

Colony Financial, Inc.  
Form 10-Q  
November 09, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2012

OR

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

Commission file number 001-34456

**COLONY FINANCIAL, INC.**

(Exact Name of Registrant as Specified in Its Charter)

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**Maryland**  
(State or Other Jurisdiction of

**27-0419483**  
(I.R.S. Employer

Incorporation or Organization)

Identification No.)

**2450 Broadway, 6th Floor**

**Santa Monica, California**  
(Address of Principal Executive Offices)

**90404**  
(Zip Code)

**(310) 282-8820**

(Registrant's Telephone Number, Including Area Code)

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

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

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

Large Accelerated Filer ☐

Accelerated Filer ☒

Non-Accelerated Filer ☐ (Do not check if a smaller reporting company)

Smaller Reporting Company ☐

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

As of November 7, 2012, 41,216,623 shares of the Registrant's common stock, par value \$0.01 per share, were outstanding.

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**COLONY FINANCIAL, INC.**

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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. Financial Statements.****COLONY FINANCIAL, INC.****CONSOLIDATED BALANCE SHEETS****(In thousands, except share and per share data)**

|   | <b>September 30,<br/>2012<br/>(Unaudited)</b> | <b>December 31,<br/>2011</b> |
|---|---|------------------------------|
| <b>ASSETS</b>   |   |                              |
| Cash  | \$ 88,918                                     | \$ 3,872                     |
| Investments in unconsolidated joint ventures  | 725,407                                       | 443,500                      |
| Loans held for investment, net  | 315,725                                       | 232,619                      |
| Beneficial interests in debt securities, available-for-sale, at fair value  | 32,318  | 32,427                       |
| Other assets  | 25,906  | 15,101                       |
| <b>Total assets</b>   | <b>\$ 1,188,274</b>                           | <b>\$ 727,519</b>            |
| <b>LIABILITIES AND EQUITY</b>   |   |                              |
| <b>Liabilities:</b>   |   |                              |
| Line of credit  | \$  | \$ 69,000                    |
| Secured financing   | 110,380                                       | 13,845                       |
| Accrued and other liabilities   | 13,950  | 16,304                       |
| Due to affiliates   | 3,930   | 3,788                        |
| Dividends payable   | 19,782  | 11,092                       |
| <b>Total liabilities</b>  | <b>148,042</b>                                | <b>114,029</b>               |
| Commitments and contingencies (Note 15)   |   |                              |
| <b>Equity:</b>  |   |                              |
| Stockholders' equity:   |   |                              |
| Preferred stock, \$0.01 par value, 8.5% Series A Cumulative Redeemable Perpetual, liquidation preference of \$25 per share, 50,000,000 shares authorized, 10,080,000 and no shares issued and outstanding, respectively | 101   |                              |
| Common stock, \$0.01 par value, 450,000,000 shares authorized, 41,220,754 and 32,624,889 shares issued and outstanding, respectively  | 412   | 326                          |
| Additional paid-in capital  | 998,584                                       | 599,470                      |
| Retained earnings   | 2,390   | 5,510                        |
| Accumulated other comprehensive loss  | (2,261)                                       | (2,330)                      |
| <b>Total stockholders' equity</b>   | <b>999,226</b>                                | <b>602,976</b>               |
| Noncontrolling interests  | 41,006  | 10,514                       |
| <b>Total equity</b>   | <b>1,040,232</b>                              | <b>613,490</b>               |
| <b>Total liabilities and equity</b>   | <b>\$ 1,188,274</b>                           | <b>\$ 727,519</b>            |

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



**Table of Contents****COLONY FINANCIAL, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except share and per share data)

(Unaudited)

|  | Three Months Ended September 30, |            | Nine Months Ended September 30, |            |
|--|----------------------------------|------------|---------------------------------|------------|
|  | 2012                             | 2011       | 2012                            | 2011       |
| <b>Income</b>  |                                  |            |                                 |            |
| Equity in income of unconsolidated joint ventures  | \$ 15,838                        | \$ 15,968  | \$ 47,273                       | \$ 33,868  |
| Interest income  | 10,816                           | 5,204      | 25,693                          | 10,877     |
| Other income from affiliates   | 396                              | 636        | 1,515                           | 1,543      |
| Total income   | 27,050                           | 21,808     | 74,481                          | 46,288     |
| <b>Expenses</b>  |                                  |            |                                 |            |
| Management fees (including \$578, \$0, \$2,942 and \$0 of share-based compensation, respectively)              | 3,812                            | 2,405      | 12,276                          | 5,929      |
| Investment expenses (including \$257, \$491, \$1,171 and \$1,020 reimbursable to affiliates, respectively)     | 516                              | 854        | 2,287                           | 1,864      |
| Interest expense   | 2,550                            | 656        | 5,873                           | 1,652      |
| Administrative expenses (including \$572, \$447, \$1,746 and \$1,321 reimbursable to affiliates, respectively) | 1,517                            | 1,398      | 4,749                           | 4,446      |
| Total expenses   | 8,395                            | 5,313      | 25,185                          | 13,891     |
| Other (loss) gain, net   | (331)                            | 39         | (835)                           | (151)      |
| <b>Income before income taxes</b>  | 18,324                           | 16,534     | 48,461                          | 32,246     |
| Income tax provision   | 596                              | 255        | 1,401                           | 253        |
| <b>Net income</b>  | 17,728                           | 16,279     | 47,060                          | 31,993     |
| Net income attributable to noncontrolling interests  | 2,170                            | 485        | 3,933                           | 799        |
| <b>Net income attributable to Colony Financial, Inc.</b>   | 15,558                           | 15,794     | 43,127                          | 31,194     |
| Preferred dividends  | 5,102                            |            | 8,560                           |            |
| <b>Net income attributable to common stockholders</b>  | \$ 10,456                        | \$ 15,794  | \$ 34,567                       | \$ 31,194  |
| Net income per common share:   |                                  |            |                                 |            |
| Basic  | \$ 0.30                          | \$ 0.48    | \$ 1.03                         | \$ 1.14    |
| Diluted  | \$ 0.30                          | \$ 0.48    | \$ 1.03                         | \$ 1.12    |
| Weighted average number of common shares outstanding:  |                                  |            |                                 |            |
| Basic  | 34,358,500                       | 32,743,000 | 33,254,300                      | 27,400,400 |
| Diluted  | 34,358,500                       | 33,034,100 | 33,277,700                      | 27,750,000 |
| Dividends declared per common share  | \$ 0.35                          | \$ 0.33    | \$ 1.04                         | \$ 0.97    |

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

**Table of Contents****COLONY FINANCIAL, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(In thousands)****(Unaudited)**

|  | <b>Three Months Ended September 30,</b> |             | <b>Nine Months Ended September 30,</b> |             |
|--|---|-------------|--|-------------|
|  | <b>2012</b>                             | <b>2011</b> | <b>2012</b>                            | <b>2011</b> |
| Net income   | \$ 17,728                               | \$ 16,279   | \$ 47,060                              | \$ 31,993   |
| Other comprehensive income, net of tax:  |   |             |  |             |
| Equity in other comprehensive (loss) income of unconsolidated joint ventures                                     | (90)                                    | (715)       | 164                                    | (779)       |
| Equity in realized gain of unconsolidated joint venture reclassified from accumulated other comprehensive income |   | (823)       |  | (823)       |
| Unrealized gain (loss) on beneficial interests in debt securities  | 140                                     | (184)       | 368                                    | (184)       |
| Change in fair value of derivative instruments designated as hedges  | (597)                                   | 1,368       | (349)                                  | 759         |
| Foreign currency translation adjustments   | (315)                                   | (3,308)     | (237)                                  | (1,688)     |
| Realized foreign exchange (gain) loss reclassified from accumulated other comprehensive income                   | (3)                                     | (29)        | 132                                    | (58)        |
| Other comprehensive (loss) income  | (865)                                   | (3,691)     | 78                                     | (2,773)     |
| Comprehensive income   | 16,863                                  | 12,588      | 47,138                                 | 29,220      |
| Comprehensive income attributable to noncontrolling interests  | 2,171                                   | 453         | 3,942                                  | 766         |
| Comprehensive income attributable to stockholders  | \$ 14,692                               | \$ 12,135   | \$ 43,196                              | \$ 28,454   |

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

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## COLONY FINANCIAL, INC.

## CONSOLIDATED STATEMENTS OF EQUITY

(In thousands, except share and per share data)

(Unaudited)

|  | Preferred Stock |        | Common Stock |        |                            | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Stockholder Equity | Noncontrolling Interests | Total Equity |
|--|-----------------|--------|--------------|--------|----------------------------|-------------------|---|--------------------------|--------------------------|--------------|
|  | Shares          | Amount | Shares       | Amount | Additional Paid-in Capital |                   |   |                          |                          |              |
| <b>Balance at December 31, 2010</b>                |                 | \$     | 17,384,000   | \$ 174 | \$ 330,777                 | \$ 1,152          | \$ 936  | \$ 333,039               | \$ 240                   | \$ 333,279   |
| Net income   |                 |        |              |        |                            | 31,194            |   | 31,194                   | 799                      | 31,993       |
| Other comprehensive loss                           |                 |        |              |        |                            |                   | (2,740)                                       | (2,740)                  | (33)                     | (2,773)      |
| Common stock offering                              |                 |        | 15,350,000   | 153    | 283,822                    |                   |   | 283,975                  |                          | 283,975      |
| Underwriting and offering costs                    |                 |        |              |        | (12,268)                   |                   |   | (12,268)                 |                          | (12,268)     |
| Anti-dilution purchase price adjustment            |                 |        | 175,000      | 2      | (164)                      |                   |   | (162)                    |                          | (162)        |
| Common stock repurchases                           |                 |        | (440,300)    | (4)    | (6,721)                    |                   |   | (6,725)                  |                          | (6,725)      |
| Share-based payments                               |                 |        | 3,000        |        | 97                         |                   |   | 97                       |                          | 97           |
| Contributions from noncontrolling interests        |                 |        |              |        |                            |                   |   |                          | 10,140                   | 10,140       |
| Distributions to noncontrolling interests          |                 |        |              |        |                            |                   |   |                          | (630)                    | (630)        |
| Common stock dividends declared (\$0.97 per share) |                 |        |              |        |                            | (26,810)          |   | (26,810)                 |                          | (26,810)     |
| <b>Balance at September 30, 2011</b>               |                 | \$     | 32,471,700   | \$ 325 | \$ 595,543                 | \$ 5,536          | \$ (1,804)                                    | \$ 599,600               | \$ 10,516                | \$ 610,116   |
| <b>Balance at December 31, 2011</b>                |                 | \$     | 32,624,889   | \$ 326 | \$ 599,470                 | \$ 5,510          | \$ (2,330)                                    | \$ 602,976               | \$ 10,514                | \$ 613,490   |
| Net income   |                 |        |              |        |                            | 43,127            |   | 43,127                   | 3,933                    | 47,060       |
| Other comprehensive income                         |                 |        |              |        |                            |                   | 69  | 69                       | 9                        | 78           |

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|   |            |        |            |        |            |          |            |            |           |              |
|---|------------|--------|------------|--------|------------|----------|------------|------------|-----------|--------------|
| Issuance of 8.5% Series A Cumulative Redeemable Perpetual Preferred Stock | 10,080,000 | 101    |            |        | 254,477    |          |            | 254,578    |           | 254,578      |
| Common stock offering   |            |        | 8,050,000  | 80     | 149,086    |          |            | 149,166    |           | 149,166      |
| Underwriting and offering costs   |            |        |            |        | (8,904)    |          |            | (8,904)    |           | (8,904)      |
| Issuance of common stock for incentive fees                               |            |        | 65,703     | 1      | 1,196      |          |            | 1,197      |           | 1,197        |
| Share-based payments  |            |        | 480,162    | 5      | 3,259      |          |            | 3,264      |           | 3,264        |
| Contributions from noncontrolling interests                               |            |        |            |        |            |          |            | 36,394     |           | 36,394       |
| Distributions to noncontrolling interests                                 |            |        |            |        |            |          |            | (9,844)    |           | (9,844)      |
| Preferred stock dividends   |            |        |            |        |            | (8,972)  |            | (8,972)    |           | (8,972)      |
| Common stock dividends declared (\$1.04 per share)                        |            |        |            |        |            | (37,275) |            | (37,275)   |           | (37,275)     |
| <b>Balance at September 30, 2012</b>                                      | 10,080,000 | \$ 101 | 41,220,754 | \$ 412 | \$ 998,584 | \$ 2,390 | \$ (2,261) | \$ 999,226 | \$ 41,006 | \$ 1,040,232 |

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

**Table of Contents****COLONY FINANCIAL, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

|   | <b>Nine Months Ended September 30,</b> |             |
|---|--|-------------|
|   | <b>2012</b>                            | <b>2011</b> |
| <b>Cash Flows from Operating Activities</b>   |  |             |
| Net income  | \$ 47,060                              | \$ 31,993   |
| Adjustments to reconcile net income to net cash provided by operating activities:   |  |             |
| Amortization of discount and net origination fees on purchased and originated loans | (2,296)                                | (1,244)     |
| Paid-in-kind interest added to loan principal                                       | (631)                                  | (403)       |
| Amortization of deferred financing costs  | 1,430                                  | 716         |
| Equity in income of unconsolidated joint ventures                                   | (47,273)                               | (33,868)    |
| Distributions of income from unconsolidated joint ventures                          | 43,901                                 | 17,493      |
| Share-based payments  | 4,461                                  | 97          |
| Changes in operating assets and liabilities:  |  |             |
| Increase in other assets  | (3,130)                                | (1,662)     |
| Increase in accrued and other liabilities   | 1,352                                  | 479         |
| Increase in due to affiliates   | 142                                    | 1,282       |
| Other adjustments, net  | 1,180                                  | 305         |
| Net cash provided by operating activities   | 46,196                                 | 15,188      |
| <b>Cash Flows from Investing Activities</b>   |  |             |
| Contributions to unconsolidated joint ventures                                      | (329,168)                              | (159,768)   |
| Distributions from unconsolidated joint ventures                                    | 80,092                                 | 7,968       |
| Investments in purchased loans receivable, net of seller financing                  | (56,427)                               | (51,685)    |
| Repayments of principal on loans receivable   | 8,348                                  |             |
| Net disbursements on originated loans   |  | (105,804)   |
| Proceeds from sales of loans receivable   | 30,159                                 |             |
| Acquisition of beneficial interests in debt securities                              |  | (28,000)    |
| Investment deposits   | (150)                                  | (15,000)    |
| Return of investment deposit  |  | 15,000      |
| Other investing activities, net   | (29)                                   | (190)       |
| Net cash used in investing activities   | (267,175)                              | (337,479)   |
| <b>Cash Flows from Financing Activities</b>   |  |             |
| Proceeds from issuance of preferred stock, net                                      | 246,559                                |             |
| Proceeds from issuance of common stock  | 149,166                                | 272,261     |
| Dividends paid to stockholders  | (37,911)                               | (22,178)    |
| Common stock repurchases  |  | (6,725)     |
| Line of credit borrowings   | 133,500                                | 32,000      |
| Line of credit repayments   | (202,500)                              | (20,000)    |
| Secured financing repayments  | (6,989)                                | (111)       |
| Payment of deferred financing costs   | (1,758)                                | (2,157)     |
| Payment of offering costs   | (435)                                  | (554)       |
| Contributions from noncontrolling interests   | 36,394                                 | 10,140      |
| Distributions to noncontrolling interests   | (9,844)                                | (630)       |
| Other financing activities, net   | (157)                                  | (272)       |

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|   |            |           |
|---|------------|-----------|
| Net cash provided by financing activities   | 306,025    | 261,774   |
| Net increase in cash  | 85,046     | (60,517)  |
| Cash, beginning of period   | 3,872      | 66,245    |
| Cash, end of period   | \$ 88,918  | \$ 5,728  |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>  |            |           |
| Cash paid for interest  | \$ 4,022   | \$ 827    |
| Cash paid for income taxes  | \$ 4,192   | \$ 310    |
| <b>SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES:</b>                         |            |           |
| Dividends payable   | \$ 19,782  | \$ 10,716 |
| Derivative liability assumed for beneficial interests in securities                                   | \$         | \$ 4,122  |
| Seller-provided secured financing on purchased loan   | \$ 103,524 | \$        |
| Interest reserve for seller financing funded by borrower of purchased loan (Note 7)                   | \$ 9,984   | \$        |
| Assignment of loans receivable and related liabilities to investment in unconsolidated joint ventures | \$ 29,427  | \$        |
| Offering costs included in accrued and other liabilities  | \$ 450     | \$        |
| Deferred payment on investment in unconsolidated joint venture  | \$         | \$ 150    |

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

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**COLONY FINANCIAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2012**

**(Unaudited)**

**1. Organization**

Colony Financial, Inc. (the Company) was organized on June 23, 2009 as a Maryland corporation for the purpose of acquiring, originating and managing commercial mortgage loans, which may be performing, sub-performing or non-performing loans (including loan-to-own strategies), and other commercial real estate-related debt and equity investments. The Company has also acquired and is expected to continue to acquire other real estate and real estate-related assets. The Company is managed by Colony Financial Manager, LLC (the Manager), a Delaware limited liability company, and an affiliate of the Company. The Company elected to be taxed as a real estate investment trust (REIT) under the Internal Revenue Code commencing with its first taxable year ended December 31, 2009.

**2. Significant Accounting Policies**

The significant accounting policies of the Company and its unconsolidated joint ventures are described below.

***Principles of Consolidation and Basis of Presentation***

The accompanying unaudited interim financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all information and footnotes required by accounting principles generally accepted in the United States of America (GAAP) for complete financial statements. These statements reflect all normal and recurring adjustments which, in the opinion of management, are necessary to present fairly the financial position, results of operations and cash flows of the Company for the interim periods presented. However, the results of operations for the interim period presented are not necessarily indicative of the results that may be expected for the year ending December 31, 2012 or any other future period. These interim financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The Company consolidates entities in which it retains a controlling financial interest or entities that meet the definition of a variable interest entity (VIE) for which the Company is deemed to be the primary beneficiary. In performing its analysis of whether it is the primary beneficiary, at initial investment and at each quarterly reporting period, the Company considers whether it individually has the power to direct the activities of the VIE that most significantly affect the entity's performance and also has the obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE. The Company also considers whether it is a member of a related party group that collectively meets the power and benefits criteria and, if so, whether the Company is most closely associated with the VIE. In making that determination, the Company considers both qualitative and quantitative factors, including, but not limited to: the amount and characteristics of its investment relative to other investors; the obligation or likelihood for the Company or other investors to fund operating losses of the VIE; the Company's and the other investors' ability to control or significantly influence key decisions for the VIE, and the similarity and significance of the VIE's business activities to those of the Company and the other investors. The determination of whether an entity is a VIE, and whether the Company is the primary beneficiary, involves significant judgments, including the determination of which activities most significantly affect the entity's performance, estimates about the current and future fair values and performance of assets held by the VIE and/or general market conditions.

***Use of Estimates***

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

***Investments in Unconsolidated Joint Ventures***

The Company holds ownership interests in certain joint ventures. The Company evaluates its interest in these entities to determine whether they meet the definition of a VIE and whether the Company is required to consolidate these entities. In each case, the Company has determined that (1) the entity is not a VIE and the Company does not have a controlling financial interest, or (2) the entity is a VIE but the Company is not the primary beneficiary. Since the Company is not required to consolidate these entities but has significant influence over operating and financial policies, it accounts for its investments in joint ventures using the equity method. Under the equity method, the Company initially records its investments at cost and adjusts for the Company's proportionate share of net earnings or losses and other comprehensive income or loss, cash contributions made and distributions received, and other adjustments, as appropriate. Distributions of operating profit from the joint ventures are reported as part of operating cash flows. Distributions related to a capital transaction, such as a refinancing transaction or sale, are reported as investing activities.

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The Company performs a quarterly evaluation of its investments in unconsolidated joint ventures to determine whether the fair value of each investment is less than the carrying value, and, if such decrease in value is deemed to be other-than-temporary, writes down the investment to fair value.

### ***Loans Receivable***

The Company and its unconsolidated joint ventures originate and purchase loans receivable. Originated loans are recorded at amortized cost, or the outstanding unpaid principal balance ( UPB ) less net deferred loan fees. Net deferred loan fees include unamortized origination and other fees charged to the borrower less direct incremental loan origination costs incurred by the Company. Purchased loans are recorded at amortized cost, or the UPB less unamortized purchase discount. Costs to purchase loans are expensed as incurred. Interest income is recognized based upon the contractual rate and the outstanding principal balance of the loans. Purchase discount or net deferred loan fees are amortized over the expected life of the loans using the effective yield method except on revolving loans, for which the straight-line method is used. Loans that the Company has the intent and ability to hold for the foreseeable future are classified as held-for-investment.

*Loans Held for Sale* Loans held for sale are loans that the Company intends to sell or liquidate in the foreseeable future and are carried at the lower of amortized cost or fair value.

*Past Due Loans* The Company places loans on nonaccrual status when any portion of principal or interest is more than 90 days past due, or earlier when concern exists as to the ultimate collection of principal or interest. When a loan is placed on nonaccrual status, the Company reverses the accrual for unpaid interest and does not recognize interest income until the cash is received and the loan returns to accrual status. Generally, a loan may be returned to accrual status when all delinquent principal and interest are brought current in accordance with the terms of the loan agreement and the borrower has met certain performance criteria.

*Impairment* The Company evaluates its loans for impairment on a quarterly basis. The Company regularly analyzes the extent and effect of any credit migration from underwriting and the initial investment review associated with a loan's performance and/or value of underlying collateral as well as the financial and operating capability of the borrower/sponsor. Specifically, a property's operating results and any cash reserves are analyzed and used to assess (i) whether cash from operations are sufficient to cover the debt service requirements currently and into the future, (ii) the ability of the borrower to refinance the loan, and/or (iii) the property's liquidation value. Where applicable, the Company also evaluates the financial wherewithal of any loan guarantors as well as the borrower's competency in managing and operating the properties. A loan is considered to be impaired when it is probable that the Company will not be able to collect all amounts due according to the contractual terms of the loan agreement. A loan is also considered to be impaired if it has been restructured in a troubled debt restructuring ( TDR ) involving a modification of terms as a concession resulting from the debtor's financial difficulties. The Company measures impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. If the loan valuation is less than the recorded investment in the loan, a valuation allowance is established with a corresponding charge to allowance for loan loss.

*Acquired Credit-Distressed Loans* The Company and its unconsolidated joint ventures acquire credit-distressed loans for which the Company or the joint venture expects to collect less than the contractual amounts due under the terms of the loan based, at least in part, on the assessment of the credit quality of the borrower. Acquired credit-distressed loans are recorded at the initial investment in the loans and accreted to the estimated cash flows expected to be collected measured at acquisition date. The excess of cash flows expected to be collected measured at acquisition date over the initial investment ( accretable yield ) is recognized in interest income over the remaining life of the loan using the effective interest method. The excess of contractually required payments at the acquisition date over expected cash flows ( nonaccretable difference ) is not recognized as an adjustment of yield, loss accrual or valuation allowance. Subsequent increases in cash flows expected to be collected are recognized prospectively through an adjustment to the loan's accretable yield over its remaining life, which may result in a reclassification from nonaccretable difference to accretable yield. Subsequent decreases in cash flows expected to be collected are evaluated to determine whether a provision for loan loss should be established. If decreases in expected cash flows result in a decrease in the estimated fair value of the loan below its amortized cost, the loan is deemed to be impaired and the Company will record a provision for loan losses calculated as the difference between the loan's amortized cost and the revised cash flows, discounted at the loan's effective yield.

Acquired credit-distressed loans may be aggregated into pools based upon common risk characteristics, such as loan performance, collateral type and/or geographic location of the collateral. Once a loan pool is identified, a composite yield and estimate of cash flows expected to be collected (including expected prepayments) are used to recognize interest income. A loan resolution within a loan pool, which may involve the sale of the loan or foreclosure on the underlying collateral, results in removal of the loan at an allocated carrying amount that preserves the yield of the pool. A loan modified within a loan pool remains in the loan pool, with the effect of the modification incorporated into the expected future cash flows.



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### ***Investments in Debt Securities***

The Company designates debt securities as held-to-maturity, available-for-sale, or trading depending upon its intent at the time of acquisition. The Company's beneficial interests in debt securities are designated as available-for-sale and are presented at fair value. Unrealized gains or losses are included as a component of other comprehensive income or loss. Premiums or discounts are amortized or accreted into income using the effective interest method over the expected lives of the individual securities. The Company performs a quarterly assessment of its debt securities to determine whether a decline in fair value below amortized cost is other than temporary. Other-than-temporary impairment exists when it is probable that the Company will be unable to recover the entire amortized cost basis of the security. If the decline in fair value is deemed to be other than temporary, the security is written down to fair value which becomes the new cost basis and an impairment loss is recognized.

### ***Investment in Real Estate***

Property is recorded at the purchase price, allocated among land, building, improvements, in-place lease values, and equipment based upon their fair values at the date of acquisition. The Company evaluates each purchase transaction to determine whether the acquired assets meet the definition of a business. Transaction costs related to acquisitions of single-family homes that are not deemed to be businesses are included in the cost basis of the acquired assets, while other transaction costs are expensed as incurred.

Depreciation on building and improvements is computed on the straight-line basis over the estimated useful lives of the assets, which is generally 20 to 40 years. Equipment is depreciated over the estimated useful lives of between 5 and 10 years.

Expenditures for ordinary repairs and maintenance are expensed as incurred, while expenditures for significant renovations that improve or extend the useful life of the asset are capitalized and depreciated over their estimated useful lives.

### ***Rental Income***

Residential leases generally have one-year terms. Rental income from residential leases is recognized monthly when due from tenants, which is not materially different from the straight-line method. Certain costs incurred to lease vacant homes, including leasing commissions and other fees, are capitalized and amortized over the term of the lease. Rents received in advance are deferred.

### ***Share-Based Payments***

The Company recognizes the cost of share-based awards based upon their fair values on a straight-line basis over the requisite service period, which is generally the vesting period of the awards. For awards to the Company's employees, including its independent directors, the fair value is determined as the grant date stock price. For share-based awards to non-employees, the fair value is based upon the vesting date stock price, which requires the amount of related expense to be adjusted to the fair value of the award at the end of each reporting period until the award has vested.

For awards with periodic vesting, the Company recognizes the related expense on a straight-line basis over the requisite service period for the entire award, subject to periodic adjustments to ensure that the cumulative amount of expense recognized through the end of any reporting period is at least equal to the fair value of the portion of the award that has vested through that date. Share-based payments are reflected in the same expense category as would be appropriate if the payments had been made in cash.

### ***Income Taxes***

The Company elected to be taxed as a REIT, commencing with the Company's initial taxable year ended December 31, 2009. A REIT is generally not subject to corporate level federal and state income tax on net income it distributes to its stockholders. To qualify as a REIT, the Company must meet a number of organizational and operational requirements, including a requirement to distribute at least 90% of its REIT taxable income to its stockholders. If the Company fails to qualify as a REIT in any taxable year, it will be subject to federal and state income taxes at regular corporate rates (including any applicable alternative minimum tax) and may not be able to qualify as a REIT for four subsequent taxable years. Even if the Company qualifies for taxation as a REIT, it and its subsidiaries may be subject to certain federal, state, local and foreign taxes on its income and property and to federal income and excise taxes on its undistributed taxable income.

The Company has elected or may elect to treat certain of its existing or newly created corporate subsidiaries as taxable REIT subsidiaries (each a TRS). In general, a TRS of a REIT may perform non-customary services for tenants of the REIT, hold assets that the REIT cannot hold directly and, subject to certain exceptions related to hotels and healthcare properties, may engage in any real estate or non-real estate related business. A

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TRS is treated as a regular corporation and is subject to federal, state, local and foreign taxes on its income and property.

Deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial reporting and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The deferred tax assets and liabilities of the TRSs relate primarily to temporary differences in the book and tax income of TRSs and operating loss carryforwards for federal and state income tax purposes, as well as the tax effect of accumulated other comprehensive income of TRSs. A valuation allowance for deferred tax assets is provided if the Company believes it is more likely than not that all or some portion of the deferred tax assets will not be realized. Realization of deferred tax assets is dependent on the Company generating sufficient taxable income in future periods.

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The Company periodically evaluates its tax positions to determine whether it is more likely than not that such positions would be sustained upon examination by a tax authority for all open tax years, as defined by the statute of limitations, based on their technical merits. As of September 30, 2012 and December 31, 2011, the Company has not established a liability for uncertain tax positions.

**3. Investments in Unconsolidated Joint Ventures**

Pursuant to an investment allocation agreement between the Company, the Manager and Colony Capital, LLC ( "Colony Capital" ), the sole member of the Manager, many of the Company's investments have been structured as joint ventures with one or more private investment funds or other investment vehicles managed by Colony Capital or its affiliates. The joint ventures are generally capitalized through equity contributions from the members, although certain investments are leveraged through various financing arrangements. The Company's exposure to the joint ventures is limited to amounts invested or committed to the joint ventures at inception, and neither the Company nor the other investors are required to provide financial or other support in excess of their capital commitments.

The Company's investments in unconsolidated joint ventures are summarized below:

| (Amounts in thousands)   |   | Ownership Percentage | Carrying Value     |                   |
|--|---|----------------------|--------------------|-------------------|
| Joint Ventures   | Investment Description  |                      | September 30, 2012 | December 31, 2011 |
| CSFR Operating Partnership, L.P. and ColFin American Investors, LLC                | Acquisition and rental of single family homes   | 37.4% <sup>(1)</sup> | \$ 147,468         | \$                |
| ColFin Court Square Funding, LLC   | Preferred equity investment in the acquisition entity that acquired a Class A office tower located in Long Island City, New York  | 50.0%                | 45,478             |                   |
| ColFin WLH Funding, LLC  | Origination of senior secured term loan secured by first mortgages on residential land and security interests in cash and other assets  | 24.0%                | 45,173             | 52,416            |
| ColFin Bulls Funding A, LLC, ColFin Bulls Funding B, LLC and Colony AMC Bulls, LLC | Acquisition of approximately 650 credit-distressed loans consisting of substantially all first mortgage recourse commercial real estate loans   | 32.5%                | 41,276             | 63,699            |
| ColFin DB Guarantor, LLC and Colony AMC DB, LLC                                    | Structured acquisition in a joint venture with the Federal Deposit Insurance Corporation (the "FDIC") of approximately 1,200 credit-distressed loans secured mostly by commercial real estate | 33.3%                | 38,842             | 37,710            |
| ColFin 2011 CRE Holdco, LLC and Colony AMC 2011 CRE, LLC                           | Structured acquisition in a joint venture with the FDIC of approximately 760 credit-distressed loans secured mostly by commercial real estate   | 44.4%                | 37,076             | 34,728            |
| ColFin London Funding, LLC   | Acquisition of 7 performing and non-performing loans secured by commercial real estate  | 50.0%                | 36,495             |                   |
| ColFin NW Funding, LLC   | Acquisition of 25 credit-distressed first mortgage loans secured by commercial real estate  | 37.9%                | 35,881             | 51,396            |
| ColFin JIH Holdco, LLC and ColFin JIH Mezzco A, LLC                                | Equity interests in and senior mezzanine loan receivable from entities owning a portfolio of 103 limited service hotels   | 33.3%                | 30,793             |                   |
| ColFin Hunt Holdco A, LLC and ColFin Hunt Holdco B, LLC                            | Acquisition of 5 non-performing first mortgage loans secured by commercial real estate located in Germany   | 37.9%                | 28,494             | 27,714            |
| ColFin Ash Funding, LLC  | Acquisition of the two most junior mortgage participation interests in a newly restructured   | 50.0%                | 24,452             |                   |

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|                         |  |       |        |        |
|-------------------------|--|-------|--------|--------|
|                         | first mortgage secured by five full-service hotels   |       |        |        |
| ColFin MF5 Funding, LLC | Acquisition of most senior bond and interest-only certificate in a CMBS trust that owns approximately 270 first mortgage loans | 11.0% | 22,405 |        |
| ColFin 666 Funding, LLC | Acquisition of a first mortgage pari-passu participation interest secured by Class A midtown Manhattan office building         | 33.3% | 17,144 | 16,578 |

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| (Amounts in thousands)   |   | Ownership Percentage | Carrying Value     |                   |
|--|---|----------------------|--------------------|-------------------|
| Joint Ventures   | Investment Description  |                      | September 30, 2012 | December 31, 2011 |
| ColFin FCDC Funding, LLC   | Equity interests in two partially developed master planned communities located in California  | 50.0%                | 15,604             |                   |
| ColFin Inland Funding, LLC and ColFin Inland Investor, LLC   | Origination of first mortgage loan secured by a Southern California master planned development and equity participation rights  | 50.0%                | 14,850             | 14,176            |
| ColFin Bow Funding A, LLC, ColFin Bow Funding B, LLC and Colony AMC Bow, LLC                                 | Acquisition of 63 credit-distressed loans consisting of substantially all first mortgage recourse commercial real estate loans  | 50.0%                | 13,180             | 14,469            |
| ColFin FRB Investor, LLC   | Equity ownership in financial institution with approximately \$32 billion of assets   | 5.9%                 | 12,701             | 21,848            |
| ColFin Axle Funding, LLC   | Structured acquisition in a joint venture with the FDIC of approximately 1,660 credit-distressed loans consisting of substantially all first mortgage recourse commercial real estate loans | 4.5%                 | 12,488             | 11,822            |
| ColFin ALS Funding, LLC  | Origination of recourse loan secured by first liens on two West Village Manhattan townhomes and a photography catalogue   | 33.3%                | 12,376             | 11,093            |
| Colony Funds Sants S.à r.l.  | Syndicated senior secured loan to a Spanish commercial real estate company  | 5.1%                 | 11,553             | 11,611            |
| ColFin SXC Funding, LLC  | Origination of mezzanine loan cross-collateralized by a portfolio of limited-service hotels   | 50.0%                | 10,903             |                   |
| ColFin 2011 ADC Funding, LLC and Colony AMC 2011 ADC, LLC  | Structured acquisition in a joint venture with the FDIC of approximately 1,500 credit-distressed loans secured mostly by commercial real estate   | 15.2%                | 9,652              | 10,159            |
| ColFin BAMO II Funding A, LLC, ColFin BAMO II Funding B, LLC and Colony AMC BMO II, LLC                      | Acquisition of 26 credit-distressed loans consisting of substantially all first mortgage recourse commercial real estate loans  | 50.0%                | 9,541              |                   |
| ColFin Palm Funding, LLC   | Acquisition of a performing senior mortgage secured by a multifamily complex in Florida   | 50.0%                | 8,564              |                   |
| ColFin 2011-2 CRE Holdco, LLC and Colony AMC 2011-2 CRE, LLC   | Structured acquisition in a joint venture with the FDIC of approximately 310 credit-distressed loans consisting of substantially all first mortgage recourse commercial real estate loans   | 24.7%                | 8,381              | 7,753             |
| ColFin Mira Mezz Funding, LLC  | Origination of senior first mortgage and mezzanine loans secured by all assets of a destination spa resort located in Arizona   | 50.0%                | 7,652              | 17,484            |
| C-VIII CDCF CFI MBS Investor, LLC  | Senior bond secured by seasoned CMBS bonds, U.S. Treasuries and a B-note  | 33.3%                | 6,084              | 5,036             |
| Other unconsolidated joint ventures (investments less than \$5 million carrying value at September 30, 2012) |   | 10.6% to 50.0%       | 20,901             | 33,808            |
|  |   |                      | \$ 725,407         | \$ 443,500        |

(1) This percentage represents the Company's blended equity ownership interest in the two named entities, CSFR Operating Partnership, L.P. ( CSFR ) and ColFin American Investors, LLC ( CAI ), as of September 30, 2012. In October 2012, additional contributions by the partners in CSFR resulted in the dilution of the Company's ownership in the single family home rental platform to 29.3%, entirely through CSFR. On July 31, 2012, the Company entered into a subscription agreement for an associate general partnership interest in CSFR and committed to invest \$150 million. CSFR is a newly formed investment vehicle created for the purpose of investing in single-family rental homes and is

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managed by Colony American Homes, LLC ( CAH ), an affiliate of the Manager. Such investment was completed through transfers of the Company's interest in CAI. According to the terms of the subscription agreement, no management fees will be paid to CAH in respect of the Company's investment in CSFR. As a participant in the initial capital raise ( Founders Round ), the Company is entitled to (a) its pro rata share of 25% of the carried interest paid by partners who invest in CSFR subsequent to the Founders Round, and (b) its pro rata share of warrants with a \$0.01 strike price (i) to participate in any distributions made by CAH and (ii) to acquire 25% to 33 1/3% of Class D Units of CAH in the event of a realization transaction, as defined in the warrant agreement. The fair value of such warrants was immaterial at September 30, 2012.

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Activity in the Company's investments in unconsolidated joint ventures is summarized below:

|  |            |
|--|------------|
| <b>(In thousands)</b>                                  |            |
| Balance at December 31, 2011                           | \$ 443,500 |
| Contributions  | 329,168    |
| Assignment of loans receivable and related liabilities | 29,427     |
| Distributions  | (123,993)  |
| Equity in net income                                   | 47,273     |
| Equity in other comprehensive income                   | 164        |
| Foreign currency translation loss                      | (132)      |
| Balance at September 30, 2012                          | \$ 725,407 |

Combined condensed balance sheets and statements of operations for all unconsolidated joint ventures are presented below:

### Combined Condensed Balance Sheets of Unconsolidated Joint Ventures

| <b>(In thousands)</b>                        | <b>September 30,<br/>2012</b> | <b>December 31,<br/>2011</b> |
|--|-------------------------------|------------------------------|
| <b>Assets:</b>                               |                               |                              |
| Cash and cash equivalents                    | \$ 126,706                    | \$ 97,157                    |
| Loans receivable, net                        | 2,476,453                     | 2,713,380                    |
| Available-for-sale investment securities     | 17,940                        | 14,820                       |
| Investments in unconsolidated joint ventures | 590,998                       | 589,246                      |
| Investments in real estate                   | 749,919                       | 143,267                      |
| Other assets                                 | 723,565                       | 555,415                      |
| Total assets                                 | \$ 4,685,581                  | \$ 4,113,285                 |
| <b>Liabilities:</b>                          |                               |                              |
| Debt   | \$ 980,954                    | \$ 1,151,237                 |
| Other liabilities                            | 47,055                        | 28,031                       |
| Total liabilities                            | 1,028,009                     | 1,179,268                    |
| Owners' equity                               | 2,758,141                     | 2,096,352                    |
| Noncontrolling interest                      | 899,431                       | 837,665                      |
| Total liabilities and equity                 | \$ 4,685,581                  | \$ 4,113,285                 |
| Company's share of equity                    | \$ 725,407                    | \$ 443,500                   |

**Table of Contents****Combined Condensed Statements of Operations of Unconsolidated Joint Ventures**

| (In thousands)                                     | Three Months Ended<br>September 30, |                | Nine Months Ended<br>September 30, |                |
|--|-------------------------------------|----------------|------------------------------------|----------------|
|  | 2012                                | 2011           | 2012                               | 2011           |
| <b>Income:</b>                                     |                                     |                |                                    |                |
| Interest income                                    | \$ 92,689                           | \$ 80,485      | \$ 277,072                         | \$ 224,125     |
| Equity in income of unconsolidated joint ventures  | 12,083                              | 16,146         | 38,086                             | 58,850         |
| Property operating                                 | 26,214                              | 3,043          | 70,039                             | 4,858          |
| Other  | 5,027                               | 6,091          | 15,264                             | 13,945         |
| <br>Total income                                   | <br>136,013                         | <br>105,765    | <br>400,461                        | <br>301,778    |
| <b>Expenses:</b>                                   |                                     |                |                                    |                |
| Interest expense                                   | 9,003                               | 7,030          | 29,763                             | 19,221         |
| Property operating                                 | 21,105                              | 2,893          | 50,784                             | 7,692          |
| Other  | 24,631                              | 18,215         | 69,923                             | 41,485         |
| <br>Total expenses                                 | <br>54,739                          | <br>28,138     | <br>150,470                        | <br>68,398     |
| <br>Other income:                                  |                                     |                |                                    |                |
| Realized and unrealized gain on investments, net   | 33,866                              | 69,076         | 89,819                             | 72,943         |
| <br>Net income                                     | <br>115,140                         | <br>146,703    | <br>339,810                        | <br>306,323    |
| Net income attributable to noncontrolling interest | 22,340                              | 21,150         | 58,274                             | 64,966         |
| <br>Net income attributable to members             | <br>\$ 92,800                       | <br>\$ 125,553 | <br>\$ 281,536                     | <br>\$ 241,357 |
| <br>Company's equity in net income                 | <br>\$ 15,838                       | <br>\$ 15,968  | <br>\$ 47,273                      | <br>\$ 33,868  |

As of September 30, 2012, the Company's combined investments in CSFR Operating Partnership, L.P. and ColFin American Investors, LLC represented 12% of total assets. No single investment represented greater than 10% of total assets at December 31, 2011.

For the three months ended September 30, 2011, ColFin FRB Investor, LLC generated greater than 10% of total income. For the nine months ended September 30, 2011, ColFin FRB Investor, LLC, ColFin WLH Funding, LLC and ColFin NW Funding, LLC individually generated greater than 10% of total income. On a combined basis, these investments generated 21% and 38% of total income for the three and nine months ended September 30, 2011, respectively. No single unconsolidated joint venture investment generated greater than 10% of total income for the three and nine months ended September 30, 2012.

**Related Party Transactions of Unconsolidated Joint Ventures** The Company has equity ownership interests in certain unconsolidated asset management companies (each an "AMC") that provide management services to certain of its unconsolidated joint ventures. The AMCs earn annual management fees equal to 50 to 75 basis points times the UPB of each loan portfolio and are responsible for the payment of allocations of compensation, overhead and direct costs incurred by an affiliate of the Manager pursuant to a cost allocation arrangement (Note 12).

Certain unconsolidated joint ventures reimburse Colony Capital and its affiliates for costs incurred on their behalf, including costs of property management personnel. The joint ventures, including AMCs, were allocated approximately \$3.1 million and \$1.7 million in costs from such affiliates of the Manager for the three months ended September 30, 2012 and 2011, respectively, and \$7.9 million and \$5.1 million for the nine months ended September 30, 2012 and 2011, respectively. The Company's proportionate share, based upon its percentage interests in the joint ventures, was \$1.0 million and \$0.4 million for the three months ended September 30, 2012 and 2011, respectively, and \$2.2 million and \$1.0 million for the nine months ended September 30, 2012 and 2011, respectively.

An affiliate of CAH provides construction and rehabilitation services on the single-family rental homes held through CSFR and CAI. For the nine months ended September 30, 2012, CSFR and CAI were billed approximately \$2.6 million by the affiliate in labor and material costs,

which have been capitalized as investments in real estate.

**Table of Contents****4. Loans Receivable**

The following table summarizes the Company's loans held for investment:

| (In thousands)      | September 30, 2012 |                 |                         |                                    | December 31, 2011 |                 |                         |                                    |
|---------------------|--------------------|-----------------|-------------------------|------------------------------------|-------------------|-----------------|-------------------------|------------------------------------|
|                     | Principal          | Carrying Amount | Weighted Average Coupon | Weighted Average Maturity in Years | Principal         | Carrying Amount | Weighted Average Coupon | Weighted Average Maturity in Years |
| Performing loans    |                    |                 |                         |                                    |                   |                 |                         |                                    |
| Mortgage loans      | \$ 235,240         | \$ 204,049      | 8.9%                    | 2.3                                | \$ 106,728        | \$ 105,580      | 10.3%                   | 4.4                                |
| B-note              | 14,338             | 14,237          | 20.9%                   | 3.5                                |                   |                 |                         |                                    |
| Mezzanine loans     | 97,500             | 97,439          | 10.6%                   | 3.5                                | 97,500            | 97,427          | 10.6%                   | 4.3                                |
|                     | 347,078            | 315,725         |                         |                                    | 204,228           | 203,007         |                         |                                    |
| Nonperforming loans |                    |                 |                         |                                    |                   |                 |                         |                                    |
| Mezzanine loans     |                    |                 |                         |                                    | 25,989            | 29,612          |                         |                                    |
|                     | \$ 347,078         | \$ 315,725      |                         |                                    | \$ 230,217        | \$ 232,619      |                         |                                    |

As of September 30, 2012, all loans were paying in accordance with their terms. There were no TDRs during the nine months ended September 30, 2012.

At December 31, 2011, the Company owned one-third interests in nonperforming, delinquent mezzanine loans with an aggregate principal amount of \$78 million, of which the Company's share was \$26 million. The remaining two-thirds interests in the mezzanine loans were owned by an investment fund managed by an affiliate of the Manager. On January 9, 2012, the Company and the co-investment fund (collectively, the JIH Lenders) completed the foreclosure on the collateral and assigned their rights as winning bidder to ColFin JIH Propco, LLC (JIH Propco), an unconsolidated joint venture in which the Company owns a one-third interest (Note 3). As a result, JIH Propco now owns 100% of the indirect equity interests in the entities that own a portfolio of limited service hotels.

In April 2012, the Company amended and restated two notes receivable, each with an original principal amount of \$19.55 million, into a \$26 million A-note and a \$14 million B-note. The A-note was sold to an unrelated third party for \$25.7 million, or 99% of par. No gain or loss was recognized as a result of the sale. The remaining B-note bears interest at approximately 20.9%, of which approximately 6% may be paid in-kind.

In May 2012, the Company, in a joint venture with two unaffiliated investors owning an aggregate 40% noncontrolling interest, acquired a \$181 million participation interest in an approximate \$250 million recourse first mortgage loan. The loan shares the same corporate guarantor as a first mortgage loan that the Company originated in September 2011. At acquisition, the newly acquired loan was collateralized by 269 residential properties located at 26 resorts in the US and various international destinations. The properties comprise the majority of the assets belonging to and operated by a leading destination club operator. This senior mortgage bears interest at the 1-month London Interbank Offered Rate (LIBOR), with a 4.57% floor, plus 4% (8.57% at September 30, 2012) plus a 0.5% collateral management fee. The \$181 million participation interest was acquired for approximately \$159 million, or 88% of par. At acquisition, the borrower contributed \$11.5 million, of which \$10.0 million was funded into an interest reserve account to service the concurrent seller financing (Note 7). The borrower will receive credit in the amount of the cash contribution upon full payoff of the loan. The loan has an initial maturity of July 2014 and can be extended to January 2017, subject to an extension fee and an additional cash deposit from the borrower and requires minimum quarterly payments.

Concurrently with the acquisition, in order to achieve consistent economic interests across both loans, the Company sold a 10% participation interest in the existing \$45.2 million loan to one of the unaffiliated investors and assigned the remaining 90% interest in the loan to a joint venture with the other unaffiliated investor who contributed approximately \$13.6 million for a one-third noncontrolling interest in the joint venture. No gain or loss resulted from the partial sale or assignment of the loan.

These two loans, which share the same corporate guarantor, generated 24% and 17% of total income for the three and nine months ended September 30, 2012, respectively.



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Activity in loans held for investment is summarized below:

|   |            |
|---|------------|
| <b>(In thousands)</b>   |            |
| Balance at December 31, 2011  | \$ 232,619 |
| Loan acquisitions   | 148,298    |
| Paid-in-kind interest added to loan principal                                 | 631        |
| Discount and net loan fee amortization  | 2,296      |
| Basis of loans sold   | (30,159)   |
| Assignment of loans receivable to investment in unconsolidated joint ventures | (29,612)   |
| Principal repayments  | (8,348)    |
| Balance at September 30, 2012   | \$ 315,725 |

Minimum scheduled principal payments required under the loan agreements for performing loans as of September 30, 2012, excluding credits available to borrowers upon full payoff, are as follows:

|                                 |                       |
|---------------------------------|-----------------------|
| <b>Year Ending December 31,</b> | <b>(In thousands)</b> |
| Remaining 2012                  | \$ 2,270              |
| 2013                            | 15,160                |
| 2014                            | 146,749               |
| 2015                            | 38,343                |
| 2016                            | 133,056               |
| Total                           | \$ 335,578            |

**5. Beneficial Interests in Debt Securities**

On June 30, 2011, the Company, through a 99%-owned joint venture with a strategic partner, acquired \$28 million in beneficial interests in a series of tax-exempt bonds with an aggregate principal amount of \$40.4 million. The bonds are secured by a multifamily property located in Georgia. At closing, the bonds financed the acquisition of the property by an institutional real estate firm. The \$28 million in beneficial interests, in the form of senior certificates, were acquired at par but had an estimated fair value of \$32.1 million at acquisition. The bonds have a six-year term, bear interest at a fixed rate of 7.125%, require semi-annual interest payments each December and June, and may be prepaid, subject to the payment of certain fees. The beneficial interests in debt securities are classified as available-for-sale and stated at estimated fair value, with changes in fair value reflected in other comprehensive income or loss. The Company's beneficial interests in debt securities are summarized below:

| <b>(In thousands)</b>  | <b>September 30,<br/>2012</b> | <b>December 31,<br/>2011</b> |
|--|-------------------------------|------------------------------|
| Principal  | \$ 28,000                     | \$ 28,000                    |
| Unamortized premium  | 3,336                         | 3,813                        |
| Amortized cost   | 31,336                        | 31,813                       |
| Unrealized gain included in accumulated other comprehensive income | 982                           | 614                          |
| Fair value   | \$ 32,318                     | \$ 32,427                    |

Concurrently with the acquisition of beneficial interests in debt securities, the Company's strategic partner entered into a separate interest rate swap agreement with the borrower which, in conjunction with a special contribution/distribution arrangement with the joint venture, will result in a net current yield to the joint venture of the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index plus

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3.25% per annum (3.43% at September 30, 2012). The Company determined that the special contribution/distribution arrangement is an embedded derivative that meets the criteria for bifurcation and recorded a derivative liability. The bifurcated derivative does not qualify as a hedging instrument, so changes in the estimated fair value of the derivative are recognized in income. The Company recognized an unrealized loss of \$334,000 and an unrealized gain of \$91,000 for the three months ended September 30, 2012 and 2011, respectively, and an unrealized loss of \$674,000 and an unrealized gain of \$91,000 for the nine months ended September 30, 2012 and 2011, respectively. These amounts are included in other gain (loss) in the accompanying statements of operations.

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### **6. Credit Agreement**

On September 17, 2012, the Company amended its existing credit agreement (the Existing Credit Agreement and, as amended, Credit Agreement ) with Bank of America, N.A., as administrative agent, and certain lenders. The Credit Agreement continues to provide a credit facility in the maximum principal amount of \$175 million, with an option to increase the maximum available principal amount to \$250 million subject to certain conditions set forth in the Credit Agreement, including each lender or substitute lenders agreeing to provide commitments for such increased amount. Borrowings under the Credit Agreement will be used to finance investments in the Company's target assets, as well as for general corporate purposes.

The maximum amount available to borrow under the Credit Agreement is increased to the lesser of (a) 3.5 times the Company's annualized consolidated cash income (as defined in the Credit Agreement) and (b) 40% of the aggregate book value of all investment assets that at such time contribute positive cash income to the calculation of annualized consolidated cash income ( contributing investment assets ). As of September 30, 2012, the maximum amount available for borrowing was \$161.5 million.

Advances under the Credit Agreement will continue to accrue interest as set forth in the Existing Credit Agreement at a per annum rate equal to the sum of, at the Company's election, the one, two, three, or six month LIBOR plus 3.50% or 3.75%, depending upon the leverage ratio as defined in the Existing Credit Agreement. At September 30, 2012, the applicable spread was 3.50% and the Company had no outstanding borrowings. The Company also pays a commitment fee of 0.5% or 0.4% of the unused amount (0.5% at September 30, 2012), depending upon usage.

The initial maturity date of the Credit Agreement remains August 30, 2013, and any amounts outstanding upon maturity will convert automatically to a fully amortizing one-year term loan payable in quarterly installments. In the event of such conversions, the term loan will continue to bear interest at the same rate as the revolving loans from which they were converted.

Some of the Company's subsidiaries provided a continuing guaranty (the Guaranty ) under which such subsidiaries guaranty the obligations of the Company under the Credit Agreement. As security for the advances under the Credit Agreement, the Company and some of its affiliates pledged their equity interests in certain subsidiaries through which the Company directly or indirectly owns substantially all of its assets.

The Credit Agreement and the Guaranty contain various affirmative and negative covenants, including financial covenants that require the Company to maintain minimum tangible net worth and liquidity levels and financial ratios, as defined in the Credit Agreement. The Credit Agreement also modifies certain financial covenants including the removal of any weighted average time to maturity requirement of contributing investment assets previously set forth in the Existing Credit Agreement. At September 30, 2012, the Company was in compliance with all of these financial covenants.

The Credit Agreement also includes customary events of default, in certain cases subject to reasonable and customary periods to cure, including but not limited to: failure to make payments when due; breach of covenants; breach of representations and warranties; insolvency proceedings; certain judgments and attachments; change of control; and failure to maintain status as a REIT. The occurrence of an event of default may result in the termination of the credit facility, accelerate the Company's repayment obligations, in certain cases limit the Company's ability to make distributions, and allow the lenders to exercise all rights and remedies available to them with respect to the collateral. There have been no events of default since the inception of the credit facility.

### **7. Secured Financing**

In connection with the acquisition of a \$181 million participation interest in a first mortgage loan (Note 4), the seller provided concurrent financing for \$103.5 million, or 65%, of the purchase price. The non-recourse, co-terminus financing bears interest at a fixed rate of 5.0%. Concurrently with the loan acquisition, the borrower funded, on behalf of the Company, an interest reserve account in an amount sufficient to service the interest for the term of the secured financing. The interest reserve account is controlled by the secured financing lender and is included in other assets in the accompanying balance sheet. The financing has an initial maturity of July 2014 and can be extended to January 2017, subject to an extension fee. Upon exercise of the extension option, the borrower of the first mortgage loan will again be required to fund the interest reserve account on behalf of the Company to service the interest for the extended term of the secured financing. At September 30, 2012, the outstanding balance on the secured financing was \$96.7 million.

On December 23, 2010, the Company assigned a \$20.75 million first mortgage it originated to a third party in exchange for \$14 million in proceeds, and retained a \$6.75 million subordinated B-note participation. The Company accounted for the assignment as a financing transaction, as the Company retained effective control over the original first mortgage loan and, accordingly, it did not meet the criteria of a loan sale. The A-note holder receives interest at 4.85% per annum, which is recognized as interest expense in the Company's consolidated statements of

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operations. Principal payments due under the original mortgage loan are allocated to the A-note holder and B-note holder in proportion to their participation interests.

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Minimum scheduled principal payments due under the secured financing arrangements as of September 30, 2012 are as follows:

| <b>Year Ending December 31,</b> | <b>(In thousands)</b> |
|---------------------------------|-----------------------|
| Remaining 2012                  | \$ 2,047              |
| 2013                            | 8,195                 |
| 2014                            | 86,877                |
| 2015                            | 229                   |
| 2016                            | 13,032                |
| <b>Total</b>                    | <b>\$ 110,380</b>     |

**8. Derivative Instruments**

The Company has investments in five unconsolidated joint ventures denominated in Euro that expose the Company to foreign currency risk. At September 30, 2012, the Company's net investments in such joint ventures totaled approximately \$34.5 million, or \$44.4 million. The Company generally uses collars (consisting of caps and floors) without upfront premium costs to hedge the foreign currency exposure of its net investments and does not anticipate entering into derivative transactions for speculative or trading purposes. At September 30, 2012, the total notional amount of the collars was approximately \$27.3 million with termination dates ranging from December 2012 to July 2015.

The fair values of derivative instruments included in the Company's consolidated balance sheets are as follows:

| <b>(In thousands)</b>  | <b>September 30,<br/>2012</b> | <b>December 31,<br/>2011</b> |
|--|-------------------------------|------------------------------|
| <b>Assets</b>  |                               |                              |
| Foreign exchange contracts designated as hedging instruments included in other assets                  | \$ 1,745                      | \$ 2,887                     |
| <b>Liabilities</b>   |                               |                              |
| Foreign exchange contracts designated as hedging instruments included in accrued and other liabilities | \$ 303                        | \$ 1,116                     |
| Embedded derivative liability (Note 5) included in accrued and other liabilities                       | 4,357                         | 4,204                        |
|  | <b>\$ 4,660</b>               | <b>\$ 5,320</b>              |

A net settlement loss on foreign currency collars of \$28,000 for the three months ended September 30, 2011 and \$29,000 and \$201,000 for the nine months ended September 30, 2012 and 2011, respectively, was reclassified from accumulated other comprehensive loss and is offset against other net gain (loss) in the consolidated statements of operations.

Certain counterparties to the derivative instruments require the Company to deposit cash or other eligible collateral for derivative financial liabilities exceeding \$100,000. As of September 30, 2012, the Company had no amounts on deposit related to these agreements.

**9. Fair Value Measurements*****Financial Instruments Reported at Fair Value***

The Company has certain assets and liabilities that are required to be recorded at fair value on a recurring basis. The following table summarizes the fair values of those assets and liabilities, aggregated by the level in the fair value hierarchy:

September 30, 2012

December 31, 2011

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| (In thousands)                          | Fair Value Measurements Using   |   |  |           | Fair Value Measurements Using   |   |  |           |
|---|---|---|--|-----------|---|---|--|-----------|
|   | Quoted Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Instruments<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total     | Quoted Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Instruments<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total     |
| <b>Assets</b>                           |   |   |  |           |   |   |  |           |
| Beneficial interests in debt securities | \$  | \$ 32,318   | \$   | \$ 32,318 | \$  | \$ 32,427   | \$   | \$ 32,427 |
| Foreign exchange contracts              |   | 1,745   |  | 1,745     |   | 2,887   |  | 2,887     |
|   | \$  | \$ 34,063   | \$   | \$ 34,063 | \$  | \$ 35,314   | \$   | \$ 35,314 |

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|  | September 30, 2012  |   |  |          | December 31, 2011   |   |  |          |
|--|---|---|--|----------|---|---|--|----------|
|  | Fair Value Measurements Using   |   |  |          | Fair Value Measurements Using   |   |  |          |
|  | Quoted Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Instruments<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total    | Quoted Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Instruments<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total    |
| (In thousands)   |   |   |  |          |   |   |  |          |
| <b>Liabilities</b>   |   |   |  |          |   |   |  |          |
| Foreign exchange contracts   | \$  | \$ 303  | \$   | \$ 303   | \$  | \$ 1,116  | \$   | \$ 1,116 |
| Embedded derivative liability associated with<br>beneficial interests in debt securities |   | 4,357   |  | 4,357    |   | 4,204   |  | 4,204    |
|  | \$  | \$ 4,660  | \$   | \$ 4,660 | \$  | \$ 5,320  | \$   | \$ 5,320 |

The fair value of the beneficial interests in debt securities and the associated embedded derivative liability were determined by discounting the expected cash flows using observable current and forward rates of a widely used index that closely follows the SIFMA Municipal Swap Index. The fair values of foreign exchange contracts are determined by discounting the expected cash flow of each derivative instrument based on forecast foreign exchange rates. This analysis reflects the contractual terms of the derivatives, observable market-based inputs, and credit valuation adjustments to appropriately reflect the non-performance risk for both the Company and the respective counterparty. The Company has determined that the majority of inputs used to value its derivative financial instruments fall within Level 2 of the fair value hierarchy. Although credit valuation adjustments, such as the risk of default, rely on Level 3 inputs, the Company has determined that these inputs are not significant to the overall valuation of its derivatives. As a result, derivative valuations in their entirety are classified in Level 2 of the fair value hierarchy.

### Fair Value Disclosure of Financial Instruments Reported at Cost

The Company and its unconsolidated joint ventures estimate the fair value of financial instruments carried at historical cost on a quarterly basis. These instruments are recorded at fair value only if they are impaired. No impairment charges were recognized by the Company during the nine months ended September 30, 2012 and 2011. In cases where quoted market prices are not available, fair values are estimated using inputs such as discounted cash flow projections, market comparables, dealer quotes and other quantitative and qualitative factors. Fair values of investments in unconsolidated joint ventures are primarily derived by applying the Company's ownership interest to the fair value of the underlying assets and liabilities of each joint venture. The Company's proportionate share of each joint venture's fair value approximates the Company's fair value of the investment as the timing of cash flows of the joint venture does not deviate materially from the timing of cash flows the Company receives from the joint venture. Considerable judgment is necessary to interpret market data and develop estimated fair value. The use of different assumptions or methodologies could have a material effect on the estimated fair value amounts.

The carrying values of interest receivable and accrued and other liabilities approximate their fair values due to their short term nature. At September 30, 2012 and December 31, 2011, the carrying value of the line of credit approximates its fair value as its contractual rate approximates the market rate of interest for similar instruments that would be available to the Company. The fair value of secured debt at September 30, 2012 and December 31, 2011 was estimated by discounting expected future cash outlays at current interest rates available for similar instruments.

The following tables present the estimated fair values and carrying values of the Company's financial instruments carried at cost, aggregated by the level in the fair value hierarchy:

|                | September 30, 2012  |   |  | Total Fair<br>Value | Carrying<br>Value |
|----------------|---|---|--|---------------------|-------------------|
|                | Quoted Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Instruments | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |                     |                   |
| (In thousands) |   |   |  |                     |                   |

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(Level  
1)

## Assets

|  |    |           |            |            |            |
|--|----|-----------|------------|------------|------------|
| Investments in unconsolidated joint ventures | \$ | \$ 20,917 | \$ 752,011 | \$ 772,928 | \$ 725,407 |
| Loans held for investment                    |    |           | 318,373    | 318,373    | 315,725    |

## Liabilities

|                   |    |    |         |         |         |
|-------------------|----|----|---------|---------|---------|
| Line of credit    | \$ | \$ | \$      | \$      | \$      |
| Secured financing |    |    | 110,330 | 110,330 | 110,380 |

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| December 31, 2011                            |  |   |   |                  |                |
|--|--|---|---|------------------|----------------|
| Fair Value Measurements Using                |  |   |   |                  |                |
|  | Quoted Prices in                                   |   |   | Total Fair Value | Carrying Value |
|  | Active Markets for Identical Instruments (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |                  |                |
| (In thousands)                               |  |   |   |                  |                |
| Assets                                       |  |   |   |                  |                |
| Investments in unconsolidated joint ventures | \$   | \$ 34,017                                     | \$ 448,822                                | \$ 482,839       | \$ 443,500     |
| Loans held for investment                    |  |   | 235,050                                   | 235,050          | 232,619        |
| Liabilities                                  |  |   |   |                  |                |
| Line of credit                               | \$   | \$ 69,000                                     | \$  | \$ 69,000        | \$ 69,000      |
| Secured financing                            |  |   | 13,900                                    | 13,900           | 13,845         |
| 10. Stockholders Equity                      |  |   |   |                  |                |

The Company's authorized capital stock consists of 50,000,000 shares of preferred stock, \$0.01 par value per share, and 450,000,000 shares of common stock, \$0.01 par value per share.

***Preferred Stock***

In March 2012, the Company completed an underwritten public offering of 5,800,000 shares of its 8.5% Series A Cumulative Redeemable Perpetual Preferred Stock, par value \$0.01 per share (Series A Preferred Stock). The net offering proceeds, after deducting underwriting discounts and commissions and offering costs payable by the Company, were approximately \$140 million.

In July 2012, the Company completed an underwritten public offering of 4,280,000 shares of Series A Preferred Stock at a premium to par that translated to a strip yield of 8.3%. The net offering proceeds, after deducting underwriting discounts and commissions and offering costs payable by the Company, were approximately \$106 million.

The Company used a portion of the net proceeds from both offerings to repay amounts outstanding under the Credit Agreement at the time of each offering and the remaining proceeds to fund acquisitions of target assets.

The Series A Preferred Stock must be paid a dividend at a rate of 8.5% per year on the \$25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series A Preferred Stock is redeemable at \$25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on March 20, 2017 (subject to the Company's right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve its qualification as a REIT or upon the occurrence of a change of control (as defined in the articles supplementary relating to the Series A Preferred Stock)). The Series A Preferred Stock is senior to the Company's common stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series A Preferred Stock generally does not have any voting rights, except if the Company fails to pay dividends on the Series A Preferred Stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series A Preferred Stock will be entitled to vote to elect two additional directors to the Company's board of directors, until all unpaid dividends have been paid or declared and set aside for payment. In addition, certain changes to the terms of the Series A Preferred Stock cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series A Preferred Stock voting separately as a class.

***Common Stock Offering***

In September 2012, the Company completed a sale of 8,050,000 shares of its common stock to an underwriter at a price of \$18.53 per share. The net offering proceeds, after deducting underwriting discounts and commissions and offering costs payable by the Company, were approximately \$149 million. The Company used a portion of the net proceeds to repay amounts outstanding under the Credit Agreement and the remaining proceeds to fund acquisitions of target assets and for working capital and general corporate purposes.

***Dividend Reinvestment and Direct Stock Purchase Plan***

The Company's Dividend Reinvestment and Direct Stock Purchase Plan (the DRIP Plan) provides existing common stockholders and other investors the opportunity to purchase shares (or additional shares, as applicable) of the Company's common stock by reinvesting some or all of

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the cash dividends received on their shares of the Company's common stock or making optional cash purchases within specified parameters. The DRIP Plan acquires shares either in the open market, directly from the Company as newly issued common stock, or in privately negotiated transactions with third parties. As of September 30, 2012, no shares had been acquired under the DRIP Plan from the Company in the form of new issuances.

**Table of Contents****Accumulated Other Comprehensive Income**

The components of accumulated other comprehensive income (loss) attributable to the stockholders are as follows:

| (In thousands)  | September 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
| Equity in accumulated other comprehensive loss of unconsolidated joint ventures                 | \$ (249)              | \$ (406)             |
| Unrealized gain on beneficial interests in debt securities                                      | 977                   | 611                  |
| Unrealized gain on fair value of derivative instruments designated as hedges, net of tax effect | 1,444                 | 1,793                |
| Unrealized loss on foreign currency translation, net of tax effect                              | (4,433)               | (4,328)              |
|   | \$ (2,261)            | \$ (2,330)           |

**11. Earnings per Share**

The Company calculates basic earnings per share using the two-class method, which allocates earnings per share for each share of common stock and nonvested shares containing nonforfeitable rights to dividends and dividend equivalents treated as participating securities. Diluted earnings per share is calculated using the more dilutive of the two-class method or the treasury stock method, which assumes that the proceeds from the exercise of participating securities are used to purchase common shares at the average market price for the period. The following table reconciles the numerator and denominator of the basic and diluted per-share computations for net income available to common stockholders:

| (In thousands, except share and per share data)                             | Three Months Ended September 30,<br>2012 |            | 2011 |            | Nine Months Ended September 30,<br>2012 |            | 2011 |            |
|---|--|------------|------|------------|---|------------|------|------------|
| <b>Numerator:</b>   |  |            |      |            |   |            |      |            |
| Net income  | \$                                       | 17,728     | \$   | 16,279     | \$                                      | 47,060     | \$   | 31,993     |
| Net income attributable to noncontrolling interest                          |  | (2,170)    |      | (485)      |   | (3,933)    |      | (799)      |
| Net income attributable to Colony Financial, Inc.                           |  | 15,558     |      | 15,794     |   | 43,127     |      | 31,194     |
| Preferred dividends   |  | (5,102)    |      |            |   | (8,560)    |      |            |
| Net income attributable to common stockholders                              |  | 10,456     |      | 15,794     |   | 34,567     |      | 31,194     |
| Net income allocated to participating securities (nonvested shares)         |  | (126)      |      | (3)        |   | (380)      |      | (7)        |
| Numerator for basic and diluted net income allocated to common stockholders | \$                                       | 10,330     | \$   | 15,791     | \$                                      | 34,187     | \$   | 31,187     |
| <b>Denominator:</b>   |  |            |      |            |   |            |      |            |
| Basic weighted average number of common shares outstanding                  |  | 34,358,500 |      | 32,743,000 |   | 33,254,300 |      | 27,400,400 |
| Weighted average effect of dilutive shares <sup>(1)</sup>                   |  |            |      | 291,100    |   | 23,400     |      | 349,600    |
| Diluted weighted average number of common shares outstanding                |  | 34,358,500 |      | 33,034,100 |   | 33,277,700 |      | 27,750,000 |
| <b>Earnings per share:</b>  |  |            |      |            |   |            |      |            |
| Net income attributable to common stockholders per share basic              | \$                                       | 0.30       | \$   | 0.48       | \$                                      | 1.03       | \$   | 1.14       |
| Net income attributable to common stockholders per share diluted            | \$                                       | 0.30       | \$   | 0.48       | \$                                      | 1.03       | \$   | 1.12       |

(1)

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For all periods with dilutive shares presented, weighted average dilutive shares include the effect of shares of common stock issuable to the Manager for incentive fees due for the period (Note 12). For the three and nine months ended September 30, 2011, weighted average dilutive shares also include the effect of shares of common stock issuable for reimbursement of the Manager's partial payment of underwriting discounts and commissions incurred in connection with the Company's initial public offering ( IPO ).

### **12. Related Party Transactions**

#### ***Management Agreement***

The Manager provides the day-to-day management of the Company's operations pursuant to a management agreement. The Manager is responsible for (1) selecting, purchasing and selling the Company's portfolio investments, (2) the Company's financing

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activities and (3) providing investment advisory services. The management agreement requires the Manager to manage the Company's business affairs in conformity with the Company's investment guidelines and other policies that are approved and monitored by the Company's board of directors. The Manager's role is under the supervision and direction of the Company's board of directors. The initial term of the management agreement expired on September 29, 2012 (the third anniversary of the completion of the IPO) and was automatically renewed for a one-year term. The management agreement may be terminated upon at least 180 days' prior written notice to the Manager.

**Base Management Fee** The Manager earns a base management fee of 1.5% of stockholders' equity, per annum. For purposes of calculating the base management fee, stockholders' equity means: (a) the sum of (1) the net proceeds from all issuances of equity securities since inception (allocated on a pro rata basis for such issuances during the fiscal quarter of any such issuance), plus (2) retained earnings at the end of the most recently completed calendar quarter (as determined in accordance with GAAP, adjusted to exclude any non-cash equity compensation expense incurred in current or prior periods), less (b) any amount paid to repurchase the Company's common stock since inception. The definition of stockholders' equity also excludes (1) any unrealized gains or losses from mark-to-market valuation changes (other than permanent impairment) that have impacted stockholders' equity as reported in the financial statements prepared in accordance with GAAP, (2) the effect of any gains or losses from one-time events pursuant to changes in GAAP, (3) non-cash items which in the judgment of management should not be included in Core Earnings (as defined below) and (4) the portion of the net proceeds of the IPO and the concurrent private placement that have not yet been initially invested in the Company's target assets. For items (2) and (3), such exclusions shall only be applied after discussions between the Manager and the independent directors and after approval by a majority of the independent directors. As a result, stockholders' equity, for purposes of calculating the management fee, could be greater or less than the amount of stockholders' equity shown in the Company's financial statements.

**Incentive Fees** The Manager is entitled to an incentive fee with respect to each calendar quarter that the management agreement is in effect, in an amount not less than zero, equal to the difference between (1) the product of (x) 20% and (y) the difference between (i) Core Earnings (as defined below), on a rolling four-quarter basis and before the incentive fee for the current quarter, and (ii) the product of (A) the weighted average of the issue price per share of common stock in all of the Company's offerings multiplied by the weighted average number of shares of common stock outstanding (including any restricted shares of common stock and any other shares of common stock underlying awards granted under our equity incentive plans, if any) in such four-quarter period and (B) 8%, and (2) the sum of any incentive fee paid to the Manager with respect to the first three calendar quarters of such previous four quarters; provided, however, that no incentive fee is payable with respect to any calendar quarter unless Core Earnings is greater than zero for the most recently completed 12 calendar quarters, or the number of completed calendar quarters since the IPO, whichever is less.

Core Earnings is a non-GAAP measure and is defined as GAAP net income (loss) excluding non-cash equity compensation expense, the incentive fee, real estate depreciation and amortization and any unrealized gains, losses or other non-cash items recorded in the period, regardless of whether such items are included in other comprehensive income or loss, or in net income. The amount is adjusted to exclude one-time events pursuant to changes in GAAP and certain other non-cash charges after discussions between the Manager and the Company's independent directors and after approval by a majority of the Company's independent directors.

The incentive fee is payable to the Manager quarterly in arrears in shares of the Company's common stock, subject to certain ownership and New York Stock Exchange (NYSE) limitations. The number of shares to be issued to the Manager is equal to the dollar amount of the portion of the quarterly installment of the incentive fee payable in shares divided by the average of the closing prices of the Company's common stock on the NYSE for the five trading days prior to the date on which such quarterly installment is settled. The Company issued 65,703 shares of its common stock during the nine months ended September 30, 2012 to settle previously accrued incentive fees.

**Reimbursement of Expenditures** Pursuant to the management agreement, the Company is required to reimburse the Manager for expenditures incurred by the Manager on behalf of the Company, including legal, accounting, financial, due diligence and other services, in amounts which are no greater than those which would be payable to third parties negotiated on an arm's length basis. In addition, pursuant to a secondment agreement between the Company and Colony Capital, the Company is responsible for Colony Capital's expenses incurred in employing the Company's chief financial officer/chief operating officer. The Company also reimburses Colony Capital for its pro rata portion of overhead expenses incurred by Colony Capital and its affiliates, including the Manager, based upon the ratio of the Company's assets to all Colony Capital-managed assets.

### ***Cost Reimbursement for Asset Management Services***

Colony AMC Milestone West, LLC (AMC Milestone West) and Colony AMC Milestone North, LLC (AMC Milestone North), each a wholly-owned subsidiary of the Company, provide asset management services to two joint ventures with the FDIC (FDIC Ventures) for which certain of our unconsolidated joint ventures are managing members. The FDIC Ventures pay an annual 50-basis point asset management fee calculated on the aggregate UPB of each respective loan portfolio. In addition, one of the unconsolidated joint ventures reimburses AMC Milestone North for any expenses not covered by the 50-basis point fee. Asset management fees and expense reimbursements were \$0.4 million

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and \$0.6 million for the three months ended September 30, 2012 and

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2011, respectively, and \$1.5 million and \$1.5 million for the nine months ended September 30, 2012 and 2011, respectively. Effective January 1, 2011, through AMC Milestone West and AMC Milestone North, the Company began reimbursing an affiliate of the Manager for compensation, overhead and direct costs incurred by the affiliate pursuant to a cost allocation arrangement. The Company was allocated costs under this arrangement of \$0.2 million and \$0.5 million for the three months ended September 30, 2012 and 2011, respectively, and \$0.8 million and \$1.0 million for the nine months ended September 30, 2012 and 2011, respectively.

The following table summarizes the amounts incurred by the Company and payable to the Manager or its affiliates for the periods presented:

| (In thousands)                                   | Three Months  |               | Nine Months Ended |               |
|--|---------------|---------------|-------------------|---------------|
|  | Ended         |               | September 30,     |               |
|  | September 30, | September 30, | September 30,     | September 30, |
|  | 2012          | 2011          | 2012              | 2011          |
| Base management fees                             | \$ 3,234      | \$ 2,317      | \$ 8,398          | \$ 5,841      |
| Incentive fees                                   |               | 88            | 936               | 88            |
| Compensation pursuant to secondment agreement    | 299           | 349           | 897               | 1,053         |
| Allocated and direct investment-related expenses | 257           | 589           | 1,171             | 1,239         |
| Allocated and direct administrative expenses     | 273           | 98            | 849               | 268           |
|  | \$ 4,063      | \$ 3,441      | \$ 12,251         | \$ 8,489      |

The following table summarizes the amounts due to the Manager or its affiliates as of each balance sheet date:

| (In thousands)  | September 30, 2012 | December 31, 2011 |
|---|--------------------|-------------------|
| Base management fees  | \$ 3,234           | \$ 2,288          |
| Incentive fee   |                    | 261               |
| Secondment reimbursement  | 633                | 880               |
| Reimbursement of direct and allocated administrative and investment costs | 63                 | 359               |
|   | \$ 3,930           | \$ 3,788          |

**13. Share-Based Payments****Director Stock Plan**

The Company's 2009 Non-Executive Director Stock Plan (the "Director Stock Plan") provides for the grant of restricted stock, restricted stock units and other stock-based awards to its non-executive directors. The maximum number of shares of stock reserved under the Director Stock Plan is 100,000. The individual share awards generally vest one year from the date of grant.

**Equity Incentive Plan**

The Colony Financial, Inc. 2011 Equity Incentive Plan (the "Equity Incentive Plan") provides for the grant of options to purchase shares of common stock, share awards (including restricted stock and stock units), stock appreciation rights, performance awards and annual incentive awards, dividend equivalent rights, long-term incentive units, cash and other equity-based awards. Certain named executive officers of the Company, along with other eligible employees, directors and service providers, including the Manager and employees of the Manager, are eligible to receive awards under the Equity Incentive Plan. The Company has reserved a total of 1,600,000 shares of common stock for issuance pursuant to the Equity Incentive Plan, subject to certain adjustments set forth in the plan.

In January 2012, the Company awarded an aggregate 475,000 restricted shares of its common stock to the Company's executive officers and certain employees of the Manager and its affiliates under the Equity Incentive Plan. The awards vest over a three-year period as follows: 25% in March 2012 and 25% on each of the first three anniversaries of the grant date.



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A summary of the Company's nonvested shares under the Director Stock Plan and Equity Incentive Plan for the nine months ended September 30, 2012 is presented below:

|   | Restricted Stock<br>Grants to<br>Non-Executive<br>Directors | Restricted<br>Stock Grants<br>to<br>Employee | Restricted<br>Stock Grants<br>to Employees of<br>Manager | Total     |
|---|---|--|--|-----------|
| Nonvested shares at December 31, 2011   | 3,000   |  |  | 3,000     |
| Granted   | 8,274   | 34,344                                       | 440,656  | 483,274   |
| Vested  | (3,000)   | (8,586)                                      | (110,164)  | (121,750) |
| Forfeited   |   |  | (3,112)  | (3,112)   |
| Nonvested shares at September 30, 2012  | 8,274   | 25,758                                       | 327,380  | 361,412   |
| Weighted average grant date fair value per share for shares granted during the period | \$ 16.32  | \$ 16.16                                     | \$ 16.16   | \$ 16.16  |

The following table summarizes the components of share-based compensation included in the consolidated statements of operations:

| (In thousands)   | Three Months<br>Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |
|--|--|------|------------------------------------|------|
|  | 2012                                   | 2011 | 2012                               | 2011 |
| Share-based compensation included in management fees         | \$ 578                                 | \$   | \$ 2,942                           | \$   |
| Share-based compensation included in administrative expenses | 76                                     | 38   | 322                                | 97   |

The total fair value of shares vested, based on the quoted closing share price of the Company's common stock on the NYSE on the day of vesting, was \$55,800 and \$39,000 for the three months ended September 30, 2012 and 2011, respectively, and \$2.0 million and \$39,000 for the nine months ended September 30, 2012 and 2011, respectively. As of September 30, 2012, aggregate unrecognized compensation cost related to restricted stock granted under the Director Stock Plan and Equity Incentive Plan was approximately \$5.6 million. That cost is expected to be fully recognized over a weighted-average period of 27 months.

**14. Income Taxes**

The Company's TRSs are subject to corporate level federal, state, foreign and local income taxes. The following is a summary of the Company's income tax provision:

| (In thousands)                        | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |        |
|---------------------------------------|-------------------------------------|----------|------------------------------------|--------|
|                                       | 2012                                | 2011     | 2012                               | 2011   |
| Current                               |                                     |          |                                    |        |
| Federal                               | \$ 711                              | \$ (144) | \$ 1,840                           | \$ 354 |
| State                                 | 152                                 | 15       | 577                                | 55     |
| Total current tax provision (benefit) | 863                                 | (129)    | 2,417                              | 409    |
| Deferred                              |                                     |          |                                    |        |
| Federal                               | (265)                               | 384      | (928)                              | (156)  |
| State                                 | (2)                                 |          | (88)                               |        |

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|  |        |        |          |        |
|--|--------|--------|----------|--------|
| Total deferred tax provision (benefit) | (267)  | 384    | (1,016)  | (156)  |
| Total income tax provision             | \$ 596 | \$ 255 | \$ 1,401 | \$ 253 |

Deferred tax assets of \$1.6 million and \$0.6 million are included in other assets as of September 30, 2012 and December 31, 2011, respectively, and deferred tax liabilities of \$130,000 and \$69,000 are included in accrued and other liabilities as of September 30, 2012 and December 31, 2011, respectively. Deferred tax assets and liabilities arise from temporary differences in income recognition for GAAP and tax purposes and the tax effect of net foreign currency translation gains and losses on certain investments in unconsolidated joint ventures held in TRSS.

### 15. Commitments and Contingencies

Pursuant to the operating agreements of certain unconsolidated joint ventures, the joint venture partners may be required to fund additional amounts for ordinary operating costs, guaranties or commitments of the joint ventures. At September 30, 2012, the Company's share of those commitments was \$5.4 million.

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On May 7, 2012, two of the Company's unconsolidated joint ventures, ColFin Bulls Funding A, LLC and ColFin Bulls Funding B, LLC, entered into loan agreements with a financial institution to finance certain commercial real estate loans for an aggregate amount of \$35.0 million. The Company provided customary non-recourse carve-out guaranties associated with the loans, which mature in May 2015 or earlier, upon full resolution of the underlying collateral loans. The aggregate balance of the debt at September 30, 2012 was \$21.3 million, or approximately 15% of the carrying amount of the collateral loans in the portfolio. The Company believes that the likelihood of making any payments under the guarantee is remote, and has not accrued for a guarantee liability as of September 30, 2012.

In the ordinary course of business, the Company may be involved in litigation which may result in legal costs and liability that could have a material effect on the Company's financial position and results of operations.

**16. Segment Information**

The Company operates in two reportable segments: real estate debt investments and single-family residential (SFR) rentals. The real estate debt investments segment includes the Company's investments in originated and acquired commercial real estate debt, real estate acquired in settlement of loans, mortgage-backed securities, and other debt-related investments. The SFR rental segment represents the Company's investment in a newly formed investment platform created for the purpose of acquiring and renting single-family homes. Prior to 2012, the Company's operating activities were exclusively within the real estate debt investments segment.

The Company's chief financial officer reviews various key financial measures to assess the performance and financial condition of each segment. Segment profit or loss is evaluated based upon income before income taxes, which includes equity in income of unconsolidated joint ventures, interest income and other income, less investment-specific expenses, including interest and asset management costs, as well as other gains or losses. Non-investment-specific income and expenses, such as interest income on cash and cash equivalents, management fees, interest expense on the line of credit and administrative expenses, are not allocated to specific segments. There is no intersegment activity. The Company's segment disclosures present the measures used by the chief financial officer for purposes of assessing each segment's performance.

The operating results for each of the reportable operating segments and reconciling items are summarized as follows:

| (In thousands)   | Real Estate<br>Debt<br>Investments | Single-Family<br>Residential<br>Rentals | Amounts Not<br>Allocated to<br>Segments | Total            |
|--|------------------------------------|---|---|------------------|
| <b>Three Months Ended September 30, 2012</b>             |                                    |   |   |                  |
| <b>Income:</b>   |                                    |   |   |                  |
| Equity in income (loss) of unconsolidated joint ventures | \$ 16,873                          | \$ (1,035)                              | \$                                      | \$ 15,838        |
| Interest income  | 10,790                             |   | 26                                      | 10,816           |
| Other income from affiliates                             | 396                                |   |   | 396              |
| Total income   | 28,059                             | (1,035)                                 | 26                                      | 27,050           |
| <b>Expenses:</b>   |                                    |   |   |                  |
| Management fees  |                                    |   | 3,812                                   | 3,812            |
| Investment expenses                                      | 497                                |   | 19                                      | 516              |
| Interest expense   | 1,585                              |   | 965                                     | 2,550            |
| Administrative expenses                                  |                                    |   | 1,517                                   | 1,517            |
| Total expenses   | 2,082                              |   | 6,313                                   | 8,395            |
| Other loss, net  | (331)                              |   |   | (331)            |
| <b>Income (loss) before income taxes</b>                 | <b>25,646</b>                      | <b>(1,035)</b>                          | <b>(6,287)</b>                          | <b>18,324</b>    |
| Income tax provision                                     |                                    |   | 596                                     | 596              |
| <b>Net income (loss):</b>                                | <b>\$ 25,646</b>                   | <b>\$ (1,035)</b>                       | <b>\$ (6,883)</b>                       | <b>\$ 17,728</b> |



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| (In thousands)   | Real Estate<br>Debt<br>Investments | Single-Family<br>Residential<br>Rentals | Amounts Not<br>Allocated to<br>Segments | Total     |
|--|------------------------------------|---|---|-----------|
| <b>Nine Months Ended September 30, 2012</b>              |                                    |   |   |           |
| <b>Income:</b>   |                                    |   |   |           |
| Equity in income (loss) of unconsolidated joint ventures | \$ 48,432                          | \$ (1,159)                              | \$                                      | \$ 47,273 |
| Interest income  | 25,662                             |   | 31                                      | 25,693    |
| Other income from affiliates                             | 1,515                              |   |   | 1,515     |
| Total income   | 75,609                             | (1,159)                                 | 31                                      | 74,481    |
| <b>Expenses:</b>   |                                    |   |   |           |
| Management fees  |                                    |   | 12,276                                  | 12,276    |
| Investment expenses                                      | 1,972                              |   | 315                                     | 2,287     |
| Interest expense   | 2,885                              |   | 2,988                                   | 5,873     |
| Administrative expenses                                  |                                    |   | 4,749                                   | 4,749     |
| Total expenses   | 4,857                              |   | 20,328                                  | 25,185    |
| Other loss, net  | (835)                              |   |   | (835)     |
| <b>Income (loss) before income taxes</b>                 | 69,917                             | (1,159)                                 | (20,297)                                | 48,461    |
| Income tax provision                                     |                                    |   | 1,401                                   | 1,401     |
| <b>Net income (loss):</b>                                | \$ 69,917                          | \$ (1,159)                              | \$ (21,698)                             | \$ 47,060 |

The net investments in each of the reportable operating segments are summarized as follows:

| (In thousands)                         | September 30,<br>2012 |
|--|-----------------------|
| <b>Assets:</b>                         |                       |
| Real estate debt investments           | \$ 940,762            |
| Single-family residential rentals      | 147,468               |
| Other assets not allocated to segments | 100,044               |
| <b>Total consolidated assets</b>       | <b>\$ 1,188,274</b>   |

**17. Subsequent Events**

In November 2012, the Company committed to invest an additional \$75 million in CSFR, bringing the Company's aggregate investment total in CSFR to \$225 million.

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

*In this quarterly report on Form 10-Q (this Report) we refer to Colony Financial, Inc. as we, us, Company, or our, unless we specifically state otherwise or the context indicates otherwise. We refer to our manager, Colony Financial Manager, LLC, as our Manager, and the parent company of our Manager, Colony Capital, LLC, together with its consolidated subsidiaries (other than us), as Colony Capital.*

The following discussion should be read in conjunction with our unaudited consolidated financial statements and the accompanying notes thereto, which are included in Item 1 of this Report, as well as the information contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, which is accessible on the Securities and Exchange Commission's (the SEC) website at [www.sec.gov](http://www.sec.gov).

### IMPORTANT INFORMATION RELATED TO FORWARD-LOOKING STATEMENTS

Some of the statements contained in this Report constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), and we intend such statements to be covered by the safe harbor provisions contained in Section 21E of the Exchange Act. Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts. In some cases, you can identify forward-looking statements by the use of forward-looking terminology such as may, will, should, expects, intends, plans, anticipates, believes, estimates or potential or the negative of these words and phrases or similar words or phrases which are predictions of or indicate future events or trends and which do not relate solely to historical matters. You can also identify forward-looking statements by discussions of our strategy, plans or intentions.

While forward-looking statements reflect our good faith beliefs, assumptions and expectations, they are not guarantees of future performance. Furthermore, we disclaim any obligation to publicly update or revise any forward-looking statement to reflect changes in underlying assumptions or factors, of new information, data or methods, future events or other changes. We caution investors not to place undue reliance on these forward-looking statements and urge you to carefully review the disclosures we make concerning risks in sections entitled Risk Factors, Forward-Looking Statements, and Management's Discussion and Analysis of Financial Condition and Results of Operations in our most recent Annual Report on Form 10-K and any subsequent Quarterly Reports on Form 10-Q.

### Overview

We are an externally managed real estate investment and finance company that was organized in June 2009 primarily to acquire, originate and manage a diversified portfolio of real estate-related debt and equity investments at attractive risk-adjusted returns. Our investment portfolio and target assets are primarily composed of interests in: (i) secondary loans acquired at a discount to par; (ii) new loan originations; and (iii) equity in single family homes to be held for investment and rented to tenants. Secondary debt purchases may include performing, sub-performing or non-performing loans (including loan-to-own strategies). See Business Our Target Assets in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 for additional information about our target assets.

We elected to be taxed as a real estate investment trust (REIT) for U.S. federal income tax purposes, commencing with our initial taxable year ended December 31, 2009. We also intend to continue to operate our business in a manner that will permit us to maintain our exemption from registration under the Investment Company Act of 1940 (the 1940 Act).

### Business Objective and Outlook

Our objective is to provide attractive risk-adjusted returns to our investors through a diversified portfolio of real estate-related debt and equity investments, including single family homes to be rented to tenants. The total return profile of our investments is composed of both current yield, which is distributed through regular-way dividends, and capital appreciation potential, which is distributed through regular-way and/or special dividends. Our investments typically fall within three general categories: 1) Loan Acquisitions the purchase of performing, sub-performing and/or non-performing commercial real estate debt, often at significant discounts to par; 2) Loan Originations the origination of structured senior and subordinate debt secured by mortgages and/or equity interests in commercial real estate with a bias towards current yield; and 3) Single Family Homes the acquisition of single family homes to be rented to tenants. We also may pursue other real estate-related special situation investments including CMBS, sale/leasebacks, triple net lease investments and minority equity interests in banks. Our investments are diversified across a wide spectrum of commercial real estate property types office, industrial, retail, multifamily, hospitality and single-family residential and geographically, with investments across the United States and Europe.

Significant dislocation has occurred in global real estate credit markets since the financial downturn, and while the market has begun the process of recovery, we continue to find opportunities to acquire financial and real estate assets that we believe are mispriced relative to intrinsic value of the underlying collateral. We believe the recovery will occur in two general phases: phase one



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will involve many loan acquisition opportunities as financial institutions around the globe deleverage and divest of troubled assets, and phase two will involve an increasing number of loan originations and property acquisitions as commercial real estate fundamentals continue to stabilize and commercial real estate assets are refinanced or acquired with new capital based on revised underwriting, valuation and operating metrics. We believe phases one and two are actively underway in the United States, whereas Europe is lagging and is currently producing mostly loan acquisition opportunities. We believe that we are well positioned to capitalize on such opportunities sourcing transactions through the numerous relationships enjoyed by our Manager through its two decade history in the real estate investment business. We also believe that our Manager's in-depth understanding of commercial real estate and real estate-related investments (including our target assets), and in-house underwriting and asset management capabilities, enable us to acquire assets with attractive risk-adjusted return profiles and the potential for meaningful capital appreciation.

## **Recent Developments**

### ***Investment Activities***

During the quarter ended September 30, 2012, we invested approximately \$81 million in two new assets and increased our equity in the Colony Capital-sponsored single-family residential ( SFR ) rental platform by another \$75 million. See Our Investments for our recent investment activities and updates relating to our existing investments. Many of our investments have been structured as joint ventures with one or more of the private investment funds managed by Colony Capital or its affiliates (collectively, Co-Investment Funds ). For more information about our investment allocation agreement and conflicts of interest that may arise in connection with these co-investments, see Business Co-Investment Funds and Risk Factors Risks Related to Our Management and Our Relationship with Our Manager in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

### ***Common Stock Offering***

In September 2012, we completed a sale (the September 2012 Common Stock Offering ) of 8,050,000 shares of our common stock to an underwriter at a price of \$18.53 per share. The net offering proceeds, after deducting underwriting discounts and commissions and offering costs payable by us, were approximately \$149 million.

### ***Preferred Stock Offering***

In March 2012, we completed an underwritten public offering (the March 2012 Preferred Stock Offering ) of 5,800,000 shares of our 8.50% Series A Cumulative Redeemable Perpetual Preferred Stock, par value \$0.01 per share ( Series A Preferred Stock ), including a partial exercise of the overallotment option by the underwriters. The net offering proceeds, after deducting underwriting discounts and commissions and offering costs payable by us, were approximately \$140 million.

In July 2012, we completed an underwritten public offering (the July 2012 Preferred Stock Offering ) of 4,280,000 shares of our Series A Preferred Stock, including a partial exercise of the overallotment option by the underwriters at a premium to par that translated to a strip yield of 8.3%. The net offering proceeds, after deducting underwriting discounts and commissions and offering costs payable by us, were approximately \$106 million.

**Table of Contents****Our Investments**

The following table is a summary of investments we owned as of September 30, 2012:

(\$ in millions)

| <b>Our Investments</b>                   | <b>Date of Initial Investment</b> | <b>Original Invested and Committed Equity<sup>(1)</sup></b> | <b>Current Equity Investment<sup>(2)</sup></b> | <b>Company's Proportionate Share of Current UPB<sup>(3)</sup></b> | <b>Company's Proportionate Share of Real Estate<sup>(3)</sup></b> | <b>Description</b>  |
|--|-----------------------------------|---|--|---|---|---|
| Colony American Homes                    | Mar-12                            | \$ 150.0  | \$ 147.5                                       | NA  | \$ 120.2  | Investment entity created for the purpose of acquiring and renting single family homes  |
| Centro Mezzanine Loans                   | Jun-11                            | 60.0  | 60.0   | 60.0  |   | Participation in mezzanine loans secured by equity interests in 107 retail centers located in 27 states.  |
| One Court Square Preferred Equity        | Jul-12                            | 44.6  | 45.5   | NA  |   | Preferred equity investment in the acquisition entity that acquired a Class A office tower located in Long Island City, New York                  |
| WLH Secured Loan                         | Oct-09                            | 48.0  | 45.2   | 50.5  |   | Senior secured term loan secured by first mortgages on residential land and security interests in cash and other assets                           |
| Bulls Loan Portfolio                     | Jun-11                            | 65.1  | 41.3   | 88.0  | 0.8   | 494 performing and non-performing loans consisting of substantially all first mortgage recourse commercial real estate loans and 4 REO properties |
| DB FDIC Portfolio                        | Jan-10                            | 34.7  | 38.8   | 70.3  | 10.3  | 667 performing and non-performing loans secured mostly by commercial real estate and 124 REO properties   |
| Extended Stay Loan                       | Oct-10                            | 37.4  | 37.4   | 37.5  |   | Performing mezzanine loan to Extended Stay Hotels, which includes a 664 hotel portfolio   |
| CRE FDIC Portfolio                       | Aug-11                            | 33.4  | 37.1   | 79.7  | 2.5   | 588 performing and non-performing loans secured mostly by commercial real estate and 15 REO properties  |
| Project London Loan Portfolio            | Sep-12                            | 36.6  | 36.5   | 49.7  |   | Acquisition of 7 performing and non-performing loans secured by commercial real estate  |
| U.S. Life Insurance Loan Portfolio       | Dec-09                            | 49.7  | 35.9   | 46.1  |   | 18 fixed-rate first mortgages secured by commercial real estate   |
| Luxury Destination Club Recourse Loan II | May-12                            | 34.3  | 34.9   | 104.7   |   | First mortgage loan collateralized by 261 high-end units at 26 resorts in the US and various international destinations                           |

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|   |        |      |      |       |      |  |
|---|--------|------|------|-------|------|--|
| Hotel Portfolio (4)                     | Apr-10 | 23.9 | 30.8 | NA    | 78.0 | Equity interests in and senior mezzanine loan receivable from entities owning a portfolio of 103 limited service hotels                              |
| Multifamily Tax-Exempt Bonds            | Jun-11 | 27.9 | 28.5 | 27.9  |      | Senior interest in tax-exempt bonds secured by a multifamily residential property located in Atlanta, GA   |
| German Loan Portfolio IV                | Jul-11 | 30.0 | 28.5 | 132.4 | 4.2  | 3 non-performing commercial real estate loans and 1 REO property   |
| Luxury Destination Club Recourse Loan I | Sep-11 | 45.8 | 26.9 | 27.2  |      | Performing first mortgage secured by 41 properties located primarily in Manhattan and Maui   |
| Ashford                                 | Feb-12 | 24.5 | 24.5 | 25.4  |      | Two most junior mortgage participation interests in a newly restructured first mortgage secured by five full-service hotels                          |
| MF5 CMBS                                | Feb-12 | 25.0 | 22.4 | 29.1  | 0.3  | Most senior bond and interest-only certificate in a CMBS trust that owns 233 performing and non-performing first mortgage loans and 4 REO properties |

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| (\$ in millions)                            | Date of Initial Investment | Original Invested and Committed Equity <sup>(1)</sup> | Current Equity Investment <sup>(2)</sup> | Company's Proportionate Share of Current UPB <sup>(3)</sup> | Company's Proportionate Share of Real Estate <sup>(3)</sup> | Description  |
|---|----------------------------|---|--|---|---|--|
| <b>Our Investments</b>                      |                            |   |  |   |   |  |
| Class A Manhattan Office Loan Participation | Mar-10                     | 15.0  | 17.1                                     | 22.0  |   | First mortgage pari-passu participation interest secured by Class A midtown Manhattan office building  |
| California Master Planned Communities       | May-12                     | 15.9  | 15.6                                     | NA  |   | Equity interests acquired through deed-in-lieu in two partially developed master planned communities located in California                           |
| Southern California Land Loan               | May-11                     | 13.4  | 14.8                                     | 14.6  |   | First mortgage loan secured by a Southern California master planned development and equity participation rights                                      |
| BOW Loan Portfolio                          | Dec-11                     | 14.5  | 13.2                                     | 26.1  | 2.2   | 50 performing and non-performing loans secured mostly by commercial real estate and 2 REO properties   |
| First Republic Bank                         | Jun-10                     | 24.0  | 12.7                                     | NA  |   | Equity ownership in financial institution with approximately \$31 billion of assets  |
| Barclays FDIC Portfolio                     | Jul-10                     | 10.3  | 12.5                                     | 22.1  | 1.0   | 1,113 performing and non-performing loans consisting of substantially all first mortgage recourse commercial real estate loans and 40 REO properties |
| West Village Loan                           | Mar-10                     | 9.9   | 12.4                                     | 11.9  |   | Recourse loan secured by first liens on two West Village Manhattan townhomes and a photography catalogue   |
| Spanish REOC/Colonial Loan                  | Nov-09                     | 12.5  | 11.6                                     | 11.5  |   | Syndicated senior secured loan to a Spanish commercial real estate company   |
| New England Hotel Portfolio Mezzanine Loan  | May-12                     | 13.7  | 10.9                                     | 10.8  |   | Origination of mezzanine loan cross-collateralized by a portfolio of limited-service hotels  |
| Manhattan Landmark Buildings Loan           | Mar-11                     | 29.1  | 10.6                                     | 10.7  |   | Performing first mortgage B-note secured by two landmark properties in Manhattan   |
| Cushman ADC FDIC Portfolio                  | Jan-11                     | 9.1   | 9.7                                      | 42.3  | 0.2   | 1,072 performing and non-performing loans secured mostly by commercial real estate and 3 REO properties  |
| BAMO Loan Portfolio                         | Jun-12                     | 9.3   | 9.5                                      | 18.4  |   | 24 credit-distressed loans consisting of substantially all first mortgage recourse commercial real estate loans                                      |
| Florida Multifamily Property Loan           | May-12                     | 8.4   | 8.6                                      | 9.7   |   | Acquisition of a performing senior mortgage secured by a multifamily complex in Florida  |

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|                                |         |            |          |            |          |  |
|--------------------------------|---------|------------|----------|------------|----------|--|
| CRE FDIC Portfolio II          | Dec-11  | 7.8        | 8.4      | 26.4       | 1.8      | 257 performing and non-performing loans secured mostly by commercial real estate and 13 REO properties |
| Luxury Destination Resort Loan | Nov-11  | 17.3       | 7.7      | 7.5        |          | Mezzanine loan secured by pledge on the equity borrower  |
| 2100 Grand B-Note              | Dec-10  | 6.6        | 6.6      | 6.5        |          | First mortgage B-note participation interest secured by an office building in El Segundo, CA           |
| CMBS-Related Bond              | May-10  | 4.3        | 5.8      | 10.2       |          | Senior bond secured by seasoned CMBS bonds, U.S. Treasuries and a B-note.                              |
| Other Investments              | various | 46.4       | 20.7     | 46.1       | 0.2      | 10 investments, each with less than \$5 million of current investment balance                          |
| Total                          |         | \$ 1,038.4 | \$ 930.1 | \$ 1,125.3 | \$ 221.7 |  |

- (1) Amounts include our share of transaction costs and working capital and are net of loan origination fees.
- (2) Amounts reflect our share of income less amounts distributed and realized since the inception of the investment and represent the carrying value of our investment at September 30, 2012, net of investment-specific financing and amounts attributable to noncontrolling interests.
- (3) Amounts reflect our share of the unpaid principal balance ( UPB ) of each loan or loan portfolio or our share of real estate assets based upon our economic interest in each investment, unadjusted for any investment-specific financing, net of amounts attributable to noncontrolling interests as of September 30, 2012.
- (4) In January 2012, we foreclosed on the collateral securing the delinquent mezzanine loans and now own indirect equity interests in the entities that own a portfolio of limited service hotels. See the description of the Hotel Portfolio Loans below.

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The following table summarizes the carrying and fair values of our investment portfolio by our target asset type as of September 30, 2012. Many of these investments are held through consolidated or unconsolidated joint ventures, and are shown net of investment-specific financing and amounts attributable to noncontrolling interests.

| (Amounts in thousands)                | Carrying Value |                         | Fair Value |                         |
|---------------------------------------|----------------|-------------------------|------------|-------------------------|
|                                       | Amount         | Percentage of Portfolio | Amount     | Percentage of Portfolio |
| Target Asset Type                     |                |                         |            |                         |
| Acquired whole mortgage loans         | \$ 370,482     | 40%                     | \$ 399,739 | 41%                     |
| Originated whole mortgage loans       | 98,311         | 11%                     | 104,012    | 11%                     |
| Mezzanine loans <sup>(1)</sup>        | 161,472        | 17%                     | 162,669    | 17%                     |
| Single-family rental homes            | 147,468        | 16%                     | 150,000    | 15%                     |
| Commercial mortgage-backed securities | 22,405         | 3%                      | 23,400     | 3%                      |
| B-notes                               | 20,901         | 2%                      | 22,056     | 1%                      |
| Equity ownership in bank              | 12,701         | 1%                      | 20,300     | 2%                      |
| Real estate owned                     | 30,793         | 3%                      | 31,400     | 3%                      |
| Other investments <sup>(2)</sup>      | 65,610         | 7%                      | 66,589     | 7%                      |
|                                       | \$ 930,143     | 100%                    | \$ 980,165 | 100%                    |

(1) Includes our investment in One Court Square Preferred Equity, which has the legal form of preferred equity but has the substantive economic characteristics of a mezzanine loan.

(2) Includes our investment in Multifamily Tax-Exempt Bonds, net of associated derivative liability.

For descriptions of our investments originated or acquired prior to December 31, 2011, see Management's Discussion and Analysis of Financial Condition and Results of Operations—Our Investments in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011. The following summaries provide certain information on investments we acquired or originated during the nine months ended September 30, 2012 (as of each of their respective acquisition or origination dates) and certain developments during the period on our existing investments.

**Colony American Homes.** In July 2012, we committed to invest up to \$150 million in the aggregate into SFR investments and on July 31, 2012, we committed to invest \$150 million in a newly formed investment vehicle, CSFR Operating Partnership, L.P. (CSFR), managed by an affiliate of our Manager. Such investment was to be made in the form of a transfer of our interest in ColFin American Investors, LLC (CAI) which held existing SFR investments. On July 31, 2012, CSFR had its initial capital raise in the amount of approximately \$500 million (inclusive of our commitment of \$150 million). Through September 30, 2012, we and the other partners had contributed, either in cash or through transfers of our interests in existing SFR investments, approximately \$400 million to the partnership. As of September 30, 2012, our blended interest in the combined SFR platform was 37.4%. As of October 5, 2012, the remaining capital had been contributed by the partners, and we have a 29.3% ownership interest in CSFR. In November 2012, we committed to invest an additional \$75 million (for a total investment of \$225 million) into CSFR.

We believe there will be many benefits to our investing in single-family homes through CSFR, including the following: our investment will enjoy much greater diversity in terms of the markets we have exposure to and the number of homes owned than if we continued with our current investment program; as part of a larger pool of homes, we should benefit from economies of scale both in terms of acquisition opportunities (participation in acquisitions of larger pools of homes where competition is often scarcer) as well as property management costs (either through obtaining better terms from vendors or from having the scale to self-manage); potentially better access to the private and public capital markets which will provide more options to grow the business as well as more options for potential exit strategies.

At September 30, 2012, the SFR rental portfolio consisted of 2,430 properties located in six different states across the United States with an aggregate purchase price of \$320 million. As of November 5, 2012, the number of properties has increased to 3,310 with an aggregate purchase price of \$422 million. The following table provides an overview of the portfolio by state at September 30, 2012 and November 5, 2012, excluding 970 properties acquired in November 2012 by an equity-method investee of CSFR:



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| (\$ in thousands) | September 30, 2012 |                  |                       | November 5, 2012 |                  |                       |
|-------------------|--------------------|------------------|-----------------------|------------------|------------------|-----------------------|
|                   | Number of Homes    | Total Cost Basis | Average Cost per Home | Number of Homes  | Total Cost Basis | Average Cost per Home |
| Arizona           | 835                | \$ 88,098        | \$ 106                | 842              | \$ 88,841        | \$ 106                |
| California        | 728                | 144,247          | 198                   | 865              | 170,232          | 197                   |
| Colorado          | 66                 | 7,837            | 119                   | 102              | 12,052           | 118                   |
| Georgia           | 267                | 19,316           | 72                    | 523              | 38,104           | 73                    |
| Nevada            | 93                 | 11,026           | 119                   | 122              | 14,319           | 117                   |
| Texas             | 441                | 49,716           | 113                   | 856              | 98,325           | 115                   |
| Total             | 2,430              | \$ 320,240       | \$ 132                | 3,310            | \$ 421,873       | \$ 127                |

**One Court Square Preferred Equity.** In July 2012, we invested \$45 million in a joint venture with a Co-Investment Fund and an unaffiliated investor that invested in and acquired a \$125 million preferred equity interest in an acquisition entity that acquired a Class A office tower located in Queens, New York. The property is 100% leased to a large financial institution through 2020. The preferred equity provides for a 15% return, of which 5.5% is paid-in-kind. At closing, the common member sponsor funded \$7.35 million into a reserve account to cover any current preferred return not covered by property income. The preferred equity is redeemable on September 1, 2015 with a 1% exit fee, and can be extended for one year at the common member's option.

**WLH Secured Loan.** In October 2009, we participated in the origination of a \$206 million senior secured term loan to William Lyon Homes, Inc. (WLH) through a joint venture (WLH Investor) with certain Co-Investment Funds. We have a 24% ownership interest in WLH Investor.

In connection with a comprehensive recapitalization plan, in December 2011, WLH announced that it filed a voluntary Chapter 11 case to seek confirmation of a pre-packaged plan of reorganization. WLH emerged from bankruptcy on February 25, 2012 with the key restructured terms including: (i) the WLH Loan amendment to increase the principal balance while reducing the interest rate; (ii) WLH's existing senior noteholders converting their existing notes into new second lien notes of WLH and common equity in William Lyon Homes (the sole shareholder of WLH); and (iii) WLH receiving new cash proceeds of \$85 million.

In order to support the borrower's operations and ensure adequate liquidity during the pendency of the Chapter 11 case, WLH Investor provided a new \$30 million non-revolving, senior secured, super priority debtor-in-possession credit facility (DIP Loan). WLH had borrowed \$5 million on the DIP loan, and fully repaid the principal, accrued interest and associated fees upon emergence from bankruptcy in February 2012.

Pursuant to the terms of the recapitalization plan, WLH Secured Loan has been amended (the Amended WLH Loan) into a new \$235 million senior secured term loan facility (upsized from \$206 million without requiring additional funding by the lenders) with a 10.25% interest rate (reduced from the previous 14.0% interest rate), and a term expiring on January 31, 2015. The Amended WLH Loan is prepayable by WLH at any time without penalty, yield maintenance or a make-whole payment, however, any early repayment of the upsized \$235.0 million outstanding loan amount would be accretive to the original yield-to-maturity on this investment. WLH Investor received a restructuring fee of 1% on the principal amount of the Amended WLH Loan. In April 2012, WLH Investor sold a \$25 million participation in the Amended WLH Loan to an unrelated third party at par (10.25% yield). In November 2012, WLH repaid the entire outstanding balance of the loan. We expect to recognize a gain of approximately \$5.0 million in the fourth quarter of 2012 as a result of the early payoff.

**Project London Loan Portfolio.** In September 2012, we invested \$37 million in a joint venture with Co-Investment Funds that acquired a portfolio of loans secured by commercial real estate. The portfolio included 7 performing and non-performing loans with an aggregate UPB of approximately \$99.5 million. The purchase price for the portfolio was approximately \$72 million, or 73% of the portfolio's UPB. Our share of this investment is 50%.

**U.S. Life Insurance Loan Portfolio.** During 2012, five loans in the U.S. Life Insurance Portfolio totaling approximately \$41 million of UPB were prepaid at par. These loans were originally acquired in December 2009 at an average allocated purchase price of 81% of the UPB. One nonperforming loan with a UPB of \$5.9 million and original acquisition price of \$2.6 million was sold under receivership for

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\$4.1 million. Our interest in this portfolio is 37.9%.

***Luxury Destination Club Recourse Loan I and Luxury Destination Club Recourse Loan II.*** In May 2012, we, in a joint venture with two unaffiliated investors, acquired, at a discount, a \$181 million participation interest in an approximate \$250 million recourse first mortgage loan, which shares the same corporate guarantor as a \$46 million loan we originated in September 2011. At acquisition, the newly acquired loan was collateralized by 269 luxury residential properties located at 26 resorts in the United States and various international destinations. The properties comprise the majority of the assets belonging to and operated by a leading luxury destination club operator. This senior mortgage bears interest at 8.57% plus a 50 basis points collateral management fee. The \$181 million participation interest was acquired for approximately \$159

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million, or 88% of par, and financed with an approximately \$103 million nonrecourse, co-terminus loan at a fixed rate of 5.0%. Our share of the net equity investment of \$56 million is \$34 million, or 60%, with the remaining 40% owned by the two unaffiliated investors. As part of the transaction, we also assigned \$18 million, or 40%, of the existing \$46 million loan originated in September 2011 to the same unaffiliated investors in the transaction to maintain consistent ownership across both interests. The estimated loan-to-value of the combined loan interests is approximately 56% and the Company's combined investment of \$62 million, which is an incremental \$16 million to its pre-existing investment, is expected to generate a blended current cash yield of approximately 20% following the transaction.

**Hotel Portfolio Loans.** As of December 31, 2011, we owned one-third interests in two nonperforming mezzanine loans with an aggregate principal amount of \$78 million, of which our share was \$26 million. The remaining two-thirds interests in the mezzanine loans were owned by a Co-Investment Fund. On January 9, 2012, we and the Co-Investment Fund (collectively, the "JIH Lenders") completed the foreclosure on the collateral from the most junior mezzanine loan and assigned our rights as winning bidder to ColFin JIH Propco, LLC ("JIH Propco"), an unconsolidated joint venture in which we own a one-third interest. As a result, JIH Propco now owns 100% of the indirect equity interests in the entities that own a portfolio of 103 limited service hotels, and we and the Co-Investment Fund continue to own the \$39 million first mezzanine loan to the entities. In October 2012, the debtors on the mortgage loan, which are wholly-owned subsidiaries of JIH Propco, filed a plan of reorganization with the U.S. Bankruptcy Court for the District of Delaware. The plan seeks approval of our business plan to restructure the existing debt, sell a minority equity interest to our new partners, change hotel management, and re-flag the hotels with various nationally recognized brands. To date, JIH Propco and its subsidiaries have incurred approximately \$5.7 million of various legal, consulting and administrative costs related to the foreclosure, bankruptcy and restructuring plans, of which our share was \$1.9 million. We expect to continue to incur similar costs throughout the bankruptcy proceedings. Bankruptcy proceedings are expected to conclude prior to December 31, 2012. We also continue to pursue litigation against the former owners to recover costs associated with the bankruptcy.

**Ashford Notes.** In February and March 2012, we invested a combined \$24.5 million in a joint venture with a Co-Investment Fund that acquired, at a slight discount to the aggregate UPB of \$51.8 million, the two most junior mortgage participation interests in a newly restructured first mortgage secured by five full-service hotels. The junior mortgage participation interests bear interest at a blended rate of 1-month LIBOR plus 9.15% with a yield-to-maturity of 13% with a flat LIBOR curve, and may be prepaid in full at any time without penalty.

**MF5 CMBS.** On February 16, 2012, we invested \$25 million in a joint venture with certain Co-Investment Funds that acquired the most senior bond and the interest-only certificate in a CMBS trust. The senior bond has a coupon of 5.1% and is secured by approximately 270 first mortgage loans (of which 89% were performing) collateralized primarily by multifamily properties. The aggregate purchase price for the senior bond and interest-only certificate was approximately \$226.1 million, representing a discount of 27.4% to par value of the senior bond.

**First Republic Bank.** In connection with First Republic Bank's secondary public offering on March 5, 2012, ColFin FRB Investor, LLC, a joint venture with certain Co-Investment Funds in which we own a 5.9% interest, sold 6,198,500 shares of common stock in First Republic Bank. Our share of net cash proceeds (after our pro rata share of underwriting discounts and expenses) and gain on sale was approximately \$10.5 million and \$3.5 million, respectively. ColFin FRB Investor, LLC sold an additional 3,000,000 shares of common stock of First Republic Bank on July 26, 2012. Our share of net cash proceeds and gain on sale was approximately \$5.5 million and \$1.9 million, respectively. This most recent secondary sale represented a cumulative sale of approximately 62% of our original share holdings and a return of approximately 118% of our original cost basis. After giving effect to the dispositions of shares to-date, we own an approximate 0.5% indirect interest in First Republic Bank through our interest in ColFin FRB Investor, LLC.

**California Master Planned Communities.** In May 2012, we invested in a joint venture with a Co-Investment Fund and an unaffiliated investor that acquired two non-performing loans secured by two master planned communities in California for approximately \$57 million, or 16% of the UPB. Immediately subsequent to acquisition, the joint venture entered into a deed-in-lieu with the borrower and now owns the properties. Our share of this investment is 24%.

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**Manhattan Landmark Buildings Loan.** In April 2012, we amended and restated two notes receivable, each with an original principal amount of \$19.55 million, into a \$26 million A-note and a \$14 million B-note. The A-note was sold to an unrelated third party for \$25.7 million, or 99% of par. The remaining B-note bears interest at approximately 20.9%, of which approximately 6% will be paid-in-kind.

**Midwest Multifamily/Retail Loan.** In May 2012, the Midwest Multifamily Retail Loan fully repaid approximately \$13 million at maturity including an exit fee. The loan was originated in May 2010 by us and an investment fund managed by an affiliate of our Manager as a \$9.8 million loan. Our share of the loan was 33.3%.

**BAMO Loan Portfolio.** In June 2012, we invested in a joint venture with a Co-Investment Fund that acquired a portfolio of loans from a U.S. commercial bank. The portfolio included 26 performing and non-performing loans with an aggregate UPB of approximately \$38.7 million, consisting of substantially all first mortgage loans geographically concentrated in the Midwest. The purchase price for the portfolio was approximately \$18 million, or 47% of the portfolio's UPB. Our share of this investment is 50%.

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***New England Hotel Portfolio Mezzanine Loan.*** In May 2012, we invested in a joint venture with a Co-Investment Fund that originated a \$17.5 million loan on a portfolio of select-service hotels in Massachusetts and New Hampshire. We and the Co-Investment Fund funded an additional \$4 million in August 2012 and will fund an additional \$6 million in the form of a mezzanine loan if the borrower adds certain hotels to the collateral package in the first 18 months of the loan term. The loan bears an interest rate of 13.5% with a 1.0% origination fee, and matures in July 2017. Our share of this investment is 50%.

***Florida Multifamily Property Loan.*** In May 2012, we invested in a joint venture with a Co-Investment Fund that acquired a performing \$20 million senior mortgage loan secured by a multifamily asset in Florida. The loan was acquired for \$17 million, or 85% of the UPB. The loan bears a 5.5% fixed interest rate and matures in March 2016. In October 2012, we obtained \$10.9 million of co-terminus, non-recourse financing bearing interest at LIBOR plus 3.75%. The floating rate debt is fixed at 4.28% with an interest rate swap. Our share of this investment is 49%.

***Luxury Destination Resort Loan.*** In May 2012, we sold our 50% share of a \$20 million senior first mortgage loan secured by all assets of a destination spa resort located in Arizona to an unrelated third party at par. We retained our 50% share of a \$15 million mezzanine loan, which bears interest at approximately 15%.

***WLH Land Acquisition and Sale.*** In June 2012, we, along with an investment fund managed by an affiliate of our Manager, sold residential development projects to WLH for an aggregate purchase price of \$21.5 million. WLH paid \$11 million in cash and issued 10,000,000 shares of Class A common stock of WLH to us and an investment fund managed by an affiliate of our Manager. These development projects were originally purchased from WLH for \$13.6 million in December 2009. Our share of this investment is 24%.

***Assisted Living Properties B-Note.*** In May 2012, we invested in a joint venture with a Co-Investment Fund that invested, at par, in a \$10 million B-note cut from a \$56 million term loan recently originated in October 2011. The loan is secured by nine assisted living properties and features full recourse to the sponsor, one of the largest operators of assisted living and memory care facilities in the United States. The B-note bears interest at LIBOR plus 12% with final maturity in October 2014. Our share of this investment is 50%.

Some of the loans in our investment portfolio are in the process of being restructured or may otherwise be under credit watch or at risk. We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. If we determine that it is probable that we will not be able to collect all amounts according to the terms of a particular loan agreement, we could be required to recognize an impairment charge or a loss on the loan. If our assumptions regarding, among other things, the present value of expected future cash flows or the value of the collateral securing our loans are incorrect or general economic and financial conditions cause a significant number of borrowers to become unable to make payments under their loans, we could be required to recognize significant impairment charges, which could result in a material reduction in earnings and distributions in the period in which the loans are determined to be impaired.

### **Critical Accounting Policies**

Our financial statements are prepared in accordance with GAAP, which requires the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. As a result of restricted stock grants to our executive officers and certain employees of our Manager and its affiliates in January 2012, we have adopted accounting policies on share-based payments as described in Note 2 to the consolidated financial statements in Item 1. Financial Statements of this Report.

The following critical accounting policies were adopted by the unconsolidated joint ventures that make up the SFR business:

#### ***Investment in Real Estate***

Property is recorded at the purchase price, allocated among land, building, improvements and equipment based upon their fair values at the date of acquisition. The Company evaluates each purchase transaction to determine whether the acquired assets meet the definition of a business. Transaction costs related to acquisitions of single-family homes that are not deemed to be businesses are included in the cost basis of the acquired assets, while other transaction costs are expensed as incurred.

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Depreciation on building and improvements is computed on the straight-line basis over the estimated useful lives of the assets, which is generally 20 to 40 years. Equipment is depreciated over the estimated useful lives of between 5 and 10 years.

Expenditures for ordinary repairs and maintenance are expensed as incurred, while expenditures for significant renovations that improve or extend the useful life of the asset are capitalized and depreciated over their estimated useful lives.

### ***Rental Income***

Residential leases generally have one-year terms. Rental income from residential leases is recognized monthly when due from tenants, which is not materially different from the straight-line method. Certain costs incurred to lease vacant homes, including leasing commissions and other fees, are capitalized and amortized over the term of the lease. Rents received in advance are deferred.

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For more of our critical accounting policies, see our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

**Results of Operations Comparison of Three Months Ended September 30, 2012 and 2011**

We operate in two reportable segments: real estate debt investments and SFR rentals. The real estate debt investments segment includes our investments in originated and acquired commercial real estate debt, real estate acquired in settlement of loans, mortgage-backed securities, and other debt-related investments. The SFR rental segment represents our investment in a newly formed investment platform created for the purpose of acquiring and renting single-family homes. Prior to 2012, our operating activities were exclusively within the real estate debt investments segment.

***Income from Our Investments***

Our primary source of income is our real estate debt investments, which we hold either directly or through our investments in unconsolidated joint ventures. We have been continually investing in our target assets throughout 2011 and 2012, and therefore, income from some investments may reflect less than a full quarter's results of operations. Income (loss) from our investments by type of investment is summarized below, shown net of investment-related expenses and amounts attributable to noncontrolling interests:

| (In thousands)                        | Three Months Ended September 30, |           |
|---------------------------------------|----------------------------------|-----------|
|                                       | 2012                             | 2011      |
| Real estate debt investments:         |                                  |           |
| Acquired whole mortgage loans:        |                                  |           |
| Single loans                          | \$ 3,757                         | \$ 1,576  |
| FDIC loan portfolios                  | 2,665                            | 2,018     |
| German non-performing loan portfolios | 895                              | 495       |
| Other loan portfolios                 | 3,597                            | 3,402     |
|                                       | 10,914                           | 7,491     |
| Originated mortgage loans             | 3,493                            | 3,626     |
| Mezzanine loans <sup>(1)</sup>        | 4,698                            | 2,833     |
| Commercial mortgage-backed securities | 756                              | 754       |
| B-notes                               | 922                              | 229       |
| Equity ownership in bank              | 2,285                            | 4,535     |
| Real estate owned                     | 43                               |           |
| Other investments                     | 365                              | 926       |
|                                       | 23,476                           | 20,394    |
| Single-family residential rentals     | (1,035)                          |           |
| Total                                 | \$ 22,441                        | \$ 20,394 |

- (1) Includes income from our investment in One Court Square Preferred Equity, which has the legal form of preferred equity but has the substantive economic characteristics of a mezzanine loan.

***Income from Real Estate Debt Investments***

Income from acquired whole mortgage loans for the three months ended September 30, 2012 increased \$3.4 million, or 46%, compared to the three months ended September 30, 2011. The increase primarily reflects income from the Luxury Destination Club Recourse Loan II acquired in May 2012, Ashford Notes acquired in first quarter of 2012, CRE FDIC Portfolio Loans acquired in August 2011 and December 2011, and German Loan Portfolio IV acquired in July 2011, and is partially offset by the sale of Manhattan Landmark Buildings Loan A-note.

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Income from originated loans for the three months ended September 30, 2012 decreased \$0.1 million, or 4%, compared to the three months ended September 30, 2011. The decrease primarily reflects the sale of G&E Secured Loan which was originated in April 2011, and is partially offset by income from the Luxury Destination Club Recourse Loan I originated in September 2011.

Income from mezzanine loans for the three months ended September 30, 2012 increased \$1.9 million, or 66%, compared to the three months ended September 30, 2011, primarily reflecting the preferred equity return from our investment in One Court Square Preferred Equity in July 2012, New England Hotel Portfolio Mezzanine Loan originated in May 2012 and Luxury Destination Resort Loan originated in November 2011.

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Income from CMBS for the three months ended September 30, 2012 is related to our investment in MF5 CMBS, which we acquired in February 2012. Income from CMBS for the corresponding period in 2011 was related to our investment in a \$40 million AAA-rated TALF-financed CMBS, which was sold in September 2011.

Income from equity ownership in bank for the three months ended September 30, 2012 decreased \$2.3 million, or 50%, compared to the three months ended September 30, 2011. The decrease reflects our reduced ownership interest in First Republic Bank following our periodic sales of shares of common stock in First Republic Bank and larger gain recognized from such sales during the three months ended September 30, 2011. Through September 2012, we have sold approximately 62% of First Republic Bank stock originally acquired in June 2010 and recovered approximately 118% of our original cost basis.

Income from real estate owned for the three months ended September 30, 2012 reflects income from the Hotel Portfolio which was classified under mezzanine loans in 2011 prior to the foreclosure in January 2012 as discussed in Our Investments. For the quarter, the investment incurred approximately \$2.9 million of legal, consulting and administrative costs related to bankruptcy and restructuring plans, of which our share was \$1.0 million.

Certain investments individually generated greater than 10% of our total income for the periods presented. For the three months ended September 30, 2012, Luxury Destination Club Recourse Loan I and II, which share the same corporate guarantor, generated 24% of total income. After deducting investment-specific interest and other expenses, and amounts attributable to noncontrolling interests, these investments represent 20% of our net income attributable to stockholders. For the three months ended September 30, 2011, ColFin FRB Investor, LLC generated 21% of our total income.

*Loss from Single-Family Residential Rentals*

Our investment in single-family residential rentals generated a loss of \$1.0 million in the three months ended September 30, 2012. The loss reflects a sub-scale portfolio that averaged approximately 1,800 owned homes and an unstabilized occupancy that averaged 53% during the period, as well as start-up and formation expenses.

*Other Income from Affiliates*

Two 100%-owned asset management companies provide asset management services to two of our FDIC portfolios and earn asset management fees of 50 basis points of each portfolio's UPB per annum, payable monthly. For the three months ended September 30, 2012 and 2011, the asset management companies earned asset management fees and received cost reimbursements of \$396,000 and \$636,000, respectively, from these portfolios, and incurred \$396,000 and \$714,000 of expenses, respectively, as described below.

*Expenses*

*Management Fees* Management fees include the following:

| (In thousands)           | Three Months Ended September 30, |          |
|--------------------------|----------------------------------|----------|
|                          | 2012                             | 2011     |
| Base management fees     | \$ 3,234                         | \$ 2,317 |
| Share-based compensation | 578                              |          |
| Incentive fees           |                                  | 88       |
|                          | \$ 3,812                         | \$ 2,405 |

Base management fees have increased by approximately \$917,000 due to an increase in our stockholders' equity fee base, as defined in the management agreement, primarily from the March 2012 Preferred Stock Offering, July 2012 Preferred Stock Offering and September 2012 Common Stock Offering. Share-based compensation of \$578,000 represents the current quarter amortization of the fair value of restricted shares awarded to certain of our executive officers and certain employees of our Manager and its affiliates in January 2012. Incentive fees are based upon our Core Earnings, further described at Non-GAAP Supplemental Financial Measure: Core Earnings, and are payable to our Manager in

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shares of our common stock. We did not meet the Core Earnings threshold for the quarter ended September 30, 2012 and, accordingly, no incentive fee was earned by the Manager for such period. For a complete description of base management fees and incentive fees, see

Business Our Manager and the Management Agreement Base Management Fee and Incentive Fee in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

*Investment Expenses* For the three months ended September 30, 2012 and 2011, we incurred investment expenses of \$516,000 and \$854,000, respectively, most of which relates to our real estate debt investments. Two of our FDIC portfolios are managed by asset management companies that are wholly-owned by us. These asset management companies receive allocations of compensation, overhead and direct costs from an affiliate of our Manager pursuant to a cost allocation arrangement. For the three months ended September 30, 2012 and 2011, the asset management companies incurred \$396,000 and \$714,000 of expenses, respectively, of which \$207,000 and \$491,000, respectively, were allocated by the affiliate of our Manager. The

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current period decrease is due to less asset management time and direct costs incurred by these two loan portfolios due to loan resolutions representing over half of the original acquired UPB. The remaining investment expenses include the cost of managing and servicing our investments and investment transaction costs expensed in connection with the initial acquisition of our investments, as well as costs associated with unsuccessful transactions.

*Interest Expense* Interest expense includes the following:

| (In thousands)   | Three Months Ended September 30, |        |
|--|----------------------------------|--------|
|  | 2012                             | 2011   |
| Real estate debt investments:                              |                                  |        |
| 2100 Grand secured financing                               | \$ 175                           | \$ 176 |
| Luxury Destination Club Recourse Loan II secured financing | 1,410                            |        |
|  | 1,585                            | 176    |
| Interest expense not allocated to segments:                |                                  |        |
| Credit facility  | 845                              | 480    |
| Other  | 120                              |        |
|  | 965                              | 480    |
| Total  | \$ 2,550                         | \$ 656 |

Interest expense for the current quarter related to our credit facility was higher due to (1) higher average outstanding borrowings to finance our investment activities during the period, and (2) higher unused commitment fees and amortization of deferred financing costs due to a \$100 million increase in total availability following the restructuring of our credit facility in September 2011. Interest expense on Luxury Destination Club Recourse Loan II represents contractual interest which was pre-funded by the borrower and amortization of deferred financing costs on the seller-provided financing of the May 2012 loan acquisition.

*Administrative Expenses* Administrative expenses are summarized below:

| (In thousands)  | Three Months Ended September 30, |          |
|---|----------------------------------|----------|
|   | 2012                             | 2011     |
| Reimbursements to Colony Capital:                       |                                  |          |
| Compensation pursuant to secondment agreement           | \$ 299                           | \$ 349   |
| Allocated overhead and direct administrative expenses   | 273                              | 98       |
| Total reimbursements to Colony Capital                  | 572                              | 447      |
| Professional fees                                       | 538                              | 610      |
| Insurance   | 164                              | 181      |
| Share-based compensation (excluding board compensation) | 38                               |          |
| Board-related costs                                     | 67                               | 77       |
| Other   | 138                              | 83       |
|   | \$ 1,517                         | \$ 1,398 |

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Total administrative expenses increased \$119,000, or 8%, for the three months ended September 30, 2012 compared to the three months ended September 30, 2011. The increase is primarily due to the reimbursement of compensation costs of certain employees of Colony Capital and an increase in the ratio of our total assets relative to total Colony Capital-managed assets.

### ***Income Tax Provision***

Our taxable REIT subsidiaries (each a TRS), which directly or indirectly hold certain of our investments, are subject to corporate level federal, state, foreign and local income taxes. For the three months ended September 30, 2012 and 2011, we recorded an income tax provision of \$596,000 and \$255,000, respectively. The 2012 expense primarily reflects current income taxes due on loan resolutions in the Cushman ADC FDIC Portfolio, Bulls Loan Portfolio, and from the operations of our TRSs. The current taxes are partially offset by a net deferred tax benefit resulting from temporary differences related to income recognition for our Bulls Loan Portfolio, Cushman ADC FDIC Portfolio and investments in certain of our foreign joint ventures. The 2011 expense reflects current federal and state income taxes which were offset by an incremental increase in deferred tax assets associated with the temporary differences related to income recognition from our investments in foreign joint ventures.

**Table of Contents****Comparison of Nine Months Ended September 30, 2012 and 2011*****Income from Our Investments***

Income (loss) from our investments by type of investment is summarized below, shown net of investment-related expenses and amounts attributable to noncontrolling interests:

| (In thousands)                        | Nine Months Ended<br>September<br>30, |           |
|---------------------------------------|---------------------------------------|-----------|
|                                       | 2012                                  | 2011      |
| Real estate debt investments:         |                                       |           |
| Acquired whole mortgage loans:        |                                       |           |
| Single loans                          | \$ 8,442                              | \$ 4,018  |
| FDIC loan portfolios                  | 7,298                                 | 5,550     |
| German non-performing loan portfolios | 2,426                                 | 1,163     |
| Other loan portfolios                 | 11,337                                | 7,026     |
|                                       | 29,503                                | 17,757    |
| Originated mortgage loans             | 11,082                                | 8,700     |
| Mezzanine loans <sup>(1)</sup>        | 10,641                                | 6,287     |
| Commercial mortgage-backed securities | 1,946                                 | 970       |
| B-notes                               | 1,825                                 | 671       |
| Equity ownership in bank              | 6,987                                 | 6,696     |
| Real estate owned                     | 481                                   |           |
| Other investments                     | 3,519                                 | 1,903     |
|                                       | 65,984                                | 42,984    |
| Single-family residential rentals     | (1,159)                               |           |
| Total                                 | \$ 64,825                             | \$ 42,984 |

- (1) Includes income from our investment in One Court Square Preferred Equity, which has the legal form of preferred equity but has the substantive economic characteristics of a mezzanine loan.

***Income from Real Estate Debt Investments***

Income from our debt investments for the nine months ended September 30, 2012 increased approximately \$23 million, or 54%, compared to the corresponding period in 2011. The substantial increase reflects our continuing investment activity throughout 2011 and 2012. Many of our investments owned as of September 30, 2012 were not owned for all or part of the nine months ended September 30, 2011, and we added new investments in every category, except in equity ownership in bank, as summarized in our investments table in Our Investments. Income from real estate owned reflects the operating results of our Hotel Portfolio, less of our share of legal, consulting and administrative costs related to foreclosure, bankruptcy and restructuring plans. To date, the portfolio has incurred approximately \$5.7 million in such costs, of which our share of \$1.9 million.

Certain investments individually generated greater than 10% of our total income for the periods presented. For the nine months ended September 30, 2012, Luxury Destination Club Recourse Loan I and II, which share the same corporate guarantor, generated 17% of total income. After deducting investment-specific interest and other expenses, and amounts attributable to noncontrolling interests, these investments represent 16% of our net income attributable to stockholders. For the nine months ended September 30, 2011, ColFin FRB Investor, LLC, ColFin WLH Funding, LLC and ColFin NW Funding, LLC collectively generated 38% of our total income.

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### *Loss from Single-Family Residential Rentals*

Our investment in single-family residential rentals generated a loss of \$1.2 million since the inception of the SFR platform. The loss reflects the ongoing ramp-up and stabilization efforts, as well as start-up and formation expenses.

### *Other Income from Affiliates*

Two 100%-owned asset management companies provide asset management services to two of our FDIC portfolios and earn asset management fees of 50 basis points of each portfolio's UPB per annum, payable monthly. For the nine months ended September 30, 2012 and 2011, the asset management companies earned asset management fees and received cost reimbursements of \$1.5 million and \$1.5 million, respectively, from these portfolios, and incurred \$1.4 million and \$1.6 million of expenses, respectively, as described below.

**Table of Contents****Expenses**

*Management Fees* Management fees include the following:

| (In thousands)           | Nine Months Ended September 30, |          |
|--------------------------|---------------------------------|----------|
|                          | 2012                            | 2011     |
| Base management fees     | \$ 8,398                        | \$ 5,841 |
| Share-based compensation | 2,942                           |          |
| Incentive fees           | 936                             | 88       |
|                          | \$ 12,276                       | \$ 5,929 |

Base management fees have increased by approximately \$2.6 million, or 44%, due to an increase in our stockholders' equity fee base, as defined in the management agreement, primarily from the March 2012 Preferred Stock Offering, July 2012 Preferred Stock Offering and September 2012 Common Stock Offering. Share-based compensation of \$2.9 million represents the current year amortization of the fair value of restricted shares awarded to certain of our executive officers and certain employees of our Manager and its affiliates in January 2012. Incentive fees are based upon our Core Earnings, further described at [Non-GAAP Supplemental Financial Measure: Core Earnings](#), and are payable to our Manager in shares of our common stock. For a complete description of base management fees and incentive fees, see [Business Our Manager and the Management Agreement Base Management Fee and Incentive Fee](#) in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

*Investment Expenses* For the nine months ended September 30, 2012 and 2011, we incurred investment expenses of \$2.3 million and \$1.9 million, respectively, most of which relates to our real estate debt investments. The current period increase reflects transaction costs incurred pursuant to the sale of the Manhattan Landmark Buildings Loan A-note and the acquisition and restructuring of the Luxury Destination Club Recourse Loans I and II as discussed in [Our Investments](#), as well as an increase in the cost of managing and servicing our investments due to a larger investment portfolio and increased transaction volume. Two of our FDIC portfolios are managed by asset management companies that are wholly-owned by us. These asset management companies receive allocations of compensation, overhead and direct costs from an affiliate of our Manager pursuant to a cost allocation arrangement. For the nine months ended September 30, 2012 and 2011, the asset management companies incurred \$1.4 million and \$1.6 million of expenses, respectively, of which \$0.8 million and \$1.0 million, respectively, were allocated by the affiliate of our Manager.

*Interest Expense* Interest expense includes the following:

| (In thousands)   | Nine Months Ended September 30, |          |
|--|---------------------------------|----------|
|  | 2012                            | 2011     |
| Real estate debt investments:                              |                                 |          |
| 2100 Grand secured financing                               | \$ 522                          | \$ 526   |
| Luxury Destination Club Recourse Loan II secured financing | 2,363                           |          |
|  | 2,885                           | 526      |
| Interest expense not allocated to segments:                |                                 |          |
| Credit facility  | 2,726                           | 1,126    |
| Other  | 262                             |          |
|  | 2,988                           | 1,126    |
| Total  | \$ 5,873                        | \$ 1,652 |

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Interest expense for the current period related to our credit facility was significantly higher due to (1) substantial outstanding borrowings to finance our investment activities, until we repaid all outstanding amounts using a portion of the net proceeds from the September 2012 Common Stock Offering, and (2) higher unused commitment fees and amortization of deferred financing costs due to a \$100 million increase in total availability following the restructuring of our credit facility in September 2011. Interest expense on Luxury Destination Club Recourse Loan II represents contractual interest which was pre-funded by the borrower and amortization of deferred financing costs on the seller-provided financing of the May 2012 loan acquisition.

*Administrative Expenses* Administrative expenses are summarized below:

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| (In thousands)  | Nine Months Ended September 30, |          |
|---|---------------------------------|----------|
|   | 2012                            | 2011     |
| Reimbursements to Colony Capital:                       |                                 |          |
| Compensation pursuant to secondment agreement           | \$ 897                          | \$ 1,053 |
| Allocated overhead and direct administrative expenses   | 849                             | 268      |
| Total reimbursements to Colony Capital                  | 1,746                           | 1,321    |
| Professional fees                                       | 1,649                           | 2,052    |
| Insurance   | 491                             | 544      |
| Share-based compensation (excluding board compensation) | 214                             |          |
| Board-related costs                                     | 231                             | 214      |
| Other   | 418                             | 315      |
|   | \$ 4,749                        | \$ 4,446 |

Total administrative expenses increased \$303,000, or 7%, for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011. The increase is primarily due to the reimbursement of compensation costs of certain employees of Colony Capital and an increase in the ratio of our total assets relative to total Colony Capital-managed assets. This is partially offset by a decrease in professional fees, primarily legal and tax consulting services.

**Income Tax Provision**

Our TRSs, which directly or indirectly hold certain of our investments in unconsolidated joint ventures, are subject to corporate level federal, state, foreign and local income taxes. For the nine months ended September 30, 2012 and 2011, we recorded an income tax provision of \$1,401,000 and \$253,000, respectively. The 2012 expense primarily reflects current income taxes due on loan resolutions in the Cushman ADC FDIC Portfolio, Bulls Loan Portfolio, and from the operations of our TRSs. The current taxes are partially offset by a net deferred tax benefit resulting from temporary differences related to income recognition for our Bulls Loan Portfolio, Cushman ADC FDIC Portfolio and investments in certain of our foreign joint ventures. The 2011 expense reflects \$409,000 of current federal and state income tax expense on our TRSs, offset by a deferred tax asset associated with the expected future benefits from our foreign joint ventures.

**Table of Contents****Information About Our Loan Portfolio**

The following tables summarize certain characteristics of the loans and beneficial interests in securities held by the Company and the joint ventures and our proportionate share as of September 30, 2012:

| (\$ in thousands)  | Total Portfolio          |                | September 30, 2012            |                |                     |                         | Current Interest Yield on Cost | Weighted Average Maturity in Years |
|--|--------------------------|----------------|-------------------------------|----------------|---------------------|-------------------------|--------------------------------|------------------------------------|
|  |                          |                | Company's Proportionate Share |                |                     |                         |                                |                                    |
| Collateral Type  | Unpaid Principal Balance | Amortized Cost | Unpaid Principal Balance      | Amortized Cost | % of Amortized Cost | Weighted Average Coupon |                                |                                    |
| Originated performing loans                                |                          |                |                               |                |                     |                         |                                |                                    |
| Retail   | \$ 60,000                | \$ 60,000      | \$ 60,000                     | \$ 60,000      | 8.5%                | 9.8%                    | 9.8%                           | 4.3                                |
| Office   | 20,328                   | 20,290         | 20,125                        | 20,087         | 2.8%                | 8.0%                    | 8.0%                           | 3.7                                |
| Hospitality  | 99,784                   | 99,030         | 75,440                        | 74,944         | 10.6%               | 11.8%                   | 11.9%                          | 4.1                                |
| Other commercial   | 7,195                    | 7,195          | 3,597                         | 3,597          | 0.5%                | 12.2%                   | 12.2%                          | 2.5                                |
| Residential  | 239,132                  | 213,389        | 65,029                        | 58,330         | 8.2%                | 10.6%                   | 12.2%                          | 3.1                                |
| Total originated performing loans                          | 426,439                  | 399,904        | 224,191                       | 216,958        | 30.6%               | 10.6%                   | 11.0%                          | 3.8                                |
| Acquired loans and beneficial interests in debt securities |                          |                |                               |                |                     |                         |                                |                                    |
| Performing:  |                          |                |                               |                |                     |                         |                                |                                    |
| Retail   | 387,016                  | 271,294        | 80,591                        | 60,452         | 8.5%                | 5.7%                    | 7.6%                           | 4.8                                |
| Office   | 273,767                  | 190,147        | 49,509                        | 34,648         | 4.9%                | 4.9%                    | 7.4%                           | 6.9                                |
| Industrial   | 224,981                  | 164,737        | 40,539                        | 29,051         | 4.1%                | 6.4%                    | 9.2%                           | 9.2                                |
| Hospitality  | 285,652                  | 236,800        | 141,377                       | 120,403        | 17.0%               | 9.1%                    | 10.7%                          | 2.7                                |
| Multifamily  | 471,094                  | 359,642        | 91,162                        | 76,927         | 10.9%               | 4.9%                    | 6.0%                           | 10.1                               |
| Other commercial   | 361,180                  | 237,825        | 40,468                        | 27,229         | 3.8%                | 10.1%                   | 14.4%                          | 3.4                                |
| Residential  | 57,379                   | 26,491         | 9,461                         | 4,985          | 0.7%                | 5.5%                    | 10.4%                          | 7.7                                |
| Land   | 154,010                  | 61,743         | 11,429                        | 4,041          | 0.6%                | 5.8%                    | 17.1%                          | 2.8                                |
| Total performing   | 2,215,079                | 1,548,679      | 464,536                       | 357,736        | 50.5%               | 6.9%                    | 9.1%                           | 5.7                                |
| Non-performing:  |                          |                |                               |                |                     |                         |                                |                                    |
| Retail   | 332,688                  | 153,459        | 45,877                        | 20,892         | 2.9%                |                         |                                |                                    |
| Office   | 531,586                  | 122,066        | 146,957                       | 28,548         | 4.0%                |                         |                                |                                    |
| Industrial   | 164,587                  | 66,431         | 23,837                        | 9,840          | 1.4%                |                         |                                |                                    |
| Hospitality  | 65,059                   | 30,933         | 7,788                         | 3,577          | 0.5%                |                         |                                |                                    |
| Multifamily  | 215,227                  | 95,770         | 39,612                        | 14,813         | 2.1%                |                         |                                |                                    |
| Other commercial   | 406,622                  | 143,159        | 52,096                        | 17,823         | 2.5%                |                         |                                |                                    |
| Residential  | 219,411                  | 96,109         | 40,413                        | 23,852         | 3.4%                |                         |                                |                                    |
| Land   | 863,062                  | 167,986        | 71,977                        | 14,733         | 2.1%                |                         |                                |                                    |
| Total non-performing                                       | 2,798,242                | 875,913        | 428,557                       | 134,078        | 18.9%               |                         |                                |                                    |
| Total acquired loans                                       | 5,013,321                | 2,424,592      | 893,093                       | 491,814        | 69.4%               |                         |                                |                                    |
| Total portfolio  | \$ 5,439,760             | \$ 2,824,496   | \$ 1,117,284                  | \$ 708,772     | 100.0%              |                         |                                |                                    |

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The following tables summarize certain characteristics of the loans held by the Company and the joint ventures and our proportionate share as of December 31, 2011:

| Collateral Type  | Total Portfolio          |                | December 31, 2011             |                |                     |                         | Current Interest Yield on Cost | Weighted Average Maturity in Years |  |
|--|--------------------------|----------------|-------------------------------|----------------|---------------------|-------------------------|--------------------------------|------------------------------------|--|
|  |                          |                | Company's Proportionate Share |                |                     |                         |                                |                                    |  |
|  | Unpaid Principal Balance | Amortized Cost | Unpaid Principal Balance      | Amortized Cost | % of Amortized Cost | Weighted Average Coupon |                                |                                    |  |
| Originated performing loans                                |                          |                |                               |                |                     |                         |                                |                                    |  |
| Retail   | \$ 60,000                | \$ 60,000      | \$ 60,000                     | \$ 60,000      | 8.9%                | 9.8%                    | 9.8%                           | 4.5                                |  |
| Office   | 20,520                   | 20,474         | 20,315                        | 20,270         | 3.0%                | 8.0%                    | 8.0%                           | 3.9                                |  |
| Hospitality  | 84,000                   | 83,273         | 84,000                        | 83,273         | 12.3%               | 11.3%                   | 11.4%                          | 4.3                                |  |
| Other commercial   | 14,848                   | 14,681         | 7,424                         | 7,341          | 1.1%                | 12.0%                   | 12.4%                          | 0.2                                |  |
| Residential  | 234,049                  | 231,491        | 63,526                        | 62,331         | 9.3%                | 13.6%                   | 14.2%                          | 3.2                                |  |
| Total originated performing loans                          | 413,417                  | 409,919        | 235,265                       | 233,215        | 34.6%               | 11.3%                   | 11.4%                          | 3.9                                |  |
| Acquired loans and beneficial interests in debt securities |                          |                |                               |                |                     |                         |                                |                                    |  |
| Performing:  |                          |                |                               |                |                     |                         |                                |                                    |  |
| Retail   | 426,160                  | 303,163        | 64,209                        | 46,594         | 6.9%                | 6.2%                    | 8.8%                           | 5.4                                |  |
| Office   | 347,441                  | 253,997        | 62,049                        | 45,626         | 6.8%                | 4.8%                    | 6.9%                           | 6.2                                |  |
| Industrial   | 229,137                  | 173,026        | 30,890                        | 23,083         | 3.4%                | 6.2%                    | 8.6%                           | 4.4                                |  |
| Hospitality  | 84,190                   | 66,353         | 21,723                        | 20,058         | 3.0%                | 9.2%                    | 9.7%                           | 6.8                                |  |
| Multifamily  | 258,500                  | 201,550        | 60,690                        | 52,538         | 7.8%                | 4.5%                    | 5.2%                           | 4.0                                |  |
| Other commercial   | 467,121                  | 331,528        | 68,650                        | 52,932         | 7.8%                | 8.2%                    | 10.3%                          | 3.6                                |  |
| Residential  | 94,085                   | 43,528         | 16,385                        | 8,426          | 1.3%                | 5.4%                    | 10.1%                          | 5.7                                |  |
| Land   | 182,746                  | 78,149         | 14,055                        | 5,544          | 0.8%                | 5.9%                    | 13.3%                          | 2.7                                |  |
| Total performing   | 2,089,380                | 1,451,294      | 338,651                       | 254,801        | 37.8%               | 6.2%                    | 8.3%                           | 4.8                                |  |
| Non-performing:  |                          |                |                               |                |                     |                         |                                |                                    |  |
| Retail   | 419,646                  | 188,483        | 54,750                        | 22,095         | 3.3%                |                         |                                |                                    |  |
| Office   | 632,546                  | 160,123        | 160,846                       | 36,168         | 5.4%                |                         |                                |                                    |  |
| Industrial   | 206,020                  | 89,640         | 28,439                        | 12,095         | 1.8%                |                         |                                |                                    |  |
| Hospitality  | 132,757                  | 78,524         | 39,090                        | 35,282         | 5.2%                |                         |                                |                                    |  |
| Multifamily  | 296,338                  | 121,716        | 51,386                        | 18,257         | 2.7%                |                         |                                |                                    |  |
| Other commercial   | 473,641                  | 163,862        | 56,335                        | 19,943         | 3.0%                |                         |                                |                                    |  |
| Residential  | 266,387                  | 106,263        | 47,254                        | 24,118         | 3.6%                |                         |                                |                                    |  |
| Land   | 1,020,972                | 208,602        | 83,228                        | 17,692         | 2.6%                |                         |                                |                                    |  |
| Total non-performing                                       | 3,448,307                | 1,117,213      | 521,328                       | 185,650        | 27.6%               |                         |                                |                                    |  |
| Total acquired loans                                       | 5,537,687                | 2,568,507      | 859,979                       | 440,451        | 65.4%               |                         |                                |                                    |  |
| Total portfolio  | \$ 5,951,104             | \$ 2,978,426   | \$ 1,095,244                  | \$ 673,666     | 100.0%              |                         |                                |                                    |  |

As of September 30, 2012, the Company's and the joint ventures' performing loan portfolio comprised fixed rate loans bearing interest rates ranging from 1.8% to 21.0% (weighted average of 7.4%) with an aggregate UPB of \$1.46 billion and variable rate loans bearing interest rates ranging from 1.25% to 18.0% (weighted average of 6.3%) with an aggregate UPB of \$1.18 billion. Maturity dates of performing loans range from October 2012 to December 2040. Scheduled maturities based on UPB of performing loans as of September 30, 2012 are as follows:

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(In thousands)

|  |            |
|--|------------|
| One year or less                               | \$ 426,929 |
| Greater than one year and less than five years | 1,344,629  |
| Greater than or equal to five years            | 869,960    |

|       |              |
|-------|--------------|
| Total | \$ 2,641,518 |
|-------|--------------|

### Liquidity and Capital Resources

Our current primary uses of liquidity are to fund:

acquisitions of our assets and related ongoing commitments;

our operations, including overhead costs and the management fee to our Manager;

distributions to our common and preferred stockholders;

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principal and interest payments on our borrowings; and

share repurchases under our common stock repurchase program from time to time.

Our current primary sources of liquidity are:

cash on hand;

our credit facility;

cash flow generated from our investments, both from operations and return of capital;

proceeds from full or partial realization of investments;

investment-level financing; and

proceeds from public or private equity offerings.

We believe that our capital resources are sufficient to meet our short-term and long-term capital requirements. However, because of distribution requirements imposed on us to qualify as a REIT, which generally require that we distribute to our stockholders 90% of our taxable income, our ability to finance our growth must largely be funded by external sources of capital. As a result, in order to continue investing in our target assets and sustain our growth, we will have to rely on third-party sources of capital, including public and private offerings of securities and debt financings, which may or may not be available on favorable terms, or at all.

***Contractual Obligations and Commitments***

The following table summarizes our known contractual obligations and commitments on an undiscounted basis as of September 30, 2012 and in future periods in which we expect to settle such obligations:

| (In thousands)  | Payments Due by Period |                     |                  |           |                      |
|---|------------------------|---------------------|------------------|-----------|----------------------|
|   | Total                  | Less Than<br>1 Year | 1-3 Years        | 3-5 Years | More Than<br>5 Years |
| <b>Contractual Obligations</b>                          |                        |                     |                  |           |                      |
| Principal payments credit facility <sup>(1)</sup>       | \$                     | \$                  | \$               | \$        | \$                   |
| Interest and fees credit facility <sup>(1)</sup>        | 812                    | 812                 |                  |           |                      |
| Secured financing principal and interest <sup>(2)</sup> | 104,975                | 12,748              | 92,227           |           |                      |
| Commitments to fund joint ventures <sup>(3)</sup>       | 5,400                  | 5,400               |                  |           |                      |
| <b>Total</b>  | <b>\$ 111,187</b>      | <b>\$ 18,960</b>    | <b>\$ 92,227</b> | <b>\$</b> | <b>\$</b>            |

(1) As of September 30, 2012, we had no outstanding borrowings on our credit facility. The contractual obligations above reflect unused commitment fees calculated at 0.5% through August 30, 2013, the contractual maturity date of our credit facility.

(2) Amounts include minimum principal and fixed-rate interest obligations through the original maturity date of the secured financing related to our Luxury Destination Club Recourse Loan II. Amounts do not include the secured financing on 2100 Grand, which is recognized as a

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- liability on our consolidated balance sheet, as we are not obligated to repurchase the A-note participation interest.
- (3) Pursuant to the operating agreements of some of our unconsolidated joint ventures, the members may be required to fund additional amounts for ordinary operating costs, guaranties or commitments of the joint ventures. Our share of those commitments is \$5.4 million. The table does not reflect amounts due under our management agreement or derivative instruments as those contracts do not have fixed and determinable payments.

### *Off-Balance Sheet Arrangements*

We have ownership interests in certain unconsolidated joint ventures as detailed in Note 3 to our consolidated financial statements included in Item 1 of this Report. For three structured transactions with the FDIC, we and certain investment funds managed by affiliates of our Manager committed to contribute additional amounts in order to satisfy additional security requirements, up to amounts set forth in the transaction documents with the FDIC. All such obligations are included in the contractual obligations table above. For the remaining four structured transactions with the FDIC, such additional security requirements were funded at closing and no additional commitments exist. The structured transactions with the FDIC are 50%-leveraged with zero-coupon financing provided by the FDIC with terms ranging from two to seven years. The loans are not guaranteed by the managing member entities in which we have ownership interests and are non-recourse to us.

We provided customary non-recourse carve-out guaranties on the secured debt at unconsolidated joint ventures that invest in the Bulls Loan Portfolio in which we have a 32.5% ownership interest. The aggregate balance of the debt at September 30, 2012 was \$21.3 million, or approximately 15% of the carrying amount of the collateral loans in the portfolio.

**Table of Contents****Acquisitions of Target Assets**

During the nine months ended September 30, 2012, we invested approximately \$363 million in eleven new target assets, including \$149 million in our SFR platform. We expect to continue to pursue our target assets for the near term and may invest additional funds in our existing investments. To the extent that we do not generate sufficient cash from our operations, we expect to fund our investments with borrowings from our credit facility, investment-level financing, redeployment of proceeds from realized investments and public or private issuance of equity.

**Dividends**

U.S. federal income tax law generally requires that a REIT distribute annually at least 90% of its REIT taxable income, without regard to the deduction for dividends paid and excluding net capital gains, and that it pay tax at regular corporate rates to the extent that it annually distributes less than 100% of its net taxable income. We intend to pay regular quarterly dividends to our stockholders in an amount equal to our net taxable income, if and to the extent authorized by our board of directors. Before we pay any dividend, whether for U.S. federal income tax purposes or otherwise, we must first meet both our operating requirements and debt service, if any. In addition, our amended credit facility limits the annual amount of distributions we can make to the greater of (i) 95% of our net income adjusted by any non-cash impairment charges, write-downs or losses and (ii) 110% of our taxable income plus depreciation. If our cash available for distribution is less than our net taxable income, we could be required to sell assets or borrow funds to make cash distributions or we may make a portion of the required distribution in the form of a taxable stock distribution or distribution of debt securities.

*Common Stock* Our board of directors declared the following dividends in 2012:

| Quarter Ended | Dividends<br>Declared per Share | Date Paid  |
|---------------|---------------------------------|------------|
| 3/31/2012     | \$ 0.34                         | 4/13/2012  |
| 6/30/2012     | \$ 0.35                         | 7/16/2012  |
| 9/30/2012     | \$ 0.35                         | 10/15/2012 |

*Preferred Stock* We are required to make quarterly cash distributions on the 10,080,000 shares of 8.5% Series A Preferred Stock. The quarterly amount of \$5.4 million is payable on or about the 15th of each January, April, July and October. The first dividend payment on our Series A Preferred Stock in the amount of \$0.6847 per share, or approximately \$4.0 million, was made on July 16, 2012 to shareholders of the March 2012 Preferred Stock Offering. The initial dividend covered the period from March 20, 2012 through July 15, 2012. The second payment, on October 15, 2012, was made to preferred shareholders from both preferred stock offerings at the run-rate of \$0.53125 per share, or approximately \$5.4 million.

**Cash and Cash Flows**

As of November 7, 2012, we had approximately \$86.3 million of cash.

The following table summarizes our cash flow activity:

| (in thousands)                            | Nine Months Ended September 30, |           |
|---|---------------------------------|-----------|
|   | 2012                            | 2011      |
| Net cash provided by operating activities | \$ 46,196                       | \$ 15,188 |
| Net cash used in investing activities     | (267,175)                       | (337,479) |
| Net cash provided by financing activities | 306,025                         | 261,774   |

*Operating Activities* For the nine months ended September 30, 2012 and 2011, cash flows from operating activities increased \$31 million, reflecting the substantial increase in the number of investments in our investment portfolio. Cash flows from operating activities are primarily distributions of earnings from unconsolidated joint ventures and interest received from our investments in loans, partially offset by payment of operating expenses. For the nine months ended September 30, 2012, distributions of earnings from unconsolidated joint ventures include approximately \$8 million of earnings and realized gain received following the sale of common stock of First Republic Bank in March and July of 2012, \$7.8 million of distributions received from the WLH Secured Loan, and distributions of cash flows from our single and portfolio loan investments.

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*Investing Activities* Net cash used in investing activities for both periods presented reflect our acquisitions of our target assets. For the nine months ended September 30, 2012, approximately \$385.6 million of cash outflows on new investments are partially offset by substantial distributions of capital from unconsolidated joint ventures resulting from various capital transactions such as financing activities and loan resolutions and sales. Such distributions of capital include approximately \$22.2 million from the Bulls Loan Portfolio, \$14 million from the U.S. Life Insurance Loan Portfolio, \$10 million from the Luxury Destination Resort Loan sale, \$8.2 million following the sale of common stock in First Republic Bank, and approximately \$38.5 million from loan repayments and sales.

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**Financing Activities** Cash from financing activities generally reflect our capital raising activities and dividend payments. For the nine months ended September 30, 2012, net cash provided by financing activities reflects net proceeds from our March and July 2012 Preferred Stock Offerings and September 2012 Common Stock Offering and contributions from noncontrolling interests related to Luxury Destination Club Recourse Loans I and II. These amounts are offset by net repayment of \$69 million of borrowings under our credit facility and payment of dividends. For the nine months ended September 30, 2011, net cash provided by financing activities reflect net proceeds from our March 2011 common stock offering, net borrowings under our credit facility and contributions from noncontrolling interests, offset by common stock repurchases.

### Credit Facility

Our current primary source of liquidity in addition to cash on hand is our credit facility. On September 17, 2012, we amended our existing credit agreement (as amended, the "Credit Agreement") with Bank of America, N.A., as administrative agent, and certain lenders. The Credit Agreement continues to provide a credit facility in the initial maximum principal amount of \$175 million at the same interest rate and maturity date, and may be increased to \$250 million, subject to certain conditions set forth in the Credit Agreement, including each lender or substitute lenders agreeing to provide commitments for such increased amount. Borrowings under the Credit Agreement will be used to finance investments in our target assets, as well as for general corporate purposes.

The amendment expanded the types of assets and associated income qualifying for the borrowing base and modified certain limitations on the types of assets and associated income that can qualify for the borrowing base. The amendment also modified certain financial covenants to be more favorable to reflect the growth of our equity capital base since the previous amendment in September 2011. As of November 8, 2012, we had the ability to borrow up to \$143.1 million, none of which had been drawn.

The Credit Agreement contains covenants and restrictions requiring us to meet certain financial ratios and reporting requirements. At September 30, 2012, we were in compliance with all debt covenants and we expect to continue to meet all financial and reporting requirements. However, in the event of an economic slow-down, volatility in the credit markets, and rising cost of capital, there is no certainty that we will be able to continue to meet all of the covenant requirements. The following table summarizes the key financial covenants and our actual results as of and for the three months ended September 30, 2012:

| (\$ in thousands)                                      | Covenant Level      | Actual Level<br>September 30, 2012 |
|--|---------------------|------------------------------------|
| Financial covenant as defined in the Credit Agreement: |                     |                                    |
| Consolidated Tangible Net Worth                        | Minimum \$801,176   | \$ 996,237                         |
| Consolidated Fixed Charge Coverage Ratio               | Minimum 2.25 to 1.0 | 3.43 to 1.0                        |
| Consolidated Leverage Ratio                            | Maximum 0.5 to 1.0  | 0.12 to 1.0                        |
| Liquidity  | Minimum \$5,000     | \$ 250,419                         |
| Total Facility Permitted Borrowings                    | Maximum 161,501     | \$                                 |

### Cash from Investments

Our investments generate cash, either from operations or as a return of our invested capital. We receive monthly or quarterly distributions from some of our unconsolidated joint ventures from earnings, principal receipts or capital transactions such as financing transactions or full or partial loan sales. We also receive interest and principal on our loans held for investment. As loans reach their maturity we may receive all or a portion of the outstanding principal balance. Certain loans held for investment require minimum principal payments, including partial paydowns of principal in the event of a sale of the underlying collateral.

We may also, from time to time, fully or partially realize our investments through sales. For example, during the nine months ended September 30, 2012, through our interest in a joint venture which holds an ownership interest in First Republic Bank, we sold 543,760 shares of common stock in First Republic Bank, which resulted in net cash proceeds of approximately \$16.1 million. We received approximately \$71.9 million of distributions of capital from our other unconsolidated joint ventures resulting from financing activities and loan resolutions, either through loan sales or payoffs (whether paid-in-full or discounted). We also received \$30.2 million from loan sales as described in "Our Investments." We expect to continue to resolve loans in some of our loan pools to generate cash, particularly those in acquired credit-distressed portfolios, such as the Bulls Loan Portfolio and German loan portfolios. We may also pursue opportunities to sell whole or partial positions in our originated loan investments or obtain financing (see "Investment-Level Financing") to generate cash and improve the total return on our investments.



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### ***Investment-Level Financing***

The structured transactions with the FDIC were consummated in part with leverage provided by the FDIC. As of September 30, 2012, three of the seven FDIC portfolios had fully repaid the purchase money notes and have begun to make distributions to investors. We also secured investment-level financing on our 2100 Grand loan by assignment of an A-note participation, seller-financing on the Luxury Destination Club Recourse Loan II, and bank financing on the Bulls Loan Portfolio and Florida Multifamily Property Loan. We may attempt to secure other investment-level financing, if available, including term loans, securitizations, warehouse facilities, repurchase agreements and the issuance of debt and equity securities. We also expect to continue to invest in a number of our assets through co-investments with other investment vehicles managed by affiliates of our Manager and/or other third parties, which may allow us to pool capital to access larger transactions and diversify investment exposure.

### ***Equity Offerings***

We received net proceeds of \$140.1 million from the March 2012 Preferred Stock Offering and used \$105 million of the proceeds to repay amounts outstanding on our credit facility. We received net proceeds of \$106 million from the July 2012 Preferred Stock Offering and used \$40.5 million of the proceeds to repay amounts outstanding on our credit facility. We received net proceeds of \$149 million from the September 2012 Common Stock Offering and used \$35 million of the proceeds to repay amounts outstanding on our credit facility. The remaining proceeds from all offerings were or will be used for our operations and to acquire our target assets. Under our current shelf registration statement filed with the SEC, we may offer up to \$594 million in various types of equity securities. These securities may be issued from time to time at our discretion based on our needs and depending upon market conditions and available pricing.

### ***Risk Management***

Risk management is a significant component of our strategy to deliver consistent risk-adjusted returns to our stockholders. Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes and our exemption from registration under the 1940 Act, our Manager closely monitors our portfolio and actively manages risks associated with, among other things, our assets and interest rates. In addition, the Audit Committee of our board of directors, in consultation with management, periodically reviews our policies with respect to risk assessment and risk management, including key risks to which we are subject, including credit risk, liquidity risk and market risk, and the steps that management has taken to monitor and control such risks.

### ***Underwriting***

Prior to investing in any particular asset, our Manager's underwriting team, in conjunction with third party providers, undertakes a rigorous asset-level due diligence process, involving intensive data collection and analysis, to ensure that we understand fully the state of the market and the risk-reward profile of the asset. The credit risk of any particular investment, whether an originated loan or an acquired loan or portfolio of loans, is built into the pricing in the form of contractual interest rates, related fees charged to the borrower, estimated transaction costs, discount to acquired principal balance, among other things. Key metrics considered during the underwriting process include, but are not limited to, loan-to-collateral value ratios ( LTV ), debt service coverage ratios ( DSCR ), debt yields, sponsor credit ratings and history, and tenant credit ratings and diversity. In addition to evaluating the merits of any particular proposed investment, our Manager evaluates the diversification of our portfolio of assets. Prior to making a final investment decision, our Manager determines whether a target asset will cause our portfolio of assets to be too heavily concentrated with, or cause too much risk exposure to, any one borrower, real estate sector, geographic region, source of cash flow for payment or other geopolitical issues. If our Manager determines that a proposed acquisition presents excessive concentration risk, it may determine not to acquire an otherwise attractive asset.

### ***Asset Management***

For each asset that we originate or acquire, Colony Capital's asset management team engages in active management of the asset, the intensity of which depends on the attendant risks. Once an asset manager has been assigned to a particular asset, the manager works collaboratively with the underwriting team to formulate a strategic plan for the particular asset, which includes evaluating the underlying collateral and updating valuation assumptions to reflect changes in the real estate market and the general economy. This plan also generally outlines several strategies for the asset to extract the maximum amount of value from each asset under a variety of market conditions. Such strategies vary depending on the type of asset, the availability of refinancing options, recourse and maturity, but may include, among others, the restructuring of non-performing or sub-performing loans, the negotiation of discounted pay-offs or other modification of the terms governing a loan, and the foreclosure and management of assets underlying non-performing loans in order to reposition them for profitable disposition. As long as an asset is in our portfolio, our Manager and its affiliates track the progress of an asset against the original business plan to ensure that the attendant risks of continuing to own the asset do not outweigh the associated rewards. We monitor and evaluate period to period changes in portfolio credit risk,

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focusing on borrower payment history and delinquencies and, if warranted, LTV. We do not have a policy to obtain routine valuations on the underlying loan collateral if there are no indicators of significant change in the value of that collateral. We may also review other information such as (i) financial data (DSCR, debt yields, delinquencies and performing status), (ii) collateral characteristics (property occupancy, tenant profiles, rental rates, operating expenses, site inspections, capitalization and discount rates), (iii) the borrower/sponsor's exit plan, and (iv) current credit spreads and discussions with market participants. Because of the diverse nature of acquired loans, the availability and relevance of these metrics vary significantly by loan.

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Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes and our exemption from registration under the 1940 Act, we currently expect that we will typically hold assets that we originate or acquire for between three and ten years. However, in order to maximize returns and manage portfolio risk while remaining opportunistic, we may dispose of an asset earlier than anticipated or hold an asset longer than anticipated if we determine it to be appropriate depending upon prevailing market conditions or factors regarding a particular asset. We can provide no assurances, however, that we will be successful in identifying or managing all of the risks associated with acquiring, holding or disposing of a particular asset or that we will not realize losses on certain assets.

### ***Interest Rate and Foreign Currency Hedging***

Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes and our exemption from registration under the 1940 Act, we may mitigate the risk of interest rate volatility through the use of hedging instruments, such as interest rate swap agreements and interest rate cap agreements. The goal of our interest rate management strategy is to minimize or eliminate the effects of interest rate changes on the value of our assets, to improve risk-adjusted returns and, where possible, to lock in, on a long-term basis, a favorable spread between the yield on our assets and the cost of financing such assets. In addition, because we are exposed to foreign currency exchange rate fluctuations, we employ foreign currency risk management strategies, including the use of, among others, currency hedges. We can provide no assurances, however, that our efforts to manage interest rate and foreign currency exchange rate volatility will successfully mitigate the risks of such volatility on our portfolio.

### **Leverage Policies**

We have used limited investment-level leverage in the form of government sponsored debt programs, such as the TALF and seller financing provided by the FDIC. We have also used various forms of non-recourse financing such as the assignment of an A-note participation on our 2100 Grand investment, seller-provided financing on the Luxury Destination Club Recourse Loan II and bank loans on the Bulls Loan Portfolio and Florida Multifamily Property Loan, in each case with a debt-to-equity ratio of less than 3-to-1. We have also temporarily used borrowings from our credit facility to finance our investments. While we believe we can achieve attractive yields on an unleveraged basis, we will continue to use prudent amounts of leverage to increase potential returns to our stockholders and/or to finance future investments. Given current market conditions, to the extent that we use borrowings to finance our assets, we currently expect that such leverage would not exceed, on a debt-to-equity basis, a 3-to-1 ratio, except with respect to investments financed with borrowings provided by the FDIC or under government sponsored debt programs, leverage on which we currently expect would not exceed, on a debt-to-equity basis, a 6-to-1 ratio. We consider these leverage ratios to be prudent for our target asset classes. Our decision to use leverage currently or in the future to finance our assets will be based on our Manager's assessment of a variety of factors, including, among others, the anticipated liquidity and price volatility of the assets in our investment portfolio, the potential for losses and extension risk in our portfolio, the ability to raise additional equity to reduce leverage and create liquidity for future investments, the availability of credit at favorable prices or at all, the credit quality of our assets and our outlook for borrowing costs relative to the interest income earned on our assets. Our decision to use leverage in the future to finance our assets will be at the discretion of our Manager and will not be subject to the approval of our stockholders, and we are not restricted by our governing documents or otherwise in the amount of leverage that we may use. To the extent that we use leverage in the future, we may mitigate interest rate risk through utilization of hedging instruments, primarily interest rate swap and cap agreements, to serve as a hedge against future interest rate increases on our borrowings.

### **Non-GAAP Supplemental Financial Measure: Core Earnings**

Core Earnings is a non-GAAP financial measure and is defined as GAAP net income excluding non-cash equity compensation expense, the costs incurred in connection with our formation and our IPO, including the initial and additional underwriting discounts and commissions, the incentive fee, real estate depreciation and amortization (to the extent that we foreclose on any properties underlying our target assets) and any unrealized gains or losses from mark-to-market valuation changes (other than permanent impairment) that are included in net income. The amount will be adjusted to exclude (i) one-time events pursuant to changes in GAAP and (ii) non-cash items which in the judgment of management should not be included in Core Earnings, which adjustments in clauses (i) and (ii) shall only be excluded after discussions between our Manager and our independent directors and after approval by a majority of our independent directors.

We believe that Core Earnings is a useful supplemental measure of our operating performance. The exclusion from Core Earnings of the items specified above allows investors and analysts to readily identify the operating results of the assets that form the core of our activity and assists in comparing those operating results between periods. Core Earnings is also the basis upon which the incentive fee to our Manager is calculated. Also, since some of our competitors use a similar supplemental measure, it facilitates comparisons of operating performance to other similar REITs. However, other REITs may use different methodologies to calculate Core Earnings, and accordingly, our calculation of Core Earnings may not be comparable to other similar REITs that present similar supplemental measures.

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Core Earnings does not represent cash flow from operations as defined by GAAP, should not be considered as an alternative to net income as defined by GAAP and is not indicative of cash available to fund all cash flow needs.

A reconciliation of our GAAP net income attributable to common stockholders to Core Earnings is presented below:

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| (In thousands)  | Three Months Ended September 30, |           | Nine Months Ended September 30, |           |
|---|----------------------------------|-----------|---------------------------------|-----------|
|   | 2012                             | 2011      | 2012                            | 2011      |
| GAAP net income attributable to common stockholders           | \$ 10,456                        | \$ 15,794 | \$ 34,567                       | \$ 31,194 |
| Adjustments to GAAP net income to reconcile to Core Earnings: |                                  |           |                                 |           |
| Noncash equity compensation expense                           | 654                              | 38        | 3,263                           | 97        |
| Incentive fee   |                                  | 88        | 936                             | 88        |
| Depreciation expense  | 1,300                            |           | 2,804                           |           |
| Net unrealized loss (gain) on derivatives                     | 75                               | (38)      | 155                             | 8         |
| Core Earnings   | \$ 12,485                        | \$ 15,882 | \$ 41,725                       | \$ 31,387 |

**Inflation**

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance more so than inflation, although inflation rates can often have a meaningful influence over the direction of interest rates. Furthermore, our financial statements are prepared in accordance with GAAP and our distributions are determined by our board of directors primarily based on our taxable income, and, in each case, our activities and balance sheet are measured with reference to historical cost and/or fair market value without considering inflation.

**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk.**

Market risk includes the exposure to loss resulting from changes in interest rates, credit curve spreads, foreign currency exchange rates, commodity prices, equity prices and credit risk in our underlying investments. The primary market risks to which the Company is exposed, either directly or indirectly through its investments in unconsolidated joint ventures, are credit risk, interest rate risk, credit curve spread risk and foreign currency risk.

**Credit Risk**

Our joint venture investments and loans receivable are subject to a high degree of credit risk. Credit risk is the exposure to loss from loan defaults. Default rates are subject to a wide variety of factors, including, but not limited to, borrower financial condition, property performance, property management, supply/demand factors, construction trends, consumer behavior, regional economics, interest rates, the strength of the U.S. economy, and other factors beyond our control. All loans are subject to a certain probability of default. We manage credit risk through the underwriting process, acquiring our investments at the appropriate discount to face value, if any, and establishing loss assumptions. We also carefully monitor the performance of the loans, including those held by the joint ventures, as well as external factors that may affect their value.

**Interest Rate and Credit Curve Spread Risk**

Interest rate risk relates to the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Interest rate risk is highly sensitive to many factors, including governmental, monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Credit curve spread risk is highly sensitive to the dynamics of the markets for commercial real estate loans and securities we hold. Excessive supply of these assets combined with reduced demand will cause the market to require a higher yield. This demand for higher yield will cause the market to use a higher spread over the U.S. Treasury securities yield curve, or other benchmark interest rates, to value these assets. The majority of the performing loans held by our unconsolidated joint ventures are fixed rate loans. As U.S. Treasury securities are priced to a higher yield and/or the spread to U.S. Treasuries used to price the assets increases, the price at which the joint ventures could sell some of the assets may decline. Conversely, as U.S. Treasury securities are priced to a lower yield and/or the spread to U.S. Treasuries used to price the assets decreases, the value of the loan portfolios may increase. In addition, fluctuations in LIBOR rates may affect the amount of interest expense we incur in connection with borrowings under our credit facility, which, based on our current debt ratio, incur interest expense at a per annum rate equal to the sum of, at our election, the one, two, three, six, or twelve-month LIBOR plus 3.5%. As of September 30, 2012, the Company had no outstanding borrowings.

As of September 30, 2012, we and our unconsolidated joint ventures did not have any interest rate hedges. In October 2012, one of our unconsolidated joint ventures obtained an interest rate swap to hedge against interest rate fluctuations. We or our unconsolidated joint ventures may, in the future, utilize a variety of financial instruments, including interest rate swaps, caps, floors and other interest rate exchange contracts, in order to limit the effects of fluctuations in interest rates on our operations. The use of these types of derivatives to hedge interest-earning

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assets and/or interest-bearing liabilities carries certain risks, including the risk that losses on a hedge position will reduce the funds available for distribution and that such losses may exceed the amount invested in such instruments. A hedge may not perform its intended purpose of offsetting losses of rising interest rates. Moreover, with respect to certain of the instruments used as hedges, we are exposed to the risk that the counterparties with which we trade may cease making markets and quoting prices in such instruments, which may render us unable to enter into an offsetting transaction with respect to an open position. If we anticipate that the income from any such hedging transaction will not be qualifying income for REIT income purposes, we may conduct all or part of our hedging activities through a to-be-formed corporate subsidiary that is fully subject to federal corporate income taxation. Our profitability may be adversely affected during any period as a result of changing interest rates.

**Table of Contents****Currency Risk**

We have foreign currency rate exposures related to our equity investments in joint ventures which hold certain commercial real estate loan investments in Europe. Our sole currency exposure is to the Euro. Changes in currency rates can adversely affect the fair values and earnings of our non-U.S. holdings. As of September 30, 2012, we had approximately 34.5 million, or \$44.4 million, in European investments. Net tax-effected accumulated foreign exchange loss on the European investments was approximately \$4.4 million, or \$3.0 million after hedge gain. A 1% change in the exchange rate would result in a \$0.4 million increase or decrease in translation gain or loss on our investments in unconsolidated joint ventures. We mitigate this risk by utilizing currency instruments to hedge the capital portion of our foreign currency risk. The type of hedging instrument that we employed on our European investments was a costless collar (buying a protective put while writing an out-of-the-money covered call with a strike price at which the premium received is equal to the premium of the protective put purchased) which involved no initial capital outlay. The puts were structured with strike prices approximately 10% lower than our cost basis in such investments, thereby limiting any Euro related foreign exchange related fluctuations to approximately 10% of the original capital invested in the deal.

At September 30, 2012, we had nine outstanding collars with an aggregate notional amount of 27.3 million. The maturity dates of such instruments approximate the projected dates of related cash flows for specific investments. Termination or maturity of currency hedging instruments may result in an obligation for payment to or from the counterparty to the hedging agreement. We are exposed to credit loss in the event of non-performance by counterparties for these contracts. To manage this risk, we select major international banks and financial institutions as counterparties and perform a quarterly review of the financial health and stability of our trading counterparties. Based on our review as of September 30, 2012, we do not expect any counterparty to default on its obligations.

The following table summarizes the notional amounts and fair values of our collars as of September 30, 2012:

(In thousands, except exchange rates)

| Hedged Asset                             | Notional Amount | Cap Range (USD/ ) | Floor Range (USD/ ) | Expiration Date         | Net Fair Value |
|--|-----------------|-------------------|---------------------|-------------------------|----------------|
| Investment in Spanish REOC/Colonial Loan | 7,800           | 1.627 1.635       | 1.340 1.350         | December 2012           | \$ 482         |
| Investments in German loan portfolios    | 19,490          | 1.300 1.510       | 1.100 1.290         | December 2012 July 2015 | 960            |
|  | 27,290          |                   |                     |                         | \$ 1,442       |

**ITEM 4. Controls and Procedures.**

The Company has established disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act) that are designed 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 period specified in the SEC's rules and forms, and is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives.

As required by Rule 13a-15(b) under the Exchange Act, we have evaluated, under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures. Based upon our evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at September 30, 2012.

During 2012, the Company entered into a new business segment when it made a series of investments into a newly formed investment platform created for the purpose of acquiring and renting single-family homes. This new business segment implemented and began using a different set of policies and key business processes than the real estate debt-related business, utilizing a separate enterprise resource planning system. The Company will continue to monitor, test and refine this system as part of management's annual evaluation of internal control over financial reporting.

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Except as described above, there have been no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act) during the quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II OTHER INFORMATION**

**ITEM 1. Legal Proceedings.**

There have been no material changes to the legal proceedings included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

**ITEM 1A. Risk Factors.**

The following is an update to the risk factors included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011:

**Our strategy of buying single-family homes for rental to tenants is subject to various risks, any of which could have a material adverse effect on our business and results of operations.**

As part of our business strategy, we have acquired and expect to continue to acquire interests in single-family homes for the purpose of renting the homes to tenants. To the extent that we own interests in single-family homes, we will be subject to various risks, including the following:

our ability to generate revenue from the single-family homes in which we own an interest will be dependent on the ability of tenants to pay rent, and the failure of a significant number of our tenants to pay rent timely or at all or a significant number of lease terminations could have a material adverse effect on our results of operations;

the single-family homes in which we own an interest will compete with numerous housing alternatives in attracting residents, including other single-family homes and apartment communities, which may reduce occupancy levels and have a material adverse effect on our revenues;

the single-family homes in which we own an interest typically are, and homes we acquire in the future likely will be, located in markets that have been particularly susceptible to adverse local and national economic conditions, and there can be no assurances that future economic downturns will not adversely affect our ability to generate revenue from the homes or cause the market value of the homes to decline significantly;

the rental markets in which the single-family homes are located may remain flat or deteriorate, which could limit the extent to which rental rates can be increased to satisfy increased expenses without having a material adverse effect on occupancy rates;

if we are unable to lease or re-lease vacant single-family homes, we will be subject to costs, including mortgage payments, insurances premiums, maintenance, real estate taxes and insurance, but will not have a source of revenue to satisfy such costs, which could have a material adverse effect on our results of operations; and

we are dependent on the performance of third-party managers to manage the leasing and maintenance of the single-family homes in which we own an interest, and our results of operations could be adversely affected if such third-party managers do not manage the homes in our best interests.

If any of the foregoing risks were to occur, our business and results of operations could be materially and adversely affected.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.**  
None.

**ITEM 3. Defaults Upon Senior Securities.**  
None.

**ITEM 4. Mine Safety Disclosures.**  
Not applicable.

**ITEM 5. Other Information.**  
None.

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### ITEM 6. Exhibits.

#### Exhibit

| No.   | Description   |
|-------|---|
| 10.1  | Second Amendment to Amended and Restated Credit Agreement, dated as of September 17, 2012, among the Company, CFI Mezz Funding, LLC, CFI RE Holdco, LLC, ColFin ESH Funding, LLC, ColFin 2100 Funding, LLC, CFI CorAmerica 2100 Funding, LLC, CFI RE Masterco, LLC, and each wholly-owned subsidiary of the Company that from time to time becomes a co-borrower thereto, as Borrowers, each lender from time to time party thereto, as Lenders, and Bank of America, N.A., as Administrative Agent (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on September 20, 2012) |
| 10.2* | Partnership Subscription Agreement for Purchase of An Associate General Partnership Interest in CSFR Operating Partnership, L.P. dated as of July 31, 2012  |
| 31.1* | Certification of Richard B. Saltzman, President and Chief Executive Officer, pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002   |
| 31.2* | Certification of Darren J. Tangen, Chief Financial Officer and Treasurer, pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.1* | Certification of Richard B. Saltzman, President and Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   |
| 32.2* | Certification of Darren J. Tangen, Chief Financial Officer and Treasurer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 101** | Financial statements from the Quarterly Report on Form 10-Q of Colony Financial, Inc. for the quarter ended September 30, 2012, formatted in XBRL (eXtensible Business Reporting Language): (1) Consolidated Balance Sheets, (2) Consolidated Statements of Operations, (3) Consolidated Statements of Comprehensive Income, (4) Consolidated Statements of Equity, (5) Consolidated Statements of Cash Flows and (6) Notes to Consolidated Financial Statements  |

\* Filed herewith

\*\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

#### SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: November 9, 2012

COLONY FINANCIAL, INC.

By: /s/ RICHARD B. SALTZMAN  
**Richard B. Saltzman**  
**Chief Executive Officer and President**

By: /s/ DARREN J. TANGEN  
**Darren J. Tangen**  
**Chief Operating Officer,**  
**Chief Financial Officer and Treasurer**

