recognized using the interest method) on our Retained Interests which is determined based on estimates of future cash flows and includes any fees collected (*i.e.*, late fees, prepayment fees, etc.) by the QSPEs in excess of anticipated fees. We update our cash flow assumptions on a quarterly basis and any changes to cash flow assumptions impact the yield on our Retained Interests.

Lease Income

Lease income consists of base and percentage rents on our properties and straight-line rental income adjustments. We record the payments remaining to be paid on the Master Lease Agreement by Arlington to us on a straight-line basis. We receive a fixed percentage of the monthly room revenue of our leased properties which is reported as income when earned.

RESULTS OF OPERATIONS

Year Ended December 31, 2004 Compared to the Year Ended December 31, 2003

Overview

Income from continuing operations increased by \$5,732,000 (88%), to \$12,253,000 during 2004 from \$6,521,000 during 2003, primarily as a result of the merger. Earnings per share from continuing operations and gain on sales of loans receivable also increased \$0.09 (8%), to \$1.21 per share during 2004 from \$1.12 per share during 2003. Primarily as a result of the merger, net income increased by \$16,607,000, to \$24,781,000 during 2004 from \$8,174,000 during 2003. Earnings per share increased \$1.17, to \$2.44 per share during 2004 from \$1.27 per share during 2003. Net income during 2004 includes an extraordinary gain from negative goodwill of \$11,593,000 representing the excess of fair value of the net assets acquired over the cost of the merger with PMC Capital on February 29, 2004.

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The increase in income from continuing operations is primarily due to the merger with PMC Capital. As a result of the merger, our assets under management increased resulting in both increased revenues and expenses. Our revenue increases were primarily from (i) our Retained Interests (approximately \$5.8 million) due primarily to the acquisition of \$43.6 million of Retained Interests in connection with the merger with PMC Capital and the completion in October 2003 of our 2003 structured loan sale transaction, (ii) increased interest income (approximately \$2.4 million) due primarily to an increase in our weighted average loans receivable outstanding due to the acquisition of \$55.1 million of loans in the merger and (iii) increased other income (approximately \$2.1 million) due primarily to increased prepayments resulting in greater prepayment fee income and servicing fees earned subsequent to the merger with PMC Capital.

Our expense increases were (i) increased overhead (comprised of salaries and related benefits, general and administrative and advisory and servicing fees expense) of approximately \$3.4 million (upon merger with PMC Capital, we became a self-managed REIT), (ii) increased interest expense of approximately \$1.3 million due to liabilities assumed in the merger with PMC Capital and (iii) realized losses from Retained Interests of approximately \$1.2 million primarily due to a reduction in expected future cash flows due to increased anticipated and actual prepayments and anticipated losses on our acquired Retained Interests.

Significant changes in our revenues and expenses are further described below.

Revenues

Interest income increased by \$2,386,000 (41%), to \$8,162,000 during 2004 from \$5,776,000 during 2003. Interest income consisted of the following:

	Years Ended		Increase
	December 31,		
	2004	2003	
	<i>(In thousands)</i>		
Interest income – loans	\$7,588	\$5,625	\$ 1,963
Accretion of loan fees and discounts	290	124	166
Interest income — idle funds	284	27	257
	<u>\$8,162</u>	<u>\$5,776</u>	<u>\$ 2,386</u>

The increase in interest income – loans was primarily attributable to an increase in our weighted average loans receivable outstanding of \$23.1 million (30%) to \$100.8 million during 2004 from \$77.7 million during 2003 primarily as a result of the merger partially offset by a decrease in the weighted average interest rate on our loans receivable from 8.1% at December 31, 2003 to 7.1% at December 31, 2004. In addition, we accreted purchase discounts and received cash payments on certain of our Non-Accrual Loans during 2004. Our idle funds interest income increased due to cash equivalents of our SBICs, acquired in the merger, which are required to be used for future operating commitments of these SBICs.

Lease income increased \$436,000 (9%), to \$5,460,000 during 2004 compared to \$5,024,000 during 2003. Lease income consists of the following: (i) base rent, (ii) percentage rent and (iii) straight-line rent adjustments. In accordance with the terms of the Master Lease Agreement, we record lease income on a straight-line basis based on all remaining payments due from Arlington over the term of the Master Lease Agreement. Base rent is currently equal to 8.5% of the Stated Value (\$46.1 million) for the Hotel Properties. Base rent for our 18 Hotel Properties included in continuing operations was approximately \$4.4 million during 2004. Base rent for the 18 Hotel Properties was reduced by approximately \$220,000 during 2004 as a result of the lease amendment. In addition to our base rent, we receive percentage rent equal to 4% of the gross room revenues of our Hotel Properties. The Master Lease Agreement provides for rent increases to approximately 10.5% and ultimately 15% unless, on a cumulative basis, at least five of the Hotel Properties are sold over each of the next four years. During the fourth quarter of 2004, we recorded approximately \$575,000 of straight-line rent adjustments to lease income for the 18 Hotel Properties included in continuing operations. Assuming no property sales during 2005, we will record a straight-line rent adjustment of approximately \$2.1 million; however, base rent would be reduced from approximately \$4.4 million to approximately \$3.9 million. Our lease payments (base and percentage rent) would be reduced as a result of any additional property sales.

Income from Retained Interests increased \$5,821,000 (198%), to \$8,763,000 during 2004 compared to \$2,942,000 during 2003. The increase was mainly due to the acquisition of \$43.6 million of Retained Interests in

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the merger and the completion of our 2003 structured loan sale transaction. The weighted average balance of our Retained Interests was \$65.9 million during 2004 compared to \$24.0 million during 2003. The income generated from the Retained Interests acquired from PMC Capital was \$4.2 million during 2004. The income from our Retained Interests consists of the accretion earned on our Retained Interests which is determined based on estimates of future cash flows and includes any fees collected by the QSPEs in excess of anticipated fees. The yield on our Retained Interests, which is comprised of the income earned less realized losses, decreased to 11.5% during 2004 from 12.3% during 2003 primarily due to realized losses incurred.

Other income increased \$2,109,000 (622%), to \$2,448,000 during 2004 compared to \$339,000 during 2003 primarily due to (i) increased prepayment fees and (ii) servicing fees earned subsequent to the merger with PMC Capital. Prepayment fees increased from \$108,000 during 2003 to \$656,000 during 2004. Prepayment activity has remained at high levels as a result of the continued low interest rate environment. We believe that we will continue to see prepayment activity at these higher levels during 2005. As a result of the merger with PMC Capital, we now earn fees (\$1,142,000 during 2004) for servicing all loans held by the QSPEs and First Western's loans sold into the secondary market.

Interest Expense

Interest expense increased by \$1,345,000 (42%), to \$4,549,000 during 2004 from \$3,204,000 during 2003. Interest expense consisted of the following:

	Years Ended	
	December 31,	
	2004	2003
	<i>(In thousands)</i>	
Structured notes	\$ 880	\$1,477
Mortgages on Hotel Properties	1,037	1,123
Uncollateralized notes payable	970	—
Debentures payable	976	—
Revolving credit facility	471	576
Other	215	28
	<u>\$4,549</u>	<u>\$3,204</u>

The increase was attributable to interest expense on liabilities assumed from PMC Capital consisting primarily of (i) uncollateralized notes payable with a face value of \$35.0 million and a weighted average cost of funds of 3.8% and (ii) debentures payable with a face value of \$18.5 million and a cost of funds of 6.0%. During April and July 2004 (at maturity), we repaid \$5.0 million and \$10.0 million, respectively, of the uncollateralized notes payable with interest rates of LIBOR plus 1.3% and LIBOR plus 1.4%, respectively. This increase was partially offset by (i) a decrease in the principal balance of the structured notes payable from our 1998 structured loan financing (\$7.2 million outstanding at December 31, 2004 compared to \$18.7 million outstanding at December 31, 2003) due to prepayments of loans and (ii) a reduction in borrowings under our revolving credit facility (\$8.0 million weighted average borrowings outstanding during 2004 compared to \$17.3 million weighted average borrowings outstanding during 2003). As a result of the rising short-term interest rate environment, our cost of funds for our variable-rate debt, primarily our revolving credit facility and \$10.0 million of our uncollateralized notes payable, has been increasing. In addition, interest expense related to our revolving credit facility increased due to unused fees and the amortization of up-front costs.

Other Expenses

During 2003 and the first two months of 2004, (i) our overhead expense for identifying, originating and servicing our investment portfolio and costs of corporate overhead was covered by an investment advisory agreement with PMC Capital and (ii) other general and administrative costs were limited primarily to professional fees, directors and officers insurance, trust manager fees and shareholder expenses. As a result of the merger, on March 1, 2004, we became a self-managed REIT and our assets under management substantially increased from approximately \$244.4 million to approximately \$563.9 million. Beginning March 1, 2004, our operating expenses consisted of salaries and related benefits, rent and other general and administrative expenses necessary to service our investment portfolio, identify and originate new investments and provide for our corporate administrative needs.

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Since our assets under management increased, the increase in our general and administrative expenses is greater than our historical advisory fee expense. We estimate that the net increase in overhead as a result of the merger during 2004 was approximately \$3.0 million (\$3.6 million annualized). This increase does not include increased overhead resulting from any costs incurred from requirements of the Act or costs of new marketing programs.

Our combined general and administrative expenses, advisory fee expense and salaries and related benefits during 2004 increased by \$3,394,000 (145%), from \$2,333,000 during 2003 to \$5,727,000 during 2004. This increase was primarily a result of the increased costs related to our larger investment portfolio and corporate structure. In addition, our professional fees, including accounting, legal and consulting services, increased to \$880,000 during 2004 from \$165,000 during 2003. The increase relates primarily to accounting and consulting fees associated with requirements of the Act and increased accounting and auditing fees resulting from (i) the larger company subsequent to the merger and (ii) tax return compliance and preparation fees. We expect our professional fees to remain at these higher levels during 2005.

Realized losses on Retained Interests were \$1,182,000 during 2004, primarily resulting from a reduction in expected future cash flows due to increased anticipated and actual prepayments and anticipated losses on our acquired Retained Interests. Our acquired Retained Interests are more susceptible to incurring realized losses. When acquired from PMC Capital, the estimated fair value at February 29, 2004 for each of the components of Retained Interests was recorded as our cost. As a result, during any period that (i) the value of any of the components of our Retained Interests is below the cost and (ii) the estimated cash flow from the particular component has been reduced, realized losses will occur. Since our originated Retained Interests were recorded based on the "net realizable value" of the residual interests which established unrealized gains included in our beneficiaries' equity, realized losses will only be recorded if the unrealized valuation gains are reversed and estimated future cash flows are decreasing. There were no realized losses on our Retained Interests during 2003.

Our provision for (reduction of) loan losses, net, was (\$253,000) during 2004 and \$310,000 during 2003. During 2004, we reversed \$675,000 of previously recorded loan loss reserves due to the reduction in the expected loss on a loan collateralized by a limited service hospitality property due to repayment of all principal on the loan. We recorded loan loss reserves of \$422,000 during 2004 primarily related to two limited service hospitality properties on which significant doubt exists as to the ultimate realization of the loans. During 2003, we increased reserves on the loan which paid off during 2004 due to significant doubt as to the ultimate realization of the loan which existed at the time.

Discontinued operations

We had a net loss on sales of real estate of \$252,000 during 2004 compared to a gain of \$283,000 during 2003. The net loss during 2004 was primarily comprised of the sale of a limited service hospitality property acquired through liquidation of a loan and the sale of two Amerihost Inn hotel properties during 2004. The limited service hospitality property was sold for approximately \$1.5 million which generated a gain of approximately \$205,000. The two Amerihost Inn hotel properties were sold during August 2004 and December 2004 for approximately \$1.8 million each resulting in losses of approximately \$354,000 and \$116,000, respectively. Pursuant to the sale of the Amerihost Inn hotel property in August, we received a lease termination fee from Arlington in the form of a note receivable with an estimated fair value of \$624,000 which is included in net earnings from discontinued operations. The property was sold prior to the lease amendment which was effective October 1, 2004. The gain during 2003 was due to the sale of an Amerihost Inn hotel property for approximately \$2.2 million.

Our net earnings from discontinued operations increased by \$528,000 (80%), to a net profit of \$1,187,000 during 2004 from a net profit of \$659,000 during 2003 primary as a result of the lease termination fee income described above. During 2004, the rental income from the Amerihost Inn properties sold during 2004 and the Amerihost Inn property held for sale at December 31, 2004 were included in discontinued operations. In addition to these properties, during 2003 discontinued operations included the Amerihost Inn hotel property which was sold during 2003.

Extraordinary item – negative goodwill

Our negative goodwill was \$11,593,000 during 2004 representing the excess of fair value of the net assets acquired over the cost of the merger with PMC Capital. The cost of the merger was allocated to the assets acquired, liabilities assumed and preferred stock of subsidiary based on estimates of their respective fair values at the date of the merger. The fair value of the net assets acquired exceeded the cost of the merger, resulting in negative goodwill. The amount of negative goodwill was allocated proportionately to reduce the assigned values of the acquired assets

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excluding current assets, financial assets and assets held for sale. Substantially all of the assets acquired were considered to be financial assets or assets to be disposed of by sale.

Year Ended December 31, 2003 Compared to the Year Ended December 31, 2002

Overview

Income from continuing operations decreased by \$1,382,000 (17%) to \$6,521,000 during 2003 from \$7,903,000 during 2002. Net income decreased by \$1,762,000 (18%), to \$8,174,000 during 2003 from \$9,936,000 during 2002. Our basic earnings per share decreased \$0.27 (18%), to \$1.27 per share during 2003 from \$1.54 per share during 2002. The decrease in net income is primarily due to:

- decreased other income of \$825,000 due to reduced prepayments resulting in lower prepayment fee income;
- decreased interest income of \$460,000 due to the sale of loans receivable and an increase in variable-rate lending with lower variable interest rates than our fixed interest rate loans; and
- a decrease in the gain on sale of our real estate investments of \$380,000 as one hotel property was sold during 2003 while two hotel properties were sold during 2002.

Partially offsetting these decreases in net income were:

- decreased interest expense of \$241,000 due primarily to reduced balances outstanding on our structured notes payable from our 1998 structured loan financing; and
- an increase in the gain on sale of our loans receivable of \$149,000 due primarily to a larger volume of loans sold.

Significant changes in revenues and expenses are further described below.

Revenues

The interest income decrease of \$460,000 (7%), to \$5,776,000 during 2003 from \$6,236,000 during 2002 was primarily attributable to (i) the sale of \$45.4 million in loans receivable in a structured loan sale transaction completed in October 2003, (ii) the sale of the majority of our fixed-rate loans receivable in a structured loan sale transaction completed in April 2002, (iii) decreasing variable interest rates and (iv) principal collections including loan maturities and prepayments of our fixed-rate loans which were reinvested in lower yielding variable-rate loans.

Our lease income increased by \$70,000 (1%), to \$5,024,000 during 2003 from \$4,954,000 during 2002 primarily due to a 2% (CPI) increase in base rent during 2003.

Income from Retained Interests increased \$49,000 (2%), to \$2,942,000 during 2003 compared to \$2,893,000 during 2002. The income from our Retained Interests consists of the accretion on our Retained Interests which is determined based on estimates of future cash flows and includes any fees collected by the QSPEs in excess of anticipated fees. The increase was primarily the result of an increase in the balance of our Retained Interests due to the completion of our 2003 structured loan sale transaction partially offset by a decrease in the yield on our Retained Interests, which is comprised of the income earned less realized losses, to 12.3% during 2003 from 13.2% during 2002 resulting primarily from better than anticipated cash flows in 2002.

Other income decreased \$825,000 (71%), to \$339,000 during 2003 compared to \$1,164,000 during 2002 which is primarily attributable to increased prepayment fees received during 2002. Prepayment fees increased sharply in 2002 as a result of the refinancing options at low fixed interest rates made available by mini-perm loans offered by banks. While interest rates remained low and "mini-perm" bank loans were still available in 2003, many of the borrowers that considered refinancing did so during 2002.

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Interest Expense

Interest expense decreased by \$241,000 (7%), to \$3,204,000 during 2003 from \$3,445,000 during 2002. Interest expense consisted of the following:

	Years Ended	
	December 31,	
	2003	2002
	<i>(In thousands)</i>	
Structured Notes	\$1,477	\$1,982
Mortgages on Hotel Properties	1,123	1,156
Revolving credit facility	576	296
Other	28	11
	<u>\$3,204</u>	<u>\$3,445</u>

The decrease was primarily attributable to a decrease in the principal balance of the structured notes payable from our 1998 structured loan financing (\$18.7 million outstanding at December 31, 2003 compared to \$26.0 million outstanding at December 31, 2002). This decrease was partially offset by an increase in the weighted average borrowings outstanding under our revolving credit facility to \$17.3 million during 2003 compared to \$4.2 million during 2002. The weighted average interest rate on our revolving credit facility decreased to 3.1% during 2003 from 3.6% during 2002.

Other Expenses

Fees associated with the advisory agreements with our Investment Manager consisted of the following:

	Years Ended	
	December 31,	
	2003	2002
	<i>(In thousands)</i>	
Investment management fee	\$2,047	\$1,927
Lease supervision fee	378	401
Total fees incurred	2,425	2,328
Less:		
Management fees included in discontinued operations	(60)	(73)
Fees incurred on behalf of the QSPEs	(338)	(298)
Cost of structured loan sale transactions	(102)	(57)
Cost of property sales	(10)	(20)
Fees capitalized as cost of originating loans	(108)	(135)
Advisory and servicing fees to affiliate, net	<u>\$1,807</u>	<u>\$1,745</u>

Our provision for loan losses increased \$245,000 (377%), to \$310,000 during 2003 from \$65,000 during 2002. During 2003, we increased reserves on a loan on which significant doubt exists as to the ultimate realization of the loan.

Discontinued operations

Our profit from discontinued operations decreased by \$529,000 (36%), to a net profit of \$942,000 during 2003 from a net profit of \$1,471,000 during 2002. The decrease was primarily a result of property sales. Included in discontinued operations are the gains from selling one Amerihost Inn hotel property in 2003 and two Amerihost Inn hotel properties in 2002. The gain recognized in 2003 was \$380,000 less than 2002. Results of operations for the two properties sold during 2002, the property sold during 2003, the two properties sold during 2004, and the property held for sale at December 31, 2004 are included in discontinued operations for 2003 and 2002.

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Gain on sale of assets

Gain on sale of loans receivable was \$711,000 and \$562,000 during 2003 and 2002, respectively. The increase in the gain is primarily the result of (i) an increase in the amount of loans sold from \$27.3 million in April 2002 to \$45.4 million during October 2003 and (ii) an increase in the spread earned at the time the transactions were completed to 2.77% for the structured loan sale transaction completed in October 2003 compared to 2.56% for the structured loan sale transaction completed in April 2002. These increases were partially offset by an increase in costs for the 2003 transaction due primarily to the delay in completing the securitization.

CASH FLOW ANALYSIS

We generated \$12,953,000 and \$8,710,000 in cash from operating activities during 2004 and 2003, respectively. The primary source of funds from operating activities is our income from continuing operations which was \$12,253,000 during 2004 compared to \$6,521,000 during 2003 (an increase of \$5,732,000) primarily due to our increased net assets resulting from the merger with PMC Capital.

Our investing activities reflect a net source of funds of \$19,953,000 and \$17,534,000 during 2004 and 2003, respectively. The primary source of funds in 2004 resulted from the cash and cash equivalents acquired in connection with the merger of \$31,488,000 while during 2003 the primary source of funds was from proceeds from our 2003 structured loan sale transaction, net, of \$39,949,000. During 2004 and 2003, our net loans funded were comparable at \$20,431,000 in 2004 versus \$22,033,000 during 2003. During 2004, we also (i) had significant increases in funds related to our Retained Interests of \$6,361,000, (ii) received proceeds from the sales of properties, net, of \$3,513,000 and (iii) paid merger related costs of \$1,006,000. We anticipate that the principal received on our Retained Interests and proceeds from property sales during 2005 will continue at or exceed the levels experienced during 2004.

Our financing activities reflect a net use of funds of \$24,919,000 and \$25,215,000 during 2004 and 2003, respectively. Proceeds from our revolving credit facility increased \$21,900,000 during 2004 compared to 2003. We increased borrowing on our revolving credit facility during 2004 due to funding of loans, net of prepayments received. This increase in proceeds was partially offset by increased payment of principal on notes payable of \$19,133,000 primarily caused by prepayments of loans in our 1998 structured loan financing transaction and the repayment (at maturity) of \$15,000,000 in medium term notes payable acquired in connection with the merger. We increased payment of dividends to \$12,872,000 during 2004 from \$10,187,000 during 2003. The increased use of funds for dividends relates to the increased shares outstanding resulting primarily from the merger; however, on a per share basis our dividends decreased from \$1.54 per share during 2003 to \$1.40 per share during 2004.

LIQUIDITY AND CAPITAL RESOURCES

Sources and Uses of Funds

General

We have \$9.1 million of cash and cash equivalents at December 31, 2004. Of this, \$8.3 million is available only for future operating commitments of our SBICs. Pursuant to SBA rules and regulations, our SBICs cannot advance funds to us. As a result, we will have to borrow funds on the revolving credit facility or use the Conduit Facility to make investments even though our SBICs have available cash and cash equivalents. Our outstanding commitments to fund new loans were \$30.3 million at December 31, 2004, of which (i) \$4.9 million represents commitments of our SBICs and (ii) \$6.9 million are for loans to be originated by First Western, approximately 75% of which will be sold into the secondary market. Commitments have fixed expiration dates and require payment of a fee to us. Since some commitments expire without the proposed loan closing, total committed amounts do not necessarily represent future cash requirements.

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In general, our liquidity requirements include operating costs, origination of new loans, debt principal payment requirements and payment of dividends. We intend to utilize, as deemed appropriate by prevailing market conditions, a combination of the following sources to generate funds:

- Operating revenues;
- Principal collections on existing loans receivable and Retained Interests;
- Structured loan financings or sales;
- Advances under our Conduit Facility;
- Junior subordinated debt;
- Borrowings under our short-term uncollateralized revolving credit facility (the “Revolver”);
- Issuance of SBA debentures;
- Proceeds from sales of Hotel Properties, net; and/or
- Common equity issuance.

We expect that these sources of funds and cash on hand will be sufficient to meet our working capital needs. However, there can be no assurance that we will be able to raise funds through these financing sources. A reduction in the availability of the above sources of funds could have a material adverse effect on our financial condition and results of operations. If these sources are not available, we may have to originate loans at reduced levels or sell assets, potentially on unfavorable terms. Historically, our primary funding source has been the securitization and sale of our loans receivable. See “Structured Loan Transactions.”

As a REIT we must distribute to our shareholders at least 90% of our REIT taxable income to maintain our tax status under the Code. Accordingly, to the extent the sources above represent taxable income, such amounts have historically been distributed to our shareholders. During 2005, we anticipate that our cash flows from operating activities will be utilized to fund our expected 2005 dividend distributions and generally will not be available to fund portfolio growth or for the repayment of principal due on our debt.

At December 31, 2004, the SBICs had \$7.0 million in available commitments from the SBA expiring in September 2007 to issue future debentures. These debentures will have 10-year maturities, will be charged interest (established on the date of issuance) at a spread over 10-year treasuries and will have semi-annual interest-only payments. To the extent funds are needed to originate loans by our SBICs, these pre-approved debentures can be issued. During March 2005, \$4.0 million of these debentures were issued to PMCIC from our available commitments.

The primary use of our funds is to originate commercial mortgage loans to small businesses in the limited service hospitality industry. During 2005, we anticipate loan originations will range from \$60 million to \$80 million. See “Lending Division” for information on current market conditions. As a REIT, we also use funds for the payment of dividends to shareholders. While there are timing differences, in aggregate, our dividends will normally approximate 100% of our REIT taxable income. We also use funds for payment of our operating overhead including salaries and other general and administrative expenses and we have payment requirements of principal and interest on our borrowings.

In addition, we may use funds to repurchase loans from the QSPEs which (i) become “charged-off” as defined in the transaction documents either through delinquency or initiation of foreclosure, (ii) reach maturity or (iii) require modification due to an assumption. During 2004, we repurchased, at a price equal to their aggregate principal balance, approximately \$5.5 million of such loans, which are included in loans funded on our consolidated statement of cash flows. We recorded these loans at their estimated fair value at the date of repurchase of approximately \$4.4 million based on an analysis of anticipated proceeds either from liquidation of these loans or collections of principal and interest. To the extent additional loans become “charged-off,” reach maturity or require modification, we may repurchase these loans from the QSPEs at prices equal to their outstanding principal balance.

Debt

Information on our Revolver and notes and debentures payable was as follows as of December 31, 2004:

	Face Amount	2005 Required Principal Payments	Range of Maturities	Weighted Average Coupon Rate	Interest Type
<i>(In thousands, except footnotes)</i>					
Revolver	\$ 14,600	\$ 14,600	2005	4.13%	Variable
Structured notes payable (1)	7,244	588	2006 to 2018	6.37%	Fixed
Mortgage notes payable	14,191	1,515	2005 to 2019	6.82%	(2)
Uncollateralized notes payable	20,000	10,000	2005 to 2006	5.40%	(3)
Debentures payable	18,500	7,000	2005 to 2013	7.27%	Fixed
	<u>\$ 74,535</u>	<u>\$ 33,703</u>			

- (1) Principal payments of our 1998 structured notes payable are dependent upon cash flows received from the underlying loans receivable. Our estimate of their repayment is based on scheduled principal payments on the underlying loans receivable. Our estimate will differ from actual amounts to the extent we experience prepayments and/or loan losses.
- (2) Of the \$14.2 million in mortgage notes payable, \$3.7 million have variable rates of interest.
- (3) Of the \$20.0 million in uncollateralized notes payable, \$10.0 million have fixed rates of interest.

At December 31, 2004, we had \$14.6 million outstanding and availability of \$25.4 million under our Revolver which matures December 31, 2005. Under our Revolver, we are charged interest on the balance outstanding at our election of either the prime rate of the lender less 50 basis points or 187.5 basis points over the 30, 60 or 90-day LIBOR. In addition, we are charged an unused fee equal to 37.5 basis points computed based on our daily available balance. The credit facility requires us to meet certain covenants, the most restrictive of which provides for an asset coverage test based on our cash and cash equivalents, loans receivable, Retained Interests and real estate investments as a ratio to our senior debt and limit our ability to pay out returns of capital as part of our dividends. The ratio must exceed 1.25 times. At December 31, 2004, we were in compliance with the covenants of this facility. During February 2005, our Revolver was reduced from \$40 million to \$20 million upon completion of the Conduit Facility.

We do not anticipate any use of funds for the maturities on our mortgage notes payable since these mortgages are typically “rolled-over” into new mortgages upon maturity, unless the underlying Hotel Property has been sold.

During 2004 (at maturity), \$3.0 million of fixed-rate mortgages payable with interest rates of 7.5% and 8.0% were “rolled-over” into \$3.0 million of variable-rate mortgages payable with interest rates of prime plus 0.5% maturing in 2009. We have a \$1.0 million mortgage payable with a fixed interest rate of 5.6% due in December 2005 and anticipate that, if the underlying Hotel Property has not been sold, that this mortgage payable will be “rolled-over” into a new variable-rate mortgage payable.

In the merger, we assumed PMC Capital’s liabilities including \$35.0 million in uncollateralized notes payable with maturities through 2006 (the “Medium Term Notes”). We repaid \$5.0 million (at an interest rate of LIBOR plus 1.3%) and \$10.0 million (at an interest rate of LIBOR plus 1.4%) of the Medium Term Notes at maturity in April 2004 and July 2004, respectively, using existing cash and our Revolver. The Medium Term Notes require us to meet certain covenants, the most restrictive of which require that (i) net loans receivable must exceed 150% of senior funded debt, (ii) loan losses for any twelve-month period must not exceed 3% of net loans receivable and (iii) consolidated earnings plus interest expense must exceed 150% of interest expense. During March 2005, we prepaid, without penalty, the remaining \$20 million of Medium Term Notes.

In the merger, we assumed \$18.5 million in SBA debentures with maturities ranging from 2005 to 2013. At December 31, 2004, we had \$7.0 million in SBA debentures due in September 2005. During March 2005, we “rolled-over” \$4.0 million of such debentures and repaid the remaining \$3.0 million using cash on hand and our Revolver.

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On February 7, 2005, we entered into a \$100.0 million Conduit Facility with a concurrent reduction in our revolving credit facility from \$40.0 million at December 31, 2004 to \$20.0 million. The Conduit Facility operates as a revolving line of credit, collateralized by loans originated by us, which have been or will be sold and/or contributed to PMC Conduit, L.P. While PMC Commercial has not guaranteed the repayment of the Conduit Facility, PMC Commercial must repurchase the loans securing the Conduit Facility if certain of the representations and warranties made by PMC Commercial in connection with the Conduit Facility are breached. Approximately \$24.4 million of our loans were contributed to PMC Conduit, L.P. who immediately advanced \$15.0 million under the Conduit Facility which was used to repay a portion of the balance outstanding on our revolving credit facility at February 7, 2005. Interest payments on the advances are payable by PMC Conduit, L.P., on a monthly basis, and PMC Conduit L.P.'s principal repayment obligations are expected to be financed through future securitizations of the loans collateralizing advances under the Conduit Facility. We anticipate that future advances under the Conduit Facility will be used to further invest in loans. The Conduit Facility allows for advances based on the amount of eligible collateral contributed to the Conduit Facility and has covenants, the most restrictive of which are maximum delinquency ratios for our contributed loans and serviced portfolio, as defined in the transaction documents. The ability to make draws under the Conduit Facility expires February 6, 2008. At the end of each annual period commencing February 6, 2006, the alternate lenders have the option to extend their respective commitments for an additional 364-day period. If the Conduit Facility is not extended, any and all principal amounts outstanding and all accrued and unpaid interest would be immediately due and payable. In connection with the closing of our \$100 million Conduit Facility, we incurred approximately \$550,000 in costs including a fee to the financial institution of \$350,000.

On March 15, 2005, PMC Commercial issued Junior Subordinated Notes of approximately \$27.1 million due March 15, 2035 to the Preferred Trust. The Junior Subordinated Notes are subordinated to PMC Commercial's existing debt. The Preferred Trust issued the Preferred Securities to an unaffiliated party in exchange for approximately \$26.3 million and issued shares of common beneficial interest to PMC Commercial for \$820,000. The Junior Subordinated Notes and the Preferred Securities each bear interest at a floating rate which resets on a quarterly basis at the 90-day LIBOR plus 3.25% (approximately 6.25% as of March 15, 2005) and generally may not be redeemed prior to March 15, 2010. After payment of costs associated with the issuance of approximately \$800,000, the proceeds from the sale of the Preferred Securities were approximately \$25.5 million. The net proceeds were used to prepay, without penalty, the \$20 million of Medium Term Notes and the remainder was used to repay a portion of the outstanding balance on our Conduit Facility.

Structured Loan Transactions

Historically, our primary source of long-term funds has been structured loan sale transactions. We generated net proceeds of \$39.9 million, \$24.0 million, \$29.5 million and \$49.2 million from the completion of our 2003, 2002, 2001 and 2000 structured loan sale transactions, respectively. The proceeds from future structured loan sale transactions, if any, are expected to be greater as a result of the merger. Due primarily to decreased loan originations and availability of alternative sources of funds, we do not anticipate completing our next structured loan transaction until the latter half of 2005.

We account for structured loan sale transactions as sales of our loans receivable and the SPE meets the definition of a QSPE; as a result, neither the loans receivable contributed to the QSPE nor the notes payable issued by the QSPE are included in our consolidated financial statements. When a structured loan sale transaction is completed the subordinate interest in the QSPE is accounted for as a Retained Interest.

A structured loan financing is similar to a structured loan sale, with the exception that the transaction is not treated as a sale for financial reporting purposes. Therefore, the loans receivable contributed to the SPE and the notes payable issued by the SPE are included in our consolidated financial statements and, as a result, the ownership interest in the SPE is not accounted for as a Retained Interest.

The transaction documents of the QSPEs contain provisions (the "Credit Enhancement Provisions") that govern the assets and the inflow and outflow of funds of the QSPE formed as part of the structured loan transactions. The Credit Enhancement Provisions include specified limits on the delinquency, default and loss rates on the loans receivable included in each QSPE. If, at any measurement date, the delinquency, default or loss rate with respect to any QSPE were to exceed the specified limits, the Credit Enhancement Provisions would automatically increase the level of credit enhancement requirements for that QSPE. During the period in which the specified delinquency, default or loss rate was exceeded, excess cash flow from the QSPE, if any, which would otherwise be distributable to us, would be used to fund the increased credit enhancement levels up to the principal amount of such loans and would delay or reduce our distribution. The increased reserve requirement would be discontinued (i) if "charged-off" loans (as defined in the transaction documents) are repurchased by us from the QSPEs thereby releasing the excess cash previously deposited into the reserve accounts, (ii) upon liquidation of the collateral underlying the loan or (iii) if excess cash flow from the QSPE rebuilds the reserve or based on a combination of the above. While management believes that any funds used to build the reserve fund would ultimately be distributed to us, there can

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be no assurance that future events would not occur to cause amounts to continue to be deferred or never be distributed to us under Credit Enhancement Provisions.

Since we have historically relied on structured loan transactions as our primary source of operating capital to fund new loan originations, any adverse changes in our ability to complete this type of transaction, including any negative impact on the asset-backed securities market for the type of product we generate, could have a detrimental effect on our ability to sell loans receivable thereby reducing our ability to originate loans. The timing of a structured loan transaction also has significant impact on our financial condition and results of operations.

A number of factors could impair our ability, or alter our decision, to complete a structured loan transaction. See “Item 1. Business – Risk Factors.”

Seasonality

Generally, our business is not subject to seasonal trends. However, since we primarily lend to the limited service hospitality industry, loan delinquencies typically rise temporarily during the winter months due primarily to reductions in business travel and consumer vacations.

Impact of Inflation

To the extent that we originate fixed-rate loans while we borrow funds at variable rates, we have an interest rate mismatch. In an inflationary environment, if variable-rates were to rise significantly and we were originating fixed-rate loans, our net interest margin would be reduced. In general, we have matched our fixed-rate debt with fixed-rate producing assets. Our fixed-rate structured notes are matched with fixed-rate loans receivable and our fixed-rate mortgages are generally matched with our properties with a fixed-rate base rent. We primarily originate variable-rate loans and have \$28.3 million in variable-rate debt; therefore, we do not believe inflation will have a significant adverse impact on us in the near future.

To the extent costs of operations (*i.e.*, utilities, salaries, etc.) rise while economic conditions prevent a matching rise in revenue rates (*i.e.*, room rates, amenities, etc.), our borrowers and Arlington would be negatively impacted and loan losses and lease income could be affected. Accordingly, our borrowers can be impacted by inflation. In addition, in an inflationary environment we may experience pressure to increase our income and dividend yield to maintain our stock price.

[Table of Contents](#)**SUMMARIZED CONTRACTUAL OBLIGATIONS, COMMITMENTS AND CONTINGENCIES AND OFF-BALANCE SHEET ARRANGEMENTS**

The following summarizes our contractual obligations at December 31, 2004:

Contractual Obligations	Payments Due by Period				
	Total	Less than 1 year	1 to 3 years	4 to 5 years	After 5 years
<i>(In thousands)</i>					
Debt:					
Notes and debentures payable (1)	\$ 59,935	\$ 19,103	\$ 17,575	\$ 5,332	\$ 17,925
Revolver (2)	14,600	14,600	—	—	—
Redeemable preferred stock of subsidiary (3)	4,000	—	—	2,000	2,000
Interest:					
Notes and debentures payable and Revolver (1) (2)	12,492	3,520	3,610	2,856	2,506
Other Contractual Obligations:					
Operating lease (4)	1,296	155	346	394	401
Employment agreements (5)	2,863	1,108	1,755	—	—
Total contractual cash obligations	<u>\$ 95,186</u>	<u>\$ 38,486</u>	<u>\$ 23,286</u>	<u>\$ 10,582</u>	<u>\$ 22,832</u>

- (1) Principal payments of our 1998 structured notes payable (\$7.2 million at December 31, 2004) are dependent upon cash flows received from the underlying loans receivable. Our estimate of their repayment is based on scheduled principal payments on the underlying loans receivable. Our estimate will differ from actual amounts to the extent we experience prepayments and/or loan losses. Notes and debentures payable are presented at face value. For the interest obligation, the variable-rate in effect at December 31, 2004 was utilized and no change in variable interest rates was assumed.
- (2) We had availability of \$25.4 million under our Revolver at December 31, 2004. On February 7, 2005, upon completion of the \$100.0 million Conduit Facility, our Revolver was reduced to \$20.0 million.
- (3) The 4% preferred stock of our subsidiary (presented at par value) is required to be repaid at par in September 2009 (\$2.0 million) and May 2010 (\$2.0 million). Dividends of approximately \$160,000 are due annually on the 4% preferred stock of our subsidiary (recorded as interest expense).
- (4) Represents future minimum lease payments under our operating lease for office space.
- (5) We have employment agreements with certain of our executive officers.

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Our commitments at December 31, 2004 are summarized as follows:

Other Commitments	Total Amounts Committed	Amount of Commitment Expiration Per Period			
		Less than 1 year	1 to 3 years	4 to 5 years	After 5 years
		(In thousands)			
Environmental (1)	\$ —	\$ —	\$ —	\$ —	\$ —
Other commitments (2)	30,342	30,342	—	—	—
Total commitments	\$ 30,342	\$ 30,342	\$ —	\$ —	\$ —

- (1) PMC Funding has recorded a liability of approximately \$300,000 for the estimated costs at December 31, 2004 to remediate an environmental obligation related to an asset sold by PMC Funding. The sale was financed by PMC Capital with a loan with a current outstanding principal balance of approximately \$500,000. Under purchase accounting, the liability was assumed and the loan was acquired by PMC Commercial in the merger with PMC Capital. Our borrower has the primary responsibility for the environmental remediation. On February 25, 2005, we were informed by the Georgia Department of Natural Resources that the current remediation plan for the property requires revision. While our borrower has the primary responsibility for the environmental remediation, to the extent we were forced to reacquire the property, we currently believe that the estimated fair value of the collateral underlying the loan exceeds the current outstanding principal balance on the loan. At the present time, we have been unable to quantify additional costs, if any, of the potential changes in remediation methods requested by the State of Georgia; however, these costs could be material and may exceed the value of the collateral net of the recorded liability.
- (2) Represents our loan commitments and approvals outstanding.

Our off-balance sheet arrangements have typically been structured as sales which are our primary method of obtaining funds for new loan originations. In a structured loan sale transaction, we contribute loans receivable to a QSPE that is not subject to consolidation in exchange for cash and beneficial interests in that entity. The QSPE issues notes payable (usually through a private placement) to unaffiliated parties and then distributes a portion of the notes payable proceeds to us. The notes payable are collateralized solely by the assets of the QSPE. The terms of the notes payable issued by the QSPEs provide that the partners of these QSPEs are not liable for any payment on the notes. Accordingly, if the financial assets in the QSPE are insufficient for the trustee to pay the principal or interest due on the notes, the sole recourse of the holders of the notes is against the assets of the QSPE. We have no obligation to pay the notes, nor do the holders of the notes have any recourse against our assets. We account for structured loan sale transactions as sales of our loans receivable and the SPE meets the definition of a QSPE; as a result, neither the loans receivable contributed to the QSPE nor the notes payable issued by the QSPE are included in our consolidated financial statements. See "Item 1. Business – Structured Loan Transactions" and "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies and Estimates – Valuation of Retained Interests."

If the SBA establishes that a loss on an SBA guaranteed loan is attributable to significant technical deficiencies in the manner in which the loan was originated, funded or serviced by our subsidiary, First Western, the SBA may seek recovery of funds from us. With respect to the guaranteed portion of SBA loans that have been sold, the SBA will first honor its guarantee and then seek compensation from us in the event that a loss is deemed to be attributable to technical deficiencies.

In connection with the closing of our \$100 million Conduit Facility, we incurred approximately \$550,000 in costs including a fee to the financial institution of \$350,000. In addition, in connection with the issuance of the Junior Subordinated Notes, we incurred approximately \$800,000 in costs.

See Note 21 to the accompanying consolidated financial statements for a detailed discussion of commitments and contingencies.

RISK MANAGEMENT

In conducting our business, we are exposed to a range of risks including:

- *Market risk* which is the risk to our earnings or capital resulting from adverse changes in the values of assets resulting from movement in market interest rates;
- *Credit risk* which is the risk of loss due to an individual borrower's unwillingness or inability to pay their obligations;
- *Operations risk* which is the risk of loss resulting from systems failure, inadequate controls, human error, fraud or unforeseen catastrophes;
- *Liquidity risk* which is the potential that we would be unable to meet our obligations as they come due because of an inability to liquidate assets or obtain funding. Liquidity risk also includes the risk of having to sell assets at a loss to generate liquid funds, which is a function of the relative liquidity (market depth) of the asset(s) and general market conditions;
- *Compliance risk* which is the risk of loss, including fines or penalties, from failing to comply with Federal, state or local laws, rules and regulations pertaining to lending and licensed activities;
- *Legal risk* which is the risk of loss, disruption or other negative effect on our operations or condition that arises from unenforceable contracts, lawsuits, adverse judgments, or adverse governmental or regulatory proceedings, or the threat thereof; and
- *Reputational risk* which is the risk that negative publicity regarding our practices whether true or not will cause a decline in our customer base.

Our risk management policies and procedures are established and evaluated under the supervision of our Chief Executive Officer. The policies and procedures are designed to focus on the following:

- identifying, assessing and reporting on corporate risk exposures and trends;
- establishing, and revising as necessary, policies and procedures;
- monitoring and reporting on adherence with risk policies; and
- approving new product developments on business initiatives.

We cannot provide assurance that our risk management process or our internal controls will prevent or reduce the risks to which we are exposed. See "Risk Factors" in Item 1 of this Form 10-K.

IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

See Note 1 of the Consolidated Financial Statements for a full description of recent accounting pronouncements including the respective dates adopted or expected dates of adoption and effect, if any, on our results of operations and financial condition.

RELATED PARTY TRANSACTIONS

Prior to the merger, our loans receivable were managed by PMC Advisers, Ltd. ("PMC Advisers") (either directly or through its subsidiary), a subsidiary of PMC Capital, pursuant to an Investment Management Agreement (the "IMA") and our properties, including the Hotel Properties, were supervised by PMC Advisers pursuant to a separate agreement (the "Lease Supervision Agreement," and together with the IMA, the "Advisory Agreements"). Pursuant to the IMA, we were charged fees between 0.40% and 1.67% annually, based upon the average principal outstanding of our loans receivable. As a result of the merger, the IMA was terminated on February 29, 2004.

In addition, the Lease Supervision Agreement provided for an annual fee of 0.70% of the original cost of the properties to be paid to PMC Advisers for providing services relating to leases on our properties, a fee of \$10,000 upon the sale of each Hotel Property and an annual loan origination fee equal to five basis points of the first \$20 million in loans receivable funded and 2.5 basis points thereafter. As a result of the merger, the Lease Supervision Agreement was terminated on February 29, 2004.

Pursuant to the Advisory Agreements, we incurred an aggregate of approximately \$370,000, \$2.4 million and \$2.3 million in management fees during the two months ended February 29, 2004, and the years ended December 31, 2003 and 2002, respectively.

DIVIDENDS

On January 12, 2004, we paid a \$0.38 per share quarterly dividend to common shareholders of record on December 31, 2003. On February 27, 2004, we paid a \$0.243 per share quarterly dividend to common shareholders

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of record on February 23, 2004. The Board declared the remaining \$0.137 per share quarterly dividend (total of \$0.38 per share for the first quarter of 2004) to common shareholders of record on March 31, 2004, which was paid on April 12, 2004. Subsequent to the merger, the Board declared \$0.34 per share quarterly dividends to common shareholders of record on June 30, 2004, September 30, 2004 and December 31, 2004, which were paid on July 12, 2004, October 12, 2004 and January 10, 2005, respectively. In March 2005, the Board declared a \$0.35 per share quarterly dividend to common shareholders of record on March 31, 2005 which will be paid on April 11, 2005.

Our shareholders are entitled to receive dividends when and as declared by our Board. Our Board considers many factors including, but not limited to, expectations for future earnings, REIT taxable income, the interest rate environment, competition, our ability to obtain leverage and our loan portfolio activity in determining dividend policy. The Board also uses REIT taxable income plus tax depreciation, less the collection of percentage rents set aside for future capital expenditures in determining the amount of dividends declared. In addition, as a REIT we are required to pay out 90% of taxable income. Consequently, the dividend rate on a quarterly basis will not necessarily correlate directly to any single factor such as REIT taxable income or earnings expectations.

We have certain covenants within our debt facilities that limit our ability to pay out returns of capital as part of our dividends. These restrictions have not historically limited the amount of dividends we have paid and management does not believe that they will restrict future dividend payments.

If our loan originations continue in 2005 at the historically low rates we experienced during 2003 and 2004 and interest rates continue at their current low historical levels, we may not be able to recognize some of the growth opportunities we previously anticipated and it may impact our ability to maintain dividends at their current rate.

REIT TAXABLE INCOME

Taxable REIT income is presented to assist investors in analyzing our performance and is a measure that is presented quarterly in our consolidated financial statements and is one of the factors utilized by our Board in determining the level of dividends to be paid to our shareholders.

The following reconciles net income to REIT taxable income:

	Years Ended December 31,		
	2004	2003	2002
	<i>(In thousands)</i>		
Net income	\$ 24,781	\$ 8,174	\$ 9,936
Less: taxable REIT subsidiaries net income, net of tax	(145)	—	—
Add: book depreciation	1,872	1,967	2,121
Less: tax depreciation	(1,935)	(1,927)	(1,987)
Book/tax difference on losses (gains) on sales	135	(650)	(550)
Book/tax difference on Retained Interests, net	3,557	672	486
Negative goodwill	(11,593)	—	—
Asset valuation	(516)	310	65
Other book/tax differences, net	96	127	(55)
REIT taxable income	<u>\$ 16,252</u>	<u>\$ 8,673</u>	<u>\$10,016</u>
Distributions declared	<u>\$ 14,140</u>	<u>\$ 9,932</u>	<u>\$10,440</u>
Common shares outstanding	<u>10,877</u>	<u>6,453</u>	<u>6,446</u>

As a REIT, PMC Commercial generally will not be subject to corporate level Federal income tax on net income that is currently distributed to shareholders provided the distribution exceeds 90% of REIT taxable income. We may make an election under the Code to treat distributions declared in the current year as distributions of the prior year's taxable income. Upon election, the Code provides that, in certain circumstances, a dividend declared subsequent to the close of an entity's taxable year and prior to the extended due date of the entity's tax return may be considered as having been made in the prior tax year in satisfaction of income distribution requirements.

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Since our consolidated balance sheet consists of items subject to interest rate risk, we are subject to market risk associated with changes in interest rates as described below. Although management believes that the analysis below is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of our balance sheet and other business developments that could affect our financial position and net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by these estimates.

LOANS RECEIVABLE

Changes in interest rates on our fixed-rate loans receivable do not have an immediate impact on our interest income. Our interest rate risk on our fixed-rate loans receivable is primarily related to loan prepayments and maturities. The average maturity of our loan portfolio is less than their average contractual terms because of prepayments. The average life of mortgage loans receivable tends to increase when the current mortgage rates are substantially higher than rates on existing mortgage loans receivable and, conversely, decrease when the current mortgage rates are substantially lower than rates on existing mortgage loans receivable (due to refinancings of fixed-rate loans).

Our loans receivable are recorded at cost and adjusted by net loan origination fees and discounts (which are recognized as adjustments of yield over the life of the loan) and loan loss reserves. The estimated fair value of our fixed interest rate loans receivable (approximately \$28.8 million at December 31, 2004) is dependent upon several factors including changes in interest rates and the market for the types of loans that we have originated. If we were required to sell our loans at a time we would not otherwise do so, our losses may be substantial. At December 31, 2004 and 2003, the estimated fair value of our fixed-rate loans receivable generally approximates the remaining unamortized principal balance of the loans receivable, less any loan loss reserves or purchase or other discounts. Our variable-rate loans receivable are generally at spreads over LIBOR or the prime rate consistent with the market. Increases or decreases in interest rates will generally not have a material impact on the fair value of our variable-rate loans receivable.

At December 31, 2004 and 2003, we had \$100.1 million and \$21.2 million of variable-rate loans receivable, respectively, and \$28.3 million of variable-rate debt at December 31, 2004. All of our debt had fixed rates of interest as of December 31, 2003. On the differential between our variable-rate loans receivable outstanding and our variable-rate debt (\$71.8 million and \$21.2 million at December 31, 2004 and 2003, respectively) we have interest rate risk. To the extent variable rates continue to decrease our interest income net of interest expense would decrease.

As a result of \$22.4 million of our variable-rate loans receivable having interest rate floors (from 5.25% to 6%), we are deemed to have derivative instruments. However, in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, we are not required to bifurcate these investments; therefore, they are not accounted for as derivatives. To the extent that interest rates decline with respect to our loans that have floors, our interest expense on our variable-rate debt will be reduced by a higher amount than our interest income. We do not use derivatives for speculative purposes.

The sensitivity of our variable-rate loans receivable and debt to changes in interest rates is regularly monitored and analyzed by measuring the characteristics of our assets and liabilities. We assess interest rate risk in terms of the potential effect on interest income net of interest expense in an effort to ensure that we are insulated from any significant adverse effects from changes in interest rates. Based on our analysis of the sensitivity of interest income and interest expense at December 31, 2004 and 2003, if the consolidated balance sheet were to remain constant and no actions were taken to alter the existing interest rate sensitivity, each hypothetical 100 basis point reduction in interest rates would reduce net income by approximately \$494,000 and \$198,000, respectively.

REVOLVER, NOTES AND DEBENTURES PAYABLE AND REDEEMABLE PREFERRED STOCK OF SUBSIDIARY ("DEBT")

As of December 31, 2004 and 2003, approximately \$50.5 million (64%) and \$33.4 million (100%) of our consolidated debt had fixed rates of interest and therefore was not affected by changes in interest rates. Any amount outstanding on our Revolver is based on the prime rate and/or LIBOR and thus subject to adverse changes in market interest rates. Assuming there were no increases or decreases in the balance outstanding under our variable-rate debt at December 31, 2004, each hypothetical 100 basis points increase in interest rates would increase interest expense and decrease net income by approximately \$283,000.

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Since our fixed-rate debt has coupon rates that are currently higher (in general) than market rates, the fair value of these financial instruments is higher than their cost thus decreasing our net worth. The majority of this debt is the structured notes payable from our 1998 structured loan financing (which cannot be repaid other than through collections of principal on the underlying loans receivable), SBA debentures, mortgages payable and Medium Term Notes. Approximately \$11.5 million of our debentures have current prepayment penalties between 1% and 4% of the principal balance and \$7.0 million have no prepayment penalties. Our \$10.0 million of fixed-rate Medium Term Notes mature in July 2005 and have prepayment penalties. Of our \$10.5 million of fixed-rate Hotel Property mortgages, \$5.9 million have significant penalties for prepayment and \$4.6 million have no prepayment penalties.

The following presents the principal amounts, weighted average interest rates and estimated fair values required by year of expected maturity to evaluate the expected cash flows and sensitivity to interest rate changes of our outstanding debt at December 31, 2004 and 2003.

Market risk disclosures related to our outstanding debt as of December 31, 2004 were as follows:

	Years Ending December 31,					Thereafter	Carrying Value	Fair Value (1)
	2005	2006	2007	2008	2009			
	(Dollars in thousands)							
Fixed-rate debt (2)	\$ 18,969	\$ 6,350	\$ 809	\$ 1,933	\$ 2,656	\$ 19,774	\$ 50,491	\$ 51,111
Variable-rate debt (LIBOR and prime based)								
(3)	14,790	10,201	214	227	2,276	638	28,346	28,346
Totals	<u>\$ 33,759</u>	<u>\$ 16,551</u>	<u>\$ 1,023</u>	<u>\$ 2,160</u>	<u>\$ 4,932</u>	<u>\$ 20,412</u>	<u>\$ 78,837</u>	<u>\$ 79,457</u>

(1) The estimated fair value is based on a present value calculation based on prices of the same or similar instruments after considering risk, current interest rates and remaining maturities.

(2) The weighted average interest rate of our fixed-rate debt at December 31, 2004 was 6.6%.

(3) The weighted average interest rate of our variable-rate debt at December 31, 2004 was 4.0%.

Market risk disclosures related to our outstanding debt as of December 31, 2003 were as follows:

	Years Ending December 31,					Thereafter	Carrying Value	Fair Value(1)
	2004	2005	2006	2007	2008			
	(Dollars in thousands)							
Fixed-rate debt (2)	<u>\$ 13,165</u>	<u>\$ 3,569</u>	<u>\$ 7,928</u>	<u>\$ 929</u>	<u>\$ 1,981</u>	<u>\$ 5,808</u>	<u>\$ 33,380</u>	<u>\$ 34,514</u>

(1) The estimated fair value is based on a present value calculation based on prices of the same or similar instruments after considering risk, current interest rates and remaining maturities.

(2) The weighted average interest rate of our fixed-rate debt at December 31, 2003 was 6.7%.

RETAINED INTERESTS

Our Retained Interests are valued based on various factors including estimates of appropriate discount rates. Changes in the discount rates used in estimating the fair value of the Retained Interests will impact their carrying value. Any appreciation of our Retained Interests is included in the accompanying balance sheet in beneficiaries' equity. Any depreciation of our Retained Interests is either included in the accompanying statement of income as a realized loss (if there is a reduction in expected future cash flows) or on our balance sheet in beneficiaries' equity as an unrealized loss. Assuming all other factors (*i.e.*, prepayments, losses, etc.) remained unchanged, if discount rates were 100 basis points and 200 basis points higher than rates estimated at December 31, 2004, the estimated fair value of our Retained Interests at December 31, 2004 would have decreased by approximately \$2.8 million and \$5.4 million, respectively. Assuming all other factors (*i.e.*, prepayments, losses, etc.) remained unchanged, if discount rates were 100 basis points and 200 basis points higher than rates estimated at December 31, 2003, the estimated fair value of our Retained Interests at December 31, 2003 would have decreased by approximately \$1.4 million and \$2.6 million, respectively.

Item 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The information required by this Item 8 is hereby incorporated by reference to our Financial Statements beginning on page F-1 of this Form 10-K.

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

Item 9A. CONTROLS AND PROCEDURES

EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

Under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, management has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of December 31, 2004. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of the Company is responsible for establishing and maintaining effective internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2004. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*. Based on their assessment, management determined that as of December 31, 2004, the Company's internal control over financial reporting was effective based on those criteria.

Management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2004 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm who audited and reported on the Company's consolidated financial statements, as stated in their report included herein on page F-2 of this Form 10-K.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

There have been no changes in our internal control over financial reporting that occurred during the quarter ended December 31, 2004 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. OTHER INFORMATION

None.

PART III

Item 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Incorporated herein by reference to our definitive proxy statement to be filed with the Securities and Exchange Commission within 120 days after the year covered by this Form 10-K with respect to the Annual Meeting of Shareholders.

Code of Ethics

We have adopted a Code of Business Conduct and Ethics for trust managers, officers and employees which is available on our website at www.pmctrust.com. Shareholders may request a free copy of the code of Business Conduct and Ethics from:

PMC Commercial Trust
Attention: Chief Financial Officer
17950 Preston Road, Suite 600
Dallas, Texas 75252
(972) 349-3235
www.pmctrust.com

We have also adopted a Code of Ethical Conduct for Senior Financial Officers setting forth a code of ethics applicable to our principal executive officer, principal financial officer and principal accounting officer, which is available on our website at www.pmctrust.com. Shareholders may request a free copy of the Code of Ethical Conduct for Senior Financial Officers from the address and phone number set forth above.

Corporate Governance Guidelines

We have adopted Corporate Governance Guidelines which are available on our website at www.pmctrust.com. Shareholders may request a free copy of the Corporate Governance Guidelines from the address and phone number set forth above under “-Code of Ethics.”

Item 11. EXECUTIVE COMPENSATION

Incorporated herein by reference to our definitive proxy statement to be filed with the Securities and Exchange Commission within 120 days after the year covered by this Form 10-K with respect to the Annual Meeting of Shareholders.

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Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED SHAREHOLDER MATTERS

All of our equity compensation plans were approved by security holders. Our equity compensation plans expired on December 31, 2003; thus, no additional options will be issued unless new plans are approved by the shareholders. Information regarding our equity compensation plans was as follows at December 31, 2004:

Plan Category	Column		
	(a)	(b)	(c)
	Number of securities to be issued upon exercise of outstanding options	Weighted average exercise price of outstanding options	Number of securities remaining available for future issuances under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	164,260	\$ 15.86	—

Additional information regarding security ownership of certain beneficial owners and management and related shareholder matters is incorporated herein by reference to our definitive proxy statement to be filed with the Securities and Exchange Commission within 120 days after the year covered by this Form 10-K with respect to the Annual Meeting of Shareholders.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Incorporated herein by reference to our definitive proxy statement to be filed with the Securities and Exchange Commission within 120 days after the year covered by this Form 10-K with respect to the Annual Meeting of Shareholders.

Item 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Incorporated herein by reference to our definitive proxy statement to be filed with the Securities and Exchange Commission within 120 days after the year covered by this Form 10-K with respect to the Annual Meeting of Shareholders.

PART IV

Item 15. EXHIBITS, FINANCIAL STATEMENTS AND SCHEDULES

(a) Documents filed as part of this report

(1) Financial Statements -

See index to Financial Statements set forth on page F-1 of this Form 10-K.

(2) Financial Statement Schedules -

Schedule II — Valuation and Qualifying Accounts
Schedule III — Real Estate and Accumulated Depreciation
Schedule IV — Mortgage Loans on Real Estate

(3) Exhibits

See Exhibit Index beginning on page E-1 of this Form 10-K.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on our behalf by the undersigned, hereunto duly authorized.

PMC Commercial Trust

By: /s/ Lance B. Rosemore
Lance B. Rosemore, *President*

Dated: March 16, 2005

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons in the capacities and on the dates indicated.

<u>Name</u>	<u>Title</u>	<u>Date</u>
<u>/s/ DR. ANDREW S. ROSEMORE</u> Dr. Andrew S. Rosemore	Chairman of the Board of Trust Managers, Chief Operating Officer and Trust Manager	March 16, 2005
<u>/s/ LANCE B. ROSEMORE</u> Lance B. Rosemore	President, Chief Executive Officer, Secretary and Trust Manager (principal executive officer)	March 16, 2005
<u>/s/ BARRY N. BERLIN</u> Barry N. Berlin	Chief Financial Officer (principal financial and accounting officer)	March 16, 2005
<u>/s/ NATHAN COHEN</u> Nathan Cohen	Trust Manager	March 16, 2005
<u>/s/ DR. MARTHA GREENBERG</u> Dr. Martha Greenberg	Trust Manager	March 16, 2005
<u>/s/ ROY H. GREENBERG</u> Roy H. Greenberg	Trust Manager	March 16, 2005
<u>/s/ BARRY A. IMBER</u> Barry A. Imber	Trust Manager	March 16, 2005
<u>/s/ IRVING MUNN</u> Irving Munn	Trust Manager	March 16, 2005
<u>/s/ DR. IRA SILVER</u> Dr. Ira Silver	Trust Manager	March 16, 2005

**PMC COMMERCIAL TRUST AND SUBSIDIARIES
FORM 10-K
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Trust Managers of
PMC Commercial Trust:

We have completed an integrated audit of PMC Commercial Trust's 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2004 and audits of its 2003 and 2002 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedules

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, comprehensive income, beneficiaries' equity, and cash flows present fairly, in all material respects, the financial position of PMC Commercial Trust (the "Company") and its subsidiaries at December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the index appearing under Item 15(a)(2) present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in "Management's Report On Internal Control Over Financial Reporting," appearing under Item 9A of this Form 10-K, that the Company maintained effective internal control over financial reporting as of December 31, 2004 based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control — Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP

Dallas, Texas
March 16, 2005

PMC COMMERCIAL TRUST AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

	December 31,	
	2004	2003
ASSETS		
Loans receivable, net	\$ 128,234	\$ 50,534
Retained interests in transferred assets	70,523	30,798
Real estate investments, net	36,223	41,205
Real estate investment held for sale, net	1,859	2,134
Cash and cash equivalents	9,065	1,078
Restricted investments	3,096	4,068
Mortgage-backed security of affiliate	1,027	—
Note receivable	733	—
Deferred tax asset, net	327	—
Other assets	2,753	1,919
Total assets	\$ 253,840	\$ 131,736
LIABILITIES AND BENEFICIARIES' EQUITY		
Liabilities:		
Notes and debentures payable	\$ 60,749	\$ 33,380
Revolving credit facility	14,600	—
Redeemable preferred stock of subsidiary	3,488	—
Dividends payable	3,761	2,452
Borrower advances	2,732	1,260
Accounts payable and accrued expenses	2,674	615
Due to affiliates, net	1,971	72
Other liabilities	1,661	1,866
Total liabilities	91,636	39,645
<i>Commitments and contingencies</i>		
Cumulative preferred stock of subsidiary	900	—
Beneficiaries' equity:		
Common shares of beneficial interest; authorized 100,000,000 shares of \$0.01 par value; 11,009,811 and 6,585,641 shares issued at December 31, 2004 and 2003, respectively, 10,876,961 and 6,452,791 shares outstanding at December 31, 2004 and 2003, respectively	110	66
Additional paid-in capital	151,818	94,792
Net unrealized appreciation of retained interests in transferred assets	5,120	3,618
Cumulative net income	111,003	86,222
Cumulative dividends	(105,462)	(91,322)
	162,589	93,376
Less: Treasury stock; at cost, 132,850 shares	(1,285)	(1,285)
Total beneficiaries' equity	161,304	92,091
Total liabilities and beneficiaries' equity	\$ 253,840	\$ 131,736

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

PMC COMMERCIAL TRUST AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)

	Years Ended December 31,		
	2004	2003	2002
Revenues:			
Interest income	\$ 8,162	\$ 5,776	\$ 6,236
Income from retained interests in transferred assets	8,763	2,942	2,893
Lease income	5,460	5,024	4,954
Premium income	526	—	—
Other income	2,448	339	1,164
Total revenues	<u>25,359</u>	<u>14,081</u>	<u>15,247</u>
Expenses:			
Interest	4,549	3,204	3,445
Salaries and related benefits	3,557	—	—
General and administrative	1,882	526	385
Depreciation	1,710	1,646	1,597
Realized losses on retained interests in transferred assets	1,182	—	53
Advisory and servicing fees to affiliate, net	288	1,807	1,745
Provision for (reduction of) loan losses, net	(253)	310	65
Impairment loss on asset acquired in liquidation held for sale	—	67	54
Total expenses	<u>12,915</u>	<u>7,560</u>	<u>7,344</u>
Income before income tax provision, minority interest, discontinued operations and extraordinary item	12,444	6,521	7,903
Income tax provision	(116)	—	—
Minority interest (preferred stock dividend of subsidiary)	(75)	—	—
Income from continuing operations	<u>12,253</u>	<u>6,521</u>	<u>7,903</u>
Discontinued operations:			
Net gain (loss) on sales of real estate	(252)	283	663
Net earnings	1,187	659	808
	<u>935</u>	<u>942</u>	<u>1,471</u>
Gain on sale of loans receivable	<u>—</u>	<u>711</u>	<u>562</u>
Income before extraordinary item	13,188	8,174	9,936
Extraordinary item:			
Negative goodwill	11,593	—	—
Net income	<u>\$ 24,781</u>	<u>\$ 8,174</u>	<u>\$ 9,936</u>
Weighted average shares outstanding:			
Basic	<u>10,134</u>	<u>6,448</u>	<u>6,444</u>
Diluted	<u>10,152</u>	<u>6,460</u>	<u>6,456</u>
Basic and diluted earnings per share:			
Income from continuing operations and gain on sales of loans receivable	\$ 1.21	\$ 1.12	\$ 1.31
Discontinued operations	0.09	0.15	0.23
Extraordinary item	1.14	—	—
Net income	<u>\$ 2.44</u>	<u>\$ 1.27</u>	<u>\$ 1.54</u>

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

PMC COMMERCIAL TRUST AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

	<u>Years Ended December 31,</u>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Net income	<u>\$ 24,781</u>	<u>\$ 8,174</u>	<u>\$ 9,936</u>
Change in net unrealized appreciation of retained interests in transferred assets:			
Net unrealized appreciation arising during period	2,012	348	2,016
Less realized gains included in net income	<u>(510)</u>	<u>(513)</u>	<u>(418)</u>
	<u>1,502</u>	<u>(165)</u>	<u>1,598</u>
Comprehensive income	<u>\$ 26,283</u>	<u>\$ 8,009</u>	<u>\$ 11,534</u>

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

PMC COMMERCIAL TRUST AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF BENEFICIARIES' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2004, 2003 AND 2002
(In thousands, except share and per share data)

	Common Shares of Beneficial Interest Outstanding	Par Value	Additional Paid-in Capital	Net Unrealized Appreciation of Retained Interests in Transferred Assets	Cumulative Net Income	Cumulative Dividends	Treasury Stock	Total Beneficiaries' Equity
Balances, January 1, 2002	6,441,291	\$ 66	\$ 94,643	\$ 2,185	\$ 68,112	\$ (70,950)	\$ (1,285)	\$ 92,771
Net unrealized appreciation	—	—	—	1,598	—	—	—	1,598
Shares issued through exercise of stock options	5,000	—	64	—	—	—	—	64
Dividends (\$1.62 per share)	—	—	—	—	—	(10,440)	—	(10,440)
Net income	—	—	—	—	9,936	—	—	9,936
Balances, December 31, 2002	6,446,291	66	94,707	3,783	78,048	(81,390)	(1,285)	93,929
Net unrealized depreciation	—	—	—	(165)	—	—	—	(165)
Shares issued through exercise of stock options	6,500	—	83	—	—	—	—	83
Issuance of stock options	—	—	2	—	—	—	—	2
Dividends (\$1.54 per share)	—	—	—	—	—	(9,932)	—	(9,932)
Net income	—	—	—	—	8,174	—	—	8,174
Balances, December 31, 2003	6,452,791	66	94,792	3,618	86,222	(91,322)	(1,285)	92,091
Net unrealized appreciation	—	—	—	1,502	—	—	—	1,502
Treasury shares, net	(21,130)	—	—	—	—	—	(311)	(311)
Shares issued through exercise of stock options	59,500	—	378	—	—	—	311	689
Shares issued in connection with merger with PMC Capital, Inc.	4,385,800	44	57,410	—	—	—	—	57,454
Merger costs	—	—	(769)	—	—	—	—	(769)
Issuance of stock options	—	—	7	—	—	—	—	7
Dividends (\$1.40 per share)	—	—	—	—	—	(14,140)	—	(14,140)
Net income	—	—	—	—	24,781	—	—	24,781
Balances, December 31, 2004	10,876,961	\$ 110	\$ 151,818	\$ 5,120	\$ 111,003	\$ (105,462)	\$ (1,285)	\$ 161,304

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

PMC COMMERCIAL TRUST AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Years Ended December 31,		
	2004	2003	2002
Cash flows from operating activities:			
Net income	\$ 24,781	\$ 8,174	\$ 9,936
Adjustments to reconcile net income to net cash provided by operating activities:			
Loans funded, held for sale	(6,611)	—	—
Proceeds from sale of guaranteed loans	6,222	—	—
Loan fees collected, net	396	221	585
Capitalized loan origination costs	(185)	—	—
Non — cash adjustments:			
Depreciation	1,872	1,879	1,903
Realized losses on retained interests in transferred assets	1,182	—	53
Extraordinary item — negative goodwill	(11,593)	—	—
Lease termination fee income	(287)	—	—
Release of debt obligation	(175)	—	—
Impairment losses on assets acquired in liquidation	—	67	54
Losses (gains) on sale of real estate	252	(994)	(1,225)
Deferred income taxes	(36)	—	—
Stock-based compensation charge	7	2	—
Premium income adjustment	91	—	—
Accretion of loan fees and discounts	(335)	(308)	(368)
Amortization	22	80	89
Provision for (reduction of) loan losses, net	(253)	310	65
Change in operating assets and liabilities:			
Borrower advances	(603)	(342)	574
Due to affiliates, net	(215)	(189)	(292)
Accounts payable and accrued expenses	(575)	294	(38)
Other liabilities	42	(35)	(104)
Other assets	(1,046)	(449)	(19)
Net cash provided by operating activities	12,953	8,710	11,213
Cash flows from investing activities:			
Loans funded	(45,248)	(29,651)	(30,732)
Principal collected on loans	24,817	7,618	12,268
Proceeds from sales of properties, net	3,513	824	3,017
Proceeds from structured loan sale transactions, net	—	39,949	24,040
Principal collected on retained interests in transferred assets	6,361	744	954
Investment in retained interests in transferred assets	(2,027)	(2,536)	(1,617)
Proceeds from mortgage-backed security of affiliate	143	—	—
Purchase of furniture, fixtures, and equipment	(605)	(290)	(388)
Cash and cash equivalents received in connection with merger	31,488	—	—
Merger related costs	(1,006)	(670)	—
Proceeds received from (investment in) asset acquired in liquidation, net	1,540	—	(30)
Release of (investment in) restricted investments, net	977	1,546	(408)
Net cash provided by investing activities	19,953	17,534	7,104
Cash flows from financing activities:			
Proceeds from issuance of common shares	378	83	64
Payment of borrowing costs	(81)	—	—
Proceeds from (payments on) revolving credit facility, net	14,600	(7,300)	(1,400)
Payment of principal on notes payable	(26,944)	(7,811)	(7,179)
Payment of dividends	(12,872)	(10,187)	(10,310)
Net cash used in financing activities	(24,919)	(25,215)	(18,825)
Net increase (decrease) in cash and cash equivalents	7,987	1,029	(508)
Cash and cash equivalents, beginning of year	1,078	49	557
Cash and cash equivalents, end of year	\$ 9,065	\$ 1,078	\$ 49

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

PMC COMMERCIAL TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies:

Business

PMC Commercial Trust (“PMC Commercial” or together with its wholly-owned subsidiaries, “we,” “us” or “our”) was organized in 1993 as a Texas real estate investment trust (“REIT”). Our common shares of beneficial interest (“Common Shares”) are traded on the American Stock Exchange (symbol “PCC”). We primarily obtain income from the yield earned on the investment portfolio, other related fee income from our lending activities and rental income from property ownership. To date, these investments have been principally in the hospitality industry. On February 29, 2004, PMC Capital, Inc., a regulated investment company related to us through common management, was merged with and into PMC Commercial.

Principles of Consolidation

The consolidated financial statements include the accounts of PMC Commercial and its wholly-owned subsidiaries. All material intercompany balances and transactions have been eliminated.

The following subsidiaries were acquired in the merger with PMC Capital: First Western SBLC, Inc. (“First Western”) which is licensed as a small business lending company that originates loans through the Small Business Administration’s (“SBA”) 7(a) Guaranteed Loan Program; PMC Investment Corporation (“PMCIC”) which is a licensed specialized small business investment company under the Small Business Investment Act of 1958, as amended (“SBIA”); Western Financial Capital Corporation (“Western Financial”) which is a licensed small business investment company under the SBIA; and PMC Funding Corp. (“PMC Funding”) and PMC Asset Holding, LLC (“Asset Holding”) which hold assets on our behalf. All of these subsidiaries are wholly-owned subsidiaries of PMC Commercial. References to PMC Capital within this annual report refer to PMC Capital and its subsidiaries.

PMC Commercial’s subsidiaries also include PMC Commercial Trust, Ltd. 1998-1 (“PMCT Trust”), a Delaware corporation formed in conjunction with our 1998 structured loan financing transaction, and four separate subsidiaries created in conjunction with the purchase of four hotel properties in 1999.

In addition, we own subordinate financial interests in several non-consolidated special purpose entities. These are PMC Capital, L.P. 1998-1 (the “1998 Partnership”), PMC Capital, L.P. 1999-1 (the “1999 Partnership”), PMC Joint Venture, L.P. 2000 (the “2000 Joint Venture”), PMC Joint Venture, L.P. 2001 (the “2001 Joint Venture”), PMC Joint Venture, L.P. 2002-1 (the “2002 Joint Venture”) and PMC Joint Venture, L.P. 2003 (the “2003 Joint Venture,” and together with the 2000 Joint Venture, the 2001 Joint Venture and the 2002 Joint Venture, the “Joint Ventures,” and the Joint Ventures together with the 1998 Partnership and the 1999 Partnership, the “QSPEs”) created in connection with structured loan sale transactions.

We account for our 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”). Accordingly, the assets, liabilities, partners’ capital and results of operations of the QSPEs are not included in our consolidated financial statements.

Loans Receivable, net

Loans receivable are carried at their unamortized principal balance less net loan origination fees, discounts and loan loss reserves. For loans originated under the SBA 7(a) Guaranteed Loan Program, when we sell the SBA guaranteed portion of the loans, a portion of the sale proceeds representing the difference in the face amount of the unguaranteed portion of the loans and the value of the loans (the “Retained Loan Discount”) is recorded as a reduction in basis of the retained portion of the loan rather than premium income. For purchased loans, we may have discounts representing the difference between the carrying value of the loan and its estimated fair value at the date of purchase.

A loan loss reserve is established based on a determination, through an evaluation of the recoverability of individual loans receivable, that significant doubt exists as to the ultimate realization of the loan receivable. The determination of whether significant doubt exists and whether a loan loss reserve is necessary for each loan receivable requires judgment and considers the facts and circumstances existing at the evaluation date. Our evaluation of the adequacy of the reserve is based on a review of our historical loss experience, known and inherent risks in the loan portfolio, adverse circumstances that may affect the ability of the borrower to repay interest and/or principal and, to the extent payment appears impaired, the estimated fair value of the collateral.

**PMC COMMERCIAL TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Retained Interests

Retained Interests represent the subordinate interest in QSPEs created in conjunction with structured loan sale transactions. Retained Interests are carried at estimated fair value, with realized gains and losses included in net income and unrealized gains and losses recorded in beneficiaries' equity. The estimated fair value of our Retained Interests is based on estimates of the present value of future cash flows we expect to receive. Estimated future cash flows are based in part upon an estimate of prepayment speeds and loan losses. Prepayment speeds and loan losses are estimated based on the current and anticipated interest rate and competitive environments, the performance of the loan pool and our historical experience with these and similar loans receivable. The discount rates that we utilize are determined for each of the components of the Retained Interests as estimates of market rates based on interest rate levels considering the risks inherent in the transaction. There can be no assurance of the accuracy of these estimates. Any appreciation of our Retained Interests is included in the accompanying balance sheet in beneficiaries' equity. Any depreciation of our Retained Interests is either included in the accompanying statement of income as either a realized loss (if there is a reduction in expected future cash flows) or on our balance sheet in beneficiaries' equity as an unrealized loss.

Real Estate Investments, net, and Real Estate Investment Held for Sale, net

Real estate investments are recorded at cost. Depreciation is provided on the straight-line method based upon the estimated useful lives of the assets. The buildings and improvements are being depreciated utilizing a 35-year useful life and the furniture, fixtures and equipment are being depreciated over a seven-year useful life. Upon retirement or sale, the cost and related accumulated depreciation are removed from our books and any resulting gains or losses are included in the consolidated statements of income. Under the lease agreements with the lessee of our properties, routine maintenance and repairs are the responsibility of the lessee and are charged to the lessee's operations as incurred; major replacements, renewals and improvements are capitalized.

We consider each individual hotel property to be an identifiable component of our business. In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," ("SFAS No. 144"), we do not consider hotels as "held for sale" until it is probable that the sale will be completed within one year. We consider a hotel property as "held for sale" once we have (i) executed a contract for sale, (ii) allowed the potential buyer to substantially complete their due diligence review and (iii) received a substantial non-refundable deposit. In addition, the determination of "held for sale" status is assessed based on all facts and circumstances, including management's intent and ability to eliminate the cash flows of the property from our operations and management's intent and ability not to have significant continuing involvement in the operations of the property.

We periodically review our real estate investments for impairment. If facts or circumstances support the possibility of impairment, we will prepare a projection of the undiscounted future cash flows without interest charges of the specific property and determine if the investment in the property is recoverable based on the undiscounted future cash flows. If impairment is indicated, an adjustment will be made to the carrying value of the property based on the difference between the current estimated fair value and the carrying amount of the asset. No impairment was deemed to exist on our real estate investments held and used at December 31, 2004.

We discontinue depreciation on hotel properties if they are classified as "held for sale." Upon designation of a hotel property as "held for sale," we compare the carrying value of the hotel property to its estimated fair value, less costs to sell. We will reclassify the hotel property to real estate investment held for sale in our consolidated balance sheet at the lesser of its carrying value or its estimated fair value, less costs to sell. Any adjustment to the carrying value of a hotel property classified as "held for sale" is reflected in discontinued operations in our consolidated statements of income. In addition, the operating results of those properties classified as "held for sale" or that have been sold are included in discontinued operations. No impairment was deemed to exist on our real estate investment held for sale, net, at December 31, 2004.

Cash and Cash Equivalents

We generally consider all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. At various times during the year we maintain cash, cash equivalents and restricted investments in accounts in excess of federally insured limits with various financial institutions. We regularly monitor the financial institutions and do not believe a significant credit risk is associated with the deposits in excess of federally insured amounts.

PMC COMMERCIAL TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Restricted Investments

Restricted Investments represent primarily escrow and capital expenditure accounts maintained pursuant to our lease agreement with the operator of our hotel properties. In addition we maintain restricted cash accounts, required to be held as collateral, for the benefit of the noteholders of PMCT Trust.

Mortgage-Backed Security of Affiliate

The mortgage-backed security represents our ownership in the Class B notes of the 1998 Partnership and is valued consistent with the techniques used to value our Retained Interests.

Note Receivable

Upon sale of each of our hotel properties, our tenant is required to provide us consideration equal to the Stated Value (as defined in Note 4) of the property being sold, either through cash proceeds from the disposition, or a note receivable from our tenant which we discount to its estimated fair value.

Borrower Advances

As part of the monitoring process to verify that the borrowers' cash equity is utilized for its intended purpose, we receive deposits from the borrowers and release the funds upon presentation of appropriate documentation. Funds held on behalf of borrowers are included as a liability on the accompanying consolidated balance sheets.

Net Unrealized Appreciation on Retained Interests

Net unrealized appreciation on Retained Interests represents the difference between the cost and estimated fair value of our Retained Interests.

Revenue Recognition

Interest Income

Interest income includes interest earned on loans and our short-term investments and includes the amortization of net loan origination fees and discounts. Interest income on loans is accrued as earned with the accrual of interest generally suspended when the related loan becomes a non-accrual loan. A loan receivable is generally classified as non-accrual (a "Non-Accrual Loan") if (i) it is past due as to payment of principal or interest for a period of more than 60 days, (ii) any portion of the loan is classified as doubtful or is charged-off or (iii) if the repayment in full of the principal and/or interest is in doubt. Generally, loans are charged off when management determines that we will be unable to collect any remaining amounts due under the loan agreement, either through liquidation of collateral or other means. Interest income on a Non-Accrual Loan is recognized on either the cash basis or the cost recovery basis.

When originating a loan receivable, we charge a commitment fee. These fees, net of costs, are deferred and recognized as an adjustment of yield over the life of the related loan receivable using a method which approximates the interest method.

For purchased loans, we may have discounts representing the difference between the unamortized principal balance of the loan and its estimated fair value at the date of purchase. These discounts are recognized as an adjustment of yield over the life of the related loan receivable using a method which approximates the interest method.

The Retained Loan Discount is amortized to interest income over the life of the underlying loan using the interest method unless the underlying loan receivable is prepaid or sold.

Lease Income

Lease income consists of base and percentage rents on our properties and straight-line rental income adjustments. Effective October 1, 2004, we amended our master lease agreement. In conjunction with this amendment, we record the payments remaining to be paid on the lease agreement by our tenant to us on a straight-line basis. In addition, we receive a fixed percentage of the monthly room revenue of our leased properties which is reported as income when earned.

Income from Retained Interests

The income from our Retained Interests represents the accretion (recognized using the interest method) on our Retained Interests which is determined based on estimates of future cash flows and includes any fees collected

**PMC COMMERCIAL TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(i.e., late fees, prepayment fees, etc.) by the QSPEs in excess of anticipated fees. We update our cash flow assumptions on a quarterly basis and any changes to cash flow assumptions impact the yield on our Retained Interests.

Premium Income

Premium income represents the difference between the relative fair value attributable to the sale of the guaranteed portion of a loan originated under the SBA 7(a) Guaranteed Loan Program and the principal balance (cost) of the loan. The sale price includes the value attributable to any excess servicing spread retained by us plus any cash received.

Other Income

Other income consists primarily of servicing income, prepayment fees and other loan related fees. Servicing income is recognized in income when earned. Prepayment fees are recognized in income when loans are prepaid. Late fees, and other loan related fees, are recognized in income when chargeable, assuming collectibility is reasonably assured.

Income Taxes

We have elected to be taxed as a REIT under the provisions of the Internal Revenue Code of 1986, as amended (the "Code"). To the extent we qualify for taxation as a REIT, we generally will not be subject to a Federal corporate income tax on our taxable income that is distributed to our shareholders. In order to remain qualified as a REIT under the Code, we must satisfy various requirements in each taxable year, including, among others, limitations on share ownership, asset diversification, sources of income, and the distribution of at least 90% of our taxable income within the specified time in accordance with the Code.

PMC Commercial has wholly-owned taxable REIT subsidiaries which are subject to Federal income taxes. The taxable REIT subsidiaries ("TRS's") are PMCIC, First Western and PMC Funding. The income generated from the taxable REIT subsidiaries is taxed at normal corporate rates. We account for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes" which uses the asset and liability method and deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases.

Earnings per Share

Earnings per share is computed by dividing net income by the weighted-average number of shares outstanding. Diluted earnings per share includes the dilutive effect, if any, of stock-based compensation awards.

Distributions to Shareholders

Distributions to shareholders are recorded on the ex-dividend date.

Derivatives

As a result of certain of our variable-rate loans receivable having interest rate floors, we are deemed to have derivative investments. However, in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended ("SFAS No. 133"), we are not required to bifurcate these investments; therefore, they are not accounted for as derivatives. We do not use derivatives for speculative purposes.

Stock-Based Compensation Plans

At December 31, 2004, we have options outstanding under our two stock-based compensation plans, which are described more fully in Note 16. Effective January 1, 2003, we adopted the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," prospectively to all awards granted, modified, or settled after January 1, 2003.

PMC COMMERCIAL TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table illustrates the effect on net income and earnings per share if the fair value based method had been applied to all outstanding and unvested awards in each period:

	December 31, 2004		December 31, 2003		December 31, 2002	
	As Reported	Pro Forma	As Reported	Pro Forma	As Reported	Pro Forma
			<i>(In thousands, except per share data)</i>			
SFAS No. 123 Charge	\$ 7	\$ 7	\$ 2	\$ 2	\$ —	\$ 33
APB No. 25 Charge	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Net income	\$ 24,781	\$ 24,781	\$ 8,174	\$ 8,174	\$ 9,936	\$ 9,903
Basic earnings per share	\$ 2.44	\$ 2.44	\$ 1.27	\$ 1.27	\$ 1.54	\$ 1.54
Diluted earnings per share	\$ 2.44	\$ 2.44	\$ 1.27	\$ 1.27	\$ 1.54	\$ 1.54

The effects of applying SFAS No. 123 in this pro forma disclosure are not indicative of future amounts.

Use of Estimates in the Preparation of Financial Statements

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 our estimates. Our most sensitive estimates involved the valuation of our net assets acquired in connection with the merger, the valuation of our Retained Interests, determination of reserves on our loans receivable and impairment analysis of our long-lived assets.

Recently Issued Accounting Pronouncements

The Financial Accounting Standards Board (“FASB”) issued SFAS No. 123R (“SFAS No. 123R”), “Share-Based Payment” in December 2004 representing the final standard on accounting for share-based payments. SFAS No. 123R requires companies to expense the value of employee stock options and other similar share-based awards. SFAS No. 123R also requires additional disclosures. SFAS No. 123R is effective for interim and annual periods beginning after June 15, 2005 and applies to all outstanding and unvested share-based payment awards at the adoption date. We adopted SFAS No. 123 on January 1, 2003 and SFAS No. 123R for our year ended December 31, 2004; thus, our consolidated financial statements now include the required disclosures of SFAS No. 123R. There was no other impact of SFAS No. 123R on our consolidated financial statements.

Reclassifications

Certain prior period amounts have been reclassified to conform to current year presentation. These reclassifications had no effect on previously reported net income or total beneficiaries’ equity.

Note 2. Merger:

PMC Capital, Inc. merged with and into PMC Commercial on February 29, 2004. At the time of the merger, the benefits expected from the merger included (i) a larger equity market capitalization that would help create new business flexibility and earnings stability and (ii) the ability to meet our liquidity needs would be enhanced through access to larger alternative credit facilities such as a warehouse line of credit. Each issued and outstanding share of PMC Capital common stock was converted into 0.37 of a common share of PMC Commercial. As a result, we issued 4,385,800 common shares of beneficial interest on February 29, 2004 valued at \$13.10 per share, which was the average closing price of our common shares for the three days preceding the date of the announcement, adjusted by declared but unpaid dividends.

The merger was accounted for using the purchase method of accounting in accordance with SFAS No. 141, “Business Combinations” as we were not deemed to be under common control. Accordingly, our consolidated results of operations have incorporated PMC Capital’s activities on a consolidated basis from the merger date. The cost of the merger was allocated to the assets acquired, liabilities assumed and preferred stock of subsidiary based on management’s estimates of their respective fair values at the date of merger. The fair value of the net assets acquired exceeded the cost of the merger, resulting in negative goodwill. The amount of negative goodwill was allocated proportionately to reduce the assigned values of the acquired assets excluding current assets, financial assets and assets held for sale. Substantially all of the assets acquired were considered to be financial assets or assets to be disposed of

PMC COMMERCIAL TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

by sale. Accordingly, we recorded negative goodwill of \$11,593,000 during the year ended December 31, 2004 representing the excess of the fair value of net assets acquired over the cost of the merger.

The cost of the merger was as follows (*dollars in thousands*):

Fair value of 4,385,800 common shares of beneficial interest	\$ 57,454
Transaction costs	1,034
Total	\$ 58,488

The following table summarizes the estimated fair values of assets acquired, liabilities assumed and preferred stock of subsidiary as of February 29, 2004 (*in thousands*):

Loans receivable	\$ 55,144
Retained Interests	43,597
Cash and cash equivalents	31,488
Assets acquired in liquidation	1,829
Mortgage-backed security of affiliate	1,164
Deferred tax asset, net	278
Other assets	599
Total fair value of assets acquired	134,099
Notes and debentures payable	54,487
Redeemable preferred stock of subsidiary	3,420
Accounts payable and accrued expenses	2,751
Borrower advances	2,075
Other liabilities	385
Cumulative preferred stock of subsidiary	900
Total liabilities assumed and preferred stock of subsidiary	64,018
Fair value of net assets acquired	\$ 70,081

PMC COMMERCIAL TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following unaudited pro forma results of operations are based on our financial statements and the financial statements of PMC Capital and assumed the merger occurred on January 1 of the respective years:

	Years Ended December 31,	
	2004	2003
	<i>(In thousands, except per share data)</i>	
Total revenues	\$ 27,505	\$ 27,376
Income from continuing operations	\$ 12,455	\$ 11,949
Income before extraordinary item	\$ 13,390	\$ 12,265
Extraordinary item — negative goodwill	\$ 11,593	\$ 13,264
Net income	\$ 24,983	\$ 25,529
Earnings per share	\$ 2.30	\$ 2.35

These unaudited pro forma results have been prepared for comparative purposes only. In the opinion of management, all material adjustments necessary to reflect the effects of the merger transaction have been made. This unaudited pro forma information is not necessarily indicative of what the actual results of operations would have been had the merger transaction occurred on the indicated dates, nor does it purport to represent our results of operations for future periods.

Note 3. Loans Receivable, net:

Loans receivable, net, consisted of the following:

	December 31,	
	2004	2003
	<i>(In thousands)</i>	
SBIC commercial mortgage loans	\$ 40,031	\$ —
SBA 7(a) Guaranteed Loan Program loans	14,236	—
Other commercial mortgage loans	74,590	51,436
Total loans receivable	128,857	51,436
Less:		
Deferred commitment fees, net	(459)	(227)
Loan loss reserves	(164)	(675)
Loans receivable, net	\$ 128,234	\$ 50,534

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Additional information on our loans receivable, net, was as follows:

	December 31,					
	2004		Weighted Average Interest Rate	2003		Weighted Average Interest Rate
	Loans Receivable Amount	%		Loans Receivable Amount	%	
	<i>(Dollars in thousands)</i>					
Fixed rate	\$ 28,100	21.9%	9.7%	\$29,331	58.0%	10.1%
Variable rate — prime	15,445	12.0%	6.6%	—	—	—
Variable rate — LIBOR	84,689	66.1%	6.4%	21,203	42.0%	5.4%
	<u>\$128,234</u>	<u>100.0%</u>	7.1%	<u>\$50,534</u>	<u>100.0%</u>	8.1%

Our loans receivable were approximately 95% concentrated in the hospitality industry at December 31, 2004. Any economic factors that negatively impact the hospitality industry could have a material adverse effect on our financial condition or results of operations. At December 31, 2004, approximately 14% and 12% of our loans receivable consisted of loans receivable to borrowers in Texas and Virginia, respectively. No other state had a concentration of 10% or greater at December 31, 2004.

The activity in our loan loss reserves was as follows:

	Years Ended December 31,		
	2004	2003	2002
	<i>(In thousands)</i>		
Balance, beginning of year	\$ 675	\$ 365	\$ 300
Provision for loan losses	422	310	65
Reduction of loan losses	(675)	—	—
Principal balances written-off	(258)	—	—
Balance, end of period	<u>\$ 164</u>	<u>\$ 675</u>	<u>\$ 365</u>

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Impaired loans are defined by generally accepted accounting principles as loans for which it is probable that the lender will be unable to collect all amounts due based on the original contractual terms of the loan. Information on loans considered to be impaired loans was as follows:

	December 31,	
	2004	2003
	<i>(In thousands)</i>	
Impaired loans requiring reserves	\$ 2,484	\$ 1,748
Impaired loans expected to be fully recoverable (1)	2,355	249
Total impaired loans	<u>\$ 4,839</u>	<u>\$ 1,997</u>

	Years Ended December 31,		
	2004	2003	2002
	<i>(In thousands)</i>		
Average impaired loans	<u>\$ 5,677</u>	<u>\$ 1,804</u>	<u>\$ 2,095</u>
Interest income on impaired loans (2)	<u>\$ 488</u>	<u>\$ 175</u>	<u>\$ 227</u>

- (1) Loans acquired in the merger, loans repurchased from the QSPEs and loans deemed to be repurchased from the QSPEs were recorded at their estimated fair value and as such are reflected at discounted amounts. Certain of these loans have no reserves and are thus shown in impaired loans expected to be fully recoverable with respect to our recorded investment in the loan; however, we do not expect to collect all amounts due based on the original contractual terms of the note.
- (2) Recorded primarily on the cash basis.

Our recorded investment in Non-Accrual Loans at December 31, 2004 and 2003 was approximately \$5.1 million and \$1.8 million, respectively. We did not have any investment in loans receivable past due 90 days or more which were accruing interest at December 31, 2004 or 2003.

Note 4. Real Estate Investments:

Our real estate investments consist of hospitality properties (the "Hotel Properties") we purchased in 1998 and 1999 from Arlington Hospitality, Inc. ("Arlington") under a sale/leaseback agreement (the "Lease Agreement").

Pursuant to the Lease Agreement, we lease the Hotel Properties to Arlington Inns, Inc., a wholly-owned subsidiary of Arlington. Effective October 1, 2004, we amended the Lease Agreement (the "Lease Amendment"). The Lease Amendment and the underlying individual property leases, as amended, expire in June 2008, but each can be extended by either Arlington or us for one five-year period, and thereafter by Arlington for a five-year period and a subsequent two-year period. If fully extended, the term of the Lease Amendment would continue until September 2020. Arlington guarantees the lease payment obligation of Arlington Inns, Inc. Arlington is a public entity that files periodic reports with the Securities and Exchange Commission and additional information about Arlington can be obtained from the SEC's website at www.sec.gov.

In conjunction with the Lease Amendment, (i) we allowed for the disposition of the Hotel Properties prior to October 1, 2008 and (ii) current base rent was reduced from approximately 10.5% to 8.5% of the Stated Value established for the Hotel Properties. The Stated Value of each Hotel Property (currently an aggregate of \$46.1 million) is the value attributed to each Hotel Property at inception of the Lease Agreement for purposes of determining the lease payment. The Lease Amendment provides for rent increases to approximately 10.5% and ultimately 15% unless, on a cumulative basis, at least five of the Hotel Properties are sold over each of the next four years. Accordingly, lease income is recorded on a straight-line basis over the remaining fixed non-cancelable term of the Lease Amendment. Due to the initial option of five years being controlled by us, the fixed non-cancelable lease term is through June 2013. During the fourth quarter of 2004, we recorded approximately \$624,000 in straight-line rent representing the

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difference between lease income as recorded on a straight-line basis and the current base rent of 8.5% of the Stated Value, which is included in other assets on our consolidated balance sheet.

Arlington previously maintained an escrow account equal to two months' base rent (approximately \$850,000). This escrow account, previously included in restricted investments in our consolidated balance sheet, was released to us during 2004 to repay certain of Arlington's obligations.

Upon the sale of each of the Hotel Properties, Arlington is required to provide us consideration equal to the Stated Value of the Hotel Property being sold, either through cash proceeds from a third-party purchaser or a note from Arlington if the cash proceeds are less than the Stated Value of the Hotel Property (a "Shortfall"). The Shortfall note receivable has a fixed interest rate of 8.5% and matures in 2011. If, at any time, the aggregate Shortfall exceeds \$4.0 million, Arlington is immediately required to pay the excess. Any sales proceeds received in excess of the Stated Value of the Hotel Property sold will be applied as a reduction of the balance outstanding on any Shortfall or if none are outstanding, then allocated to reduce the Stated Value on remaining Hotel Properties to be sold.

A Shortfall note receivable from Arlington is recorded as a deferred liability at the estimated fair value of the note received since an uncertainty exists as to whether the note receivable will ultimately be collected from Arlington or third party sales proceeds from the sale of the remaining properties. If principal payments are made on the Shortfall note such that the face amount of the Shortfall note is less than the deferred liability, lease income will be recorded. No later than the disposition of the final property, any remaining deferred liability will be considered earned and accordingly, will be recorded as lease income.

The 2005 annual base rent payment required for the remaining 19 Hotel Properties is approximately \$3.9 million, assuming the lease rent remains at 8.5%. In addition to our base rent we receive percentage rent equal to 4% of the gross room revenues of the Hotel Properties (the "Percentage Rent"). For the years ended December 31, 2004 and 2003, our Percentage Rent was approximately \$561,000 and \$584,000, respectively.

Minimum future lease payments receivable on our non-cancelable individual property leases, as amended, were as follows at December 31, 2004:

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
	<i>(In thousands)</i>				
Minimum future lease payments	<u>\$ 4,149</u>	<u>\$ 5,359</u>	<u>\$ 6,915</u>	<u>\$ 6,915</u>	<u>\$ 6,915</u>

Our real estate investments consisted of the following:

	<u>December 31, 2004</u>		<u>December 31, 2003</u>	
	Real Estate Investments	Real Estate Held for Sale	Real Estate Investments	Real Estate Held for Sale
	<i>(Dollars in thousands)</i>			
Land	\$ 4,469	\$ 325	\$ 5,084	\$ 263
Buildings and improvements	36,579	1,819	40,151	2,080
Furniture, fixtures and equipment	4,825	214	4,744	227
	45,873	2,358	49,979	2,570
Accumulated depreciation	(9,650)	(499)	(8,774)	(436)
	<u>\$ 36,223</u>	<u>\$ 1,859</u>	<u>\$ 41,205</u>	<u>\$ 2,134</u>
Number of Hotel Properties	<u>18</u>	<u>1</u>	<u>20</u>	<u>1</u>

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We sold a hotel property during August 2004 (prior to the Lease Amendment), which was previously classified as real estate investment held for sale on our consolidated balance sheet, for \$1.8 million and recognized a loss of approximately \$354,000. As consideration for terminating the individual property lease, Arlington provided us with a note receivable with an estimated fair value of \$624,000 representing the lease termination fee which is the difference between the Stated Value of the property and the proceeds received from the third party purchaser. The lease termination fee is included in net earnings from discontinued operations in our consolidated statement of income.

Subsequent to the Lease Amendment, we sold a hotel property during December 2004 for \$1.8 million and recognized a loss of approximately \$116,000. Arlington provided us with a Shortfall note receivable with an estimated fair value of \$443,000 and we recorded a corresponding deferred liability which is included in other liabilities in our consolidated balance sheet.

The real estate investment held for sale at December 31, 2004 is one of our Hotel Properties with a Stated Value of \$2.3 million which was sold for approximately \$2.1 million to a third party during March of 2005 for a gain of approximately \$150,000. Arlington provided us with a Shortfall note receivable with an estimated fair value of \$267,000 and we recorded a corresponding deferred liability.

We have mortgages on eleven of our hotel properties. The net book value of our mortgaged real estate investments was approximately \$22.5 million at December 31, 2004. Our mortgages payable for these hotel properties were approximately \$14.2 million at December 31, 2004.

Note 5. Retained Interests:

In our structured loan sale transactions detailed below, we contributed loans receivable to a QSPE in exchange for cash and beneficial interests in that entity. The QSPE issued notes payable (the "Structured Notes") (usually through a private placement) to unaffiliated parties ("Structured Noteholders"). The QSPE then distributed a portion of the proceeds from the Structured Notes to us. The Structured Notes are collateralized solely by the assets of the QSPE which means that should the financial assets in the QSPE be insufficient for the trustee to make payments on the Structured Notes, the Structured Noteholders have no recourse against us. Upon the completion of our structured loan sale transactions, we recorded the transfer of loans receivable as a sale in accordance with SFAS No. 140. As a result, the loans receivable contributed to the QSPE, the Structured Notes issued by the QSPE, and the operating results of the QSPE 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 relative fair value of our Retained Interests, constituted the gain or loss on sale. Retained Interests are carried at estimated fair value, with realized gains and losses recorded in net income and unrealized gains and losses recorded in beneficiaries' equity.

We completed joint structured loan sale transactions with PMC Capital, Inc. during 2000, 2001, 2002 and 2003. Our interests related to the loans receivable we contributed to these structured loan sale transactions are the "Originated Structured Loan Sale Transactions". As a result of the merger, on February 29, 2004, we acquired PMC Capital's retained interests in the Joint Ventures and 100% of the 1998 Partnership and the 1999 Partnership (collectively, the "Acquired Structured Loan Sale Transactions").

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Information pertaining to the Originated Structured Loan Sale Transactions was as follows.

	2000 Joint Venture	2001 Joint Venture	2002 Joint Venture	2003 Joint Venture
	<i>(Dollars in thousands, except footnotes)</i>			
Transaction date	12/18/00	6/27/01	4/12/02	10/7/03
At inception:				
Principal amount of sold loans	\$ 55,675	\$ 32,662	\$ 27,286	\$ 45,456
Structured Notes issued	\$ 49,550	\$ 30,063	\$ 24,557	\$ 40,910
Interest rate on the Structured Notes (1)	7.28%	6.36%	6.67%	L+1.25%
Structured Notes rating (2)	"Aaa"	"Aaa"	"Aaa"	"Aaa"
Weighted average interest rate on loans (1)	9.63%	9.62%	9.23%	L+4.02%
Weighted average remaining life of loans (3)	5.16 years	5.15 years	5.38 years	4.79 years
Aggregate principal losses assumed (4)	2.37%	2.80%	2.88%	3.03%
Constant prepayment rate assumption	8.0%	9.0%	9.0%	10.0%
Discount rate assumptions	9.3% to 14.0%	8.5% to 13.3%	8.2% to 12.9%	7.8% to 11.6%
Net gain recorded (5)	\$ 1,117	\$ 1,433	\$ 562	\$ 711
Value of Retained Interests	\$ 11,174	\$ 5,871	\$ 5,293	\$ 8,698
At December 31, 2004:				
Principal outstanding on sold loans	\$ 37,526	\$ 27,337	\$ 25,362	\$ 37,985
Structured Notes balance outstanding	\$ 33,255	\$ 24,778	\$ 22,704	\$ 33,543
Cash in the collection account	\$ 1,580	\$ 239	\$ 288	\$ 311
Cash in the reserve account	\$ 2,331	\$ 1,644	\$ 1,528	\$ 2,289
Weighted average interest rate on loans (1)	9.49%	9.59%	9.24%	L+4.02%
Constant prepayment rate assumption (6)	11.00%	10.75%	10.75%	11.00%
Discount rate assumptions (7)	6.5% to 11.2%	6.5% to 11.2%	6.5% to 11.2%	7.7% to 11.2%
Weighted average remaining life of loans (3)	3.41 years	3.91 years	3.58 years	4.45 years
Aggregate principal losses assumed (4)	3.54%	2.74%	3.82%	3.73%
Aggregate principal losses to date (8)	0.33%	—%	—%	—%

- (1) Variable interest rates are denoted by the spread over the 90-day LIBOR ("L").
- (2) Structured Notes issued by the QSPEs were rated by Moody's Investors Service, Inc.
- (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 initial or remaining principal balance, as applicable.
- (4) Represents aggregate estimated future losses as a percentage of the principal outstanding based upon per annum losses ranging from 0.0% to 2.2%. To the extent loans are likely to be liquidated in the next twelve months, estimated losses were assumed to occur during the year ending December 31, 2005. No losses are assumed in for the year ending December 31, 2005 for those structured loan sale transactions with no current potential impaired loans.
- (5) The net gain recorded does not include \$877,000, \$520,000, \$439,000, and \$700,000 for the 2000 Joint Venture, the 2001 Joint Venture, the 2002 Joint Venture and the 2003 Joint Venture, respectively, which was deferred and recorded as unrealized appreciation in our beneficiaries' equity in accordance with SFAS No. 140.
- (6) The prepayment rate was based on the actual performance of the loan pools, adjusted for anticipated principal prepayments considering similar loans.
- (7) Discount rates utilized were (i) 6.5% to 7.7% for our required overcollateralization, (ii) 8.2% for our reserve funds and (iii) 11.2% for our interest-only strip receivables.
- (8) For the 2000 Joint Venture, represents the loss on a loan receivable repurchased by PMC Commercial due to a loan modification and assumption.

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Information pertaining to the Acquired Structured Loan Sale Transactions (purchased on February 29, 2004) was as follows:

	1998 Partnership	1999 Partnership	2000 Joint Venture	2001 Joint Venture	2002 Joint Venture	2003 Joint Venture
<i>(Dollars in thousands)</i>						
At February 29, 2004:						
Principal amount of sold loans	\$ 21,702	\$ 29,800	\$ 17,345	\$ 37,191	\$ 36,102	\$ 56,424
Structured Notes balance outstanding	\$ 21,221	\$ 26,394	\$ 15,636	\$ 33,324	\$ 32,932	\$ 50,774
Interest rate on the Structured Notes (1)	P-1%	6.60%	7.28%	6.36%	6.67%	L+1.25%
Structured Notes rating (2)	"Aaa"	"Aaa"	"Aaa"	"Aaa"	"Aaa"	"Aaa"
Weighted average interest rate on loans (1)	P+1.22%	9.40%	9.20%	9.64%	9.58%	L+4.02%
Weighted average remaining life of loans (3)	3.17 years	2.95 years	2.96 years	3.89 years	4.04 years	4.63 years
Aggregate principal losses assumed (4)	3.38%	2.32%	4.19%	5.51%	3.51%	3.10%
Constant prepayment rate assumption (5)	12.00%	14.00%	14.00%	11.00%	10.00%	10.00%
Discount rate assumptions	4.0% to 11.9%	7.1% to 11.8%	7.2% to 11.9%	7.2% to 11.9%	7.3% to 12.0%	7.3% to 11.8%
At December 31, 2004:						
Principal outstanding on sold loans	\$ 19,427	\$ 23,264	\$ 15,014	\$ 31,589	\$ 27,031	\$ 49,655
Structured Notes balance outstanding	\$ 18,770	\$ 22,814	\$ 12,349	\$ 27,662	\$ 22,785	\$ 44,043
Cash in the collection account	\$ 624	\$ 3,456	\$ 202	\$ 370	\$ 318	\$ 439
Cash in the reserve account	\$ 1,591	\$ 1,586	\$ 906	\$ 136	\$ 1,629	\$ 2,994
Weighted average interest rate of loans (1)	P+1.22%	9.13%	9.12%	9.60%	9.63%	L+4.02%
Discount rate assumptions (6)	6.4% to 11.2%	6.5% to 11.2%	6.9% to 11.6%	6.8% to 11.5%	6.8% to 11.5%	7.7% to 11.2%
Constant prepayment rate assumption (5)	12.00%	15.00%	15.00%	11.00%	11.00%	11.00%
Weighted average remaining life of loans (3)	3.27 years	2.93 years	2.44 years	3.67 years	4.02 years	4.36 years
Aggregate principal losses assumed (4)	3.35%	2.54%	3.33%	2.88%	5.82%	3.52%
Aggregate principal losses to date (7)	—%	—%	4.27%	2.62%	—%	—%

(1) Variable interest rates are denoted by the spread over (under) the prime rate ("P") or the 90-day LIBOR ("L").

(2) Structured Notes issued by the QSPEs were rated by Moody's Investors Service, Inc.

(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 future losses as a percentage of the principal outstanding based upon per annum estimated losses that ranged from 0.0% to 2.4%. To the extent loans are likely to be liquidated in the next twelve months, estimated losses were assumed to occur during the year ending December 31, 2005. No losses are assumed in the year ending December 31, 2005 for those structured loan sale transactions with no current potential impaired loans.

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

(6) The discount rates utilized on the components of our Retained Interests (as described below) were (i) 6.4% to 7.7% for our required overcollateralization, (ii) 8.2% to 8.6% for our reserve funds and (iii) 11.2% to 11.6% for our interest-only strip receivables.

(7) For the 2000 Joint Venture, represents historical losses incurred prior to our acquisition. For the 2001 Joint Venture, represents losses on delinquent loans receivable with a "charged-off" status (i) repurchased by PMC Commercial subsequent to the merger and (ii) on which we had initiated foreclosure and were contractually allowed to repurchase from the QSPE.

In conjunction with sold loans of the QSPEs, approximately 93% were concentrated in the hospitality industry and approximately 27% were to borrowers in Texas. No other state had a concentration of 10% or greater at December 31, 2004.

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At December 31, 2004, none of the loans within our Originated Structured Loan Sale Transactions or Acquired Structured Loan Sale Transactions were delinquent over 60 days as to payment of principal and interest. However, at December 31, 2004, we have identified two sold loans (\$3.2 million) that we consider problem loans. Problem loans are loans which are not complying with their contractual terms, the collection of the balance of the principal is considered impaired and on which the fair value of the collateral is less than the remaining unamortized principal balance. If we had to liquidate these loans, the losses could exceed estimates and the estimated fair value of our Retained Interests would decline.

In addition, First Western has Retained Interests related to the sale of loans originated pursuant to the SBA 7(a) Guaranteed Loan Program. First Western sold the unguaranteed portion of its loans receivable through a private placement in 1997 ("FW 97") and has retained the right to service these loans receivable. Pursuant to the sale, First Western maintains a reserve fund and receives cash flow from the interest-only strip receivable established in connection with the sold loans receivable. At December 31, 2004, the principal balance outstanding on the sold loans of FW 97 was approximately \$2.3 million and the reserve fund balance (currently at its minimum requirement) was \$912,000.

The SBA guaranteed portions of First Western's loans receivable are sold to either dealers in government guaranteed loans receivable or institutional investors ("Secondary Market Loan Sales") as the loans are fully funded. On all Secondary Market Loan Sales, we retain the excess spread between the interest rate paid to us from our borrowers and the rate we pay to the purchaser of the guaranteed portion of the note. At December 31, 2004, the aggregate principal balance of First Western's serviced loans receivable on which we have an excess spread was approximately \$42.3 million and the weighted average excess spread was approximately 0.75%.

In determining the estimated fair value of our Retained Interests related to First Western, our assumptions at December 31, 2004 included prepayment speeds ranging from 20% to 30% per annum, a loss rate of 0.2% per annum (relates only to FW 97) and discount rates ranging from 4.0% to 11.2%.

The estimated fair value of our Retained Interests is based upon 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 the amount and timing of those cash flows and the discount rates. The amount and timing of cash flows is generally determined based on estimates of loan losses and anticipated prepayment speeds relating to the loans receivable contributed to the QSPE. Actual loan losses and prepayments may vary significantly from assumptions. The discount rates that we utilize in computing the estimated fair value are based upon estimates 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, our estimate of the fair value may or may not vary from what a willing buyer would pay for these assets.

The components of our Retained Interests are as follows:

- (1) Our required overcollateralization (the "OC Piece"). The OC Piece represents the excess of the loans receivable contributed to the QSPE over the principal amount of the Structured Notes Payable issued by the QSPE, which 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 QSPE, pursuant to the terms of the transaction documents, as collateral for the Structured Noteholders, a portion of which was contributed by us to the QSPE upon formation and a portion which is built up over time by the QSPE 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 are expected to be received by us in the future after payment by the QSPE 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.

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Our Retained Interests consisted of the following:

	December 31, 2004				
	Estimated Fair Value				
	OC Piece	Reserve Fund	IO Receivable	Total	Cost
	(In thousands)				
First Western (100%)	\$ —	\$ 906	\$ 853	\$ 1,759	\$ 1,739
1998 Partnership (100%)	1,131	1,280	520	2,931	2,783
1999 Partnership (100%)	4,070	1,340	641	6,051	5,844
2000 Joint Venture (100%)	9,376	2,631	1,079	13,086	11,644
2001 Joint Venture (100%)	7,847	3,302	4,041	15,190	13,658
2002 Joint Venture (100%)	8,324	2,661	1,517	12,502	11,330
2003 Joint Venture (100%)	10,891	4,397	3,716	19,004	18,405
	<u>\$ 41,639</u>	<u>\$ 16,517</u>	<u>\$ 12,367</u>	<u>\$ 70,523</u>	<u>\$ 65,403</u>

	December 31, 2003				
	Estimated Fair Value				
	OC Piece	Reserve Fund	IO Receivable	Total	Cost
	(In thousands)				
2000 Joint Venture (68%)	\$ 6,322	\$ 2,290	\$ 1,521	\$ 10,133	\$ 8,876
2001 Joint Venture (42%)	3,051	1,317	1,918	6,286	5,230
2002 Joint Venture (39%)	3,050	1,208	1,099	5,357	4,850
2003 Joint Venture (44%)	4,817	1,930	2,275	9,022	8,224
	<u>\$ 17,240</u>	<u>\$ 6,745</u>	<u>\$ 6,813</u>	<u>\$ 30,798</u>	<u>\$ 27,180</u>

The following sensitivity analysis of our Retained Interests at December 31, 2004 highlights the volatility that results when prepayments, loan losses and discount rates are different than our assumptions:

Changed Assumption	Value	Asset Change (1)
	(In thousands)	
Losses increase by 50 basis points per annum (2)	\$66,766	(\$3,757)
Losses increase by 100 basis points per annum (2)	\$63,099	(\$7,424)
Rate of prepayment increases by 5% per annum (3)	\$69,235	(\$1,288)
Rate of prepayment increases by 10% per annum (3)	\$68,261	(\$2,262)
Discount rates increase by 100 basis points	\$67,761	(\$2,762)
Discount rates increase by 200 basis points	\$65,159	(\$5,364)

- (1) Any depreciation of our Retained Interests is either included in the accompanying statement of income as a realized loss (if there is a reduction in expected future cash flows) or on our balance sheet in beneficiaries' equity as an unrealized loss.
- (2) If we experience significant losses (i.e., in excess of anticipated losses), the effect on our Retained Interests would first reduce the value of our 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.
- (3) 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. Values based on changes in these assumptions generally cannot be extrapolated since the relationship of the change in assumptions to the change in estimated fair value is not linear. The effect of a variation in a particular assumption on the estimated fair value of our Retained

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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.

In accordance with SFAS No. 140, our consolidated financial statements do not include the assets, liabilities, partners' capital, revenues or expenses of the QSPEs. As a result, at December 31, 2004 and 2003, our consolidated balance sheets do not include the \$321.4 million and \$156.8 million in assets, respectively, and \$263.4 million and \$131.3 million in liabilities, respectively, related to these structured loan sale transactions recorded by the QSPEs. Our Retained Interests related to these structured loan sale transactions were approximately \$68.8 million and \$30.8 million at December 31, 2004 and 2003, respectively, including unrealized appreciation of approximately \$5.1 million and \$3.6 million at December 31, 2004 and 2003, respectively.

The following information summarizes the financial position of the QSPEs at December 31, 2004 and 2003. We owned 100% of the subordinate interest in the QSPEs at December 31, 2004. The subordinate interests were approximately 68% of the 2000 Joint Venture, 42% of the 2001 Joint Venture, 39% of the 2002 Joint Venture and 44% of the 2003 Joint Venture as of December 31, 2003. We did not own any of the subordinate interest in the 1998 Partnership or the 1999 Partnership as of December 31, 2003; however, the financial information is presented below for comparative purposes. The remaining subordinate interests in the Joint Ventures and 100% of the subordinate interests in the 1998 Partnership and the 1999 Partnership were owned by PMC Capital, Inc. at December 31, 2003 and prior.

Summary of Financial Position (1):

	<u>1998 Partnership</u>		<u>1999 Partnership</u>		<u>2000 Joint Venture</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
	<i>(In thousands)</i>					
Loans receivable, net	<u>\$19,392</u>	<u>\$22,258</u>	<u>\$23,264</u>	<u>\$30,053</u>	<u>\$52,540</u>	<u>\$65,608</u>
Total assets	<u>\$21,662</u>	<u>\$24,463</u>	<u>\$28,427</u>	<u>\$34,294</u>	<u>\$57,808</u>	<u>\$70,683</u>
Notes payable	<u>\$18,770</u>	<u>\$21,435</u>	<u>\$22,814</u>	<u>\$28,161</u>	<u>\$45,604</u>	<u>\$57,634</u>
Total liabilities	<u>\$18,829</u>	<u>\$21,490</u>	<u>\$22,940</u>	<u>\$28,317</u>	<u>\$45,742</u>	<u>\$57,809</u>
Partners' capital	<u>\$ 2,833</u>	<u>\$ 2,973</u>	<u>\$ 5,487</u>	<u>\$ 5,977</u>	<u>\$12,066</u>	<u>\$12,874</u>
	<u>2001 Joint Venture</u>		<u>2002 Joint Venture</u>		<u>2003 Joint Venture</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
	<i>(In thousands)</i>					
Loans receivable, net	<u>\$58,926</u>	<u>\$65,731</u>	<u>\$52,029</u>	<u>\$63,471</u>	<u>\$87,640</u>	<u>\$101,360</u>
Total assets	<u>\$63,591</u>	<u>\$72,422</u>	<u>\$56,001</u>	<u>\$69,765</u>	<u>\$93,915</u>	<u>\$108,293</u>
Notes payable	<u>\$52,440</u>	<u>\$61,165</u>	<u>\$45,489</u>	<u>\$57,788</u>	<u>\$77,586</u>	<u>\$ 91,408</u>
Total liabilities	<u>\$52,579</u>	<u>\$61,327</u>	<u>\$45,615</u>	<u>\$57,948</u>	<u>\$77,705</u>	<u>\$ 91,503</u>
Partners' capital	<u>\$11,012</u>	<u>\$11,095</u>	<u>\$10,386</u>	<u>\$11,817</u>	<u>\$16,210</u>	<u>\$ 16,790</u>

(1) Balances represent 100% of the limited partnership interests in the QSPEs.

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The following information summarizes the results of operations for the QSPEs.

Summary of Operations(1):

	Years Ended December 31,					
	1998 Partnership			1999 Partnership		
	2004	2003	2002	2004	2003	2002
	<i>(In thousands)</i>					
Interest income	\$ 1,174	\$ 1,351	\$ 1,797	\$ 2,624	\$ 3,367	\$ 4,187
Total revenues	\$ 1,203	\$ 1,388	\$ 1,845	\$ 2,979	\$ 3,899	\$ 4,559
Provision for (reduction of) losses	\$ (206)	\$ 7	\$ 103	\$ —	\$ —	\$ —
Interest expense	\$ 639	\$ 742	\$ 1,002	\$ 1,613	\$ 2,146	\$ 2,689
Total expenses	\$ 509	\$ 953	\$ 1,204	\$ 1,710	\$ 2,268	\$ 2,840
Net income	\$ 694	\$ 435	\$ 641	\$ 1,269	\$ 1,631	\$ 1,719

	Years Ended December 31,					
	2000 Joint Venture			2001 Joint Venture		
	2004	2003	2002	2004	2003	2002
	<i>(In thousands)</i>					
Interest income	\$ 5,729	\$ 6,526	\$ 7,092	\$ 5,990	\$ 6,895	\$ 7,507
Total revenues	\$ 6,534	\$ 6,617	\$ 7,351	\$ 6,097	\$ 7,335	\$ 7,815
Provision for losses	\$ 84	\$ 65	\$ 1,514	\$ 812	\$ 337	\$ 140
Interest expense	\$ 3,791	\$ 4,379	\$ 4,988	\$ 3,588	\$ 4,144	\$ 4,463
Total expenses	\$ 4,068	\$ 4,670	\$ 6,752	\$ 4,604	\$ 4,712	\$ 4,849
Net income	\$ 2,466	\$ 1,947	\$ 599	\$ 1,493	\$ 2,623	\$ 2,966

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	Years Ended December 31,				
	2002 Joint Venture			2003 Joint Venture	
	2004	2003	2002 (2)	2004	2003 (3)
	<i>(In thousands)</i>				
Interest income	\$ 5,417	\$ 6,340	\$ 4,850	\$ 5,403	\$ 1,272
Total revenues	\$ 6,165	\$ 6,649	\$ 4,897	\$ 5,886	\$ 1,274
Provision for losses	\$ 364	\$ —	\$ —	\$ —	\$ —
Interest expense	\$ 3,380	\$ 4,013	\$ 2,999	\$ 2,403	\$ 519
Total expenses	\$ 3,927	\$ 4,233	\$ 3,153	\$ 2,722	\$ 576
Net income	\$ 2,238	\$ 2,416	\$ 1,744	\$ 3,164	\$ 698

(1) Amounts represent 100% of the limited partnership interests in the Joint Ventures.

(2) From April 12, 2002 (inception) to December 31, 2002.

(3) From October 7, 2003 (inception) to December 31, 2003.

We owned 100% of the subordinate interests of the Joint Ventures as of December 31, 2004. Our limited partnership allocation of the net income of the Joint Ventures prior to 2004 was as follows:

	2000 Joint Venture		2001 Joint Venture	
	2003	2002	2003	2002
	<i>(In thousands)</i>			
Net income	\$ 1,482	\$ 1,501	\$ 1,027	\$ 1,072

	2002 Joint Venture		2003 Joint Venture
	2003	2002 (1)	2003 (2)
	<i>(In thousands)</i>		
Net income	\$ 816	\$ 675	\$ 310

(1) From April 12, 2002 (inception) to December 31, 2002

(2) From October 7, 2003 (inception) to December 31, 2003

As a result of the merger on February 29, 2004, we now service all loans held by the QSPEs. Servicing fee income for the year ended December 31, 2004 for loans held by the QSPEs was approximately \$781,000 and is included in other income in our consolidated statement of income for 2004. We have not established a servicing asset or liability related to the loans held by the QSPEs as the servicing fees are considered adequate compensation. PMC Capital, Inc. was the servicer for all loans receivable held by the QSPEs prior to the merger; therefore, no servicing fees were earned or received by us for the years ended December 31, 2003 or 2002.

We received approximately \$15.1 million and \$3.7 million in cash distributions from the Joint Ventures during 2004 and 2003, respectively. The annualized yield on our Retained Interests, which is comprised of the income earned less realized losses, was 11.5%, 12.3% and 13.2% during 2004, 2003 and 2002, respectively.

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In accordance with Emerging Issues Task Force issue number 02-09, as a result of a delinquent loan on which we initiated foreclosure and were contractually allowed to repurchase from the QSPE, we recorded a loan receivable and a corresponding due to affiliate at the estimated fair value of the loan receivable of approximately \$2.1 million. The principal balance of this loan in the 2001 Joint Venture was approximately \$2.5 million.

Note 6. Restricted Investments:

Restricted investments consisted of the following:

	At December 31,	
	2004	2003
	<i>(In thousands)</i>	
Escrow and capital expenditures accounts	\$1,268	\$2,170
Structured noteholders reserve account	1,439	1,265
Structured noteholders collection account	369	461
Other	20	172
	<u>\$3,096</u>	<u>\$4,068</u>

The escrow and capital expenditures accounts represent restricted investments maintained pursuant to our Lease Agreement. At December 31, 2003, the escrow account included a deposit equal to two months' base rent. This escrow account was released to us during 2004 to repay certain of Arlington's obligations. In accordance with the terms of the Lease Agreement, we deposit the Percentage Rent received into a capital expenditures account for future capital expenditures required to maintain the real estate investments. Funds are released from this account when capital expenditures are incurred.

The structured noteholders reserve and collection accounts represent cash collected that has not yet been remitted to the structured noteholders and reserve account balances that are required to be held as collateral on behalf of the structured Noteholders of PMCT Trust. The structured Noteholders reserve account is currently at its minimum. The collection and reserve accounts consist of cash and liquid money market funds.

Note 7. Revolving Credit Facility and Notes and Debentures Payable:

Information on our revolving credit facility and notes and debentures payable was as follows:

	December 31,		Face Amount and Carrying Value	Range of Maturities	Weighted Average Coupon Rate
	2004	2003			
	Face Amount	Carrying Value			
	<i>(In thousands)</i>				
Revolving credit facility	\$ 14,600	\$ 14,600	\$ —	2005	4.13%
Structured notes payable	7,244	7,244	18,667	2006 to 2018	6.37%
Mortgage notes payable	14,191	14,191	14,713	2005 to 2019	6.82%
Uncollateralized notes payable	20,000	20,017	—	2005 to 2006	5.40%
Debentures payable	18,500	19,297	—	2005 to 2013	7.27%
	<u>\$ 74,535</u>	<u>\$ 75,349</u>	<u>\$ 33,380</u>		

PMC COMMERCIAL TRUST AND SUBSIDIARIES
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Scheduled principal payments on our revolving credit facility, notes and debentures payable at December 31, 2004 were as follows (face amount):

Years Ending December 31,	Total (1)
	<i>(In thousands)</i>
2005	\$ 33,703
2006	16,552
2007	1,023
2008	2,160
2009	3,172
Thereafter	17,925
	<u>\$ 74,535</u>

(1) Payments of the structured notes payable are dependent upon the timing of the cash flows received from the underlying loans receivable.

Revolving Credit Facility

PMC Commercial has a revolving credit facility which provides funds to originate loans collateralized by commercial real estate. The revolving credit facility matures in December 2005 and provides us with credit availability up to \$40 million. We are charged interest on the balance outstanding under the revolving credit facility at our election of either the prime rate of the lender less 50 basis points or 187.5 basis points over the 30, 60 or 90-day LIBOR. In addition, we are charged an unused fee equal to 37.5 basis points computed based on our daily available balance. The credit facility requires us to meet certain covenants, the most restrictive of which provides for an asset coverage test based on our cash and cash equivalents, loans receivable, Retained Interests and real estate investments as a ratio to our senior debt and limit our ability to pay out returns of capital as part of our dividends. At December 31, 2004, we were in compliance with the covenants of this facility. On February 7, 2005, we completed a \$100 million conduit warehouse facility and a portion of the outstanding balance on our revolving credit facility (\$15 million) was repaid and our revolving credit facility was reduced from \$40 million to \$20 million.

Structured Notes Payable

In June 1998, PMC Commercial formed a bankruptcy remote partnership that completed a private placement of fixed-rate loan-backed notes (the "Trust Structured Notes"). The Trust Structured Notes have a stated maturity in 2019; however, repayment of their principal is based on collections of principal on the underlying loans receivable. The Trust Structured Notes are collateralized by the loans that we contributed to the partnership. At December 31, 2004 and 2003, the principal amount of the outstanding underlying loans receivable was approximately \$12.9 million and \$26.0 million, respectively. We have no obligation to pay the Trust Structured Notes, nor do the holders of the Trust Structured Notes have any recourse against our assets. Accordingly, if PMCT Trust fails to pay the Trust Structured Notes, the sole recourse of the holders of the Trust Structured Notes is against the assets of PMCT Trust.

Mortgage Notes Payable

We have entered into eleven mortgage notes payable, each collateralized by a Hotel Property. Four of the mortgage notes payable are through our subsidiaries formed to issue the mortgage notes and seven are through PMC Commercial. The mortgage notes payable of PMC Commercial have a weighted average interest rate of 6.0%, mature between December 2005 and August 2019 and have amortization periods of 20 years. At December 31, 2004 and 2003, the aggregate balances outstanding on these obligations were approximately \$8.3 million and \$8.6 million, respectively. During June 2004 (at maturity), a \$1.5 million fixed-rate mortgage payable with an interest rate of 7.5% was "rolled-over" into a new \$1.5 million variable-rate mortgage payable with an interest rate of prime plus 0.5% and a maturity in June 2009. A mortgage note payable with a principal balance of \$1.5 million matured in October 2004 at an interest rate of 8.0% and was "rolled-over" into a new \$1.5 million variable-rate mortgage payable at an interest rate of prime plus 0.5% and a maturity in November 2009.

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The four mortgage notes payable of our subsidiaries have a weighted average interest rate of approximately 8.0% and relate to four Hotel Properties. These mortgages are amortized over 20 years, mature from January 2010 to December 2017 and have restrictive provisions which provide for substantial prepayment penalties. At December 31, 2004 and 2003, the aggregate balances outstanding on these mortgage notes payable were approximately \$5.9 million and \$6.1 million, respectively, of which approximately \$3.1 million and \$3.3 million, respectively, were guaranteed by PMC Commercial.

Uncollateralized Notes Payable

Our uncollateralized notes payable outstanding at December 31, 2004 were assumed in connection with the merger and mature from July 2005 to July 2006 with a weighted average cost of funds of 5.3% at December 31, 2004. Quarterly interest only payments are due on the uncollateralized notes payable until maturity. These notes payable require us to meet certain covenants (terms as defined in the agreement), the most restrictive of which require (i) that net loans receivable must exceed 150% of senior funded debt, (ii) loan losses for any twelve-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 December 31, 2004, we were in compliance with the covenants of these notes payable. During April 2004 and July 2004 (at maturity), we repaid \$5.0 million and \$10.0 million, respectively, of these notes payable using existing cash and our revolving credit facility. During March 2005, we prepaid, without penalty, the \$20 million of uncollateralized notes payable.

Debentures Payable

Debentures payable, assumed in connection with the merger, represent amounts due to the SBA as a result of borrowings made pursuant to the SBIA. The debentures mature from September 2005 to September 2013 with a weighted average cost of funds at December 31, 2004 of 6.0%. Semi-annual interest only payments are due on the debentures until maturity.

Note 8. Cumulative and Redeemable Preferred Stock of Subsidiary:

PMCIC has outstanding 30,000 shares of \$100 par value, 3% cumulative preferred stock (the "3% Preferred Stock") and 40,000 shares of \$100 par value, 4% cumulative preferred stock (the "4% Preferred Stock"). The 3% Preferred Stock and the 4% Preferred Stock are held by the SBA pursuant to the SBIA.

PMCIC is entitled to redeem, in whole or part, the 3% Preferred Stock by paying the par value (\$3.0 million) of these securities plus dividends accumulated and unpaid on the date of redemption. While the 3% Preferred Stock may be redeemed, redemption is not mandatory. The 3% Preferred Stock was valued at \$900,000 at the merger date. Dividends of approximately \$75,000 were recognized on the 3% Preferred Stock during 2004 and are reflected in our consolidated statements of income as minority interest.

The 4% Preferred Stock was issued during 1994 (\$2.0 million) and 1995 (\$2.0 million) and must be redeemed at par no later than 15 years from the date of issuance. In accordance with SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity," we have classified the 4% Preferred Stock as a liability on our consolidated balance sheet. The 4% Preferred Stock was valued at \$3,420,000 at the merger date. Dividends of approximately \$134,000 were recognized on the 4% Preferred Stock during 2004 and are included in interest expense in our consolidated statement of income.

Note 9. Earnings Per Share:

The computations of basic earnings per common share are based on our weighted average shares outstanding. The weighted average number of common shares outstanding was approximately 10,134,000, 6,448,000 and 6,444,000 for the years ended December 31, 2004, 2003 and 2002, respectively. For purposes of calculating diluted earnings per share, the weighted average shares outstanding were increased by approximately 18,000, 12,000 and 12,000 shares, respectively, during 2004, 2003 and 2002 for the dilutive effect of stock options.

For purposes of calculating earnings per share, the gain on sale of loans receivable of \$711,000 and \$562,000 for the years ended December 31, 2003 and 2002, respectively, has been combined with income from continuing operations.

Not included in the computation of diluted earnings per share were outstanding options to purchase 59,875, 15,000 and 57,600 common shares during 2004, 2003 and 2002, respectively, because the options' exercise prices were greater than the average market price of the stock.

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Note 10. Dividends:

On January 12, 2004, we paid a \$0.38 per share quarterly dividend to common shareholders of record on December 31, 2003. On February 27, 2004, we paid a \$0.243 per share quarterly dividend to common shareholders of record on February 23, 2004. The Board of Trust Managers declared the remaining \$0.137 per share quarterly dividend (total of \$0.38 per share for the first quarter of 2004) to common shareholders of record on March 31, 2004, which was paid on April 12, 2004. Subsequent to the merger, the Board of Trust Managers declared \$0.34 per share quarterly dividends to common shareholders of record on June 30, 2004, September 30, 2004 and December 31, 2004 which were paid on July 12, 2004, October 12, 2004 and January 10, 2005, respectively. In March 2005, the Board of Trust Managers declared a \$0.35 per share quarterly dividend to common shareholders of record on March 31, 2005 which will be paid on April 11, 2005.

We have certain covenants within our debt facilities that limit our ability to pay out returns of capital as part of our dividends. These restrictions have not historically limited the amount of dividends we have paid and management does not believe that they will restrict future dividend payments.

Note 11. Taxable Income:

As a REIT, PMC Commercial generally will not be subject to corporate level Federal income tax on net income that is currently distributed to shareholders provided the distribution exceeds 90% of REIT taxable income. We may, however, be subject to certain Federal excise taxes and state and local taxes on our income and property. If PMC Commercial fails to qualify as a REIT in any taxable year, it will be subject to Federal income taxes at regular corporate rates (including any applicable alternative minimum tax) and will not be able to qualify as a REIT for four subsequent taxable years.

We may make an election under the Code to treat distributions declared in the current year as distributions of the prior year's taxable income. Upon election, the Code provides that, in certain circumstances, a dividend declared subsequent to the close of an entity's taxable year and prior to the extended due date of the entity's tax return may be considered as having been made in the prior tax year in satisfaction of income distribution requirements.

PMC Commercial has wholly-owned taxable REIT subsidiaries which are subject to Federal income taxes. The TRS's are PMCIC, First Western and PMC Funding. The income generated from the taxable REIT subsidiaries is taxed at normal corporate rates. We account for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes" which uses the asset and liability method and deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. The measurement of net deferred tax assets is adjusted by a valuation allowance, if, based on our evaluation, it is more likely than not that they will not be realized. We previously have provided a valuation allowance against our deferred tax assets based on our ongoing assessment of their future realization.

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The following reconciles our net income to REIT taxable income:

	Years Ended December 31,		
	2004	2003	2002
	<i>(In thousands)</i>		
Net income	\$ 24,781	\$ 8,174	\$ 9,936
Less: TRS net income, net of tax	(145)	—	—
Add: book depreciation	1,872	1,967	2,121
Less: tax depreciation	(1,935)	(1,927)	(1,987)
Book/tax difference on losses (gains) on sales	135	(650)	(550)
Book/tax difference on Retained Interests, net	3,557	672	486
Negative goodwill	(11,593)	—	—
Asset valuation	(516)	310	65
Other book/tax differences, net	96	127	(55)
	<u>\$ 16,252</u>	<u>\$ 8,673</u>	<u>\$10,016</u>
REIT taxable income			
Distributions declared	<u>\$ 14,140</u>	<u>\$ 9,932</u>	<u>\$10,440</u>

Dividends per share for dividend reporting purposes were as follows:

	Years Ended December 31,					
	2004		2003		2002	
	Amount Per Share	Percent	Amount Per Share	Percent	Amount Per Share	Percent
Ordinary income	\$ 1.400	100.00%	\$ 1.487	96.53%	\$ 1.517	93.67%
Capital gains	—	—	0.053	3.47%	0.103	6.33%
	<u>\$ 1.400</u>	<u>100.00%</u>	<u>\$ 1.540</u>	<u>100.00%</u>	<u>\$ 1.620</u>	<u>100.00%</u>

Income tax provision related to the TRS's consists of the following:

	Year Ended December 31, 2004
	<i>(In thousands)</i>
Federal:	
Current	\$ 152
Deferred	(36)
	<u>\$ 116</u>

PMC COMMERCIAL TRUST AND SUBSIDIARIES
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The provision for income taxes results in effective tax rates that differ from Federal statutory rates of 35%. The reconciliation of TRS income tax attributable to net income computed at Federal statutory rates to income tax expense was as follows:

	Year Ended December 31, 2004
	<i>(In thousands)</i>
Income before income taxes for TRS's	\$ 261
Expected Federal income tax provision	\$ 91
Preferred dividend of subsidiary recorded as minority interest	25
Income tax provision	\$ 116

The components of the net deferred tax asset at December 31, 2004 were as follows *(in thousands)*:

Deferred tax assets:	
Operating loss carryforwards	\$ 171
Servicing asset	188
Loan valuation	105
Premiums on acquired notes and debentures payable	133
Other	80
Total gross deferred tax assets	677
Valuation allowance	171
	506
Deferred tax liabilities:	
Discount on acquired redeemable preferred stock of subsidiary	179
Total gross deferred tax liabilities	179
Deferred tax asset, net	\$ 327

The net operating loss carryforwards were generated by PMC Funding. These net operating loss carryforwards are available to offset future taxable income of PMC Funding. However, based on PMC Funding's historical and anticipated pretax earnings, management does not believe that we will realize the benefit of these net operating loss carryforwards. Accordingly, they were valued at zero at December 31, 2004. The net operating loss carryforwards expire from 2012 to 2022.

Note 12. Discontinued Operations:

Effective January 1, 2002, we adopted SFAS No. 144. In accordance with SFAS No. 144, the operations of our hotel properties either sold during 2002, 2003 or 2004 or held for sale at December 31, 2004 have been reflected as discontinued operations in our accompanying statements of income and the prior period financial statements have been reclassified to reflect the operations of these properties as discontinued operations during 2003 and 2002.

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Property sales included in discontinued operations consisted of the following:

	Years Ended December 31,		
	2004	2003	2002
<i>(In thousands, except number of property sales and footnotes)</i>			
Number of sales of real estate:			
Hotel properties	2	1	2
Assets acquired in liquidation	7 (1)	1	—
	<u>9</u>	<u>2</u>	<u>2</u>
Net sales proceeds — hotel properties	\$ 3,513	\$ 2,160 (2)	\$ 5,061 (3)
Net book value of hotel properties sold	<u>(3,983)</u>	<u>(1,877)</u>	<u>(4,398)</u>
	<u>(470)</u>	<u>283</u>	<u>663</u>
Net sales proceeds — assets acquired in liquidation	\$ 3,052 (4)	\$ 333	\$ —
Net book value of assets acquired in liquidation sold	<u>(2,834)</u>	<u>(333)</u>	<u>—</u>
	<u>218</u>	<u>—</u>	<u>—</u>
Net gain (loss) on sales of real estate	<u>\$ (252)</u>	<u>\$ 283</u>	<u>\$ 663</u>

- (1) Includes four sales of real estate (assets acquired in liquidation) by First Western with net sale proceeds of \$423,000, net book value of \$416,000 and a net gain on sales of real estate of \$7,000.
- (2) We financed the hotel property sale through origination of a loan of \$1,669,000 at an interest rate of LIBOR plus 4%.
- (3) We financed one of the hotel property sales through origination of a loan of \$2,004,000 at an interest rate of LIBOR plus 4%.
- (4) We financed two of the asset acquired in liquidation sales through origination of loans of \$900,000 each with interest rates of LIBOR plus 4.5%.

In conjunction with the sale of a hotel property in August 2004, Arlington provided us with a Shortfall note receivable with an estimated fair value of \$624,000 representing the lease termination fee which is the difference between the Stated Value of the property and the proceeds received from the third party purchaser. The lease termination fee is included in net earnings from discontinued operations in our consolidated statement of income. In addition, in conjunction with the sale of a hotel property in December 2004, Arlington provided us with a Shortfall note receivable with an estimated fair value of \$443,000 and we recorded a corresponding deferred liability which is included in other liabilities in our consolidated balance sheet. The Shortfall note receivable bears interest at a fixed rate of 8.5% and matures in 2011.

The real estate investment held for sale at December 31, 2004 is one of our Hotel Properties with a Stated Value of \$2.3 million which was sold for approximately \$2.1 million to a third party during March of 2005 for a gain of approximately \$150,000. Arlington provided us with a Shortfall note receivable with an estimated fair value of \$267,000 and we recorded a corresponding deferred liability.

PMC COMMERCIAL TRUST AND SUBSIDIARIES
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Our discontinued operations consisted of the following:

	Years Ended December 31,		
	2004	2003	2002
	<i>(In thousands)</i>		
Lease income	\$ 735	\$ 951	\$ 1,186
Lease termination fee income	624	—	—
Depreciation	(162)	(232)	(305)
Advisory fees	(8)	(60)	(73)
Other expenses	(2)	—	—
Net earnings	1,187	659	808
Net gain (loss) on sales of real estate	(252)	283	663
Discontinued operations	<u>\$ 935</u>	<u>\$ 942</u>	<u>\$ 1,471</u>

Note 13. Other Income:

Other income consisted of the following:

	Years ended December 31,		
	2004	2003	2002
	<i>(In thousands)</i>		
Servicing income	\$ 1,142	\$ —	\$ —
Prepayment fees	656	108	813
Debt release income	175	—	—
Other loan related fees	475	231	351
Other income	<u>\$ 2,448</u>	<u>\$ 339</u>	<u>\$ 1,164</u>

Note 14. Dividend Reinvestment and Cash Purchase Plan:

We have a dividend reinvestment and cash purchase plan (the "Plan"). Participants in the Plan have the option to reinvest all or a portion of dividends received. The purchase price of the Common Shares is 100% of the average of the closing price of the Common Shares as published for the five trading days immediately prior to the dividend record date or prior to the optional cash payment purchase date, whichever is applicable. The optional cash purchase plan was suspended during January 2000. In addition, since January 2000 we have been using the open market to purchase Common Shares with proceeds from the dividend reinvestment portion of the Plan. Accordingly, there were no plan shares issued during 2004, 2003 and 2002.

Note 15. Profit Sharing Plan:

Commencing with the merger, we have a profit sharing plan available to our full-time employees after one year of employment. Vesting increases ratably to 100% after the sixth year of employment. Pursuant to our profit sharing plan, approximately \$183,000 was expensed during 2004. Contributions to the profit sharing plan are at the discretion of our Board of Trust Managers.

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Note 16. Stock-Based Compensation Plans:

Options have been issued pursuant to two stock-based compensation plans, the 1993 Employee Share Option Plan (the “Employee Plan”) and the Trust Manager Share Option Plan (the “Trust Manager Plan”), referred to collectively as the “Stock Option Plans.” The Stock Option Plans provided that the exercise price of any stock option would not be less than the fair market value of our Common Stock on the date of grant. In general, all options vested immediately. The Stock Option Plans expired in December 2003; thus, no additional options will be issued unless new stock option plans are approved by the shareholders.

Effective January 1, 2003, we adopted the fair value recognition provisions of SFAS No. 123 prospectively to all awards granted, modified or settled after January 1, 2003.

The Trust Manager Plan was a nondiscretionary plan pursuant to which options to purchase 2,000 Common Shares were granted to certain trust managers on the date such trust manager took office. In addition, options to purchase 1,000 shares were granted on June 1 of each year through December 31, 2003. Such options were exercisable at the fair market value of the shares on the date of grant. The options granted under the Trust Manager Plan became exercisable one year after date of grant and expired if not exercised on the earlier of (i) 30 days after the option holder no longer held office for any reason or (ii) within five years after date of grant. We issued 5,000 options under the Trust Manager Plan during 2003 and 2002. Due to expiration of the Trust Manager Plan, we did not grant any options under the Trust Manager Plan during 2004.

A summary of the status of our stock options as of December 31, 2004, 2003 and 2002 and the changes during the years ended on those dates are as follows:

	2004		2003		2002	
	Number of Shares Underlying Options	Weighted Average Exercise Prices	Number of Shares Underlying Options	Weighted Average Exercise Prices	Number of Shares Underlying Options	Weighted Average Exercise Prices
Outstanding, January 1	150,876	\$ 12.64	204,426	\$ 13.86	202,976	\$ 15.28
Granted	—	—	5,000	\$ 13.78	54,800	\$ 13.29
Acquired in the merger	88,483	\$ 19.19	—	—	—	—
Exercised	(59,500)	\$ 11.58	(6,500)	\$ 12.76	(5,000)	\$ 12.80
Forfeited	(92)	\$ 12.97	(8,950)	\$ 14.92	(600)	\$ 18.63
Expired	(15,507)	\$ 19.97	(43,100)	\$ 18.05	(47,750)	\$ 19.78
Outstanding, December 31	<u>164,260</u>	<u>\$ 15.86</u>	<u>150,876</u>	<u>\$ 12.64</u>	<u>204,426</u>	<u>\$ 13.86</u>
Exercisable, December 31	<u>164,260</u>	<u>\$ 15.86</u>	<u>145,876</u>	<u>\$ 12.60</u>	<u>199,426</u>	<u>\$ 13.83</u>
Weighted-average fair value of stock options granted during the year	<u>—</u>		<u>\$ 0.38</u>		<u>\$ 0.60</u>	

Upon notification of intent to exercise stock options, our policy is to first verify that the options are exercisable, then to contact our transfer agent instructing them to issue new shares and then to collect the cash proceeds. We received approximately \$378,000 in cash proceeds related to the cash exercise of stock options during 2004. In addition, we issued 6,620 Common Shares to certain of our executive officers in exchange for 27,750 stock options utilizing stock-for-stock exercise provisions of the Employee Plan.

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The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions for grants in 2003 and 2002:

	Years Ended December 31,	
	2003	2002
Assumption:		
Expected Term (years)	3.0	3.0
Risk-Free Interest Rate	1.48%	2.33%
Expected Dividend Yield	11.03%	12.20%
Expected Volatility	18.50%	22.61%

The following table summarizes information about stock options outstanding at December 31, 2004:

Range of Exercise Prices	Options Outstanding and Exercisable		
	Number Outstanding at 12/31/04	Weighted Average Remaining Contract Life (in years)	Weighted Average Exercise Price
\$10.75 to \$12.97	18,885	3.5	\$ 12.85
\$13.125 to \$14.90	90,500	2.5	\$ 13.27
\$17.95 to \$24.49	54,875	1.5	\$ 21.15
\$10.75 to \$24.49	164,260	2.3	\$ 15.86

Note 17. Supplemental Disclosure of Cash Flow Information:

Supplemental cash flow information was as follows:

	Years Ended December 31,		
	2004	2003	2002
	<i>(In thousands)</i>		
Cash paid for interest	\$ 4,727	\$ 3,138	\$ 3,218
Cash paid for income taxes	\$ 85	\$ —	\$ —
Non-cash investing activities:			
Loan receivable established through due to affiliates, net	\$ 2,126	\$ —	\$ —
Reclassification from loans receivable to assets acquired in liquidation	\$ 2,115	\$ —	\$ —
Loans receivable originated in connection with the sale of assets acquired in liquidation	\$ 1,800	\$ 1,669	\$ 2,044
Note receivable and deferred liability recorded upon sale of hotel property	\$ 443	\$ —	\$ —
Loans and interest receivable transferred to QSPEs, net	\$ —	\$ 4,592	\$ 2,810
Reclassification from Retained Interests to due to affiliates, net	\$ —	\$ 781	\$ —

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See Note 2 for information on assets acquired and liabilities assumed in connection with the merger with PMC Capital.

Note 18. Fair Values of Financial Instruments:

The estimates of fair value as required by SFAS No. 107, "Disclosures about Fair Value of Financial Instruments" differ from the carrying amounts of the financial assets and liabilities primarily as a result of the effects of discounting future cash flows. Considerable judgment is required to interpret market data and develop estimates of fair value. Accordingly, the estimates presented below may not be indicative of the amounts we could realize in a current market exchange.

The estimated fair values of our financial instruments were as follows:

	Years Ended December 31,			
	2004		2003	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
	(In thousands)			
Assets:				
Loans receivable, net	\$128,234	\$ 129,392	\$ 50,534	\$ 50,761
Retained Interests	70,523	70,523	30,798	30,798
Cash and cash equivalents	9,065	9,065	1,078	1,078
Restricted investments	3,096	2,829	4,068	3,782
Mortgage-backed security of affiliate	1,027	1,027	—	—
Note receivable, net	733	733	—	—
Liabilities:				
Notes and debentures payable	60,749	61,376	33,380	34,514
Redeemable preferred stock of subsidiary	3,488	3,488	—	—
Revolving credit facility	14,600	14,600	—	—

Loans receivable, net and Notes receivable: We generally estimate the fair value of variable-rate loans to approximate the remaining unamortized principal of the loan less any purchase or other discounts, unless there is doubt as to realization of the loan. In addition, we generally estimate the fair value of fixed-rate loans and notes based on a net present value calculation utilizing current market interest rates and anticipated principal collections. A valuation reserve is established for a problem loan or note based on the creditor's payment history, collateral value, guarantor support and other factors. In the absence of a readily ascertainable market value, the estimated value of our loans and notes receivable may differ from the values that would be placed on the portfolio if a ready market for the receivables existed.

Retained Interests and Mortgage-backed security of affiliate: The assets are reflected in our consolidated financial statements at estimated fair value based on valuation techniques as described in Note 4.

Cash and cash equivalents: The carrying amount is a reasonable estimation of fair value due to the short maturity of these instruments.

Restricted investments: The fair value of the reserve fund associated with the 1998 structured loan financing transaction is estimated by utilizing discounted cash flow techniques based on management's estimates of market rates including risks inherent in the transaction. The carrying amount of the remaining restricted investments is a reasonable estimate of fair value due to the short maturity of these instruments.

Notes and debentures payable: The estimated fair value is based on a present value calculation based on prices of the same or similar instruments after considering risk, current interest rates and remaining maturities.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Redeemable preferred stock of subsidiary: The estimated fair value is based on a present value calculation based on prices of the same or similar instruments after considering risk, current interest rates and remaining maturities.

Revolving credit facility: The carrying amount is a reasonable estimation of fair value as the interest rate on this instrument is a variable rate of interest.

Note 19. Related Party Transactions:

Our investment advisor at December 31, 2003 was PMC Advisers, Ltd. and its subsidiary (“PMC Advisers” or the “Investment Manager”), an indirect wholly-owned subsidiary of PMC Capital, Inc. Our loans receivable were originated and serviced by PMC Advisers pursuant to an Investment Management Agreement (the “IMA”). Property acquisitions were supervised pursuant to a separate agreement with PMC Advisers (the “Lease Supervision Agreement” and together with the IMA, the “Advisory Agreements”).

Pursuant to the IMA we were charged fees between 0.40% and 1.55% annually, based on the average principal outstanding of our loans receivable. The IMA also provided for a fee of \$10,000 upon the sale of each Hotel Property and an annual loan origination fee equal to five basis points for the first \$20 million of loans funded and 2.5 basis points thereafter. As a result of the merger, the IMA was terminated.

The Lease Supervision Agreement provided for an annual fee of 0.70% of the original cost of the Hotel Properties to be paid to PMC Advisers for providing services relating to the leases on the Hotel Properties. In addition, the Lease Supervision Agreement provided for a fee in connection with the acquisition of properties of 0.75% of the acquisition cost. As a result of the merger, the Lease Supervision Agreement was terminated.

Fees associated with the Advisory Agreements consisted of the following:

	Years Ended December 31,		
	2004	2003	2002
	<i>(In thousands)</i>		
Investment management fee	\$ 310	\$ 2,047	\$ 1,927
Lease supervision fee	60	378	401
Total fees incurred	370	2,425	2,328
Less:			
Management fees included in discontinued operations	(8)	(60)	(73)
Fees incurred on behalf of the QSPEs	(74)	(338)	(298)
Cost of structured loan sale transactions	—	(102)	(57)
Cost of property sales	—	(10)	(20)
Fees capitalized as cost of originating loans	—	(108)	(135)
Advisory and servicing fees to affiliate, net	<u>\$ 288</u>	<u>\$ 1,807</u>	<u>\$ 1,745</u>

PMC COMMERCIAL TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 20. Selected Quarterly Financial Data: (unaudited)

The following represents our selected quarterly financial data which, in the opinion of management, reflects adjustments (comprising only normal recurring adjustments) necessary for fair presentation.

	For the Year Ended December 31, 2004			
	Income From		Net	Earnings
	Revenues (1)	Continuing Operations (1)		
	<i>(In thousands, except earnings per share and footnotes)</i>			
First Quarter	\$ 4,439	\$ 2,505	\$ 14,246 (2)	\$ 1.79 (2)
Second Quarter	6,602	3,189	3,583	\$ 0.33
Third Quarter	6,711	2,773	3,148 (3)	\$ 0.29 (3)
Fourth Quarter	7,607	3,786	3,804	\$ 0.35
	\$ 25,359	\$ 12,253	\$ 24,781	(4)

	For the Year Ended December 31, 2003			
	Income From		Net	Earnings
	Revenues (1)	Continuing Operations (1)		
	<i>(In thousands, except earnings per share and footnotes)</i>			
First Quarter	\$ 3,414	\$ 1,634	\$ 1,812	\$ 0.28
Second Quarter	3,610	1,664	1,839	0.29
Third Quarter	3,812	1,816	2,265 (5)	0.35 (5)
Fourth Quarter	3,245	1,407	2,258 (6)	0.35 (6)
	\$ 14,081	\$ 6,521	\$ 8,174	\$ 1.27

- (1) Certain amounts were previously reported in continuing operations in our quarterly filings on Form 10-Q. Such amounts have been reclassified to discontinued operations in accordance with SFAS No. 144.
- (2) Includes negative goodwill of \$11,593,000 related to our merger.
- (3) Includes a loss of \$354,000 from the sale of a hotel property. Also includes termination fee income of \$624,000 from the sale of a hotel property.
- (4) Due to the merger on February 29, 2004, our weighted average shares have fluctuated significantly and the sum of our quarterly earnings per share will not equal year-to-date earnings per share of \$2.44.
- (5) Includes a gain of \$283,000 from the sale of a hotel property.
- (6) Includes a gain of \$711,000 related to our structured loan sale transaction.

Note 21. Commitments and Contingencies:

Loan Commitments

Commitments to extend credit are agreements to lend to a customer provided the terms established in the contract are met. Our outstanding loan commitments and approvals to fund new loans were \$30.3 million at December 31, 2004, of which (i) \$4.9 million represents commitments of our SBICs and (ii) \$6.9 million are for loans to be originated by First Western, approximately 75% of which will be sold pursuant to Secondary Market Loan Sales. At December 31, 2004, approximately \$8.3 million of our cash and cash equivalents was only available for future operating commitments of our SBICs. Pursuant to SBA rules and regulations, our SBICs cannot advance funds to PMC Commercial or its affiliates. As a result, PMC Commercial may have to borrow funds on its revolving credit facility to make investments even though our SBICs have available cash and cash equivalents.

PMC COMMERCIAL TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The majority of our commitments and approvals were for variable-rate loans based on the prime rate or the 90-day LIBOR at spreads over the prime rate generally ranging from 1.75% to 2.75% and over LIBOR generally ranging from 3.5% to 4.5%. The weighted average interest rate on our loan commitments and approvals at December 31, 2004 was approximately 6.9%. 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, total commitment amounts do not necessarily represent future cash requirements.

Operating Lease

We lease office space in Dallas, Texas under a lease which expires in October 2011. Future minimum lease payments under this lease are as follows:

	<u>Amount</u>
	<u>(In thousands)</u>
2005	\$ 155
2006	167
2007	179
2008	191
2009	203
Thereafter	401
	<u>\$ 1,296</u>

Rental expense, which is being recorded on a straight-line basis, amounted to approximately \$133,000 during 2004.

Employment Agreements

In connection with the merger, we assumed employment agreements with certain of our executive officers. During the third quarter of 2004, we extended the outstanding employment periods of these executive officers from September 2006 to July 2007. Future payments under these contracts are approximately \$1,108,000, \$1,108,000 and \$647,000 for 2005, 2006 and 2007, respectively. Compensation to officers was approximately \$1.1 million during 2004.

Structured Loan Financing Transaction

Our structured loan financing is not treated as a sale for financial reporting purposes. Distributions of the net assets from PMCT Trust, pursuant to its trust indenture, are limited and restricted. The reserve requirement is currently at its minimum of \$1.4 million at December 31, 2004. The reserve fund balance is included in restricted investments on our consolidated balance sheet.

Structured Loan Sale Transactions

The transaction documents of the QSPEs contain provisions (the "Credit Enhancement Provisions") that govern the assets and the inflow and outflow of funds of the QSPE formed as part of the structured loan sale transactions. The Credit Enhancement Provisions include specified limits on the delinquency, default and loss rates on the loans receivable included in each QSPE. If, at any measurement date, the delinquency, default or loss rate with respect to any QSPE were to exceed the specified limits, the Credit Enhancement Provisions would automatically increase the level of credit enhancement requirements for that QSPE. During the period in which the specified delinquency, default or loss rate was exceeded, excess cash flow from the QSPE, if any, which would otherwise be distributable to us, would be used to fund the increased credit enhancement levels up to the principal amount of such loans and would delay or reduce our distribution. As a result of a delinquent loan with a principal balance of approximately \$2.5 million related to a structured loan sale transaction, a Credit Enhancement Provision was triggered. We repaid the noteholders using the reserve fund; thus, the reserve fund was below its minimum required balance. Cash flows of approximately \$1.5 million have been deferred and utilized to replenish the reserve fund requirement (an additional \$1.0 million is currently necessary to replenish the reserve fund to its required balance). Cash flows up to a maximum of \$2.5 million may be deferred and utilized to fund the increased reserve requirement related to this loan. Management believes that these funds used to rebuild the reserve fund will be distributed to us in future periods. In general, there can be no assurance that amounts deferred under Credit Enhancement Provisions would be received in future periods or that future deferrals or losses will not occur.

**PMC COMMERCIAL TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Environmental

PMC Funding has recorded a liability of approximately \$300,000 for the estimated costs at December 31, 2004 to remediate an environmental obligation related to an asset sold by PMC Funding. The sale was financed by PMC Capital with a loan with a current outstanding principal balance of approximately \$500,000. Under purchase accounting, the liability was assumed and the loan was acquired by PMC Commercial in the merger with PMC Capital. Our borrower has the primary responsibility for the environmental remediation.

On February 25, 2005, we were informed by the Georgia Department of Natural Resources that the current remediation plan for the property requires revision. While our borrower has the primary responsibility for the environmental remediation, to the extent we were forced to reacquire the property, we currently believe that the estimated fair value of the collateral underlying the loan exceeds the current outstanding principal balance on the loan. At the present time, we have been unable to quantify additional costs, if any, of the potential changes in remediation methods requested by the State of Georgia; however, these costs could be material and may exceed the value of the collateral net of the recorded liability.

Litigation

In the normal course of business, including our assets acquired in liquidation and the QSPEs, we are periodically party to certain legal actions and proceedings involving matters that are generally incidental to our business (*i.e.*, collection of loans receivable). In management's opinion, the resolution of these legal actions and proceedings will not have a material adverse effect on our consolidated financial statements.

Note 22. Business Segments:

Operating results and other financial data are presented for our reportable business segments. These segments are categorized by line of business which also corresponds to how they are operated. The segments include (i) the Lending Division, which originates loans receivable to small businesses primarily in the hospitality industry and (ii) the Property Division which owns the Hotel Properties.

PMC COMMERCIAL TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Our business segment data as of December 31, 2004, 2003 and 2002 and for the years ended December 31, 2004, 2003 and 2002 is as follows:

	Years Ended December 31,					
	2004			2003		
	Total	Lending Division	Property Division	Total	Lending Division	Property Division
	<i>(In thousands)</i>					
Revenues:						
Interest income — loans and other income	\$ 10,610	\$ 10,610	\$ —	\$ 6,115	\$ 6,115	\$ —
Lease income	5,460	—	5,460	5,024	—	5,024
Income from Retained Interests	8,763	8,763	—	2,942	2,942	—
Premium income	526	526	—	—	—	—
Total	<u>25,359</u>	<u>19,899</u>	<u>5,460</u>	<u>14,081</u>	<u>9,057</u>	<u>5,024</u>
Expenses:						
Interest (1)	4,549	2,928	1,621	3,204	1,480	1,724
Depreciation	1,710	2	1,708	1,646	—	1,646
Salaries and related benefits (2)	3,557	3,201	356	—	—	—
Advisory and servicing fees to affiliate, net	288	236	52	1,807	1,499	308
General and administrative	1,882	1,868	14	526	509	17
Realized losses on Retained Interests	1,182	1,182	—	—	—	—
Impairment loss on asset acquired in liquidation	—	—	—	67	67	—
Provision for (reduction of) loan losses, net	(253)	(253)	—	310	310	—
Total	<u>12,915</u>	<u>9,164</u>	<u>3,751</u>	<u>7,560</u>	<u>3,865</u>	<u>3,695</u>
Income before income tax provision, minority interest, discontinued operations and extraordinary item	12,444	10,735	1,709	6,521	5,192	1,329
Income tax provision	(116)	(116)	—	—	—	—
Minority interest (preferred stock dividend of subsidiary)	(75)	(75)	—	—	—	—
Income from continuing operations	<u>12,253</u>	<u>10,544</u>	<u>1,709</u>	<u>6,521</u>	<u>5,192</u>	<u>1,329</u>
Discontinued operations:						
Net gain (loss) on sales of real estate	(252)	218	(470)	283	—	283
Net earnings	1,187	13	1,174	659	—	659
	<u>935</u>	<u>231</u>	<u>704</u>	<u>942</u>	<u>—</u>	<u>942</u>
Gain on sale of loans receivable	—	—	—	711	7	—
Income before extraordinary item	<u>13,188</u>	<u>10,775</u>	<u>2,413</u>	<u>8,174</u>	<u>5,903</u>	<u>2,271</u>
Extraordinary item:						
Negative goodwill	11,593	11,593	—	—	—	—
Net income	<u>\$ 24,781</u>	<u>\$ 22,368</u>	<u>\$ 2,413</u>	<u>\$ 8,174</u>	<u>\$ 5,903</u>	<u>\$ 2,271</u>

(1) Interest expense specifically identifiable to a particular division is allocated to that division. Interest expense which is not specifically identifiable is allocated based on the relative total assets of each division.

(2) Salaries and related benefits were allocated to the property division based on management's estimate of time spent for oversight of the Lease Agreement, as amended.

PMC COMMERCIAL TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	Year Ended December 31, 2002		
	Total	Lending Division	Property Division
	(In thousands)		
Revenues:			
Interest income — loans and other income	\$ 7,400	\$ 7,400	\$ —
Lease income	4,954	—	4,954
Income from Retained Interests	2,893	2,893	—
Total	15,247	10,293	4,954
Expenses:			
Interest (1).	3,445	1,898	1,547
Depreciation	1,597	—	1,597
Advisory and servicing fees to affiliate, net	1,745	1,437	308
General and administrative	385	367	18
Realized losses on Retained Interests	53	53	—
Impairment loss on asset acquired in liquidation	54	54	—
Provision for loan losses	65	65	—
Total	7,344	3,874	3,470
Income from continuing operations	7,903	6,419	1,484
Discontinued operations:			
Net gain on sales of real estate	663	—	663
Net earnings	808	—	808
	1,471	—	1,471
Gain on sale of loans receivable	562	562	—
Net income	\$ 9,936	\$ 6,981	\$ 2,955

(1) Interest expense specifically identifiable to a particular division is allocated to that division. Interest expense which is not specifically identifiable is allocated based on the relative total assets of each division.

Total assets were allocated as follows:

	Years Ended December 31,		
	2004	2003	2002
	(In thousands)		
Lending Division	\$ 214,252	\$ 86,014	\$ 100,717
Property Division	39,588	45,722	48,981
	\$ 253,840	\$ 131,736	\$ 149,698

Additions to furniture, fixtures and equipment were as follows:

	Years Ended December 31,		
	2004	2003	2002
	(In thousands)		
Lending Division	\$ 10	\$ —	\$ —
Property Division	595	290	388
	\$ 605	\$ 290	\$ 388

PMC COMMERCIAL TRUST AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 23. Subsequent Event:

Conduit Warehouse Facility

On February 7, 2005, we entered into a \$100.0 million conduit warehouse facility (the "Conduit Facility") with a concurrent reduction in our revolving credit facility from \$40.0 million at December 31, 2004 to \$20.0 million. In conjunction with the Conduit Facility, we created a new subsidiary, PMC Conduit, L.P., which will hold the assets and liabilities of the Conduit Facility.

The Conduit Facility operates as a revolving line of credit, collateralized by loans originated by us, which have been or will be sold and/or contributed to PMC Conduit, L.P. While PMC Commercial has not guaranteed the repayment of the Conduit Facility, PMC Commercial must repurchase the loans securing the Conduit Facility if certain of the representations and warranties made by PMC Commercial in connection with the Conduit Facility are breached. Approximately \$24.4 million of our loans were contributed to PMC Conduit, L.P. who immediately advanced \$15.0 million under the Conduit Facility which was used to repay a portion of the balance outstanding on our revolving credit facility at February 7, 2005. Interest payments on the advances are payable by PMC Conduit, L.P., on a monthly basis, and PMC Conduit L.P.'s principal repayment obligations are expected to be financed through future securitizations of the loans collateralizing advances under the Conduit Facility. We anticipate that future advances under the Conduit Facility will be used to further invest in loans. The Conduit Facility allows for advances based on the amount of eligible collateral contributed to the Conduit Facility and has covenants, the most restrictive of which are maximum delinquency ratios for our contributed loans and serviced portfolio, as defined in the transaction documents. The ability to make advances under the Conduit Facility expires February 6, 2008. At the end of each annual period commencing February 6, 2006, the alternate lenders have the option to extend their respective commitments for an additional 364-day period. If the Conduit Facility is not extended, any and all principal amounts outstanding and all accrued and unpaid interest would be immediately due and payable. In connection with the closing of our \$100 million Conduit Facility, we incurred approximately \$550,000 in costs including a fee to the financial institution of \$350,000.

Junior Subordinated Debt

On March 15, 2005, PMC Commercial issued notes payable (the "Junior Subordinated Notes") of approximately \$27.1 million due March 15, 2035 to a special purpose subsidiary, PMC Preferred Capital Trust-A, a Delaware statutory trust (the "Preferred Trust"). The Junior Subordinated Notes are subordinated to PMC Commercial's existing debt. The Preferred Trust issued shares of its preferred beneficial interest (the "Preferred Securities") to an unaffiliated party in exchange for approximately \$26.3 million and issued shares of common beneficial interest to PMC Commercial for \$820,000. The Junior Subordinated Notes and the Preferred Securities each bear interest at a floating rate which resets on a quarterly basis at the 90-day LIBOR plus 3.25% (approximately 6.25% as of March 15, 2005) and generally may not be redeemed prior to March 15, 2010. After payment of costs associated with the issuance of approximately \$800,000, the proceeds from the sale of the Preferred Securities were approximately \$25.5 million. The net proceeds were used to prepay, without penalty, the \$20 million of uncollateralized notes payable and the remainder was used to repay a portion of the outstanding balance on our Conduit Facility.

Schedule II
PMC COMMERCIAL TRUST AND SUBSIDIARIES
VALUATION AND QUALIFYING ACCOUNTS
AS OF DECEMBER 31, 2004
(In thousands)

Description	Balance at beginning of period	Additions		Deductions	Balance at end of period
		Charged to costs and expenses	Charged to other accounts		
Year ended December 31, 2002:					
Loan Loss Reserves	\$ 300	\$ 65	\$ —	\$ —	\$ 365
Year ended December 31, 2003:					
Loan Loss Reserves	\$ 365	\$ 310	\$ —	\$ —	\$ 675
Year ended December 31, 2004:					
				\$ (258)(1)	
				(675)(2)	
Loan Loss Reserves	\$ 675	\$ 422	\$ —	\$ (933)	\$ 164
Deferred Tax Asset Valuation Allowance	\$ —	\$ —	\$ 171(3)	\$ —	\$ 171

(1) Principal written off.

(2) During 2004, \$675,000 of previously recorded loan loss reserves was reversed due to the reduction in the expected loss on a loan collateralized by a limited service hospitality property due to repayment of all principal on the loan.

(3) We acquired net operating losses in the merger with PMC Capital which were fully reserved at acquisition.

Schedule III
PMC COMMERCIAL TRUST AND SUBSIDIARIES
REAL ESTATE AND ACCUMULATED DEPRECIATION
AS OF DECEMBER 31, 2004
(In thousands, except footnotes)

Description of Property	Encumbrances	Initial Cost			Cost Capitalized Subsequent To Acquisition			Gross Amounts at Which Carried at Close of Period(1)			Total
		Land	Building and Improvements	Furniture and Fixtures	Land	Building and Improvements	Furniture and Fixtures	Land	Building and Improvements	Furniture and Fixtures	
The following are all hotel properties operating as Amerihost Inns											
Ashland, OH	\$ —	\$ 215	\$ 2,626	\$ 185	\$ —	\$ 5	\$ 104	\$ 215	\$ 2,631	\$ 289	\$ 3,135
Coopersville, MI	1,303	242	1,999	180	—	4	89	242	2,003	269	2,514
Eagles Landing, GA(2)	—	325	1,815	180	—	4	34	325	1,819	214	2,358
Grand Rapids-N, MI	1,497	221	2,323	180	—	5	56	221	2,328	236	2,785
Grand Rapids-S, MI	1,411	368	2,173	183	—	4	70	368	2,177	253	2,798
Jackson, TN	—	403	1,936	183	—	4	46	403	1,940	229	2,572
McKinney, TX	—	273	2,066	183	—	4	72	273	2,070	255	2,598
Monroe, MI	—	273	2,060	189	—	4	137	273	2,064	326	2,663
Mosinee, WI	1,056	140	1,416	159	—	3	81	140	1,419	240	1,799
Mt. Pleasant, IA	951	179	1,851	189	—	4	101	179	1,855	290	2,324
Rochelle, IL	838	221	2,017	183	—	4	161	221	2,021	344	2,586
Storm Lake, IA	1,285	220	1,716	183	—	3	55	220	1,719	238	2,177
Tupelo, MS	—	236	1,901	183	—	4	46	236	1,905	229	2,370
Wooster-E, OH	—	171	1,673	174	—	3	66	171	1,676	240	2,087
Wooster-N, OH	—	263	1,575	229	—	7	71	263	1,582	300	2,145
Macomb, IL	1,585	194	2,277	180	—	4	69	194	2,281	249	2,724
Sycamore, IL	1,544	250	2,220	180	—	4	78	250	2,224	258	2,732
Marysville, OH	1,308	300	2,712	237	—	6	95	300	2,718	332	3,350
Plainfield, IN	1,414	300	1,962	180	—	4	68	300	1,966	248	2,514
	<u>\$ 14,192</u>	<u>\$ 4,794</u>	<u>\$ 38,318</u>	<u>\$ 3,540</u>	<u>\$ —</u>	<u>\$ 80</u>	<u>\$ 1,497</u>	<u>\$ 4,794</u>	<u>\$ 38,398</u>	<u>\$ 5,039</u>	<u>\$ 48,231</u>

(1) The aggregate cost of our real estate for Federal income tax purposes was \$48,231,000 (unaudited).

(2) Real estate investment held for sale.

Schedule III
PMC COMMERCIAL TRUST AND SUBSIDIARIES
REAL ESTATE AND ACCUMULATED DEPRECIATION
AS OF DECEMBER 31, 2004
(In thousands)

Description of Property	Accumulated Depreciation — Building and Improvements; Furniture and Fixtures	Date of Construction	Date of Acquisition	Life upon Which Depreciation in Statement Is Computed
The following are all hotel properties operating as Amerihost Inns;				
Ashland, OH	\$ 649	8/9/1996	6/30/1998	7 - 35 years
Coopersville ,MI	548	1/9/1996	6/30/1998	7 - 35 years
Eagles Landing, GA	499	8/8/1995	6/30/1998	7 - 35 years
Grand Rapids-N, MI	587	7/5/1995	6/30/1998	7 - 35 years
Grand Rapids-S, MI	571	6/11/1997	6/30/1998	7 - 35 years
Jackson, TN	527	4/1/1998	6/30/1998	7 - 35 years
McKinney, TX	546	1/6/1997	6/30/1998	7 - 35 years
Monroe, MI	591	9/19/1997	6/30/1998	7 - 35 years
Mosinee, WI	429	4/30/1993	6/30/1998	7 - 35 years
Mt. Pleasant, IA	535	7/2/1997	6/30/1998	7 - 35 years
Rochelle, IL	550	3/7/1997	6/30/1998	7 - 35 years
Storm Lake, IA	486	3/13/1997	6/30/1998	7 - 35 years
Tupelo, MS	517	7/25/1997	6/30/1998	7 - 35 years
Wooster-E, OH	482	1/18/1994	6/30/1998	7 - 35 years
Wooster-N, OH	490	10/21/1995	6/30/1998	7 - 35 years
Macomb, IL	525	5/1/1995	3/23/1999	7 - 35 years
Sycamore, IL	515	5/31/1996	3/23/1999	7 - 35 years
Marysville, OH	638	6/1/1990	3/5/1999	7 - 35 years
Plainfield, IN	464	9/1/1992	3/5/1999	7 - 35 years
	<u>\$ 10,149</u>			

Schedule III
PMC COMMERCIAL TRUST AND SUBSIDIARIES
REAL ESTATE AND ACCUMULATED DEPRECIATION
AS OF DECEMBER 31, 2004
(In thousands, except footnotes)

Gross amount carried:		Totals
Balance at December 31, 2001		\$ 58,995
Additions during period:		
Acquisitions through foreclosure	\$ —	
Other Acquisitions	—	
Improvements, etc	388	
Other (describe)	—	\$ 388
Deductions during period:		
Cost of real estate sold	\$ (4,965)	
Other (describe)	—	\$ (4,965)
Balance at December 31, 2002		\$ 54,418
Additions during period:		
Acquisitions through foreclosure	\$ —	
Other Acquisitions	—	
Improvements, etc	290	
Other (describe)	—	\$ 290
Deductions during period:		
Cost of real estate sold	\$ (2,159)	
Other (describe)	—	\$ (2,159)
Balance at December 31, 2003		\$ 52,549
Additions during period:		
Acquisitions through foreclosure	\$ —	
Other Acquisitions	—	
Improvements, etc	595	
Other (describe)	—	\$ 595
Deductions during period:		
Cost of real estate sold	\$ (4,913)	
Other (describe)	—	\$ (4,913)
Balance at December 31, 2004(1)		\$ 48,231
Accumulated Depreciation:		
Balance at December 31, 2001		\$ 6,277
Additions during period:		
Depreciation expense during the period		1,903
Accumulated Depreciation:		
Real estate held for sale		—
Assets sold or written-off during the period		(567)
Balance at December 31, 2002.		\$ 7,613
Additions during period:		
Depreciation expense during the period		1,879
Accumulated Depreciation:		
Real estate held for sale		—
Assets sold or written-off during the period		(282)
Balance at December 31, 2003		\$ 9,210
Additions during period:		
Depreciation expense during the period		1,870
Accumulated Depreciation:		
Real estate held for sale		—
Assets sold or written-off during the period		(931)
Balance at December 31, 2004 (1)		\$ 10,149

(1) Includes property held for sale with a cost of \$2,358,000 and accumulated depreciation of \$499,000.

Schedule IV
PMC COMMERCIAL TRUST AND SUBSIDIARIES
MORTGAGE LOANS ON REAL ESTATE
AS OF DECEMBER 31, 2004
(Dollars in thousands, except footnotes)

Conventional Loans — States 2% or greater (1):

	Number of Loans	Size of Loans		Interest Rate		Final Maturity Date	Carrying Amount of Mortgages
		From	To	Variable	Fixed		
Virginia	1	\$ 0	\$ 1,000	6.51%	NA	12/1/2006	\$ 632
Virginia	1	\$ 1,000	\$ 2,000	6.01%	NA	2/28/2023	1,510
Virginia	1	\$ 2,000	\$ 3,000	6.02%	NA	10/4/2024	2,707
Virginia	3	\$ 3,000	\$ 4,000	6.01% to 6.51%	NA	4/25/23--6/29/24	9,698
Texas (2)	13	\$ 0	\$ 1,000	6.01% to 7.01%	10.50% to 10.63%	10/15/05--12/24/24	7,680
Texas	4	\$ 1,000	\$ 2,000	6.01%	NA	3/1/22--4/22/24	6,023
Florida	2	\$ 0	\$ 1,000	NA	8.5% to 10.25%	4/30/06--11/23/09	547
Florida	1	\$ 1,000	\$ 2,000	NA	8.90%	4/1/2025	1,220
Florida	2	\$ 2,000	\$ 3,000	NA	8.24% to 8.90%	5/17/21--1/01/24	5,368
Florida	1	\$ 3,000	\$ 4,000	6.26%	NA	7/1/2024	3,675
Arizona (3)	1	\$ 0	\$ 1,000	6.51%	NA	3/29/2005	717
Arizona	3	\$ 1,000	\$ 2,000	6.26% to 6.51%	NA	5/1/23--9/29/24	3,850
Arizona	1	\$ 2,000	\$ 3,000	6.51%	NA	8/11/2024	2,304
Arizona	1	\$ 3,000	\$ 4,000	6.26%	NA	1/1/2024	3,086
Ohio	2	\$ 0	\$ 1,000	NA	9.75% to 10.50%	5/31/16--11/28/20	439
Ohio	3	\$ 1,000	\$ 2,000	6.26% to 6.76%	9.00%	9/28/09--5/28/24	3,913
Ohio	1	\$ 2,000	\$ 3,000	6.01%	NA	2/5/2024	2,920
New Mexico	1	\$ 0	\$ 1,000	6.26%	NA	3/10/2023	853
New Mexico	2	\$ 1,000	\$ 2,000	6.26% to 6.51%	NA	3/4/24--5/17/24	2,699
New Mexico	1	\$ 2,000	\$ 3,000	NA	9.90%	2/16/2021	2,126
New York (4)	1	\$ 0	\$ 1,000	8.26%	NA	9/19/2013	407
New York	3	\$ 1,000	\$ 2,000	5.51% to 6.38%	NA	4/9/23--3/1/24	4,386
Georgia	4	\$ 0	\$ 1,000	6.51%	8.50%	11/1/04--12/3/22 (5)	2,392
Georgia	1	\$ 2,000	\$ 3,000	6.96%	NA	12/22/2024	2,334
Pennsylvania	1	\$ 0	\$ 1,000	7.01%	NA	12/29/2015	514
Pennsylvania	1	\$ 1,000	\$ 2,000	6.51%	NA	9/5/2023	1,451
Pennsylvania	1	\$ 2,000	\$ 3,000	NA	10.80%	9/1/2017	2,132
Mississippi	1	\$ 1,000	\$ 2,000	NA	9.25%	4/14/2018	1,134
Mississippi	1	\$ 2,000	\$ 3,000	6.51%	NA	9/29/2023	2,286
Colorado	2	\$ 1,000	\$ 2,000	6.97%	8.90%	5/17/21--12/13/24	3,321
Michigan	1	\$ 3,000	\$ 4,000	6.92%	NA	12/27/2024	3,067
North Carolina	3	\$ 1,000	\$ 2,000	6.51%	NA	5/5/23--5/20/24	3,052
California	2	\$ 0	\$ 1,000	NA	11.25% to 11.28%	7/1/2001 - 6/29/07 (6)	957
California	1	\$ 2,000	\$ 3,000	6.26%	NA	9/18/2023	2,082
South Carolina (7)	1	\$ 0	\$ 1,000	6.26%	NA	1/16/2020	234
South Carolina	2	\$ 1,000	\$ 2,000	6.50% to 6.78%	NA	7/10/18--12/23/24	2,802
Iowa	1	\$ 2,000	\$ 3,000	6.01%	NA	5/12/2023	2,947
Other	10	\$ 0	\$ 1,000	6.51%	6.00% to 10.75%	11/1/05--10/1/20	5,359
Other	9	\$ 1,000	\$ 2,000	5.88% to 6.69%	9.40% to 11.25%	6/1/05--12/2/24	11,149
	<u>91</u>						<u>\$ 113,973</u>

Footnotes:

- (1) As of December 31, 2004, there were no individual mortgage loans that were 3% of the total loans outstanding.
- (2) Includes two loans with principal outstanding of approximately \$649,000 and \$92,000 which is collateralized by second liens on properties which are subordinated to our first liens on the respective property.
- (3) An SBA 504 Program loan which is the second lien which is subordinated to our first lien on the property.
- (4) This loan is collateralized by a second lien on property.
- (5) Includes one acquired loan with a maturity date of November 1, 2004. We are currently negotiating with the borrower to extend the loan maturity.
- (6) Includes one SBIC loan with a maturity date of July 1, 2001. We are currently negotiating with the borrower to extend the loan maturity.
- (7) This loan is collateralized by a second lien on property which is subordinated to our first lien on that property.

Schedule IV
PMC COMMERCIAL TRUST AND SUBSIDIARIES
MORTGAGE LOANS ON REAL ESTATE
AS OF DECEMBER 31, 2004
(Dollars in thousands, except footnotes)

SBA 7(a) Loans — States 2% or greater (1):

	Number of Loans	Size of Loans		Interest Rate		Final Maturity Date	Carrying Amount of Mortgages
		From	To	Variable	Fixed		
Texas	28	\$ 0	\$ 100	5.75% to 11.00%	NA	8/10/06--10/30/23	\$ 877
Texas	9	\$ 100	\$ 200	5.75% to 7.25%	NA	3/13/13--9/21/26	1,367
Texas	4	\$ 200	\$ 300	5.75% to 6.75%	NA	4/24/25--6/10/29	999
Texas	3	\$ 300	\$ 400	6.50% to 7.0%	NA	1/25/21--5/22/23	1,021
Texas	1	\$ 400	\$ 500	6.50%	NA	8/23/2024	411
Alabama	2	\$ 200	\$ 300	6.50% to 7.0%	NA	4/28/23--7/27/25	519
Arkansas	2	\$ 0	\$ 100	6.75% to 7.50%	NA	10/25/11--3/17/20	137
Arkansas	1	\$ 100	\$ 200	6.75%	NA	11/12/2021	164
Arizona	1	\$ 0	\$ 100	7.25%	NA	2/10/2008	8
Arizona	1	\$ 300	\$ 400	6.50%	NA	8/16/2024	310
California	2	\$ 0	\$ 100	6.75% to 7.50%	NA	2/28/09--2/12/11	36
California	2	\$ 100	\$ 200	5.75% to 6.50%	NA	1/5/12--8/3/21	348
Florida	5	\$ 0	\$ 100	6.75% to 7.50%	NA	12/14/08--12/16/17	126
Florida	1	\$ 400	\$ 500	6.50%	NA	3/18/2018	404
Georgia	3	\$ 0	\$ 100	5.75% to 7.25%	NA	11/20/08--7/01/20	84
Georgia	2	\$ 100	\$ 200	6.63% to 7.25%	NA	6/1/17--9/25/21	333
Georgia	1	\$ 400	\$ 500	6.75%	NA	9/23/2024	436
Georgia	2	\$ 500	\$ 600	5.75%	NA	6/29/24--11/10/24	1,140
Illinois	1	\$ 200	\$ 300	7.00%	NA	1/13/2023	289
Kansas	2	\$ 0	\$ 100	6.50% to 7.50%	NA	3/17/18--5/13/23	105
Kansas	2	\$ 100	\$ 200	6.50% to 6.75%	NA	5/18/21--11/14/22	275
Missouri	2	\$ 0	\$ 100	7.00% to 7.50%	NA	2/20/11--7/10/23	91
Missouri	2	\$ 100	\$ 200	6.25% to 6.75%	NA	3/29/22--12/19/22	232
Missouri	1	\$ 1,100	\$ 1,200	6.50%	NA	12/14/2029	1,148
Ohio	3	\$ 0	\$ 100	5.75% to 7.25%	NA	5/22/09--10/16/20	139
Ohio	1	\$ 100	\$ 200	7.50%	NA	12/29/2017	162
Ohio	1	\$ 200	\$ 300	6.25%	NA	10/26/2019	208
Ohio	1	\$ 300	\$ 400	7.25%	NA	7/30/2024	310
Oklahoma	5	\$ 100	\$ 200	6.75% to 7.50%	NA	11/24/06--10/15/24	509
Other	18	\$ 0	\$ 100	5.75% to 12.00%	NA	6/11/06--1/10/25	748
Other	6	\$ 100	\$ 200	5.75% to 6.75%	NA	11/27/11--7/21/20	856
Other	2	\$ 200	\$ 300	7.13% to 7.50%	NA	9/18/23--8/30/24	469
	<u>117</u>						<u>\$ 14,261</u>

Footnote:

(1) Includes approximately \$684,000 of loans not secured by real estate and \$518,000 of loans secured by second liens on properties which are subordinated to our first liens on the respective property.

Schedule IV
PMC COMMERCIAL TRUST AND SUBSIDIARIES
MORTGAGE LOANS ON REAL ESTATE
AS OF DECEMBER 31, 2004
(In thousands)

Balance at December 31, 2001		\$ 78,485
Additions during period:		
New mortgage loans	\$ 32,776	
Other — accretion of commitment fees	455	33,231
Deductions during period:		
Collections of principal	\$ (12,268)	
Foreclosures	—	
Cost of mortgages sold	(27,216)	
Amortization of premium	—	
Loan loss reserve	(65)	
Other — deferral for collection of commitment fees, net of costs	(175)	(39,724)
Balance at December 31, 2002		71,992
Additions during period:		
New mortgage loans	\$ 31,320	
Other — accretion of commitment fees	362	31,682
Deductions during period:		
Collections of principal	\$ (7,618)	
Foreclosures	—	
Cost of mortgages sold	(45,032)	
Amortization of premium	—	
Loan loss reserve	(310)	
Other — deferral for collection of commitment fees, net of costs	(130)	
Other — reclass of deferred income related to loan receivable	(50)	(53,140)
Balance at December 31, 2003		50,534
Additions during period:		
New mortgage loans	\$ 53,659	
Mortgage loans acquired in merger with PMC Capital, Inc.	55,145	
Other — loan deemed to be repurchased from securitization	2,126	
Other — reduction of loan loss reserves	511	
Other — accretion of loan fees and discounts	329	111,770
Deductions during period:		
Collections of principal	\$ (24,817)	
Foreclosures	(2,115)	
Cost of mortgages sold, net	(6,786)	
Amortization of premium	—	
Other — deferral for collection of commitment fees, net of costs	(352)	(34,070)
Balance at December 31, 2004		<u>\$ 128,234</u>

EXHIBIT INDEX

Exhibit Number	Description
2.1	Agreement of Purchase and Sale, dated as of May 21, 1998, by and among Registrant and the various corporations identified on Exhibit A thereto (which includes as Exhibit D thereto, the form of the Master Agreement relating to the leasing of the properties), including Amerihost Properties, Inc. and Amerihost Inns, Inc. (previously filed with the Commission as Exhibit 2.2 to the Registrant's Form 8-K dated June 5, 1998 and incorporated herein by reference).
2.2	Agreement and Plan of Merger by and between PMC Commercial Trust and PMC Capital, Inc. dated March 27, 2003 (previously filed with Commission as Annex A to the Registrant's Form S-4 dated November 10, 2003 and incorporated herein by reference).
2.3	Amendment No. 1 to Agreement and Plan of Merger between PMC Commercial Trust and PMC Capital, Inc. dated August 1, 2003 (incorporated by reference to Exhibit 2.5 from Registrant's Form 10-Q filed on August 12, 2003).
3.1	Declaration of Trust. Previously filed as an exhibit to our Registration Statement on Form S-11 filed with the Commission on June 25, 1993, as amended (Registration No. 33-65910), and incorporated herein by reference.
3.1(a)	Amendment No. 1 to Declaration of Trust. Previously filed as an exhibit to our Registration Statement on Form S-11 filed with the Commission on June 25, 1993, as amended (Registration No. 33-65910), and incorporated herein by reference.
3.1(b)	Amendment No. 2 to Declaration of Trust (incorporated by reference from Registrant's Form 10-K for the year ended December 31, 1993).
3.1(c)	Amendment No. 3 to Declaration of Trust dated February 10, 2004 (incorporated by reference from Registrant's Form 10-K for the year ended December 31, 2003).
3.2	Bylaws. Previously filed as an exhibit to our Registration Statement on Form S-11 filed with the Commission on June 25, 1993, as amended (Registration No. 33-65910), and incorporated herein by reference.
4.1	Instruments defining the rights of security holders. The instruments filed in response to items 3.1 and 3.2 are incorporated in this item by reference. Previously filed as an exhibit to our Registration Statement on Form S-11 filed with the Commission on June 25, 1993, as amended (Registration No. 33-65910), and incorporated herein by reference.

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Exhibit Number	Description
10.2	1993 Employee Share Option Plan. Previously filed as an exhibit to our Registration Statement on Form S-11 filed with the Commission on June 25, 1993, as amended (Registration No. 33-65910), and incorporated herein by reference.
10.3	1993 Trust Manager Share Option Plan. Previously filed as an exhibit to our Registration Statement on Form S-11 filed with the Commission on June 25, 1993, as amended (Registration No. 33-65910), and incorporated herein by reference.
10.11	Trust Indenture between PMC Joint Venture, L.P. 2000 and BNY Midwest Trust Company, dated as of December 15, 2000 (incorporated by reference to Exhibit 2.1 from Registrant's Form 8-K filed on March 13, 2001).
10.12	Servicing Agreement by and among BNY Midwest Trust Company, PMC Joint Venture, L.P. 2000 and PMC Capital and PMC Commercial Trust, dated as of December 15, 2000 (incorporated by reference to Exhibit 2.2 from Registrant's Form 8-K filed on March 13, 2001).
10.13	Servicing Agreement by and among BNY Midwest Trust Company as Trustee and Supervisory Servicer, PMC Joint Venture, L.P. 2001, as Issuer and PMC Capital, Inc. and PMC Commercial Trust, as Servicers (incorporated by reference to Exhibit 10.1 from Registrant's Form 10-Q for the quarterly period ended June 30, 2001).
10.14	Trust Indenture by and among BNY Midwest Trust Company as Trustee and PMC Joint Venture, L.P. 2001, as Issuer (incorporated by reference to Exhibit 10.2 from Registrant's Form 10-Q for the quarterly period ended June 30, 2001).
10.15	Amended and Restated Master Agreement, dated as of January 24, 2001, by and among PMC Commercial Trust, and certain of its subsidiaries, and Amerihost Properties, Inc., doing business as Arlington Hospitality, Inc. (incorporated by reference to Exhibit 2.3 from Registrant's Form 8-K filed on March 13, 2001).
10.16	Third Amendment to Amended and Restated Master Agreement dated October 4, 2004 among PMC Commercial Trust and Arlington Hospitality, Inc. (incorporated by reference to Exhibit 10.1 from Registrant's Form 8-K filed on October 8, 2004).
10.20	Trust Indenture between PMC Joint Venture, L.P. 2002-1 and BNY Midwest Trust Company, dated April 3, 2002 (incorporated by reference to Exhibit 2.1 from Registrant's Form 8-K filed on April 19, 2002).
10.21	Servicing Agreement by and among BNY Midwest Trust Company, PMC Joint Venture, L.P. 2002-1, PMC Capital, Inc. and PMC Commercial Trust, dated April 3, 2002 (incorporated by reference to Exhibit 2.2 from Registrant's Form 8-K filed on April 19, 2002).

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Exhibit Number	Description
10.27	Trust Indenture between PMC Joint Venture, L.P. 2003-1 and The Bank of New York, as Trustee, dated September 16, 2003 (incorporated by reference from Registrant's Form 8-K filed October 10, 2003).
10.28	Servicing Agreement by and among The Bank of New York as Trustee and Supervisory Servicer, PMC Joint Venture, L.P. 2003-1 as Issuer and PMC Capital, Inc. and PMC Commercial Trust as Servicers, dated September 16, 2003 (incorporated by reference from Registrant's Form 8-K filed October 10, 2003).
10.29	Revolving Credit Agreement dated February 29, 2004 between PMC Commercial and Bank One, Texas, N.A. (incorporated by reference from Registrant's Form 10-K filed March 15, 2004).
10.30	Employment contract with Lance B. Rosemore dated September 27, 2004 (incorporated by reference to Exhibit 10.1 from Registrant's Form 8-K filed October 1, 2004).
10.31	Employment contract with Andrew S. Rosemore dated September 27, 2004 (incorporated by reference to Exhibit 10.2 from Registrant's Form 8-K filed October 1, 2004).
10.32	Employment contract with Barry N. Berlin dated September 27, 2004 (incorporated by reference to Exhibit 10.4 from Registrant's Form 8-K filed October 1, 2004).
10.33	Employment contract with Jan F. Salit dated September 27, 2004 (incorporated by reference to Exhibit 10.3 from Registrant's Form 8-K filed October 1, 2004).
10.35	Assumption, Waiver and Amendment Agreement dated February 27, 2004 between PMC Capital, Inc., PMC Commercial Trust, Security Life of Denver Insurance Company and ING USA Annuity and Life Insurance Company (incorporated by reference from Registrant's Form 10-K filed March 15, 2004).
10.38	Senior Note dated July 19, 2000 for \$10,000,000 with Security Life of Denver (incorporated by reference to Exhibit 4.33 from PMC Capital, Inc.'s (Commission File Number 1-09589) Form 10-K for the year ended December 31, 2000).
10.39	Senior Note dated July 19, 2001 for \$10,000,000 with Security Life of Denver (incorporated by reference to Exhibit 4.36 from PMC Capital, Inc.'s (Commission File Number 1-09589) Form 10-K for the year ended December 31, 2001).
10.40	Amendment No. 1 to Revolving Credit Facility dated March 15, 2004 between PMC Commercial Trust and Bank One, Texas, N.A. (incorporated by reference from Registrant's Form 10-Q for the quarterly period ended June 30, 2004 filed August 9, 2004).

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Exhibit Number	Description
10.41	Servicing Agreement by and among PMC Conduit, L.P. as Borrower, PMC Commercial Trust as Servicer and JPMorgan Chase Bank, National Association as Agent dated February 7, 2005 (incorporated by reference to Exhibit 10.2 from Registrant's Form 8-K filed February 11, 2005).
10.42	Purchase and Contribution Agreement by and between PMC Commercial Trust as Seller and PMC Conduit, L.P. as Purchaser dated February 7, 2005 (incorporated by reference to Exhibit 10.3 from Registrant's Form 8-K filed February 11, 2005).
10.43	Credit and Security Agreement by and among PMC Conduit, L.P. as Borrower, PMC Conduit, LLC, PMC Commercial Trust as Servicer, Jupiter Securitization Corporation as the Conduit Lender, The Alternate Lenders From Time to Time Party Hereto and JPMorgan Chase Bank, National Association as Agent dated February 7, 2005 (incorporated by reference to Exhibit 10.1 from Registrant's Form 8-K filed February 11, 2005).
*10.44	Second Amendment to Credit Agreement between PMC Commercial Trust and JPMorgan Chase Bank, N.A. dated December 29, 2004.
*10.45	Third Amendment to Credit Agreement between PMC Commercial Trust and JPMorgan Chase Bank, N.A. dated February 7, 2005.
*21.1	Subsidiaries of the Registrant
*23.1	Consent of PricewaterhouseCoopers LLP
*31.1	Section 302 Officer Certification – Chief Executive Officer
*31.2	Section 302 Officer Certification – Chief Financial Officer
**32.1	Section 906 Officer Certification – Chief Executive Officer
**32.2	Section 906 Officer Certification – Chief Financial Officer

* Filed herewith.

** Submitted herewith.

The Registrant agrees to furnish to the Securities and Exchange Commission upon request a copy of any instrument with respect to long-term debt not filed herewith as to which the total amount of securities authorized thereunder does not exceed 10 percent of the total assets of the Registrant and its subsidiaries on a consolidated basis.

SECOND AMENDMENT TO CREDIT AGREEMENT

THIS SECOND AMENDMENT TO CREDIT AGREEMENT (this "Amendment") is entered into as of December 29, 2004, among PMC COMMERCIAL TRUST, a real estate investment trust organized under the laws of the State of Texas ("Borrower"), certain Lenders, and JPMORGAN CHASE BANK, N.A. (successor by merger to Bank One, N.A. (Main Office Chicago)) ("Administrative Agent").

PRELIMINARY STATEMENT:

Borrower, Administrative Agent and Lenders are party to that certain Credit Agreement (as renewed, extended, amended and restated, the "Credit Agreement") dated as of February 29, 2004, pursuant to which the Lenders have made and may hereafter make loans to Borrower. The parties hereto have agreed to amend the Credit Agreement as described herein.

Accordingly, for adequate and sufficient consideration, the receipt of which is hereby acknowledged, Borrower, Administrative Agent and Lenders agree as follows:

1. Defined Terms; References. Unless otherwise stated in this Amendment (a) terms defined in the Credit Agreement have the same meanings when used in this Amendment and (b) references to "Sections," "Schedules" and "Exhibits" are to sections, schedules and exhibits to the Credit Agreement.

2. Amendments.

(a) The defined term "Commitment" in Section 1.1 of the Credit Agreement is amended in its entirety as follows:

"Commitment" means an amount (subject to reduction or cancellation as herein provided) equal to (a) \$40,000,000 at any time prior to the Commitment Reduction Date, and (b) \$20,000,000 at any time thereafter. For purposes hereof, the term "Commitment Reduction Date" means the closing date for the first Asset Securitization to be completed after January 1, 2005.

(b) The defined term "Stated Termination Date" in Section 1.1 of the Credit Agreement is amended in its entirety as follows:

"Stated Termination Date" means December 31, 2005.

(c) A new Section 4.6 of the Credit Agreement is added as follows:

Section 4.6 Renewal Fee. On March 31, 2005, Borrower shall pay to Administrative Agent a renewal fee equal to 0.25% multiplied by the Commitment in effect on such date.

3. Conditions Precedent. Notwithstanding any contrary provisions, the foregoing paragraphs in this Amendment are not effective unless and until (a) the representations and warranties in this Amendment are true and correct and (b) Administrative Agent receives counterparts of this Amendment executed by each party named below.

4. Ratifications. This Amendment modifies and supersedes all inconsistent terms and provisions of the Credit Documents, and except as expressly modified and superseded by this Amendment, the Credit Documents are ratified and confirmed and continue in full force and effect. Borrower, Administrative Agent and Lenders agree that the Credit Documents, as amended by this Amendment, continue to be legal, valid, binding and enforceable in accordance with their respective terms.

5. Representations and Warranties. Borrower hereby represents and warrants to Administrative Agent and Lenders that (a) this Amendment and any Credit Documents to be delivered under this Amendment have been duly executed and delivered by Borrower, (b) no action of, or filing with, any Governmental Authority is required to authorize, or is otherwise required in connection with, the execution, delivery, and performance by Borrower of this Amendment and any Credit Document to be delivered under this Amendment, (c) this Amendment and any Credit Documents to be delivered under this Amendment are valid and binding upon Borrower and are enforceable against Borrower in accordance with their respective terms, except as limited by any applicable Debtor Relief Laws, (d) the execution, delivery and performance by Borrower of this Amendment and any Credit Documents to be delivered under this Amendment do not require the consent of any other Person and do not and will not constitute a violation of any Governmental Requirements, agreements or understandings to which Borrower is a party or by which Borrower is bound, (e) the representations and warranties contained in the Credit Agreement, as amended by this Amendment, and any other Credit Document are true and correct in all material respects as of the date of this Amendment, and (f) as of the date of this Amendment, no Event of Default or Potential Default exists or is imminent.

6. References. All references in the Credit Documents to the "Credit Agreement" refer to the Credit Agreement as amended by this Amendment. This Amendment is a "Credit Document" referred to in the Credit Agreement and the provisions relating to Credit Documents in the Credit Agreement are incorporated by reference, the same as if set forth verbatim in this Amendment.

7. Counterparts. This Amendment may be executed in any number of counterparts with the same effect as if all signatories had signed the same document.

8. Parties Bound. This Amendment binds and inures to the benefit of Borrower, Administrative Agent and each Lender, and, subject to Section 14 of the Credit Agreement, their respective successors and assigns.

9. Entirety. **THIS AMENDMENT, THE CREDIT AGREEMENT AS AMENDED BY THIS AMENDMENT, AND THE OTHER CREDIT DOCUMENTS REPRESENT THE FINAL AGREEMENT BETWEEN THE PARTIES FOR THE TRANSACTIONS THEREIN, AND MAY NOT BE CONTRADICTED BY EVIDENCE OF PRIOR, CONTEMPORANEOUS, OR SUBSEQUENT ORAL AGREEMENTS**

BETWEEN THE PARTIES. THERE ARE NO UNWRITTEN ORAL AGREEMENTS BETWEEN THE PARTIES.

EXECUTED as of the date first stated above.

JPMORGAN CHASE BANK, NA,
as *Administrative Agent, Bank One* and a *Lender*

By: /s/ Bradley C. Peters
Bradley C. Peters, First Vice President

PMC COMMERCIAL TRUST,
as *Borrower*

By: /s/ Barry N. Berlin
Name: Barry N. Berlin
Title: CFO

THIRD AMENDMENT TO CREDIT AGREEMENT

THIS THIRD AMENDMENT TO CREDIT AGREEMENT (this "Amendment") is entered into as of February 7, 2005, among PMC COMMERCIAL TRUST, a real estate investment trust organized under the laws of the State of Texas ("Borrower"), certain Lenders, and JPMORGAN CHASE BANK, N.A. (successor by merger to Bank One, N.A. (Main Office Chicago)) ("Administrative Agent").

PRELIMINARY STATEMENT:

Borrower, Administrative Agent and Lenders are party to that certain Credit Agreement (as renewed, extended, amended and restated, the "Credit Agreement") dated as of February 29, 2004, pursuant to which the Lenders have made and may hereafter make loans to Borrower. The parties hereto have agreed to amend the Credit Agreement as described herein.

Accordingly, for adequate and sufficient consideration, the receipt of which is hereby acknowledged, Borrower, Administrative Agent and Lenders agree as follows:

1. Defined Terms; References. Unless otherwise stated in this Amendment (a) terms defined in the Credit Agreement have the same meanings when used in this Amendment and (b) references to "Sections," "Schedules" and "Exhibits" are to sections, schedules and exhibits to the Credit Agreement.

2. Amendments.

(a) The following new defined terms are added to Section 1.1 of the Credit Agreement as follows (to be inserted in alphabetical order):

"CDO Subsidiary" means a Subsidiary (i) of which all of the issued and outstanding common equity interests are held by Borrower or one or more of its wholly-owned Subsidiaries, (ii) which is formed for the sole purpose of issuing preferred securities to an unrelated third party, and (iii) which has no assets other than its rights as payee in respect of Qualified Intercompany Debt.

"Qualified Intercompany Debt" means any unsecured indebtedness, in a principal amount not to exceed \$100,000,000, owing by the Borrower to a CDO Subsidiary from time to time and evidenced by one or more promissory notes or other evidences of indebtedness, which indicate that such indebtedness is subordinated to the Obligation (such subordination to be on terms reasonably acceptable to the Administrative Agent). In any case, the Borrower shall deliver the promissory notes or other documents evidencing the terms of such indebtedness, containing all the materially final or substantially final terms, to the Administrative Agent at least 5 Business Days in advance of the incurrence of any Qualified Intercompany Debt.

(b) Clause (ii) of the definition of "Asset Coverage Ratio" in Section 1.1 of the Credit Agreement is amended in its entirety as follows:

(ii) the outstanding principal amount of all Funded Debt for which either Borrower or First Western is obligated (other than any Qualified Intercompany Debt, any Mortgages related to the Amerihost Properties and any preferred stock of PMC Investment Corporation).

(c) The defined term “Total Liabilities” in Section 1.1 of the Credit Agreement is amended in its entirety as follows:

“Total Liabilities” means, at any time and for the Consolidated Companies, all liabilities properly reflected on the Consolidated Companies’ consolidated balance sheet in accordance with GAAP (other than any Qualified Intercompany Debt).

(d) Section 7.1(f) of the Credit Agreement is amended in its entirety as follows:

(f) [Intentionally Deleted]

(e) Section 7.1(c) of the Credit Agreement is amended in its entirety as follows:

(c) SEC Filings. Promptly after preparation, but in any event (i) within 60 days after the end of each of the first three fiscal quarters of Borrower, an accurate and complete copy of Borrower’s Form 10-Q as filed with the Securities and Exchange Commission, (ii) within 90 days after the end of each fiscal year of Borrower, an accurate and complete copy of Borrower’s Form 10-K as filed with the Securities and Exchange Commission, and (iii) promptly upon their becoming available, accurate and complete copies of all registration statements, other reports (including those on Form 8-K) and statements and schedules filed by Borrower with any securities exchange, the Securities and Exchange Commission or any other similar Governmental Authority.

(f) Section 8.2(a)(iii) of the Credit Agreement is amended in its entirety as follows:

(iii) either (A) any Debt arising under or in connection with any Structured Financing that is entered into as a result of an Asset Securitization or (B) any Qualified Intercompany Debt;

(g) Section 8.2(b) of the Credit Agreement is amended in its entirety as follows:

(b) Prepay, purchase, repurchase, defease or redeem, or cause to be prepaid, purchased, repurchased, defeased or redeemed, any principal of, or any premium (if any) or interest on, any of its Debt (including, without limitation, any Qualified Intercompany Debt), or fund or cause to be funded any sinking or similar fund for any such Debt (including, without limitation, any Qualified Intercompany Debt), except for:

(i) the Obligation;

(ii) any Debt (other than any Qualified Intercompany Debt) permitted under Section 8.2(a)(iv) above in connection with the sale of the underlying real property to a third party in an arm's-length transaction, so long as all prepayments required by Section 3.2(c) are made simultaneously therewith;

(iii) any Debt owed by a Special Purpose Entity (other than any CDO Subsidiary) incurred in connection with an Asset Securitization, so long as (A) such Debt has been reduced to 15% or less of its original principal amount, (B) such prepayment fully extinguishes such Debt, (C) no Default or Event of Default then exists or would be created by such prepayment, and (D) all remaining Mortgage Loans and related assets of such Special Purpose Entity are immediately transferred to Borrower; or

(iv) in the case of Qualified Intercompany Debt, any payments expressly permitted by Section 8.2(c) below.

(h) Section 8.2 of the Credit Agreement is amended by adding the following as a new Section 8.2(c):

(c) Prepay, purchase, repurchase, defease or redeem, or cause to be prepaid, purchased, repurchased, defeased or redeemed, any principal of, or any premium (if any) or interest on, any of its Qualified Intercompany Debt, or fund or cause to be funded any sinking or similar fund for any Qualified Intercompany Debt. Notwithstanding the foregoing, (i) the Borrower may make regularly scheduled interest payments on its Qualified Intercompany Debt and payments of principal on its Qualified Intercompany Debt upon its stated maturity unless (A) an Event of Default has occurred and is continuing under Section 10.1 as a result of a failure to make a payment of principal or interest under any Note or under Section 10.11 as a result of any nonpayment of any Rate Management Obligation when due, or (B) the maturity of the Obligation has been accelerated pursuant to either Section 11.1(a) or 11.1(b) hereof, and (ii) the Borrower may make other principal payments or prepayments of Qualified Intercompany Debt (and payment of accrued interest thereon), at its option, at any time prior to the stated maturity thereof, unless an Event of Default has occurred and is then continuing.

(i) Section 8.5 of the Credit Agreement is amended in its entirety as follows:

8.5 Transactions with Affiliates. No Company may enter into any transaction with any of its Affiliates except (a) Asset Securitizations, but only so long as (i) no Event of Default or Potential Default has occurred and is continuing at the time of such Asset Securitization, and (ii) all mandatory prepayments on the Obligation required by Section 3.2(c) are made in connection therewith, (b) the issuance of Qualified Intercompany Debt, and (c) other transactions (other than

Investments) in the ordinary course of business and upon fair and reasonable terms not materially less favorable than it could obtain or could become entitled to in an arm's-length transaction with a Person that was not its Affiliate.

(j) Section 8.9(a) of the Credit Agreement is amended in its entirety as follows:

(a) Distributions to Borrower from any other Company and Distributions by any CDO Subsidiary to any of its owners; and

(k) Section 8 of the Credit Agreement is amended by adding the following as a new Section 8.18:

8.18 Amendments to Qualified Intercompany Debt. Without the prior written consent of the Administrative Agent, no Company may amend, restate or otherwise modify any of the terms of any Qualified Intercompany Debt which relate to the subordination of such Qualified Intercompany Debt to the Obligations.

(l) Section 9.2 of the Credit Agreement is amended in its entirety as follows:

9.2 Maximum Leverage Ratio. The ratio of the Consolidated Companies' consolidated Total Liabilities to the Consolidated Companies' consolidated Net Worth shall not at any time exceed 2.00 to 1.00.

(m) Section 9.5 of the Credit Agreement is amended in its entirety as follows:

9.5 [Intentionally Deleted]

(n) Section 10.7 of the Credit Agreement is amended in its entirety as follows:

10.7 Ownership of Other Companies. Except as a result of transactions permitted by this agreement, any Company (other than Borrower or any CDO Subsidiary) fails to constitute the direct or indirect wholly owned Subsidiary of Borrower.

3. Conditions Precedent. Notwithstanding any contrary provisions, the foregoing paragraphs in this Amendment are not effective unless and until (a) the representations and warranties in this Amendment are true and correct and (b) Administrative Agent receives counterparts of this Amendment executed by each party named below.

4. Ratifications. This Amendment modifies and supersedes all inconsistent terms and provisions of the Credit Documents, and except as expressly modified and superseded by this Amendment, the Credit Documents are ratified and confirmed and continue in full force and effect. Borrower, Administrative Agent and Lenders agree that the Credit Documents, as amended by this Amendment, continue to be legal, valid, binding and enforceable in accordance with their respective terms.

5. Representations and Warranties. Borrower hereby represents and warrants to Administrative Agent and Lenders that (a) this Amendment and any Credit Documents to be delivered under this Amendment have been duly executed and delivered by Borrower, (b) no action of, or filing with, any Governmental Authority is required to authorize, or is otherwise required in connection with, the execution, delivery, and performance by Borrower of this Amendment and any Credit Document to be delivered under this Amendment, (c) this Amendment and any Credit Documents to be delivered under this Amendment are valid and binding upon Borrower and are enforceable against Borrower in accordance with their respective terms, except as limited by any applicable Debtor Relief Laws, (d) the execution, delivery and performance by Borrower of this Amendment and any Credit Documents to be delivered under this Amendment do not require the consent of any other Person and do not and will not constitute a violation of any Governmental Requirements, agreements or understandings to which Borrower is a party or by which Borrower is bound, (e) the representations and warranties contained in the Credit Agreement, as amended by this Amendment, and any other Credit Document are true and correct in all material respects as of the date of this Amendment, and (f) as of the date of this Amendment, no Event of Default or Potential Default exists or is imminent.

6. References. All references in the Credit Documents to the “Credit Agreement” refer to the Credit Agreement as amended by this Amendment. This Amendment is a “Credit Document” referred to in the Credit Agreement and the provisions relating to Credit Documents in the Credit Agreement are incorporated by reference, the same as if set forth verbatim in this Amendment.

7. Counterparts. This Amendment may be executed in any number of counterparts with the same effect as if all signatories had signed the same document.

8. Parties Bound. This Amendment binds and inures to the benefit of Borrower, Administrative Agent and each Lender, and, subject to Section 14 of the Credit Agreement, their respective successors and assigns.

9. Special Provision Regarding Indemnities. Notwithstanding anything in the Credit Agreement to the contrary, no CDO Subsidiary (as defined herein) will be an “Indemnitor” for purposes of Section 7.11 of the Credit Agreement.

10. Entirety. **THIS AMENDMENT, THE CREDIT AGREEMENT AS AMENDED BY THIS AMENDMENT, AND THE OTHER CREDIT DOCUMENTS REPRESENT THE FINAL AGREEMENT BETWEEN THE PARTIES FOR THE TRANSACTIONS THEREIN, AND MAY NOT BE CONTRADICTED BY EVIDENCE OF PRIOR, CONTEMPORANEOUS, OR SUBSEQUENT ORAL AGREEMENTS BETWEEN THE PARTIES. THERE ARE NO UNWRITTEN ORAL AGREEMENTS BETWEEN THE PARTIES.**

EXECUTED as of the date first stated above.

JPMORGAN CHASE BANK, NA,
as *Administrative Agent, Bank One* and a *Lender*

By: /s/ Bradley C. Peters, Senior Vice President
 Bradley C. Peters, Senior Vice President

PMC COMMERCIAL TRUST,
as *Borrower*

By: /s/ Jan F. Salit
Name: Jan F. Salit
Title: Executive Vice President

Subsidiaries of Registrant

<u>Company</u>	<u>State of Incorporation</u>
PMC Commercial Trust, Ltd. 1998-1	Delaware
PMCT Corp. 1998-1	Delaware
PMCT Sycamore, L.P.	Delaware
PMCT AH Sycamore, Inc.	Delaware
PMCT Macomb, L.P.	Delaware
PMCT AH Macomb, Inc.	Delaware
PMCT Marysville, L.P.	Delaware
PMCT AH, Inc.	Delaware
PMCT Plainfield, L.P.	Delaware
PMC Joint Venture, L.P. 2000	Delaware
PMC Joint Venture LLC 2000	Delaware
PMC Joint Venture, L.P. 2001	Delaware
PMC Joint Venture LLC 2001	Delaware
PMC Joint Venture, L.P. 2002-1	Delaware
PMC Joint Venture LLC 2002-1	Delaware
PMC Joint Venture, L.P. 2003-1	Delaware
PMC Joint Venture LLC 2003-1	Delaware
PMC Investment Corporation	Florida
Western Financial Capital Corporation	Florida
First Western SBLC, Inc.	Florida
PMC Funding Corp.	Florida
FW 97 L.L.C.	Delaware
PMC Capital, L.P. 1998-1	Delaware
PMC Capital Corp. 1998-1	Delaware
PMC Capital, L.P. 1999-1	Delaware
PMC Capital Corp. 1999-1	Delaware
PMC Asset Holding, LLC	Delaware
PMC Conduit, L.P.	Delaware
PMC Conduit, LLC	Delaware
PMC Preferred Capital Trust A	Delaware

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We hereby consent to the incorporation by reference in the Registration Statement on Form S-3 (No. 333-24767) of PMC Commercial Trust of our report dated March 16, 2005 relating to the financial statements, financial statement schedules, management's assessment of the effectiveness of internal control over financial reporting and the effectiveness of internal control over financial reporting, which appears in this Form 10-K.

PricewaterhouseCoopers LLP

Dallas, Texas
March 16, 2005

CERTIFICATION

I, Lance B. Rosemore, Chief Executive Officer, certify that:

1. I have reviewed this annual report on Form 10-K of PMC Commercial Trust;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15 (e) and 15d-15 (e)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 16, 2005

/s/ Lance B. Rosemore
Lance B. Rosemore
Chief Executive Officer

CERTIFICATION

I, Barry N. Berlin, Chief Financial Officer, certify that:

1. I have reviewed this report on Form 10-K of PMC Commercial Trust;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15 (e) and 15d-15 (e)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 16, 2005

/s/ Barry N. Berlin

Barry N. Berlin
Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of PMC Commercial Trust (the "Company") on Form 10-K for the year ended December 31, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Lance B. Rosemore, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Lance B. Rosemore

Lance B. Rosemore

Chief Executive Officer

March 16, 2005

This certification accompanies the Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934.

A signed original of this statement required by Section 906 of the Sarbanes-Oxley Act of 2002 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of PMC Commercial Trust (the "Company") on Form 10-K for the year ended December 31, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Barry N. Berlin, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Barry N. Berlin

Barry N. Berlin
Chief Financial Officer
March 16, 2005

This certification accompanies the Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934.

A signed original of this statement required by Section 906 of the Sarbanes-Oxley Act of 2002 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.