

Colony Financial, Inc.  
Form 10-Q  
May 13, 2010  
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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 March 31, 2010

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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|  |  |
|--|--|
| <b>Maryland</b><br>(State or Other Jurisdiction of<br>Incorporation or Organization)                               | <b>27-0419483</b><br>(I.R.S. Employer<br>Identification No.) |
| <b>2450 Broadway, 6th Floor</b><br><br><b>Santa Monica, California</b><br>(Address of Principal Executive Offices) | <b>90404</b><br>(Zip Code)                                   |
| <b>(310) 282-8820</b><br>(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 website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 and 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 <input type="checkbox"/>  | Accelerated Filer <input type="checkbox"/>         |
| Non-Accelerated Filer <input checked="" type="checkbox"/> (Do not check if a smaller reporting company) | Smaller Reporting Company <input type="checkbox"/> |

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 May 13, 2010, 14,631,000 shares of the Registrant's common stock, par value \$.01 per share, were outstanding.

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

|   | March 31,<br>2010<br>(Unaudited) | December 31,<br>2009 |
|---|----------------------------------|----------------------|
| <b>ASSETS</b>   |                                  |                      |
| Investments in unconsolidated joint ventures  | \$ 188,034                       | \$ 129,087           |
| Cash and cash equivalents   | 99,507                           | 157,330              |
| Other assets  | 1,866                            | 1,112                |
| <b>Total assets</b>   | <b>\$ 289,407</b>                | <b>\$ 287,529</b>    |
| <b>LIABILITIES AND EQUITY</b>   |                                  |                      |
| <b>Liabilities:</b>   |                                  |                      |
| Accrued and other liabilities   | \$ 1,275                         | \$ 1,112             |
| Due to affiliate  | 863                              | 476                  |
| Dividends payable   | 2,341                            | 1,024                |
| Deferred underwriting discounts and commissions payable to underwriters                                 | 5,750                            | 5,750                |
| Deferred underwriting discounts and commissions reimbursable to Manager                                 | 5,750                            | 5,750                |
| <b>Total liabilities</b>  | <b>15,979</b>                    | <b>14,112</b>        |
| Commitments and contingencies   |                                  |                      |
| <b>Equity:</b>  |                                  |                      |
| Stockholders' equity:   |                                  |                      |
| Preferred stock, \$0.01 par value, 50,000,000 shares authorized, none outstanding                       |                                  |                      |
| Common stock, \$0.01 par value, 450,000,000 shares authorized, 14,631,000 shares issued and outstanding | 146                              | 146                  |
| Additional paid-in capital  | 275,262                          | 275,247              |
| Distributions in excess of earnings   | (1,669)                          | (1,424)              |
| Accumulated other comprehensive loss  | (362)                            | (592)                |
| <b>Total stockholders' equity</b>   | <b>273,377</b>                   | <b>273,377</b>       |
| Noncontrolling interest   | 51                               | 40                   |
| <b>Total equity</b>   | <b>273,428</b>                   | <b>273,417</b>       |
| <b>Total liabilities and equity</b>   | <b>\$ 289,407</b>                | <b>\$ 287,529</b>    |

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

**Table of Contents****COLONY FINANCIAL, INC.****CONSOLIDATED STATEMENT OF OPERATIONS****(In thousands, except share and per share data)****(Unaudited)**

|   | <b>Three Months Ended<br/>March 31, 2010</b> |
|---|--|
| <b>Income</b>   |  |
| Equity in income of unconsolidated joint ventures                   | \$ 3,915                                     |
| Interest income   | 170  |
| Total income  | 4,085  |
| <b>Expenses</b>   |  |
| Base management fees  | 660  |
| Investment expenses   | 99   |
| Administrative expenses   | 929  |
| Administrative expenses reimbursed to affiliate                     | 271  |
| Total expenses  | 1,959  |
| Foreign exchange loss, net of gain on foreign currency hedge of \$5 | (28)   |
| <b>Net income</b>   | <b>2,098</b>                                 |
| Net income attributable to noncontrolling interest                  | 2  |
| <b>Net income attributable to common stockholders</b>               | <b>\$ 2,096</b>                              |
| Net income per share:   |  |
| Basic   | \$ 0.14                                      |
| Diluted   | \$ 0.14                                      |
| Weighted average number of common shares outstanding:               |  |
| Basic   | 14,625,000                                   |
| Diluted   | 14,912,500                                   |
| Dividends declared per common share                                 | \$ 0.16                                      |

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

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

|   | <b>Three Months Ended<br/>March 31, 2010</b> |
|---|--|
| <b>Cash Flows from Operating Activities</b>                                       |  |
| Net income  | \$ 2,098                                     |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |
| Amortization of nonvested common stock compensation                               | 15   |
| Equity in income of unconsolidated joint ventures                                 | (3,915)                                      |
| Distributions of income from unconsolidated joint ventures                        | 2,362  |
| Foreign exchange loss   | 28   |
| Changes in operating assets and liabilities:                                      |  |
| Increase in other assets  | (351)  |
| Increase in accrued liabilities   | 445  |
| Increase in due to affiliate  | 387  |
| Net cash provided by operating activities   | 1,069  |
| <b>Cash Flows from Investing Activities</b>                                       |  |
| Contributions to unconsolidated joint ventures                                    | (58,062)                                     |
| Distributions from unconsolidated joint ventures                                  | 316  |
| Proceeds from settlement of derivatives   | 5  |
| Net cash used in investing activities   | (57,741)                                     |
| <b>Cash Flows from Financing Activities</b>                                       |  |
| Dividends paid to common stockholders   | (1,024)                                      |
| Payment of offering costs   | (125)  |
| Distributions to noncontrolling interest  | (2)  |
| Net cash used in financing activities   | (1,151)                                      |
| Net decrease in cash  | (57,823)                                     |
| Cash and cash equivalents, beginning of period                                    | 157,330                                      |
| Cash and cash equivalents, end of period  | \$ 99,507                                    |
| <b>SUPPLEMENTAL DISCLOSURE OF NONCASH FINANCING ACTIVITIES:</b>                   |  |
| Dividends payable   | \$ 2,341                                     |

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

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**COLONY FINANCIAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**March 31, 2010**

**(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 investments. The Company completed the initial public offering (the IPO) and concurrent private placement of its common stock and commenced operations on September 29, 2009. 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**

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

The accompanying interim financial statements have been prepared, without audit, 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 period 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, 2010 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, 2009.

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

***Investment in Unconsolidated Joint Ventures***

Since the commencement of operations on September 29, 2009, all of the Company's investment activities have been structured as joint ventures with one or more of the private investment funds managed by affiliates of Colony Capital, LLC (Colony Capital), the sole member of the Manager, under the investment allocation agreement (see Note 7). The Company has evaluated the joint ventures and concluded that they are variable interest entities (VIEs); however, the Company is not the primary beneficiary of the VIEs. Since the Company is not the primary beneficiary and is not required to consolidate the VIEs, the Company accounts for investments in joint ventures using the equity method. The Company initially records investments in unconsolidated joint ventures at cost and adjusts for the Company's proportionate share of net earnings or losses, cash contributions made and distributions received, and other adjustments, as appropriate. Distributions of operating profit from 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. The joint ventures' critical accounting policies are similar to the Company's and their financial statements are prepared in accordance with GAAP.

***Foreign Currency Translation***

Investments in unconsolidated foreign joint ventures denominated in Euro are translated at the exchange rate on the balance sheet date. Income from investments in unconsolidated foreign joint ventures is translated at the average rate of exchange prevailing during the period such income was earned. Translation adjustments resulting from this process are recorded as other comprehensive income (loss).

***Income Taxes***

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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 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.

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**COLONY FINANCIAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**March 31, 2010**

**(Unaudited)**

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 the Company may perform non-customary services for tenants of the Company, hold assets that the Company 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 TRS is treated as a regular corporation and is subject to federal, state, local, and foreign taxes on its income and property.

***Recent Accounting Updates***

On June 12, 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 166, Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140, subsequently reissued as Accounting Standards Update (ASU) No. 2009-16, *Accounting for Transfers of Financial Assets*, which updates FASB Accounting Standards Codification (ASC) 860, *Transfers and Servicing*. ASU No. 2009-16 removes the concept of a qualifying special-purpose entity (SPE) from FASB ASC 860 and eliminates the exception for qualifying SPEs from the consolidation guidance of FASB ASC 810, *Consolidation*. In addition, among other things, ASU No. 2009-16 (i) amends and clarifies the unit of account eligible for sale accounting as an entire financial asset, group of entire financial assets, or participating interest in an entire financial asset; (ii) eliminates the practicability exception for fair value measurement of assets obtained and liabilities incurred by a transferor in a transfer that meets the conditions for sale accounting; (iii) removes the special provisions in FASB ASC 860 for guaranteed mortgage securitizations; (iv) clarifies the requirements of the legal isolation analysis and the principle of effective control; and (v) requires enhanced disclosure about, among other things, a transferor's continuing involvement with transfers of financial assets accounted for as sales, the risks inherent in transferred financial assets that have been retained, and the nature and financial effect of restrictions on the transferor's assets that continue to be reported on the balance sheet.

In conjunction with the issuance of SFAS No. 166, the FASB also issued SFAS No. 167, Amendments to FASB Interpretation No. 46(R), subsequently reissued as ASU No. 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*, which updates FASB ASC 810. Among other things, ASU No. 2009-17 amends certain guidance in FASB ASC 810 for determining whether an entity is a VIE, requires a qualitative rather than a quantitative analysis to determine the primary beneficiary of a VIE, and requires enhanced disclosures about an enterprise's involvement with a VIE. Under ASU No. 2009-17, an entity will be required to consolidate a VIE if it has both (a) the power to direct the activities of a VIE that most significantly impact the entity's economic performance and (b) the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. In addition, ASU No. 2009-17 removes the current exemption for troubled debt restructurings.

The adoption of ASU No. 2009-16 and ASU No. 2009-17 effective January 1, 2010 did not have a material effect on the Company's consolidated financial position, results of operations or disclosures.

On January 21, 2010, the FASB issued ASU No. 2010-06, *Improving Disclosures about Fair Value Measurements*. ASU No. 2010-06 amends FASB ASC 820, *Fair Value Measurements and Disclosures*, to require a number of additional disclosures regarding fair value measurements. Specifically, ASU No. 2010-06 requires entities to disclose: (1) the amount of significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for these transfers; (2) the reasons for any transfers in or out of Level 3; and (3) information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements on a gross basis. Except for the requirement to disclose information about purchases, sales, issuances, and settlements in the reconciliation of recurring Level 3 measurements on a gross basis, which are effective for fiscal years beginning after December 15, 2010, all the amendments to FASB ASC 820 made by ASU No. 2010-06 were effective for the Company beginning January 1, 2010. The adoption of the new disclosure requirements did not have a material effect on the Company's disclosures, as we did not have any transfers between Level 1 and Level 2 fair value measurements and do not have any Level 3 assets or liabilities. The adoption of the remaining provisions of ASU No. 2010-06 is not expected to have a material effect on the Company's disclosures.

On April 29, 2010, the FASB issued ASU No. 2010-18, *Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset a consensus of the FASB Emerging Issues Task Force*. ASU No. 2010-18 amends FASB ASC 310, *Receivables*, such that

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modifications of loans that are accounted for within a pool do not result in the removal of those loans from the pool even if the modification of those loans would otherwise be considered a troubled debt restructuring. ASU No. 2010-18 is effective for the first interim or annual period ending on or after July 15, 2010, or three months ending September 30, 2010 for the Company. The Company is currently evaluating the effect, if any, the adoption of ASU No. 2010-18 will have on its consolidated financial position and results of operations.

**Table of Contents****COLONY FINANCIAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2010****(Unaudited)****3. Investments in Unconsolidated Joint Ventures**

Pursuant to the investment allocation agreement between the Company, the Manager and Colony Capital (see Note 7), the Company's recent investment activities have been structured as joint ventures with one or more funds managed by Colony Capital or its affiliates. The joint ventures are generally capitalized through equity contributions from the members, although in certain cases they have leveraged their investments through Term Asset-Backed Securities Loan Facility ( TALF ) financing or other lending arrangements. The Company believes that the joint ventures could obtain financing for their investments, if necessary, at competitive market rates. 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 has analyzed each of the joint ventures and determined that they are VIEs, but that the Company is not the primary beneficiary. In performing its analysis of whether it is the primary beneficiary, the Company considers whether it individually has the power to direct the activities of the VIE that most significantly impact 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, involve significant judgments, including estimates about the current and future fair values and performance of assets held by the VIE and/or general market conditions.

Activity in the Company's investments in unconsolidated joint ventures for the three months ended March 31, 2010 is summarized below (in thousands):

|                                      | <b>Three Months Ended<br/>March 31, 2010</b> |
|--------------------------------------|--|
| Balance at December 31, 2009         | \$ 129,087                                   |
| Contributions                        | 58,062                                       |
| Distributions                        | (2,678)                                      |
| Equity in net income                 | 3,915  |
| Equity in other comprehensive income | 548  |
| Foreign exchange translation loss    | (900)  |
| <b>Balance at March 31, 2010</b>     | <b>\$ 188,034</b>                            |

The following are the Company's investments in various joint ventures with one or more funds managed by Colony Capital or its affiliates under the investment allocation agreement (see Note 7). The Company's interest in each joint venture as of March 31, 2010 is as follows:

**Joint Venture**

**The Company's  
Ownership Percentage**

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|   |                    |
|---|--------------------|
| ColFin NW Funding, LLC ( NW Investor )                          | 37.88%             |
| ColFin WLH Funding, LLC ( WLH Investor )                        | 24.03%             |
| ColFin DB Guarantor, LLC ( DB Investor )                        | 33.33%             |
| ColFin FRB Investor, LLC ( FRB Investor )                       | TBD <sup>(1)</sup> |
| ColFin 666 Funding, LLC ( 666 Investor )                        | 33.33%             |
| Colony Funds Sants S.à r.l. ( Colonial Investor )               | 5.12%              |
| ColFin ALS Funding, LLC ( ALS Investor )                        | 33.33%             |
| ColFin J-11 Funding, LLC ( J-11 Investor )                      | 33.33%             |
| ColLaguna (CA Lux) S.à r.l. ( Laguna Investor )                 | 33.33%             |
| ColFin WLH Land Acquisitions, LLC ( WLH Land Investor )         | 24.03%             |
| Matrix CDCF-CFI Advisors VI, LLC ( Matrix Investor )            | 33.33%             |
| C-VIII CDCF CFI MBS Investor, LLC ( MBS Investor )              | 33.33%             |
| Colony CDCF-VIII-CFI Investor, LLC ( Deposit Funding Investor ) | 33.33 %            |

(1) The final ownership percentage is dependent on the final capitalization of the transaction.

**Table of Contents****COLONY FINANCIAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2010****(Unaudited)**

The Company made the following investments in unconsolidated joint ventures during the three months ended March 31, 2010:

On January 7, 2010, DB Investor, a joint venture with investment funds managed by affiliates of the Manager, consummated a structured transaction with the Federal Deposit Insurance Corporation (the "FDIC"). DB Investor acquired a 40% managing-member interest in a newly formed limited liability company ("DB Venture") created to hold acquired portfolio of loans, with the FDIC retaining the remaining 60% equity interest. This portfolio of loans includes approximately 1,200 loans with an aggregate unpaid principal balance of approximately \$1.02 billion, substantially all of which are first mortgage, recourse commercial real estate loans. The portfolio was effectively acquired at approximately 44% of the unpaid principal balance of the loans. The financing of the transaction includes 50% leverage (\$233 million of zero-coupon notes on which interest is imputed at 3.8%) provided by the FDIC, which has a term of up to seven years and must be paid in full prior to any distributions to the equity holders. DB Venture also pays DB Investor a 50-basis point asset management fee calculated on the aggregate unpaid principal balance of the outstanding portfolio (some of which will be used to pay costs associated with primary and special servicing). The Company contributed approximately \$30.2 million, exclusive of the required working capital and transaction costs, for its interest in DB Investor. In addition, the Company and other members of the joint venture committed to contribute up to an additional \$5.0 million to the extent it is required, in order to support a guaranty issued by the joint venture. The Company's share of this additional commitment is up to \$1.7 million.

On March 5, 2010, 666 Investor, a joint venture with investment funds managed by affiliates of the Manager, acquired a \$66.0 million pari-passu participation interest in a performing first mortgage loan on a Class A office building in midtown Manhattan with an aggregate unpaid principal balance of \$1.2 billion. The purchase price for the pari-passu first mortgage interest was approximately \$44.9 million, exclusive of transaction costs. The Company's pro rata share of the purchase price was approximately \$15.0 million, exclusive of transaction costs.

On March 8, 2010, ALS Investor, a joint venture with investment funds managed by affiliates of the Manager, originated a five-year \$30.4 million recourse loan secured by first liens on two Manhattan townhomes and a photography catalog. The Company's pro rata share of the loan funding was approximately \$9.9 million, exclusive of transaction costs and net of upfront origination fee of 2.0% of the loan amount. The loan bears an interest rate of 14% per annum, of which 4% may be paid-in-kind in the first 12 months at the borrower's option. ALS Investor is entitled to certain participation in the borrower's photography business based on the amount of free cash flow generated.

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

***Combined Condensed Balance Sheets of Unconsolidated Joint Ventures (in thousands)***

|  | <b>March 31, 2010</b> | <b>December 31, 2009</b> |
|--|-----------------------|--------------------------|
| <b>Assets:</b>                             |                       |                          |
| Cash                                       | \$ 9,089              | \$ 2,458                 |
| Loans held for investment net              | 860,578               | 371,907                  |
| Available-for-sale investment securities   | 39,325                | 37,580                   |
| Investment in unconsolidated joint venture | 213,054               | 220,227                  |
| Other assets                               | 42,525                | 21,149                   |

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|                              |              |            |
|------------------------------|--------------|------------|
| Total assets                 | \$ 1,164,571 | \$ 653,321 |
| Liabilities:                 |              |            |
| Debt                         | \$ 223,251   | \$ 31,856  |
| Other liabilities            | 10,776       | 14,104     |
| Total liabilities            | 234,027      | 45,960     |
| Owners' equity               | 782,614      | 607,361    |
| Noncontrolling interest      | 147,930      |            |
| Total liabilities and equity | \$ 1,164,571 | \$ 653,321 |
| Company's equity             | \$ 188,034   | \$ 129,087 |

**Table of Contents****COLONY FINANCIAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2010****(Unaudited)*****Combined Condensed Statement of Operations of Unconsolidated Joint Ventures (in thousands)***

|  | <b>Three Months Ended<br/>March 31, 2010</b> |               |
|--|--|---------------|
| <b>Income:</b>                                     |  |               |
| Interest income                                    | \$   | 18,406        |
| Income from joint venture                          |  | 5,425         |
| Other  |  | 640           |
| <b>Total income</b>                                |  | <b>24,471</b> |
| <b>Expenses:</b>                                   |  |               |
| Interest expense                                   |  | 2,260         |
| Transaction costs                                  |  | 1,706         |
| Other  |  | 2,946         |
| <b>Total expenses</b>                              |  | <b>6,912</b>  |
| <b>Net income</b>                                  |  | <b>17,559</b> |
| Net income attributable to noncontrolling interest |  | 170           |
| <b>Net income attributable to members</b>          | <b>\$</b>                                    | <b>17,389</b> |
| Company's share of transaction costs               | \$   | 568           |
| <b>Company's equity in net income</b>              | <b>\$</b>                                    | <b>3,915</b>  |

The accounting policies of the joint ventures are similar to those of the Company. Loans originated by the joint ventures are recorded at amortized cost, or the outstanding unpaid principal balance of the loan, net of unamortized acquisition premiums or discounts and unamortized costs and fees directly associated with the origination of the loan. Net deferred loan fees and origination costs are recognized in interest income over the loan term as a yield adjustment using the effective interest method or a method that approximates a level rate of return over the loan term. Loans acquired at a discount to face value where, at the acquisition date, 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 are recorded at the initial investment in the loan and subsequently accreted to the estimate of cash flows at acquisition expected to be collected. Costs and fees directly associated with acquiring loans with evidence of deteriorated credit quality are expensed as incurred. Loans are considered impaired when it is deemed probable that the joint venture will not be able to collect all amounts due according to the contractual terms of the loan or, for loans acquired at a discount to face value, when it is deemed probable that the joint venture will not be able to collect all amounts estimated to be collected at the time of acquisition. No loans held by the joint ventures were impaired at March 31, 2010.

As of March 31, 2010, approximately \$132.3 million, or 70%, of the Company's investments in unconsolidated joint ventures consisted of three investments.

**4. Derivative Instruments**

The Company has investments in two unconsolidated joint ventures denominated in Euro that expose the Company to foreign currency risk. The Company generally uses collars (consisting of caps and floors) without upfront premium costs to hedge the foreign currency exposure of its net investments. At March 31, 2010, the total notional amount of the collar is approximately 10.9 million with termination dates ranging from June 2010 to December 2012.

The fair values of derivative instruments included in the Company's balance sheet as of March 31, 2010 and December 31, 2009 are as follows (in thousands):

|   | March 31,<br>2010 | December 31,<br>2009 |
|---|-------------------|----------------------|
| <b>Assets</b>   |                   |                      |
| Foreign exchange contracts designated as hedging instruments under FASB ASC 815 included in other assets                  | \$ 896            | \$ 697               |
| <b>Liabilities</b>  |                   |                      |
| Foreign exchange contracts designated as hedging instruments under FASB ASC 815 included in accrued and other liabilities | \$ 223            | \$ 439               |

**Table of Contents****COLONY FINANCIAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2010****(Unaudited)****5. Fair Value Measurements**

The Company values certain assets and liabilities using the methods of fair value as described in FASB ASC 820. FASB ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. The three levels of inputs that may be used to measure fair value are as follows:

*Level 1* Quoted prices in active markets for identical assets or liabilities.

*Level 2* Prices are determined using other significant observable inputs. Observable inputs are inputs that other market participants would use in pricing a security. These may include quoted prices for similar securities, interest rates, prepayment speeds, credit risk and others.

*Level 3* Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period), unobservable inputs may be used.

The Company has certain assets and liabilities that are required to be recorded at fair value on a recurring basis in accordance with GAAP. These include cash equivalents and financial derivative instruments. The following table summarizes those assets and liabilities measured at fair value on a recurring basis as of March 31, 2010 and December 31, 2009 (in thousands):

|                                     | March 31, 2010 |         |         |           | December 31, 2009 |         |         |           |
|-------------------------------------|----------------|---------|---------|-----------|-------------------|---------|---------|-----------|
|                                     | Level 1        | Level 2 | Level 3 | Total     | Level 1           | Level 2 | Level 3 | Total     |
| <b>Assets:</b>                      |                |         |         |           |                   |         |         |           |
| Money market funds                  | \$ 26,023      | \$      | \$      | \$ 26,023 | \$ 36,015         | \$      | \$      | \$ 36,015 |
| Derivative instruments (see Note 4) |                | 896     |         | 896       |                   | 697     |         | 697       |
| Total assets                        | \$ 26,023      | \$ 896  | \$      | \$ 26,919 | \$ 36,015         | \$ 697  | \$      | \$ 36,712 |
| <b>Liabilities:</b>                 |                |         |         |           |                   |         |         |           |
| Derivative instruments (see Note 4) | \$             | \$ 223  | \$      | \$ 223    | \$                | \$ 439  | \$      | \$ 439    |
| Total liabilities                   | \$             | \$ 223  | \$      | \$ 223    | \$                | \$ 439  | \$      | \$ 439    |

The carrying value for money market funds approximates fair value because of the immediate or short-term maturity of these financial instruments. Money market funds are included in cash and cash equivalents on the Company's balance sheets.

**6. 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. 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):

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|   | <b>Three Months Ended<br/>March 31, 2010</b> |
|---|--|
| <b>Numerator:</b>   |  |
| Net income  | \$ 2,098                                     |
| Net income attributable to noncontrolling interest  | (2)  |
| Net income available to common stockholders   | \$ 2,096                                     |
| Net income allocated to participating securities (nonvested shares)   | (1)  |
| Numerator for basic and diluted net income allocated to common stockholders   | \$ 2,095                                     |
| <b>Denominator:</b>   |  |
| Basic weighted average number of common shares outstanding  | 14,625,000                                   |
| Weighted average effect of dilutive shares - common stock issuable for reimbursement of Manager's payment of initial underwriting discounts and commissions | 287,500                                      |
| Diluted weighted average number of common shares outstanding  | 14,912,500                                   |
| <b>Earnings per share:</b>  |  |
| Net income available to common stockholders per share - basic   | \$ 0.14                                      |
| Net income available to common stockholders per share - diluted   | \$ 0.14                                      |

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**COLONY FINANCIAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**March 31, 2010**

**(Unaudited)**

**7. Related Party Transactions**

***Management Agreement***

The Company entered into a management agreement with the Manager pursuant to which the Manager provides the day-to-day management of the Company's operations and earns base management and incentive fees. For the three months ended March 31, 2010, the Manager earned base management fees of \$660,000 and no incentive fees.

Pursuant to the management agreement, the Manager is reimbursed for expenditures related to the Company incurred by the Manager, including legal, accounting, financial, due diligence and other services. The Company does not reimburse the Manager for the salaries and other compensation of its personnel. However, 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. The Company may be required to pay its pro rata portion of rent, telephone, utilities, office furniture, equipment, machinery and other office, internal and overhead expenses of the Manager and its affiliates required for the Company's operations. For the three months ended March 31, 2010, administrative expenses include \$227,000 charged to the Company by Colony Capital for the costs of the Company's chief financial officer, \$24,000 of Colony Capital's expenses allocated to the Company on a pro rata basis, and \$20,000 of other direct charges incurred by Colony Capital related to the Company. In addition, Colony Capital charged the Company \$110,000 related to costs it incurred on behalf of the Company, of which \$48,000 is included in investment expenses, \$10,000 is included in investments in unconsolidated joint ventures and \$52,000 is included in other assets as pending investment costs.

***Investment Allocation Agreement***

Concurrently with the closing of the IPO, the Company, the Manager and Colony Capital entered into an investment allocation agreement, which provides for the Company to co-invest in investment vehicles that are substantially similar to the Company's target assets with certain current or future private investment funds managed by Colony Capital or its affiliates (including Colony Distressed Credit Fund, L.P., Colony Investors VIII, L.P. and related funds, and Colyzeo Investors, II, L.P.). Under the investment allocation agreement, the Company is entitled (but not obligated) to contribute (subject to the Company's investment guidelines, its availability of capital and maintaining its qualification as a REIT for U.S. federal income tax purposes and its exemption from registration under the Investment Company Act of 1940) at least one-third of the capital to be funded by such co-investment vehicles until the termination of the commitment period of Colony Distressed Credit Fund, L.P. in July 2010, and thereafter, at least one-half the capital to be funded by co-investment vehicles in assets secured by U.S. collateral. In the event that the Company does not have sufficient capital to contribute at least one-third (or one-half, as applicable) of the capital required for any proposed investment by such investment vehicles, the investment allocation agreement provides for a fair and equitable allocation of investment opportunities among all such vehicles and the Company, in each case, taking into account the suitability of each investment opportunity for the particular vehicle and the Company and each such vehicle's and the Company's availability of capital for investment.

The Company does not incur any additional fees payable to Colony Capital, the Manager or any of their affiliates in connection with investments made pursuant to the investment allocation agreement. The Company is required to pay its pro rata portion (based upon percentage of equity) of transaction and other investment-level expenses incurred in connection with such co-investment.

**8. Stock-Based Compensation**

In connection with the IPO, the Company granted 6,000 shares of its restricted common stock under its 2009 Non-Executive Director Stock Plan to the Company's three independent directors, which shares vest ratably on each of the first and second anniversaries of the IPO, subject to the directors' continued service on the board of directors. Notwithstanding the vesting schedule set forth above, the shares will vest in full upon termination of such director's service due to death or disability. For the three months ended March 31, 2010, the Company recognized compensation cost of \$15,000 related to the restricted stock awards. As of March 31, 2010, total compensation cost related to unvested restricted

stock not yet recognized was \$87,000.

**Table of Contents****COLONY FINANCIAL, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2010****(Unaudited)****9. Other Comprehensive Income**

The components of comprehensive income are as follows (in thousands):

|   | <b>Three Months Ended<br/>March 31, 2010</b> |
|---|--|
| Net income  | \$ 2,098                                     |
| Other comprehensive income:   |  |
| Equity in other comprehensive income of unconsolidated joint venture                                    | 548  |
| Unrealized gain on fair value of derivative instruments designated as hedges, net of tax effect of \$71 | 344  |
| Foreign currency translation loss, net of tax effect of \$216   | (684)  |
| Realized foreign exchange loss reclassified from accumulated other comprehensive loss                   | 33   |
| Comprehensive income  | 2,339  |
| Comprehensive income attributable to noncontrolling interest  | (13)   |
| Comprehensive income attributable to the Company  | \$ 2,326                                     |

The components of accumulated other comprehensive loss attributable to the Company are as follows (in thousands):

|  | <b>March 31,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|--|---------------------------|------------------------------|
| Equity in accumulated other comprehensive income (loss) of unconsolidated joint venture  | \$ 405                    | \$ (132)                     |
| Unrealized gain on fair value of derivative instruments designated as hedges, net of tax | 602                       | 258                          |
| Unrealized loss on foreign currency translation, net of tax                              | (1,369)                   | (718)                        |
|  | \$ (362)                  | \$ (592)                     |

**10. Income Taxes**

The Company's TRSs subject to corporate level federal, state, foreign and local income taxes are Colony Financial Holdco, LLC, Colony Financial TRS, LLC and CFI DB Holding, LLC, which directly and indirectly hold the Company's investments in Laguna Investor and DB Investor. The Company's TRSs did not have significant tax provisions for the three months ended March 31, 2010.

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 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

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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.

In connection with TRS activities for the three months ended March 31, 2010, the Company recorded current and deferred tax liabilities of \$337,000 and \$71,000, respectively, included in accrued and other liabilities and deferred tax assets of \$553,000, included in other assets.

### **11. Commitments and Contingencies**

On December 2, 2009, the Company committed to invest a total of \$13.3 million in Colonial Investor. Through March 31, 2010, the Company had invested \$12.0 million for the purchase and customary and ordinary operating costs of the joint venture, leaving a \$1.3 million commitment for future fundings.

In connection with its investment in DB Investor, the Company committed to contribute up to an additional \$1.7 million, to the extent it is required, in order to support a guaranty issued by the joint venture.

The Company has a commitment to invest \$24.0 million in the FRB Investor to acquire an interest in Sequoia Acquisition, Inc. ( Sequoia Acquisition ), in connection with Sequoia Acquisition's purchase of First Republic Bank from Merrill Lynch Bank & Trust Co., F.S.B. FRB Investor's commitment, together with additional amounts from other third-party investors, is intended to provide sufficient financing for Sequoia Acquisition's payment obligations to consummate the transaction. FRB Investor's commitment under the equity commitment letter is subject to, among other things, the successful closing of the transaction. The Company's percentage ownership interest in Sequoia Acquisition is dependent on the final capitalization of the transaction. This transaction is subject to regulatory approval and the satisfaction of other customary conditions precedent set forth in the purchase and sale agreement related to the transaction.

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**COLONY FINANCIAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**March 31, 2010**

**(Unaudited)**

**12. Subsequent Events**

The Company has evaluated all subsequent events through the filing date of this Quarterly Report on Form 10-Q (this Report) with the Securities and Exchange Commission to ensure that this Report includes appropriate disclosure of events both recognized in the consolidated financial statements as of March 31, 2010, and events that occurred subsequent to March 31, 2010 but were not recognized in the consolidated financial statements. From the balance sheet date through the filing date of this Report, the Company invested \$10.7 million for one-third participation in the acquisition of a hotel portfolio mezzanine loan and invested another \$4.3 million in MBS Investor.

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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, 2009, 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 Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

#### ***Overview***

We are a real estate finance company that was organized in June 2009 as a Maryland corporation to acquire, originate and manage a diversified portfolio of real estate-related debt instruments. We completed the initial public offering, or IPO, and concurrent private placement of our common stock on September 29, 2009. We focus primarily on 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 investments. We also may acquire other real estate and real estate-related debt assets. We collectively refer to commercial mortgage loans, other commercial real estate-related debt investments, commercial mortgage-backed securities, or CMBS, real estate owned, or REO, properties and other real estate and real estate-related assets as our target assets.

We are managed by our Manager, a Delaware limited liability company and a wholly-owned subsidiary of Colony Capital. The Manager is an affiliate of the Company. We elected to qualify as a real estate investment trust, or REIT, for U.S. federal income tax purposes, commencing with our initial taxable year ended December 31, 2009. We also intend to operate our business in a manner that will permit us to maintain our exemption from registration under the Investment Company Act of 1940, or the 1940 Act.

#### ***Business Objective and Outlook***

Our objective is to provide attractive risk-adjusted returns to our investors, primarily through dividends and secondarily through capital appreciation. We intend to achieve this objective through investments in, and active management of, a diversified investment portfolio of performing, sub-performing and non-performing commercial mortgage loans and other attractively priced real estate-related debt investments. We believe there are abundant opportunities among our target assets that currently present attractive risk-return profiles. We believe that events in the financial markets have created significant dislocation between price and intrinsic value in certain of our target assets and that attractive investment opportunities will be available for a number of years. We believe that we are well positioned to capitalize on such opportunities as well as to remain flexible to adapt our strategy as market conditions change. We also believe that our Manager's and its affiliates' 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.



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**Table of Contents*****Recent Developments******Investment Activities***

From the closing of our IPO on September 29, 2009 to March 31, 2010, all of our investment activities have been structured as joint ventures with one or more private investment funds managed by Colony Capital or its affiliates (including Colony Distressed Credit Fund, L.P., Colony Investors VIII, L.P. and related funds, and Colyzeo Investors, II, L.P., which funds are collectively referred to herein as the 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 Conflicts of Interest and Related Policies and Business Co-Investment Funds in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

As of March 31, 2010, we had entered into agreements or consummated transactions representing net investments or commitments to invest approximately \$215 million, or 78% of the net proceeds from our IPO and the private placement. The following summaries provide information on our investments for the three months ended March 31, 2010 as of each of their respective acquisition or origination date.

On January 7, 2010, we, together with investment funds managed by affiliates of our Manager, consummated a structured transaction with the Federal Deposit Insurance Corporation, or FDIC. Deutsche Bank, or DB, served as advisor to the FDIC in connection with this transaction. As a result, we and such investment funds acquired a 40% managing-member interest in a newly formed limited liability company created to hold the acquired loans, with the FDIC retaining the remaining 60% equity interest. This portfolio of loans, which we refer to as the DB FDIC portfolio, includes approximately 1,200 loans (of which approximately 29% were performing and approximately 71% were non-performing by allocated purchase price and which collectively had a weighted-average seasoning of 39 months) with an aggregate unpaid principal balance of approximately \$1.02 billion, substantially all of which are first mortgage, recourse commercial real estate loans. The DB FDIC portfolio was effectively acquired at approximately 44% of the unpaid principal balance of the loans. The average interest rate on the performing loans in the DB FDIC portfolio was 5.9% exclusive of scheduled amortization payments, and the weighted-average remaining term for the performing loans was 57 months. The financing of the transaction includes 50% leverage (\$233 million of zero-coupon notes) provided by the FDIC, which has a term of up to seven years and must be paid in full prior to any distributions to the equity holders. The newly formed limited liability company also pays the managing member a 50-basis point asset management fee calculated on the aggregate unpaid principal balance of the outstanding portfolio (some of which will be used to pay costs associated with primary and special servicing). Our pro rata share of the managing-member interest is 33.3%, or approximately \$30.2 million, exclusive of our pro rata share of the required working capital and transaction costs. In addition, we, together with investment funds managed by affiliates of our Manager, committed to contribute up to an additional \$5.0 million to the extent it is required, in order to support a guaranty issued by our subsidiary. Our share of this additional commitment is up to \$1.7 million.

On March 5, 2010, we, together with investment funds managed by affiliates of our Manager, acquired a \$66.0 million pari-passu participation interest in a performing first mortgage on a Class A office building in midtown Manhattan with an aggregate unpaid principal balance of \$1.2 billion from a real estate investment firm. The loan is currently in special servicing, although there has been no specific event, failure or default under the loan at this time. The purchase price for the pari-passu first mortgage interest was approximately \$44.9 million, excluding transaction costs. Our pro rata share of the purchase price was approximately \$15.0 million (exclusive of our pro rata share of transaction costs), which represents a 33.3% ownership interest. The unleveraged current cash yield on the loan, net of the special servicing fee, is approximately 9.0% based upon the purchase price (and would be approximately 9.5% if the loan were to be transferred out of special servicing), which was at approximately 68% of the unpaid principal balance of the pari-passu first mortgage interest.

On March 8, 2010, we, together with investment funds managed by affiliates of our Manager, originated a five-year \$30.4 million recourse loan to a world-renowned celebrity photographer. We invested approximately \$10.1 million, before origination fees, for a 33.3% economic interest in the loan. The loan is secured by first liens on two West Village Manhattan townhomes and a photography catalog. The loan bears an interest rate of 14% per annum, of which 4% may be paid-in-kind in the first 12 months at the borrower's option, and includes an upfront origination fee of 2.0% of the loan amount. The lender is also entitled to certain participation in the borrower's photography business based on the amount of free cash flow generated.



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The following table sets forth certain information as of the acquisition or commitment date regarding the investments consummated and committed to as of March 31, 2010:

(Dollars in thousands)

| <b>Our Investments</b>                      | <b>Invested<sup>(1)</sup></b> | <b>Committed<sup>(1)</sup></b> | <b>Total</b>      | <b>Our Economic Ownership<sup>(2)</sup></b> | <b>Total Colony Funds Investment</b> | <b>Unpaid Principal Balance</b> | <b>Description</b>  |
|---|-------------------------------|--------------------------------|-------------------|---|--------------------------------------|---------------------------------|---|
| U.S. Life Insurance Loan Portfolio          | \$ 49,700                     | \$                             | \$ 49,700         | 37.9%                                       | \$ 131,300                           | \$ 174,700                      | 25 performing, fixed rate first mortgages secured by commercial real estate   |
| WLH Secured Loan                            | 48,000                        |                                | 48,000            | 24.0%                                       | 199,800                              | 206,000                         | Senior secured term loan secured by first mortgages on residential land and security interests in cash and other assets |
| DB FDIC Portfolio                           | 33,000                        | 1,700                          | 34,700            | 33.3%                                       | 103,900                              | 1,020,000                       | Approximately 1,200 performing and non-performing loans secured mostly by commercial real estate                        |
| First Republic Bank                         |                               | 24,000                         | 24,000            | TBD <sup>(3)</sup>                          | TBD <sup>(3)</sup>                   | NA                              | Equity stake in approximately \$20 billion retail bank  |
| Class A Manhattan Office Loan Participation | 15,000                        |                                | 15,000            | 33.3%                                       | 44,900                               | 66,000                          | First mortgage pari-passu participation interest secured by Class A midtown Manhattan office building                   |
| Spanish REOC/Colonial Loan <sup>(4)</sup>   | 12,000                        | 1,300                          | 13,300            | 5.1%  | 259,900                              | 658,700                         | Syndicated senior secured loan to a Spanish commercial real estate company  |
| West Village Townhomes/Photography Loan     | 9,900                         |                                | 9,900             | 33.3%                                       | 29,800                               | 30,400                          | Recourse loan secured by first liens on two West Village Manhattan townhomes and a photography catalogue                |
| U.S. Commercial Bank Loan Portfolio         | 6,700                         |                                | 6,700             | 33.3%                                       | 20,100                               | 33,000                          | 10 performing and one delinquent, fixed rate first mortgages secured by commercial real estate                          |
| German Loan Portfolio                       | 5,300                         |                                | 5,300             | 33.3%                                       | 16,000                               | 91,000                          | 94 primarily first mortgage non-performing commercial real estate loans   |
| WLH Land Acquisition                        | 3,400                         |                                | 3,400             | 24.0%                                       | 14,000                               | NA                              | Approximately 1,100 residential lots in a sale/easement   |
| Westlake Village Loan                       | 2,500                         |                                | 2,500             | 33.3%                                       | 7,600                                | 11,300                          | First mortgage commercial loan  |
| AAA CMBS Financed with TALF <sup>(4)</sup>  | 2,000                         |                                | 2,000             | 32.7%                                       | 6,100                                | 40,000                          | AAA CMBS security financed with five-year TALF  |
| <b>Total Committed &amp; Invested</b>       | <b>\$ 187,500</b>             | <b>\$ 27,000</b>               | <b>\$ 214,500</b> |   |                                      |                                 |   |

(1) Invested and committed amounts include our share of transaction costs and working capital and are net of origination fees.

(2) Represents our share of the acquisition entities formed by us with investment funds managed by affiliates of our Manager except for the Colonial Loan and AAA CMBS Financed with Term Asset-Backed Securities Loan Facility, or TALF; refer to note 4.

(3) Although our total commitment has been determined, our percentage of minority ownership has not yet been determined.

(4) The acquisition entities for the Colonial Loan and the AAA CMBS Financed with TALF include a 33.3% and 2.0% co-investment, respectively, from third parties and the amounts stated in Our Economic Ownership, Total Colony Funds Investment and Unpaid Principal

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Balance include these third parties' co-investments. Our economic interests in the Colonial Loan and the AAA CMBS Financed with TALF, excluding such third party co-investments, are 7.7% and 33.3%, respectively.

### ***Critical Accounting Policies***

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP, which requires the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. There have been no material changes to our critical accounting policies or those of our unconsolidated joint ventures since the filing of our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, except for changes resulting from our adoption of the provisions of Financial Accounting Standards Board Accounting Standards Update ( ASU ) No. 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*, effective January 1, 2010. The adoption of ASU No. 2009-17 did not have a material effect on our consolidated financial position, results of operations or disclosures.

### ***Investment in Unconsolidated Joint Ventures***

The Company analyzes each of its joint ventures to determine whether they are variable interest entities, or VIEs. In performing our analysis of whether it is the primary beneficiary, the Company considers whether it individually has the power to direct the activities of the VIE that most significantly impact the entity's performance and also has the obligation to absorb losses or the right to

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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, involve significant judgments, including estimates about the current and future fair values and performance of assets held by the VIE and/or general market conditions.

*Recent Accounting Updates*

Recent accounting updates are included in Note 2 to the consolidated financial statements in Item 1. Consolidated Financial Statements of this Report.

*Results of Operations**Equity in Income of Unconsolidated Joint Ventures*

Net income (loss) from our unconsolidated joint ventures for the three months ended March 31, 2010 included \$568,000 of one-time investment transaction costs expensed in connection with the initial acquisition of the investments. Net income (loss) from our unconsolidated joint ventures before and after these transaction costs is summarized below (in thousands):

|   | Net Income (Loss)<br>from<br>Unconsolidated Joint<br>Ventures Before<br>Transaction Costs |       | Transaction Costs | Net Income (Loss)<br>from<br>Unconsolidated<br>Joint Ventures |
|---|---|-------|-------------------|---|
| ColFin NW Funding, LLC ( NW Investor )                  | \$  | 1,402 | \$                | 1,402   |
| ColFin WLH Funding, LLC ( WLH Investor )                |   | 1,847 |                   | 1,847   |
| ColFin DB Guarantor, LLC ( DB Investor )                |   | 400   | 555               | (155)   |
| ColFin 666 Funding, LLC ( 666 Investor )                |   | 150   | 13                | 137   |
| Colony Funds Sants S.à r.l. ( Colonial Investor )       |   | 238   |                   | 238   |
| ColFin ALS Funding, LLC ( ALS Investor )                |   | 95    |                   | 95  |
| ColFin J-11 Funding, LLC ( J-11 Investor )              |   | 203   |                   | 203   |
| ColLaguna (CA Lux) S.à r.l. ( Laguna Investor )         |   | (100) |                   | (100)   |
| ColFin WLH Land Acquisitions, LLC ( WLH Land Investor ) |   | 71    |                   | 71  |
| Matrix CDCF-CFI Advisors VI, LLC ( Matrix Investor )    |   | 71    |                   | 71  |
| C-VIII CDCF CFI MBS Investor, LLC ( MBS Investor )      |   | 106   |                   | 106   |
|   | \$  | 4,483 | \$                | 568   |
|   |   |       | \$                | 3,915   |

*Interest Income*

For the three months ended March 31, 2010, we earned \$170,000 of interest from our cash and cash equivalents on deposit at various financial institutions.

*Expenses*

Expenses consisted primarily of administrative expenses of approximately \$1.2 million (of which \$271,000 was reimbursed to an affiliate). These expenses included directors' and officers' insurance costs of \$337,000, professional fees of \$362,000 and salary, bonus and benefit costs of \$227,000. The Company incurred base management fees of \$660,000 pursuant to the management agreement with the Manager. Investment expenses of \$99,000 included \$50,000 of costs associated with unsuccessful deals.



**Table of Contents***Investments in Unconsolidated Joint Ventures*

As of March 31, 2010, our interest in each unconsolidated joint venture was as follows:

| <b>Joint Venture</b>               | <b>The Company's Ownership Percentage</b> |
|------------------------------------|---|
| ColFin NW Funding, LLC             | 37.88%                                    |
| ColFin WLH Funding, LLC            | 24.03%                                    |
| ColFin DB Guarantor, LLC           | 33.33%                                    |
| ColFin FRB Investor, LLC           | TBD <sup>(1)</sup>                        |
| ColFin 666 Funding, LLC            | 33.33%                                    |
| Colony Funds Sants S.à r.l.        | 5.12%                                     |
| ColFin ALS Funding, LLC            | 33.33%                                    |
| ColFin J-11 Funding, LLC           | 33.33%                                    |
| ColLaguna (CA Lux) S.à r.l.        | 33.33%                                    |
| ColFin WLH Land Acquisitions, LLC  | 24.03%                                    |
| Matrix CDCF-CFI Advisors VI, LLC   | 33.33%                                    |
| C-VIII CDCF CFI MBS Investor, LLC  | 33.33%                                    |
| Colony CDCF-VIII-CFI Investor, LLC | 33.33%                                    |

(1) The final ownership percentage is dependent on the final capitalization of the transaction.

Three of our largest investments in unconsolidated joint ventures made up approximately \$132.3 million, or 70% of our total investments in unconsolidated joint ventures at March 31, 2010.

The following tables summarize certain characteristics of the joint ventures' loans receivable and our proportionate share as of March 31, 2010 and December 31, 2009 (amounts in thousands):

| <b>Collateral Type</b>      | <b>Unpaid Principal Balance</b> |                            | <b>March 31, 2010 Amortized Cost</b> |                            | <b>Net Weighted Average Coupon</b> | <b>Current Yield on Original Cost</b> | <b>Average Maturity In Years</b> |
|-----------------------------|---------------------------------|----------------------------|--------------------------------------|----------------------------|------------------------------------|---------------------------------------|----------------------------------|
|                             | <b>Total</b>                    | <b>Company's</b>           | <b>Total</b>                         | <b>Company's</b>           |                                    |                                       |                                  |
|                             |                                 | <b>Proportionate Share</b> |                                      | <b>Proportionate Share</b> |                                    |                                       |                                  |
| <b>Performing loans</b>     |                                 |                            |                                      |                            |                                    |                                       |                                  |
| Residential                 | \$ 242,464                      | \$ 60,451                  | \$ 232,684                           | \$ 58,473                  | 13.82%                             | 14.13%                                | 4.7                              |
| Retail                      | 156,382                         | 45,884                     | 111,398                              | 33,321                     | 6.13%                              | 9.11%                                 | 8.6                              |
| Office                      | 150,204                         | 48,599                     | 105,773                              | 34,678                     | 6.41%                              | 9.14%                                 | 6.9                              |
| Industrial                  | 66,564                          | 18,088                     | 47,201                               | 13,233                     | 6.20%                              | 8.68%                                 | 7.0                              |
| Hospitality                 | 20,459                          | 4,165                      | 13,454                               | 2,436                      | 6.44%                              | 9.22%                                 | 14.6                             |
| Multifamily                 | 11,837                          | 1,578                      | 6,592                                | 879                        | 7.85%                              | 14.83%                                | 11.8                             |
| Land                        | 27,544                          | 3,673                      | 13,049                               | 1,740                      | 6.57%                              | 12.41%                                | 2.0                              |
| Other commercial            | 53,876                          | 7,184                      | 31,325                               | 4,177                      | 6.95%                              | 12.23%                                | 6.9                              |
| <b>Total performing</b>     | <b>729,330</b>                  | <b>189,622</b>             | <b>561,476</b>                       | <b>148,937</b>             | <b>9.07%</b>                       | <b>12.47%</b>                         | <b>6.8</b>                       |
| <b>Non-performing loans</b> |                                 |                            |                                      |                            |                                    |                                       |                                  |
| Residential                 | 78,453                          | 11,732                     | 24,509                               | 3,539                      |                                    |                                       |                                  |
| Retail                      | 112,718                         | 15,380                     | 52,424                               | 7,106                      |                                    |                                       |                                  |

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|                      |              |            |            |            |
|----------------------|--------------|------------|------------|------------|
| Office               | 45,789       | 6,592      | 20,887     | 2,863      |
| Industrial           | 41,081       | 6,003      | 19,435     | 2,900      |
| Hospitality          | 66,857       | 9,667      | 42,629     | 5,852      |
| Multifamily          | 97,997       | 20,347     | 37,355     | 5,787      |
| Land                 | 339,218      | 48,360     | 67,133     | 9,573      |
| Other commercial     | 88,339       | 12,576     | 34,730     | 4,770      |
| Total non-performing | 870,452      | 130,657    | 299,102    | 42,390     |
| Total loans          | \$ 1,599,782 | \$ 320,279 | \$ 860,578 | \$ 191,327 |

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| Collateral Type             | Unpaid Principal Balance   |            | December 31, 2009<br>Amortized Cost |            | Net<br>Weighted<br>Average<br>Coupon | Current<br>Yield on<br>Original<br>Cost | Average<br>Maturity<br>In Years |
|-----------------------------|----------------------------|------------|-------------------------------------|------------|--------------------------------------|---|---------------------------------|
|                             | Company's<br>Proportionate |            | Company's<br>Proportionate          |            |                                      |   |                                 |
|                             | Total                      | Share      | Total                               | Share      |                                      |   |                                 |
| <b>Performing loans</b>     |                            |            |                                     |            |                                      |   |                                 |
| Residential                 | \$ 206,000                 | \$ 49,502  | \$ 200,145                          | \$ 48,095  | 14.00%                               | 14.41%                                  | 4.8                             |
| Retail                      | 92,176                     | 34,430     | 68,146                              | 25,532     | 6.11%                                | 8.41%                                   | 9.2                             |
| Office                      | 65,893                     | 24,219     | 49,066                              | 18,075     | 6.10%                                | 8.39%                                   | 7.1                             |
| Industrial                  | 37,716                     | 14,287     | 28,215                              | 10,687     | 6.17%                                | 8.27%                                   | 7.3                             |
| Hospitality                 | 5,876                      | 2,226      | 2,585                               | 979        | 6.38%                                | 14.50%                                  | 8.0                             |
| Mixed use                   | 14,803                     | 4,934      | 9,706                               | 3,236      | 6.24%                                | 9.51%                                   | 8.1                             |
| Total performing            | 422,464                    | 129,598    | 357,863                             | 106,604    | 9.97%                                | 10.58%                                  | 6.5                             |
| <b>Non-performing loans</b> |                            |            |                                     |            |                                      |   |                                 |
| Residential                 | 8,780                      | 2,927      | 1,533                               | 511        |                                      |   |                                 |
| Retail                      | 7,939                      | 2,646      | 1,063                               | 354        |                                      |   |                                 |
| Industrial                  | 9,923                      | 3,308      | 2,279                               | 760        |                                      |   |                                 |
| Hospitality                 | 3,771                      | 1,257      | 946                                 | 315        |                                      |   |                                 |
| Multifamily                 | 39,003                     | 13,001     | 4,075                               | 1,358      |                                      |   |                                 |
| Land                        | 15,106                     | 5,035      | 3,264                               | 1,088      |                                      |   |                                 |
| Other                       | 5,765                      | 1,922      | 884                                 | 295        |                                      |   |                                 |
| Total non-performing        | 90,287                     | 30,096     | 14,044                              | 4,681      |                                      |   |                                 |
| Total loans                 | \$ 512,751                 | \$ 159,694 | \$ 371,907                          | \$ 111,285 |                                      |   |                                 |

The following tables summarize the geographical dispersion of the real estate properties collateralizing the joint ventures' loans and our proportionate share as of March 31, 2010 and December 31, 2009 (amounts in thousands):

| Region             | March 31, 2010<br>Unpaid Principal Balance |                 | Amortized Cost                   |                 |
|--------------------|--|-----------------|----------------------------------|-----------------|
|                    | Company's<br>Proportionate Share           |                 | Company's<br>Proportionate Share |                 |
|                    | Total                                      | \$ %            | Total                            | \$ %            |
| Northeast          | \$ 140,609                                 | \$ 46,985 14%   | \$ 106,652                       | \$ 35,680 19%   |
| Mideast            | 58,538                                     | 13,031 4%       | 39,509                           | 9,374 5%        |
| Southeast          | 532,301                                    | 80,756 25%      | 225,471                          | 36,320 19%      |
| East North Central | 90,037                                     | 21,611 7%       | 58,226                           | 15,003 8%       |
| West North Central | 37,624                                     | 8,789 3%        | 22,133                           | 5,884 3%        |
| Southwest          | 25,430                                     | 5,678 2%        | 15,912                           | 3,985 2%        |
| Mountain           | 286,320                                    | 50,287 16%      | 123,959                          | 26,877 14%      |
| Pacific            | 358,377                                    | 69,627 22%      | 256,546                          | 54,147 28%      |
| Europe             | 70,546                                     | 23,515 7%       | 12,170                           | 4,057 2%        |
| Total              | \$ 1,599,782                               | \$ 320,279 100% | \$ 860,578                       | \$ 191,327 100% |

| Region | December 31, 2009<br>Unpaid Principal Balance |       | Amortized Cost                   |       |
|--------|---|-------|----------------------------------|-------|
|        | Company's<br>Proportionate Share              |       | Company's<br>Proportionate Share |       |
|        | Total   | Total | Total                            | Total |

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| <b>Region</b>      |                   | <b>\$</b>         | <b>%</b>    |                   | <b>\$</b>         | <b>%</b>    |
|--------------------|-------------------|-------------------|-------------|-------------------|-------------------|-------------|
| Northeast          | \$ 36,598         | \$ 13,863         | 9%          | \$ 26,342         | \$ 9,978          | 9%          |
| Mideast            | 21,384            | 8,100             | 5%          | 16,691            | 6,322             | 6%          |
| Southeast          | 46,126            | 15,974            | 10%         | 29,084            | 10,116            | 9%          |
| East North Central | 39,288            | 14,882            | 9%          | 29,373            | 11,126            | 10%         |
| West North Central | 15,397            | 5,832             | 4%          | 11,890            | 4,504             | 4%          |
| Southwest          | 9,336             | 3,537             | 2%          | 7,549             | 2,859             | 2%          |
| Mountain           | 78,826            | 22,646            | 14%         | 70,600            | 19,736            | 18%         |
| Pacific            | 177,959           | 45,581            | 29%         | 166,741           | 42,098            | 38%         |
| Europe             | 87,837            | 29,279            | 18%         | 13,637            | 4,546             | 4%          |
| <b>Total</b>       | <b>\$ 512,751</b> | <b>\$ 159,694</b> | <b>100%</b> | <b>\$ 371,907</b> | <b>\$ 111,285</b> | <b>100%</b> |

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As of March 31, 2010, the joint ventures performing loan portfolio comprises fixed rate loans bearing interest rates ranging from 3.25% to 18% with an aggregate unpaid principal balance of \$662.9 million and variable rate loans bearing interest rates ranging from 3.25% to 8.0% with an aggregate unpaid principal balance of \$66.4 million. Maturity dates of performing loans range from 2010 to 2037. Scheduled maturities based on unpaid principal balance of performing loans as of March 31, 2010 are as follows (in thousands):

|  | <b>March 31, 2010</b> |
|--|-----------------------|
| Less than one year                             | \$ 44,673             |
| Greater than one year and less than five years | 320,768               |
| Greater than or equal to five years            | 363,889               |
| <br>Total                                      | <br>\$ 729,330        |

**Liquidity and Capital Resources**

Our financing sources include the net proceeds from our IPO and the private placement. Subject to maintaining our qualification as a REIT and our 1940 Act exemption, we also may attempt to secure corporate-level credit facilities (including term loans and revolving facilities), if available, to finance our assets and provide a funding source for future investments. In addition, the joint venture between us and investment funds managed by affiliates of our Manager, on the one hand, and the FDIC, on the other hand, acquired the DB FDIC portfolio, in part, with leverage provided by the FDIC, and one of our co-investments with investment funds managed by affiliates of our Manager utilized funds made available under the TALF. We also may attempt to secure 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. For more information about the conflicts of interest that may arise in connection with these co-investments, see *Business Conflicts of Interest and Related Policies* in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

Our primary uses of cash are to fund acquisitions of our target assets, to fund our operations, including overhead costs and the management fee to our Manager, to fund distributions to our stockholders and, to the extent we utilize leverage to acquire our target assets, to repay principal and interest on our borrowings. We expect to meet our capital requirements using cash on hand, cash flow generated from our operations, and principal and interest payments received from our investments. 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, we will have to rely on third-party sources of capital, which may or may not be available on favorable terms or at all.

**Cash and Cash Flows**

At May 13, 2010, we had cash and cash equivalents of \$82.6 million, which is sufficient to satisfy all of our existing obligations.

For the three months ended March 31, 2010, net cash provided by operating activities was approximately \$1.1 million. Cash flows from operating activities resulted primarily from distributions of earnings from unconsolidated joint ventures offset by payment of administrative expenses.

For the three months ended March 31, 2010, net cash used in investing activities was approximately \$57.7 million, primarily for contributions to unconsolidated joint ventures described in *Recent Developments Investment Activities*, offset by distribution of capital from an unconsolidated joint venture.

For the three months ended March 31, 2010, net cash used in financing activities was approximately \$1.1 million, primarily for the payment of dividends declared during 2009 and the payment of previously accrued offering costs in connection with our IPO.

**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

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Manager closely monitors our portfolio and actively manages risks associated with, among other things, our assets and interest rates. 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. 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.

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For each asset that we acquire, Colony Capital's in-house 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 intense 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 continuously 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. 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.

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 intend to 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 may 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***

Other than borrowings under government sponsored debt programs, such as the TALF and seller financing provided by the FDIC, we have not used leverage to finance our investments. However, while we believe we can achieve attractive yields on an unleveraged basis, we may use prudent amounts of leverage to increase potential returns to our stockholders and/or to finance future investments. To that end, 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 attempt to secure corporate-level credit facilities (including term loans and revolving credit facilities). 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, such as the TALF, leverage on which we currently expect would not exceed, on a debt-to-equity basis, a 6-to-1 ratio. We consider these initial 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.

### ***Contractual Obligations and Commitments***

On January 7, 2010, in connection with our investment in DB Investor, we committed to contribute up to an additional \$1.7 million, to the extent it is required, in order to support a guaranty issued by the joint venture. There have been no other material changes to our contractual obligations and capital commitments as disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

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### ***Dividends***

We intend to make regular quarterly distributions to holders of our common stock. 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. 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. We currently do not intend to use the proceeds of our IPO or the private placement to make distributions to our stockholders, except if necessary to meet our REIT distribution requirements or eliminate our U.S federal taxable income.

On December 21, 2009, our board of directors declared a quarterly dividend of \$0.07 per share of our common stock, which was paid on January 20, 2010 to stockholders of record on December 31, 2009.

On March 24, 2010, our board of directors declared a quarterly dividend of \$0.16 per share of our common stock, payable to stockholders of record on April 5, 2010, with an ex-dividend date of March 31, 2010. The dividend payment was made on April 15, 2010.

### ***Off-Balance Sheet Arrangements***

On January 7, 2010, we, together with investment funds managed by affiliates of our Manager, committed to contribute up to an additional \$5 million, to the extent it is required, in order to support a guaranty issued by DB Investor. Our share of this additional commitment is up to \$1.7 million.

On December 2, 2009, we committed to invest a total of \$13.3 million in a joint venture with investment funds managed by affiliates of our Manager that acquired a performing loan issued by a Spanish real estate company. To date, we have invested \$12.0 million for the purchase, transaction costs, and customary and ordinary operating costs of the joint venture, leaving a \$1.3 million commitment for future fundings.

On October 21, 2009, we, through an acquisition entity formed by us with investment funds managed by affiliates of our Manager, made a \$24.0 million equity commitment in connection with the pending acquisition of First Republic Bank. The equity commitment is subject to, among other things, the successful closing of the transaction, which is expected close in the second quarter of 2010, subject to regulatory approval and the satisfaction of other customary conditions precedent set forth in the purchase and sale agreement related to the transaction. We also entered into a limited guaranty in connection with this transaction. In the event that our obligations under limited guaranty are triggered, our aggregate liability would be capped at \$24.0 million.

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

Core Earnings is a non-GAAP 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, 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 will be adjusted to exclude one-time events pursuant to changes in GAAP and certain other non-cash charges 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 non-cash expenses and gains and losses 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 and is a key factor in determining the performance hurdle for the reimbursement of our Manager's partial payment of the initial underwriting discounts and commissions (see *Business* Our Manager and the Management Agreement *Reimbursement of Manager's Partial Payment of IPO Underwriting Discounts and Commissions* in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009). Also, as some of our competitors use a similar supplemental measure, it facilitates comparisons of operating performance to other mortgage REITs. However, other mortgage REITs may use different methodologies to calculate Core Earnings, and accordingly, our Core Earnings may not be comparable to all other mortgage REITs.

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.



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A reconciliation of our GAAP net income attributable to common stockholders to Core Earnings for the three months ended March 31, 2010 is presented below (in thousands):

|  | <b>Three Months Ended<br/>March 31, 2010</b> |
|--|--|
| GAAP net income attributable to common stockholders          | \$ 2,096                                     |
| Adjustment to GAAP net income to reconcile to Core Earnings: |  |
| Noncash equity compensation expense                          | 15   |
| Core Earnings  | \$ 2,111                                     |

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

The Company's joint venture investments 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 the control of the Company. All loans are subject to a certain probability of default. The Company manages credit risk through the underwriting process, acquiring our investments at the appropriate discount to face value, if any, and establishing loss assumptions. The Company also carefully monitors the performance of the loans 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 the control of the Company. Credit curve spread risk is highly sensitive to the dynamics of the markets for commercial real estate loans and securities held by the Company. 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.

As of March 31, 2010, the Company and the joint ventures did not have any interest rate hedges. However, in the future, the Company or its unconsolidated joint ventures may 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 its operations. The use of these types of derivatives to hedge interest-earning 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, the Company is exposed to the risk that the counterparties with which the Company trades may cease making markets and quoting prices in such instruments, which may render the Company unable to enter into an offsetting transaction with respect to an open position. If the Company anticipates that the income from any such hedging transaction will not be qualifying income for REIT income purposes, the Company may conduct all or part of its hedging activities through a to-be-formed corporate subsidiary that is fully subject to federal corporate income taxation. The profitability of the Company may be adversely affected during any period as a result of changing interest rates.

***Currency Risk***

The Company has foreign currency rate exposures related to its equity investments in joint ventures which hold certain commercial real estate loan investments in Europe. The Company's sole currency exposure is to the Euro. Changes in currency rates can adversely impact the fair values and earnings of the Company's non-U.S. holdings. As of March 31, 2010, the Company had approximately \$11.1 million, or \$15.0 million, in European investments. Accumulated foreign exchange losses on the European investments were approximately \$1.6 million, before tax effect. A 1% change in the exchange rate would result in a \$150,000 increase or decrease in translation gain or loss on the Company's investments in unconsolidated joint ventures. The Company mitigates this impact by utilizing currency instruments to hedge the capital portion of its foreign currency risk. The type of hedging instrument that the Company employed on its European investments as of March 31, 2010 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 the Company's 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.



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At March 31, 2010, the Company had six outstanding hedging instruments with an aggregate notional amount of 10.9 million and a net fair value of \$0.7 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. During the three months ended March 31, 2010, the Company partially unwound the collar expiring in June 2010 in connection with a distribution of capital from its Laguna Investment, resulting in a net cash receipt of \$5,000. The Company is exposed to credit loss in the event of non-performance by counterparties for these contracts. The Company selects major international banks and financial institutions as counterparties to manage this risk and does not expect any counterparty to default on its obligations.

The following table summarizes the notional amounts and fair (carrying) values of the Company's derivative financial instruments as of March 31, 2010 (in thousands, except exchange rates):

| Derivative Financial Instrument | Notional Amount | Cap (USD/ ) | Floor (USD/ ) | Expiration Date | Net Fair Value |
|---------------------------------|-----------------|-------------|---------------|-----------------|----------------|
| Collar                          | 557             | 1.614       | 1.350         | June 2010       | \$ 16          |
| Collar                          | 1,250           | 1.614       | 1.350         | December 2010   | 64             |
| Collar                          | 640             | 1.618       | 1.350         | June 2011       | 39             |
| Collar                          | 650             | 1.620       | 1.350         | December 2011   | 43             |
| Collar                          | 4,000           | 1.635       | 1.350         | December 2012   | 273            |
| Collar                          | 3,800           | 1.627       | 1.340         | December 2012   | 238            |
|                                 | 10,897          |             |               |                 | \$ 673         |

**ITEM 4T. 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 March 31, 2010.

There have been no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act) during the period ended March 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II OTHER INFORMATION**

**ITEM 1. Legal Proceedings.**

As of March 31, 2010, we were not involved in any legal proceedings.

**ITEM 1A. Risk Factors.**

There have been no material changes to the risk factors included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

On September 23, 2009, the SEC declared effective our IPO registration statement on Form S-11 (File No. 333-160323), pursuant to which we received net proceeds of \$247.5 million before deferred underwriting discounts and commissions and other accrued offering costs.

On October 23, 2009, in connection with the exercise of the overallotment option by the underwriters, we received net proceeds of approximately \$37.1 million, net of underwriting discounts and commissions of \$375,000.

As of March 31, 2010, we had entered into agreements or consummated transactions representing net investments or commitments to invest approximately \$215 million, or 78%, of the net proceeds from our IPO and the private placement in the manner described in this Report under the heading **Recent Developments Investment Activities** and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009 under the heading **Business Recent Developments**.

**ITEM 3. Defaults Upon Senior Securities.**

None.

**ITEM 4. (Removed and Reserved)**

**ITEM 5. Other Information.**

None.

**ITEM 6. Exhibits.**

**Exhibit**

| <b>No.</b> | <b>Description</b>  |
|------------|---|
| 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    |

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- 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

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**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: May 13, 2010

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 Financial Officer and Treasurer**  
**(Principal Financial Officer)**