FALCON FINANCIAL INVESTMENT TRUST
Form 10-Q
May 17, 2004

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For The Quarterly Period Ended March 31, 2004

FALCON FINANCIAL INVESTMENT TRUST

(Exact name of registrant as specified in its charter)

Commission file number 000-50509

Maryland	**57-6208172**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

15 Commerce Road

Stamford, CT 06902

(Address of principal executive offices) (Zip code)

203-967-0000

(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 ý No o

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes o No ý

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

(Class)	**(Outstanding as of May 17, 2004)**
COMMON SHARES, $0.01 PAR VALUE	15,985,800 SHARES

FALCON FINANCIAL INVESTMENT TRUST AND PREDECESSOR

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PART I. CONSOLIDATED FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

FALCON FINANCIAL INVESTMENT TRUST AND PREDECESSOR

Consolidated Statements of Financial Position

	Company March 31, 2004 (unaudited)	Company December 31, 2003
ASSETS		
ASSETS:		
Cash and cash equivalents	$ 32,612,892	$ 25,645,578
Loans receivable, net of allowance for possible loan losses of $1,318,368 and $1,086,692, respectively	151,888,877	126,076,622
Retained interests in loan securitization	7,386,747	7,239,136
Due from broker	2,380,000	
Accrued interest receivable	1,003,182	994,821
Restricted cash	2,226,193	2,657,660
Property and equipment, net	427,775	335,860
Prepaid expenses and other assets	809,685	1,497,245
Total assets	$ 198,735,351	$ 164,446,922
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES :		
Borrowings	$ 74,235,213	$ 53,475,879
Accrued interest payable	171,366	255,707
Interest rate swap contracts	2,929,733	(389,783)
Customer deposits	61,325	140,276
Hold back of loan proceeds	2,226,193	2,657,660
Accounts payable and accrued liabilities	1,005,756	2,405,496
Total liabilities	80,629,586	58,545,235
COMMITMENTS AND CONTINGENCIES STOCKHOLDERS EQUITY:		
Preferred shares, $0.01 par value, 50,000,000 authorized none issued and outstanding		
Common shares, $0.01 par value, 100,000,000 authorized 15,985,800 and 14,105,800 issued and outstanding, respectively	159,858	141,058
Additional paid in capital	123,679,281	108,020,597

Unearned compensation		(2,650,902)		(2,840,827)
Accumulated deficit		(1,637,116)		(1,090,858)
Accumulated other comprehensive income (loss)		(1,445,356)		1,671,717
Total stockholders equity		118,105,765		105,901,687
Total liabilities and stockholders equity	$	198,735,351	$	164,446,922

See accompanying notes to consolidated financial statements

FALCON FINANCIAL INVESTMENT TRUST AND PREDECESSOR

Consolidated Statements of Operations

(unaudited)

	Company Three Months Ended March 31, 2004	Predecessor Three Months Ended March 31, 2003
REVENUES:		
Interest income on loans.	$ 2,948,798	$ 1,647,017
Interest income on securities purchased under resale agreements - related party		22,732
Interest income from retained interests	304,474	355,893
Gain on sale of loans		10,696,524
Gain on sale of retained interests		265,352
Gain on securities sold, but not yet purchased - related party		1,081,269
Change in value of interest rate swap contracts	(65,483)	678,816
Income from loan servicing	112,580	97,842
Interest and other income	106,746	18,317
Total revenues.	3,407,115	14,863,762
EXPENSES:		
Interest expense on borrowings	436,354	187,487
Interest expense on borrowings - related party		672,542
Interest expense on securities sold, but not yet repurchased - related party		149,304
Provision for possible loan losses	231,676	
Facility fee expense	750,000	93,750
Salaries and benefits	1,414,219	867,440
Professional fees.	280,918	86,433
General and administrative	479,063	234,714
Advertising and promotion	330,974	241,238
Depreciation and amortization.	30,169	35,248
Total expenses	3,953,373	2,568,156
Net (loss) income	$ (546,258)	$ 12,295,606
Net loss per share - basic and diluted	(0.04)	
Weighted average shares outstanding:		
Basic	15,003,159	
Diluted	15,041,098	

See accompanying notes to consolidated financial statements.

FALCON FINANCIAL INVESTMENT TRUST AND PREDECESSOR

Consolidated Statements of Changes in Stockholders Equity and Comprehensive Income (Loss)

For the three months ended March 31, 2004

(unaudited)

	Common Stock Number of Shares	Common Stock Par Value ($ 0.01 per share)	Additional Paid-in Capital	Unearned Compensation	Retained Earnings (Accumlated Surplus)	Accumulated Other Comprehensive Income	Total Stockholders Equity	Comprehensive Income (Loss)
BALANCE, December 31, 2003	14,105,800	$ 141,058	$ 108,020,597	$ (2,840,827)	$ (1,090,858)	$ 1,671,717	$ 105,901,687	
Net loss					(546,258)		(546,258)	$ (546,258)
Overallotment Transaction on February 2, 2004:								
Issuance of shared in connection with overallotment	1,875,000	18,750	16,856,250				16,875,000	
Underwriters Fee and Offering expenses			(1,246,316)				(1,246,316)	
Issuance of restricted shares to Employees and Trustees, net	5,000	50	48,750	(48,800)				
Amortization of unearned compensation				238,725			238,725	
Unrealized losses on hedging transactions						(3,254,033)	(3,254,033)	(3,254,033)
Unrealized gain on retained interests in securitizations						136,960	136,960	136,960
Comprehensive loss								$ (3,663,331)
BALANCE, March 31, 2004	15,985,800	$ 159,858	$ 123,679,281	$ (2,650,902)	$ (1,637,116)	$ (1,445,356)	$ 118,105,765	

See accompanying notes to consolidated financial statements.

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FALCON FINANCIAL INVESTMENT TRUST AND PREDECESSOR

Consolidated and Combined Statements of Cash Flows

(unaudited)

	The Company Three months ended March 31, 2004	The Predecessor Three months ended March 31, 2003
Cash flows from operating activities		
Net (loss) income	$ (546,258)	$ 12,295,606
Adjustments to reconcile net (loss) income to net cash used in operating activities:		
Gain on sale of loans		(10,696,524)
Gain on sale of retained interests		(265,352)
Depreciation and amortization - property and equipment	30,169	35,248
Depreciation and amortization - deferred origination fees, net of expense	(32,939)	(22,242)
Provision for possible loan losses	231,676	
Amortization of deferred compensation	238,725	
(Accretion)/amortization of (discount)/premium on retained interests	10,651	(26,314)
Changes in operating assets and liabilities:		
Increase in securities sold, but not yet purchased - related party		8,812,177
Increase in interest rate swap contracts - related party		(5,900,800)
Increase in securities purchased under resale agreements - related party		(8,656,620)
(Decrease) increase in due from broker	(2,380,000)	6,440,000
(Increase) decrease in accrued interest receivable	(8,361)	1,106,674
Decrease (increase) in prepaid expenses and other assets	687,560	(228,603)
Decrease in due to broker - related party		(1,644,647)
(Decrease) increase in accrued interest payable	(84,341)	114,500
Decrease in accrued interest payable - related party		(1,855,829)
(Decrease) increase in customer deposits	(78,951)	53,498
Decrease in accounts payable and accrued liabilities	(1,399,759)	(197,826)
Net cash used in operating activities	(3,353,110)	(637,052)
Cash flows from investing activities:		
Disbursements for loan originations, net of fees received	(26,990,253)	(38,747,329)
Repayments of loans	1,045,466	681,087
Net proceeds from sale of retained interests		2,983,560
Net proceeds from sale of loans		145,464,590
Net purchases of property and equipment	(122,006)	(4,294)
Net cash (used in) provided by investing activities	(26,066,793)	110,377,614
Cash flows from financing activities:		
Proceeds from overallotment	16,875,000	
Payment of overallotment expenses	(1,246,316)	
Borrowings from warehouse line of credit	21,804,000	35,834,000

Repayments of warehouse line of credit		(1,045,467)		(130,185,825)
Borrowings from subordinated loans				4,934,135
Repayments of subordinated loans				(19,905,820)
Borrowings from interest capitalization notes				69,043
Net cash provided by (used in) financing activities		36,387,217		(109,254,467)
Net increase in cash and cash equivalents		6,967,314		486,093
Cash and cash equivalents, beginning of preiod		25,645,578		610,430
Cash and cash equivalents, end of period	$	32,612,892	$	1,096,523
Supplemental disclosure of cash flow information:				
Interest paid	$	520,695	$	2,601,358

FALCON FINANCIAL INVESTMENT TRUST AND PREDECESSOR

Notes to Consolidated Financial Statements

(unaudited)

(1) Organization

Falcon Financial Investment Trust (the Trust) is a fully integrated, self-advised finance company focused solely on the business of originating and servicing loans to automotive dealers in the United States. The Trust was formed as a Maryland Real Estate Investment Trust (REIT) on August 27, 2003. The Trust was formed to address the specialized capital needs of the automotive retailing industry. The Trust commenced operations on December 22, 2003 when it completed its initial public offering (IPO) and concurrently consummated certain other formation transactions, including a merger with Falcon Financial, LLC (the Predecessor).

The IPO consisted of the sale of 12,500,000 common shares to the public at a price of $9 per share, generating gross proceeds of $112.5 million. The aggregate proceeds to the Trust, net of underwriters discount and offering costs, was approximately $102.4 million. Concurrent with the IPO, the Trust issued 1,287,500 common shares to the owners of its Predecessor as part of the formation transaction in acquiring the assets and assuming the liabilities of the Predecessor. Also concurrently with the IPO, the Trust issued 318,300 restricted shares as part of its Equity Incentive Plan to its independent trustees, trustee nominees, members of senior management and other employees. The total number of common shares outstanding immediately following the IPO was 14,105,800. In February 2004, the underwriters exercised the over-allotment and the Trust sold an additional 1,875,000 common shares to the public at a price of $9 per share. The aggregate proceeds to the Trust, net of underwriters discount and offering costs, was approximately $15.6 million, bringing the total aggregate net proceeds of the IPO to approximately $118.0 million. The total number of common shares outstanding immediately following the over-allotment was 15,985,800, which includes an additional 5,000 restricted shares issued in connection with the Equity Incentive Plan.

The Predecessor was owned by Falcon Auto Venture, LLC (40%), SunAmerica, Inc. (30%), and MLQ Investors, LP (an affiliate of Goldman, Sachs & Co.) (30%). Members of the senior management of the Trust owned an 86% interest in Falcon Auto Venture, LLC. Subsequent to the IPO, owners of the Predecessor collectively owned 10.3% of the Trust, with no individual owning greater than 5%.

Concurrently with the completion of the IPO, the Trust authorized 50 million preferred share of beneficial interest. No preferred shares have been issued.

The Trust utilized its net proceeds of $102.4 million to repay $77.8 million in borrowings. After repayment of certain borrowings, the Trust had $24.6 million in available cash immediately following the IPO.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

The unaudited consolidated financial statements presented herein include all of the accounts of the Trust and its wholly owned subsidiary Falcon Financial II, LLC (collectively, the Company) which commenced operations on December 22, 2003. For periods prior to that time, this report includes the financial statements of the Predecessor and its subsidiary. All intercompany transactions and account balances have been eliminated in consolidation.

The accompanying unaudited financial statements have been prepared by management in accordance with accounting principles generally accepted in the United States of America, commonly referred to as GAAP, for interim financial information and in conformity with the rules and regulations of the Securities and Exchange Commission, commonly referred to as the SEC. Accordingly, they do not include all of the information and footnotes for complete GAAP financial statements. In the opinion of management, the accompanying consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of the Company s consolidated financial position at March 31, 2004 and December 31, 2003 and the results of its operations, changes in shareholders /members equity and its cash flows for the three months ended March 31, 2004 and 2003.

The results of operations for the three months ended March 31, 2004 are not necessarily indicative of the results that may be expected for the full year. The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates. These financial statements should be read in conjunction with the Company s audited consolidated financial statements and footnotes thereto, included in the Company s transition report on Form 10-K for the transition period from October 1, 2003 to December 31, 2003.

(b) Cash Flows

For purposes of the statements of cash flows, the Company and its Predecessor consider all highly liquid investments with maturities of less than three months at the date of acquisition to be cash equivalents. These assets are carried at cost, which approximates fair value. Restricted cash is not considered cash or cash equivalents for the purpose of the statements of cash flows.

(c) Loans, net

The Company originates loans that are underwritten with the intention of securitizing the receivables in a financing transaction, which will be accounted for as secured borrowings under the provisions of SFAS Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities , and carry the loans on the statement of financial position to maturity. The loans receivable are stated at their principal amount outstanding, less net deferred loan fees, unearned discounts and allowance for loan losses. Nonrefundable origination fees less certain related direct costs associated with the origination of the loans are deferred and amortized into interest income over the term of the loan using a method that approximates the interest method.

All loans originated by the Predecessor were underwritten with the intention of securitizing and selling the portfolio and are carried at the lower of cost or market value on the statement of financial position. The amount (if any) by which the cost exceeds the fair value is recorded in a valuation allowance. Changes in the valuation allowance are recorded in the statement of operations. As of March 31, 2003, no valuation allowance was deemed necessary.

(d) Allowance for Loan Losses

The allowance for loan losses is based on a periodic analysis of the loan portfolio and in management s judgment, reflects an amount that is adequate to absorb losses inherent in the existing portfolio. In evaluating the portfolio, management considers a variety of factors such as the size of the portfolio, prior loss experience, current and potential risks of the loan portfolio, present financial condition of the borrower, current economic conditions and other portfolio risk characteristics. Provisions for loan losses are charged to operations. Loans, including impaired loans, are charged against the allowance for loan losses when actual losses have been established.

A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. A loss from impairment represents the amount by which a creditor s recorded investment in a loan exceeds the present value of the expected future cash flows from the loan discounted at the loan s effective interest rate (including the fair value of the collateral that may be part of the loan). Losses for which such provisions for impairment are made, unless applied as a write-down of the recorded investment in the loan, represent a portion of the creditor s allowance for loan losses.

(e) Retained Interests in Loan Securitizations

The Predecessor accounted for its loan securitizations in accordance with Statement of Financial Accounting Standards (SFAS) No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement 125*. When the Predecessor sold loans in a securitization, it may retain one or more subordinated certificates from the certificates issued. Securitizations may be structured in various ways but generally conform to a common model. Typically, an issuer sells a portfolio of loans to a special-purpose entity established for the sole purpose of purchasing and reselling the loans to a securitization trust. The securitization trust then may issue bonds or certificates collateralized by the loans transferred to the securitization trust. The proceeds received from these bonds or certificates are used to purchase the loans from the issuing entity. The gain on the sale of loans is the difference between the proceeds from the sale of loans (net of related sale costs) and the allocated carrying amount of the receivables sold, including deferred origination fees and costs. The Predecessor determined the carrying amount by allocating the total carrying amount of the loans sold between the portion sold and the interests retained based on each portion s relative fair values at the time of the securitization. Assumptions used in calculating the estimated fair value of such retained interests are subject to volatility that could materially affect operating results.

Retained interests in securitizations are accounted for as available for sale securities and are carried at estimated fair value, with unrealized gains or losses included in members equity (accumulated other comprehensive income or loss). The Company is not aware of an active market for the purchase and sale of these retained interests at this time; accordingly, the Company estimates the fair value of the retained interest by calculating the present value of the estimated expected future cash flows received by the Company after being released by the securitization trust, using a discount rate commensurate with the risk involved taking into consideration the results of sales of certificates owned by the Company to third parties. The cash flows being discounted are adjusted for estimated net losses due to defaults or prepayments. The Company has experienced four defaults (of which one has been fully resolved, one has cured the default and two are pending resolution) and no prepayments in its retained interests in securitizations at March 31, 2004. All other loans are current.

Each loan securitization has a specific credit enhancement in the form of cash flow requirements that must be met before the Company receives any cash on its retained interest. The retained interests which the Company holds are subordinate in the right of payment to all other classes of certificates, which must receive their applicable distributions before any cash is available for distribution to the holders of the retained interests.

Changes in the fair value of the retained interests resulting from changes in the timing of cash flows to be received by the Company or changes in market interest rates are adjusted through other comprehensive income in members equity. Reductions in the estimated aggregate cash flows to be received by the Company, caused by defaults or prepayments that result in a reduction to the fair value of the retained interests, are considered an other than temporary impairment and are recognized through a charge to expense in that period.

(f) Restricted Cash and Holdback of Loan Proceeds.

The Company maintains various escrow accounts on behalf of its borrowers to fund work that needs to be performed on the borrower s property as a condition to the loan agreement. At March 31, 2004 and December 31, 2003 the Company held $2,226,193 and $2,657,660, respectively, of cash collateral for the completion of those projects.

(g) Interest, Fees and Direct Costs on Loans

Interest is accrued monthly on outstanding principal balances unless management considers the collection of interest to be uncertain (generally, when loans are contractually past due three months or more).

Origination fees received and direct costs incurred related to the origination of the loans are deferred as an adjustment to the carrying value of the loans held for sale. Origination fees and direct costs incurred are amortized into income over the life of the related loan. At the time of sale of the related loans, any remaining deferred fees and costs are recognized as income and included with the gain or loss on the sale of such loans.

(h) Servicing Income

Under servicing agreements for all Company securitizations, servicing fees for loans in good standing are accrued monthly based upon the then outstanding principal balances on loans serviced. The Company acts as primary servicer and special servicer with respect to loans securitized. A subsidiary of the Bank of New York acts as Master Servicer. The Company earns a servicing fee of 0.085% per annum (0.095% on the Company s most recently completed securitization in 2003) of the outstanding loan balance with respect to each loan serviced in its capacity as primary servicer. As special servicer, the Company will earn a servicing fee of 0.25% per annum of the outstanding balance of each loan in default. Servicing fees on defaulted loans are earned and paid monthly once a loan enters default status. Currently, there are two loans in default. Fees received for loan servicing approximate the actual cost of servicing.

(i) Securities Sold, But Not Yet Purchased

The Predecessor entered into certain transactions (short sales and purchases, and securities resale and repurchase agreements) to mitigate the effects that changes in interest rates and credit spreads have on the fair value of its fixed rate loan portfolio held for sale. In connection with the Predecessor s short sales, its obligation to deliver the securities to Goldman, Sachs & Co. is recorded in the statement of financial position under the caption Securities sold, but not yet purchased . This liability is carried at market value with any unrealized gain or loss recorded in the statement of operations. The related interest expense is recorded in the income statement of operations over the period held.

(j) Securities Purchased Under Resale Agreements

Purchases of securities under agreements to resell and sales of securities under agreements to repurchase are accounted for as secured lending and financing transactions, respectively. In connection with the Predecessor s purchase contracts, its obligation to resell the securities to Goldman, Sachs & Co. is recorded in the Statement of Financial Position under the caption Securities purchased under resale agreements. These assets are carried at the amounts at which the identical securities will be subsequently resold as specified in the agreements, generally at market value. The related interest income is recorded in the statements of operations over the contract period.

(k) Interest Rate Swap Contracts

The Company enters into forward interest rate swap contracts as a means of mitigating the impact that changes in interest rates and credit spreads have with respect to the forecasted issuance of long term debt. The contracts are evaluated at inception and on an on-going basis in order to determine whether the contracts qualify for hedge accounting under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities , as amended and interpreted. The hedge instrument must be highly effective in achieving offsetting changes in the hedged item attributable to the risk being hedged in order to qualify for hedge accounting treatment. Forward starting interest rate swaps accounted for cash flow hedges are carried on the statement of financial position at fair value with changes in their fair value recorded in accumulated other comprehensive income (loss). Any ineffectiveness which arises during the hedging relationship is recognized in interest expense during the period in which it arises.

The Predecessor entered into interest rate swap arrangements to mitigate the impact that changes in interest rates and credit spreads have on the value of its fixed rate loan portfolio held for sale. The term of the derivative contracts is determined by duration of the loans held for sale pool. Swap contracts are carried at market value with any unrealized gain or loss recorded in the statement of operations. The related interest income and interest expense is recorded in the statements of operations over the period held.

(l) Property and Equipment

Property and equipment are reported at cost less accumulated depreciation. Depreciation is recorded on a straight-line basis over five years for furniture and fixtures, and three years for computers and equipment. Leasehold improvements are amortized over the remaining term of the respective leases.

Depreciation expense for the three months ended March 31, 2004 and 2003 was $30,169 and $35,248, respectively.

(m) Equity incentive and Option plan

Immediately prior to the IPO, the Company adopted an equity incentive plan and issued restricted common shares to its executives, employees and non-employee trustees. Deferred compensation expenses were recorded by the Company as reduction to stockholders equity and charged to compensation expense on a straight-line basis over the vesting period of three years.

The options of the Predecessor were recorded based on the fair value method as prescribed in SFAS 123, *Accounting for Stock-Based Compensation*. The option plan was terminated prior to the formation transaction on December 22, 2003.

(n) Comprehensive Income (Loss)

Comprehensive income (loss) represents net income (loss) and certain amounts reported directly in stockholders equity, such as net unrealized gain or loss on retained interests in securitizations and the change in the fair value of cash flow hedges. The Company has reported comprehensive income (loss) in the statements of changes in stockholders equity. Accumulated other comprehensive income (loss) reported in the statements of financial position as of March 31, 2004 and December 31, 2003, represents the accumulated unrealized gain on retained interests in securitizations and interest rate swaps accounted for as cash flow hedges.

(o) Income Taxes

The Company has elected to be treated as a real estate investment trust (hereafter REIT) for federal income tax purposes. To maintain its status as a REIT, the Company must comply with the REIT provisions of the Internal Revenue Code of 1986, as amended (hereafter IRC). If the Company distributes 90% of its taxable income to its shareholders and satisfies the various REIT asset, income, stock ownership and other tests under the IRC, the Company generally will not be subject to federal income tax. If the Company fails to qualify as a REIT in any taxable year, it will be subject to federal income tax (including any applicable alternative minimum tax) on its taxable income at regular corporate rates. Even if the Company qualifies as a REIT, it may be subject to federal income tax and excise tax on its undistributed taxable income and may also be subject to state and local income taxes. The Company s subsidiary, Falcon Financial II, LLC is a taxable REIT subsidiary (TRS) for federal income tax purposes and is fully taxable at normal corporate tax rates.

(p) Loss per Share

The Company calculates basic earnings per share by dividing net income (loss) for the period by the weighted-average shares of its common stock outstanding for that period. Diluted earnings per share takes into account the effect of dilutive instruments, such as unvested restricted shares, based on the average share price for the period in determining the number of incremental shares that are added to the weighted-average number of shares outstanding using the treasury stock method.

(q) Reclassifications

Certain items from prior years have been reclassified to conform with the 2004 classifications.

(r) Recent Accounting Developments

In January 2003, the FASB issued FASB Interpretation (FIN) No. 46 Consolidation of Variable Interest Entities. FIN No. 46 requires a company to consolidate a variable interest entity (VIE) if the company has variable interests that give it a majority of the expected losses or a majority of the expected residual returns of the entity. Prior to FIN No. 46, VIEs were commonly referred to as SPEs. FIN No. 46, as amended by FIN No. 46-6 Effective Date of FASB Interpretation 46 which was released by FASB in October 2003, is effective for public companies in the first interim or annual period ending after December 15, 2003, if certain conditions are met. The Company must apply the standards of FIN No. 46 in its year end September 30, 2004 financial statements. Adoption of this new accounting standard did not have a material effect on the Company s financial condition or results of operations.

(3) Loans and Loans Held for Sale

Loans as of March 31, 2004 and December 31, 2003 are summarized as follows:

	March 31, 2004	December 31, 2003
Franchise mortgage loans	$ 154,056,613	$ 127,846,080
Less: Net deferred loan origination fees and initial direct costs	849,368	682,766
Allowance for possible loan losses	(1,318,368)	(1,086,692)
Loans, net	$ 151,888,877	$ 126,076,622

Loans receivable at March 31, 2004 are comprised of fixed-rate loans with interest rates ranging between 7.18 % and 9.52%. Maturity dates range from February 1, 2011 to April 1, 2023 with 70.4% maturing during 2018. Five loans totaling approximately $36.8 have balloon payments of approximately $4.0 million on February 1, 2011, approximately $1.5 million on December 1, 2013, approximately $2.0 million on March 1, 2014 and approximately $17.1 million on April 1, 2014. There are 20 borrowers located in 16 states. Approximately 44.6% of the principal balance of the loans are to six borrowers located in three states (Florida-18.1%, Tennessee-13.9% and Ohio-12.6%). There are no other concentrations greater than 10% in any other state or to any individual borrower.

Loans receivable at December 31, 2003 are comprised of fixed-rate loans with interest rates ranging between 8.14 % and 9.52%. Maturity dates range from February 1, 2011 to April 1, 2023 with 78.9% maturing during 2018. Two loans totaling approximately $9.6 have balloon payments of approximately $4.0 million on February 1, 2011 and approximately $1.5 million on December 1, 2013. There are 17 borrowers located in 15 states. Approximately 33.13% of the principal balance of the loans are to three borrowers located in two states (Florida-22.1% and Virginia-11.03%). There are no other concentrations greater than 10% in any other state or to any individual borrower.

The Company originates franchise mortgage loans secured by automotive dealerships, including real estate and improvements (real collateral), parts inventory, and blue-sky value (business asset collateral). Blue-sky, or franchise value, is an intangible asset that is a function of, among other things, the business reputation, brand strength, financial strength, and market share of the dealership. The Company also originates mortgage loans secured by real collateral. The Company s liens on business asset collateral may be subordinated in whole or in part to liens held by other lenders.

There were no loans with unpaid principal or interest balances contractually past due or on non-accrual status as of March 31, 2004 and December 31, 2003.

(4) Allowance for Possible Loan Losses

The Company establishes an allowance for possible loan losses to reserve for losses inherent in its loan portfolio. The following summarizes the activity in the allowance for possible loan losses for the period from December 31, 2003 through March 31, 2004:

Balance at December 31, 2003	$ 1,086,692
Provision for possible loan losses	231,676
Balance at March 31, 2004	$ 1,318,368

(5) Derivative Instruments and Hedging Activities

The Company enters into forward starting interest rate swap transactions to mitigate the effect that changes in interest rates and credit spreads have on the forecasted issuance of long-term debt. In swap transactions, the Company will generally enter into an interest rate swap contract, receiving a floating rate of interest and paying a fixed rate of interest. The term of the swap contracts is determined by the duration of the forecasted long-term debt to be issued. These swaps are accounted for as cash flow hedges and changes in their fair value are recorded in other comprehensive income.

The Predecessor entered into certain transactions (short sales and purchases, securities resale and repurchase agreements, and interest rate swaps) to mitigate the effect that changes in interest rates and credit spreads have on the fair value of its fixed rate loan portfolio held for sale. Periods of rising interest rates and widening credit spreads decrease the fair value of the loan portfolio held for sale. Generally, the Predecessor entered into these transactions when the rate was locked on a pending loan just prior to the closing of the loan. The new loan was added to the pool of loans being held for sale and the pool then reviewed to determine what, if any, additional hedging transaction was to be executed. Generally, the Predecessor shorted U.S. Treasuries and invested the proceeds in repurchase agreements with Goldman, Sachs & Co. with U.S. Treasury notes as the underlying securities. In swap transactions, the Predecessor generally entered into an interest rate swap contract, receiving a floating rate of interest and paying a fixed rate of interest. The term of the swap contracts was determined by duration of the loans held for sale pool. The Predecessor had a contractual obligation to settle the repurchase and swap agreements with Goldman, Sachs & Co. at the current fair value on the repurchase date. These contracts have been recorded as free standing derivatives with changes in fair value recorded in earnings.

As of March 31, 2004, the Company had four forward starting interest rate swap contracts accounted for as cash flow hedges on which the Company pays fixed and received floating. The contracts had a total notional amount of $94,271,976 and a fair value of ($2,929,733). There was no accrued interest on these contracts at March 31, 2004. The contracts had maturity dates ranging from April 1, 2014 to December 1, 2016. Fixed interest rates ranged from 4.045% to 4.815% and a floating rate of 1.10%.

As of December 31, 2003, the Company had four forward starting interest rate swap contracts accounted for as cash flow hedges on which the Company pays fixed and received floating. The contracts had a total notional amount of $94,271,976 and a fair value of $389,783. There was no accrued interest on these contracts at December 31, 2003. The contracts had maturity dates ranging from April 1, 2014 to December 1, 2016. Fixed interest rates ranged from 4.045% to 4.815% and a floating rate of 1.12%.

As of March 31, 2004 and December 31, 2003, included in accumulated other comprehensive income (loss) for the forward starting interest rate swap contracts was ($2,864,250) and $389,783, respectively. The balance at March 31, 2004 is net of $65,483 that was reclassified to the statement of operations for ineffectiveness in the hedge relationship.

(6) Loan Securitization

Through a special purpose bankruptcy remote subsidiary, the Predecessor entered into securitization transactions that qualified as sales for financial reporting purposes, resulting in off-balance sheet accounting treatment. The Predecessor retained rated and nonrated certificates issued in connection with the securitization transaction.

In February 2003, the Predecessor completed Falcon Auto Dealership Loan Trust Certificates 2003-1, securitizing loans with a principal balance of $141,060,558, receiving net proceeds (after the payment of expenses) of $145,464,590 and retaining rated and non-rated certificates with an allocated book value of $4,962,378 and a fair value of $5,431,623. The securitization transaction resulted in a pretax gain of $10,696,524. The proceeds from the securitization were used to pay down borrowings outstanding under the warehouse line of credit and the senior subordinated loan.

In February 2003, the Predecessor sold 100% of its rated retained interest in the 2003-1 Trust to a third party. The Predecessor received proceeds of $2,983,560 and realized a gain of $265,352.

In August 2003, a delinquency was experienced in the 2003-1 Trust for a loan with an unpaid principal balance of approximately $9.5 million. The loan defaulted in September 2003 and the Predecessor estimated that there would be an other than temporary reduction in the aggregate cash flows that the Predecessor expects to receive from the 2003-1 Trust for its unrated retained interest. Accordingly, the Predecessor charged $422,477 to expense, which was the amount considered to be other than temporary decline in the Predecessor s fair value of the unrated retained interest. This estimated reduction in aggregate cash flows was based on management s assessment of the amounts it would ultimately collect on the defaulted loan.

In October 2003, Moody s downgraded the Class A-1 and A-2 certificates in the 2003 securitization from From Aaa to Aa1, the Class B certificates from Aa2 to Aa3, the Class C certificates from A2 to A3, the Class D certificates from Baa2 to Baa3, the Class E certificates from Ba2 to Ba3, and the Class F certificates from B3 to Caa2. In November 2003, Moody s further downgraded the the Class A-1 and A-2 certificates in this securitization from Aa1 to Aa2, the Class B certificates from Aa3 to A1, the Class C certificates from A3 to Baa1, the Class D certificates from Baa3 to Ba1, the Class E certificates fromBa3 to B3, and the Class F certificates from Caa2 to Caa3. In November 2003, Fitch Ratings downgraded the Class E certificates in this securitization from BB to B+ and the Class F certificates from B to CC. Additionally, Fitch Ratings placed the Class B, C, D, E and F certificates on rating watch for potential downgrade. Fitch Ratings affirmed the Class A certificates at AAA. There have been no other ratings downgrades subsequent to November 2003.

In January 2004, a delinquency was experienced in the 2001-1 Trust for a loan with an unpaid principal balance of approximately $2.5 million. The loan defaulted in January 2004 and the Company estimated that there would be an other than temporary reduction in the aggregate cash flows that the Company expects to receive from the 2001-1 Trust for its unrated retained interest. While this delinquency resulted in an estimated $0.2 million reduction in the value of the retained interest on the 2001-1 Trust, it was offset by unrealized gains in accumulated other comprehensive income for the 2001-1 transaction and accordingly, did not result in a charge to the statement of operations. This estimated reduction in aggregate cash flows was based on management s assessment of the amounts it would ultimately collect on the defaulted loan. The real estate collateral for this loan was foreclosed upon.

For the 1999-1 Trust, 2000-1 Trust, 2001-1 Trust and the 2003-1 Trust, the Master Servicer fee rate was 0.065% (0.055% on the 2003-1 Trust), the Primary Servicer fee rate was 0.085% (0.095% on the 2003-1 Trust) and the Trustee fee rate was 0.010%.

The activity related to the Company s retained interests for the three months ended March 31, 2004 is as follows:

	Three Months ended March 31, 2004
Balance at beginning of period	$ 7,239,136
Interest income recorded	304,474
Cash received	(293,823)
Fair value adjustments	136,960
Balance at end of period	$ 7,386,747

The Company s key assumptions used to value the retained interests at March 31, 2004 are the loss/prepayment rate over the life of the transaction (which range from 3.10% to 5.88%), and the discount rates applied to the future cash flows (which range from 14.37% to 18.80%). These assumptions are consistent with the assumption used at December 31, 2003 to value the retained interests. The result of changing the key economic and sensitivity of the current fair value of retained interest to an immediate 10% and 20% adverse change in those assumptions would not be materially different than those previously discussed in the Company s Transition Report on Form 10-K for the transition period ended December 31, 2003.

As of March 31, 2004 and December 31, 2003 net unrealized gains for the Company's retained interests in securitizations included in accumulated other comprehensive income (loss) was $1,418,893 and $1,281,933, respectively.

(7) Borrowings

The Predecessor entered into a $150 million Revolving Warehouse Financing Agreement dated January 7, 1998 (the Warehouse Loan Agreement) with ABN AMRO Bank, N.V., as lender, and SunAmerica Life Insurance Company or SALIC (an affiliate of SunAmerica, Inc.), as guarantor (collectively, the Lenders), solely for the purpose of originating loans. SALIC, along with Goldman Sachs Mortgage Company (an affiliate of Goldman, Sachs & Co.), as a result of a participation agreement between two entities, were the guarantors of the Warehouse Loan Agreement. As guarantors, each of the entities was paid fees of $197,998. The fees are shown on the statements of operations within the caption interest expense related party. The maturity date is October 1, 2004. This credit facility was collateralized by the loans held for sale. The Company is required to make prepayments under the warehouse facility under certain circumstances. Among other things, in the event that a customer defaulted on a scheduled loan payment that is not cured within 30 days, such loan was to be treated as a defaulted receivable and the Company required to prepay the outstanding principal amount of the borrowings incurred under the warehouse facility in respect of such defaulted receivable. Interest was calculated using a 30 day commercial paper rate plus 300 basis points until December 22, 2003, when it was reduced to a 30 day commercial paper rate plus 200 basis points (which includes amounts paid to the guarantors as described above.) The interest rates as of March 31, 2004 and December 31, 2003 were 3.03% and 3.09%, respectively. The outstanding balance as of March 31, 2004 and December 31, 2003 was $74,235,213 and $53,475,879, respectively. On April 28, 2004, the outstanding balance under the Warehouse Loan Agreement was paid in full and the Warehouse Loan Agreement was terminated, as described below in Note 10 - Subsequent Events.

The Company entered into a $19.3 million Amended and Restated Senior Subordinated Loan Agreement dated January 7, 1998, with Goldman Sachs Mortgage Company and SALIC. The agreement provided for a $5.0 million working capital loan, a $2.0 million hedge loan and $12.3 million for loan originations. The interest rate on the senior subordinated loan was 12%, with 9% payable in cash and 3% accrued and capitalized. This loan was paid-in-full on December 23, 2003 and the loan terminated.

The Predecessor entered into a $0.5 million Junior Subordinated Loan Agreement dated April 19, 1999 with Falcon Auto Venture, LLC. The agreement provided for a $0.5 million working capital loan. The interest rate on the junior subordinated loan was 12%, with 9% payable in cash and 3% accrued and capitalized. This loan was paid-in-full on December 23, 2003 and the loan terminated.

The Warehouse Loan Agreement required that the Company maintain certain financial covenants related to aggregate indebtedness, net income, net worth, leverage ratio, capital expenditures and lease commitments. In addition, the Warehouse Loan Agreement also specified various events (Termination Events) that would allow the Lenders to terminate the warehouse facility in its entirety should one of these events occur, including, among other things, (i) a material adverse change in the Company s business, financial condition or prospects or (ii) a downgrade or other impairment of the rating of any notes issued in the Company s securitization transactions. In October 2003 and November 2003, the notes issued in the Company s Falcon Trust Series 2003-1 securitization were downgraded by the ratings agencies. The Company received a waiver from the Lenders for this Termination Event.

(8) Equity Incentive and Option Plan

In November 2003, the Company adopted the 2003 Equity Incentive Plan to provide incentives to employees, non-employee trustees and other service providers to stimulate their efforts toward the Company s continued success, long-term growth and profitability and to attract, reward and retain key personnel. The plan approved 725,658 restricted common shares reserved for issuance, of which 318,300 were issued immediately prior to the closing of the IPO, with the remaining 407,358 shares available for future issuance. The 318,300 shares issued were valued at the IPO price of $9 per share and recorded in equity under the caption of unearned compensation. During the three months ended March 31, 2004, 10,000 additional shares valued at $9.38 per share were issued and 5,000 shares were retired bringing the outstanding restricted shares to 323,300. The shares vest over three years and will be amortized into the statement of operations as compensation expense ratably over the vesting period.

In September 1999, the Predecessor adopted the Falcon Financial, LLC Option Plan. The Predecessor granted certain employees options, which generally expired 10 years from the grant date, to purchase membership interests in the Predecessor at prices not less than the market value of the membership interests on the grant date. Option exercise prices were determined by reference to comparable public company market values and earnings multiples. Options vested at a rate of 20% per year beginning one year after the date of hire. The Predecessor did not incur an expense associated with the option plan for the three months ended March 31, 2003. The plan was terminated prior to the formation transaction on December 22, 2003 and thru that date no options had been exercised.

(9) Commitments and Contingencies

(a) Financial Instruments with Off-Balance Sheet Risk

The Company s financial instruments with off-balance sheet risk were limited to fixed-rate mortgage loan origination commitments with total contractual amounts of $0 and $2.2 million as of March 31, 2004 and December 31, 2003, respectively. These instruments involve elements of credit risk and interest rate risk in addition to the amounts recognized in the statements of financial position. The contractual amounts represent the Company s maximum potential exposure to credit loss but do not necessarily represent future cash requirements since certain commitments may expire without being funded. Loan commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee by the customer. Commitments are subject to the Company s credit approval process, including a case-by-case evaluation of the customer s creditworthiness and related collateral requirements. The Company collected cash deposits in connection with these commitments of $0 and $19,534, as of March 31, 2004 and December 31, 2003, respectively.

(10) Related Party Transactions

The Company is involved in significant financing, risk management and other transactions, and has had significant related party balances, with Goldman, Sachs & Co. (an affiliate of MLQ Investors, LP), SunAmerica, Inc. and Falcon Auto Venture, LLC, both directly and indirectly through affiliates and subsidiaries of the entities. The Company enters into these transactions in the ordinary course of business and believes that the terms of these transactions are on market terms that could be obtained from unrelated third parties. As of December 22, 2003 after the IPO transaction, the aforementioned related parties are no longer considered related parties as their ownership of the Company has been significantly reduced (less than 5%).

Included in the Statement of Operations are revenues and expenses resulting from various financing, capital markets transactions and loan sales transactions. The following table sets forth the related party revenues and expenses included in the respective captions on the Statement of Operations for the three months ended March 31, 2003. The amounts reflect the related party transactions with Goldman, Sachs & Co., except where otherwise indicated and are as follows:

	Three months ended March 31,2003