PMC CAPITAL INC
Form 10-Q
August 13, 2003

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**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended **June 30, 2003**

OR

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

For the transition period from _____ to _____ ..

Commission File Number 1-09589

**PMC CAPITAL, INC.**
(Exact name of registrant as specified in its charter)

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

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2).
YES o NO þ

As of August 8, 2003, Registrant had outstanding 11,853,516 shares of Common Stock, par value $.01 per share.

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**PMC CAPITAL, INC. AND SUBSIDIARIES**

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## PART I

### Financial Information

## ITEM I.

### Financial Statements

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

| | June 30, 2003 | December 31, 2002 |
|---|---|---|
| **ASSETS** | | |
| **Investments at value:** | | |
| Loans receivable | $ 94,976 | $ 87,245 |
| Retained interests in transferred assets | 37,644 | 40,003 |
| Assets acquired in liquidation | 3,212 | 2,252 |
| Cash equivalents | 2,461 | 4,915 |
| Mortgage-backed security of affiliate | 1,345 | 1,381 |
| Investment in unconsolidated subsidiaries | 246 | 81 |
| Restricted investments | 36 | 299 |
| Total investments at value | 139,920 | 136,176 |
| **Other assets:** | | |
| Due from affiliates | 3,632 | 1,839 |
| Deferred charges and other assets | 651 | 728 |
| Accrued interest receivable | 271 | 225 |
| Cash | 251 | 563 |
| Property and equipment, net | 78 | 98 |
| Receivable for loans sold | | 637 |
| Total other assets | 4,883 | 4,090 |
| **Total assets** | $ 144,803 | $ 140,266 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| **Liabilities:** | | |
| Current portion of notes and debentures payable | $ 10,000 | $ 5,000 |
| Revolving credit facility | 6,250 | |
| Dividends payable | 1,484 | 1,486 |
| Borrower advances | 1,255 | 1,754 |
| Due to affiliates | 1,137 | 102 |
| Accounts payable | 993 | 748 |
| Accrued interest payable | 709 | 1,294 |
| Other liabilities | 886 | 1,569 |
| Total current liabilities | 22,714 | 11,953 |
| Notes and debentures payable | 44,310 | 49,310 |
| **Total liabilities** | 67,024 | 61,263 |
| *Commitments and contingencies* | | |
| **Cumulative preferred stock of subsidiary** | 7,000 | 7,000 |
| **Shareholders equity:** | | |
| | 119 | 119 |

| | | |
|---|---|---|
| Common stock, authorized 30,000,000 shares of $0.01 par value, 11,853,516 shares issued and outstanding at June 30, 2003 and December 31, 2002 | | |
| Additional paid-in capital | 71,508 | 71,508 |
| Dividends in excess of retained earnings | (3,229) | (2,022) |
| Net unrealized appreciation on investments | 2,381 | 2,398 |
| | 70,779 | 72,003 |
| **Total liabilities and shareholders equity** | $ 144,803 | $ 140,266 |
| Net asset value per common share | $ 5.97 | $ 6.07 |

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

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

| | Six Months Ended June 30, | | Three Months Ended June 30, | |
|---|---|---|---|---|
| | **2003** | **2002** | **2003** | **2002** |
| **Investment income:** | | | | |
| Interest income | $ 3,242 | $ 4,257 | $ 1,609 | $ 1,650 |
| Income from retained interests in transferred assets | 2,267 | 2,518 | 1,098 | 1,371 |
| Advisory fee income | 928 | 955 | 452 | 506 |
| Premium income | 344 | 271 | 205 | 139 |
| Equity in income of unconsolidated subsidiaries, net | 167 | 195 | 56 | 94 |
| Other income, net | 508 | 557 | 240 | 208 |
| Total investment income | 7,456 | 8,753 | 3,660 | 3,968 |
| **Expenses:** | | | | |
| Salaries and related benefits | 2,042 | 1,964 | 1,007 | 952 |
| Interest | 1,563 | 2,421 | 781 | 1,215 |
| Merger related costs | 519 | | 197 | |
| General and administrative | 428 | 482 | 193 | 261 |
| Professional fees | 181 | 196 | 118 | 96 |
| Rent | 152 | 168 | 74 | 89 |
| Loss from operations of assets acquired in liquidation | 151 | 107 | 54 | 97 |
| Profit sharing plan | 75 | 75 | 37 | 37 |
| Total expenses | 5,111 | 5,413 | 2,461 | 2,747 |
| Net investment income | 2,345 | 3,340 | 1,199 | 1,221 |
| **Realized and unrealized gain (loss) on investments:** | | | | |
| Realized losses | (582) | (465) | (367) | (309) |
| Sale of assets | | 1,463 | | 1,463 |
| Change in unrealized appreciation (depreciation) on investments | (17) | (194) | 256 | 89 |
| Total realized and unrealized gain (loss) on investments | (599) | 804 | (111) | 1,243 |
| **Net increase in net assets resulting from operations** | $ 1,746 | $ 4,144 | $ 1,088 | $ 2,464 |
| *Preferred dividends* | $ 125 | $ 124 | $ 63 | $ 62 |
| *Basic weighted average common shares outstanding* | 11,854 | 11,854 | 11,854 | 11,854 |
| *Diluted weighted average common shares outstanding* | 11,854 | 11,856 | 11,854 | 11,855 |
| ***Basic and diluted earnings per common share*** | $ 0.14 | $ 0.34 | $ 0.09 | $ 0.20 |

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

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

| | Six Months Ended June 30, 2003 | Six Months Ended June 30, 2002 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net increase in net assets resulting from operations | $ 1,746 | $ 4,144 |
| Adjustments to reconcile net increase in net assets resulting from operations to net cash provided by operating activities: | | |
| Loans funded, held for sale | (2,720) | (3,834) |
| Proceeds from sale of guaranteed loans | 3,677 | 3,443 |
| Realized and unrealized (gain) loss on investments | 599 | (804) |
| Unrealized premium (income) expense, net | (41) | 8 |
| Depreciation and amortization | 47 | 79 |
| Accretion of loan discount and deferred fees | (44) | (85) |
| Equity in income of unconsolidated subsidiaries, net | (167) | (195) |
| Other operating assets and liabilities | (1,205) | 142 |
| **Net cash provided by operating activities** | 1,892 | 2,898 |
| **Cash flows from investing activities:** | | |
| Loans funded | (16,841) | (15,634) |
| Principal collected on loans | 6,106 | 10,471 |
| Principal collected on retained interests in transferred assets | 1,813 | 2,928 |
| Principal collected on mortgage-backed security of affiliate | 39 | 206 |
| Proceeds from debt issued by SPE | | 37,901 |
| Proceeds from asset acquired in liquidation | 216 | |
| Purchase of property and equipment | (5) | (150) |
| Investment in assets acquired in liquidation | (258) | |
| Investment in retained interests in transferred assets | (258) | (2,742) |
| Release of (investment in) restricted cash | 263 | (15) |
| Advances from affiliates, net | 1,056 | 75 |
| **Net cash provided by (used in) investing activities** | (7,869) | 33,040 |
| **Cash flows from financing activities:** | | |
| Proceeds from revolving line of credit, net | 6,250 | |
| Payment of dividends on common stock | (2,844) | (4,267) |
| Payment of dividends on preferred stock | (125) | (124) |
| Payment of debt issuance costs | (70) | |
| **Net cash provided by (used in) financing activities** | 3,211 | (4,391) |
| **Net increase (decrease) in cash and cash equivalents** | (2,766) | 31,547 |
| **Cash and cash equivalents, beginning of year** | 5,478 | 17,318 |
| **Cash and cash equivalents, end of period** | $ 2,712 | $ 48,865 |
| **Supplemental disclosures:** | | |

| | | | | |
|---|---|---|---|---|
| Interest paid | $ | 1,580 | $ | 2,405 |
| Reclassification from loans receivable to due from affiliate | $ | 1,465 | $ | |
| Reclassification from loans receivable to assets acquired in liquidation | $ | 1,090 | $ | 2,848 |
| Reclassification from retained interests in transferred assets to due from affiliate, net | $ | 565 | $ | |
| Loans and interest receivable transferred to SPE, net | $ | | $ | 4,435 |

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

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1. Interim Financial Statements:**

The accompanying consolidated balance sheet of PMC Capital, Inc. ( PMC Capital ) and its wholly-owned registered investment company subsidiaries (collectively, we, us or our ) as of June 30, 2003 and the consolidated statements of operations for the three and six months ended June 30, 2003 and 2002 and cash flows for the six months ended June 30, 2003 and 2002 have not been audited by independent accountants. In the opinion of our management, the financial statements reflect all adjustments necessary to present fairly the financial position at June 30, 2003 and the results of operations for the three and six months ended June 30, 2003 and 2002. These adjustments are of a normal recurring nature.

Certain notes and other information have been omitted from the interim financial statements presented in this Quarterly Report on Form 10-Q. Therefore, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended December 31, 2002.

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

The results for the three and six months ended June 30, 2003 are not necessarily indicative of future financial results.

**Note 2. Reclassifications:**

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

**Note 3. Business and Consolidation:**

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

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

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

In addition, at June 30, 2003, PMC Capital owned approximately 32% of PMC Joint Venture, L.P. 2000 (the 2000 Joint Venture ), 60% of PMC Joint Venture, L.P. 2001 (the 2001 Joint Venture ) and 61% of PMC Joint Venture, L.P. 2002-1 (the 2002 Joint Venture, and together with the 1998 Partnership, the 1999 Partnership, the 2000 Joint Venture and the 2001 Joint Venture, the SPEs ). PMC Commercial Trust ( PMC Commercial ), our affiliate through common management, owns the remaining interests in the 2000 Joint Venture, the 2001 Joint Venture and the 2002 Joint Venture (together, the Joint Ventures ).

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

PMC Advisers, which acts as the investment advisor for PMC Commercial, and PMC Funding and Asset Holding, which hold assets on our behalf, are accounted for using the equity method of accounting in conformity with Federal securities laws.

Our ownership interests in the SPEs are accounted for as retained interests in transferred assets ( Retained Interests ) in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities ( SFAS No. 140 ).

**Note 4. Agreement and Plan of Merger:**

On March 27, 2003, PMC Capital entered into an Agreement and Plan of Merger with PMC Commercial. Under the terms of the merger agreement, PMC Capital will be merged into PMC Commercial, with PMC Commercial continuing as the surviving entity. Each issued and outstanding share of PMC Capital common stock will be converted into 0.37 of a common share of PMC Commercial. The merger has been recommended by each company s special committee comprised of independent directors and unanimously approved by the Board of Directors of PMC Capital and the Board of Trust Managers of PMC Commercial. In addition, the boards and management of each company have entered into voting agreements pursuant to which they have agreed to vote their shares in favor of the merger and related transactions. Completion of the merger, which is expected to occur on January 1, 2004, but no later than February 29, 2004, is subject to approval by the shareholders of PMC Capital and PMC Commercial, certain governmental consents and customary closing conditions. We have expensed approximately $519,000 in costs related to the merger as of June 30, 2003.

**Note 5. Stock-Based Compensation Plan:**

At June 30, 2003, we have a stock-based compensation plan. Effective January 1, 2003, we adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, prospectively to all awards granted, modified or settled after January 1, 2003. Awards under the plan generally vest over a one-year period.

We did not recognize any compensation expense during the three and six months ended June 30, 2003 since we did not grant any awards.

The following table illustrates the effect on our net increase in net assets resulting from operations ( net income ) and earnings per share if the fair value based method had been applied to all outstanding previously granted and unvested awards in each period:

| | Six Months Ended June 30, | | | | Three Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2003 | | 2002 | | 2003 | | 2002 | |
| | As Reported | Pro-Forma | As Reported | Pro-Forma | As Reported | Pro-Forma | As Reported | Pro-Forma |
| | (In thousands, except per share data) | | | | | | | |
| SFAS No. 123 charge | $ | $ 15 | $ | $ 26 | $ | $ 7 | $ | $ 22 |
| APB 25 charge | $ | $ | $ | $ | $ | $ | $ | $ |
| Net income | $ 1,746 | $ 1,731 | $ 4,144 | $ 4,118 | $ 1,088 | $ 1,081 | $ 2,464 | $ 2,442 |
| Basic and diluted earnings per common share | $ 0.14 | $ 0.14 | $ 0.34 | $ 0.34 | $ 0.09 | $ 0.09 | $ 0.20 | $ 0.20 |

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

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 6. Recently Issued Accounting Pronouncements**

In April 2003, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. The statement, which is effective for contracts entered into or modified after June 30, 2003 and hedging relationships designated after June 30, 2003, amends and clarifies financial accounting and reporting for derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133. The statement requires that contracts with comparable characteristics be accounted for similarly. Specifically, the statement (i) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative, (ii) clarifies when a derivative contains a financing component, (iii) amends the definition of an underlying to conform it to FASB Interpretation No. 45 and (iv) amends certain other related existing pronouncements. SFAS No. 149 will not impact our consolidated financial statements since we do not have any derivatives.

In May 2003, SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity was issued. SFAS No. 150, is effective upon issuance for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The statement requires that a financial instrument which falls within the scope of the statement to be classified as a liability and initially measured at fair value. The following financial instruments are required to be classified as liabilities: (i) shares that are mandatorily redeemable, (ii) an obligation to repurchase the issuer s equity shares or one indexed to such an obligation and that requires or may require settlement by transferring assets and (iii) the embodiment of an unconditional obligation that the issuer may or may not settle by issuing a variable number of equity shares if, at inception, the monetary value of the obligation is based on certain measurements defined in the statement. We will adopt SFAS No. 150 effective July 1, 2003. Upon adoption, the $4.0 million of 4% cumulative preferred stock of subsidiary with mandatory redemption in 2009 and 2010 will be reclassified to a liability at an estimated value of $3,350,000. Subsequent to adoption, the 4% cumulative preferred stock of subsidiary will be accreted to redemption value using the interest method with the resulting change included as a component of interest expense. In addition, the preferred dividends of $160,000 per year will also be included as a component of interest expense.

**Note 7. Retained Interests:**

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

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Information pertaining to our structured loan sale transactions as of June 30, 2003 was as follows. Balances represent PMC Capital s share of the respective Joint Ventures.

| | 1998 Partnership | 1999 Partnership | 2000 Joint Venture | 2001 Joint Venture | 2002 Joint Venture |
|---|---|---|---|---|---|
| | | | (Dollars in thousands) | | |
| Principal outstanding on sold loans | $ 25,254 | $ 35,527 | $ 18,957 | $ 43,837 | $ 40,984 |
| Structured Notes balance outstanding | $ 24,065 | $ 33,333 | $ 17,713 | $ 39,979 | $ 36,787 |
| Cash in the collection account | $ 365 | $ 1,762 | $ 1,684 | $ 437 | $ 486 |
| Cash in the reserve account | $ 2,039 | $ 2,217 | $ 1,231 | $ 2,638 | $ 2,469 |
| Weighted average interest rate of loans | Prime + 1.23% | 9.40% | 9.28% | 9.73% | 9.50% |
| Interest rate on the Structured Notes | Prime - 1.00% | 6.60% | 7.28% | 6.36% | 6.67% |
| Discount rate assumptions (1) | 4.0% to 11.5% | 6.8% to 11.5% | 7.1% to 11.8% | 6.7% to 11.4% | 7.0% to 11.7% |
| Constant prepayment rate assumption (2) | 11.00% | 10.00% | 14.00% | 9.75% | 9.75% |
| Weighted average remaining life of loans (3) | 3.53 years | 3.81 years | 3.19 years | 4.70 years | 4.47 years |
| Aggregate losses assumed (4) | 2.97% | 2.63% | 2.93% | 3.13% | 3.22% |
| Aggregate principal losses to date | % | % | 4.27% | % | % |

(1) *The discount rates utilized on the components of our Retained Interests (as detailed below) were (i) 4.0% to 7.1% for our required overcollateralization, (ii) 8.4% to 8.8% for our reserve funds and (iii) 11.4% to 11.8% for our interest-only strip receivables.*

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

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

(4) *Represents aggregate estimated future losses as a percentage of the principal outstanding based upon per annum estimated losses that ranged from 0.5% to 1.2%.*

In addition to the transactions described above, First Western has Retained Interests. First Western sold the unguaranteed portion of its loans receivable through a private placement in 1997 ( FW 97 ) and has retained the right to service these loans receivable. Pursuant to the sale, First Western maintains a reserve fund and receives cash flow from the interest-only strip receivable established in connection with the sold loans receivable. At June 30, 2003, the principal balance outstanding on the sold loans of FW 97 was approximately $3.4 million and the reserve fund balance (currently at its minimum requirement) was $912,000.

The SBA guaranteed portions of First Western s loans receivable are sold to either dealers in government guaranteed loans receivable or institutional investors ( Secondary Market Loan Sales ) as the loans are fully funded. On all Secondary Market Loan Sales, we retain an excess spread between the interest rate paid to us from our borrowers and the rate we pay to the purchaser of the guaranteed portion of the note. At June 30, 2003, the aggregate principal balance of First Western s serviced loans receivable on which we have an excess spread was approximately $46.9 million, and the weighted average excess spread (before estimated servicing costs) was approximately 1.8%.

In determining the fair value of our Retained Interests related to First Western for our SBA 7(a) transactions, our assumptions at June 30, 2003 included prepayment speeds ranging from 20% to 30% per annum, loss rates ranging from 0.2% to 0.4% per annum (relates only to FW 97) and discount rates ranging from 5.8% to 11.4%.

**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The components of our Retained Interests are as follows:

(1) Our required overcollateralization (the OC Piece ). The OC Piece represents the excess of the loans receivable contributed to the SPE over the principal amount of the Structured Notes Payable issued by the SPE, which serves as additional collateral for the Structured Noteholders.

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

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

Our Retained Interests consisted of the following:

| | June 30, 2003 | | | | |
|---|---|---|---|---|---|
| | Value | | | | |
| | OC Piece | Reserve Fund | IO Receivable | Total | Cost |
| | (In thousands) | | | | |
| First Western | $ | $ 846 | $ 1,843 | $ 2,689 | $ 2,343 |
| 1998 Partnership | 1,459 | 1,612 | 743 | 3,814 | 3,375 |
| 1999 Partnership | 4,191 | 1,781 | 1,618 | 7,590 | 7,088 |
| 2000 Joint Venture | 3,014 | 1,053 | 323 | 4,390 | 4,107 |
| 2001 Joint Venture | 4,770 | 2,117 | 3,094 | 9,981 | 8,905 |
| 2002 Joint Venture | 5,108 | 1,972 | 2,100 | 9,180 | 8,591 |
| | $ 18,542 | $ 9,381 | $ 9,721 | $ 37,644 | $ 34,409 |

| | December 31, 2002 | | | | |
|---|---|---|---|---|---|
| | Value | | | | |
| | OC Piece | Reserve Fund | IO Receivable | Total | Cost |
| | (In thousands) | | | | |
| First Western | $ | $ 842 | $ 1,890 | $ 2,732 | $ 2,388 |
| 1998 Partnership | 1,519 | 1,672 | 823 | 4,014 | 3,553 |
| 1999 Partnership | 4,216 | 1,923 | 1,967 | 8,106 | 7,540 |
| 2000 Joint Venture | 3,058 | 1,420 | 323 | 4,801 | 4,492 |
| 2001 Joint Venture | 4,798 | 2,282 | 3,613 | 10,693 | 9,603 |
| 2002 Joint Venture | 5,213 | 2,036 | 2,408 | 9,657 | 8,965 |
| | $ 18,804 | $ 10,175 | $ 11,024 | $ 40,003 | $ 36,541 |

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The following sensitivity analysis of our Retained Interests as of June 30, 2003 highlights the volatility that results when prepayments, losses and discount rates are different than our assumptions:

| Changed Assumption | Pro-Forma Value | Asset and Net Income Change |
|---|---|---|
| | (In thousands) | |
| Losses increase by 50 basis points per annum (1) | $ 35,140 | ($2,504) |
| Losses increase by 100 basis points per annum (1) | $ 32,717 | ($4,927) |
| Rate of prepayment increases by 5% per annum (2) | $ 36,352 | ($1,292) |
| Rate of prepayment increases by 10% per annum (2) | $ 35,411 | ($2,233) |
| Discount rates increase by 100 basis points | $ 36,133 | ($1,511) |
| Discount rates increase by 200 basis points | $ 34,712 | ($2,932) |

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

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

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

The following information summarizes the financial position of the SPEs at June 30, 2003 and December 31, 2002. We own 100% of the 1998 Partnership and the 1999 Partnership. At June 30, 2003, we owned approximately 32% of the 2000 Joint Venture, 60% of the 2001 Joint Venture and 61% of the 2002 Joint Venture. At December 31, 2002, we owned approximately 34% of the 2000 Joint Venture, 61% of the 2001 Joint Venture and 61% of the 2002 Joint Venture.

Summary of Financial Position (1):

| | 1998 Partnership | | 1999 Partnership | |
|---|---|---|---|---|
| | June 30, 2003 | December 31, 2002 | June 30, 2003 | December 31, 2002 |
| | (In thousands) | | | |
| Loans Receivable, Net | $ 25,070 | $ 25,865 | $ 35,527 | $ 39,216 |
| Total Assets | $ 27,563 | $ 28,477 | $ 39,732 | $ 42,475 |
| Notes Payable | $ 24,065 | $ 24,806 | $ 33,333 | $ 35,907 |
| Total Liabilities | $ 24,132 | $ 24,885 | $ 33,517 | $ 36,106 |
| Partners Capital | $ 3,431 | $ 3,592 | $ 6,215 | $ 6,369 |

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

| | 2000 Joint Venture | | 2001 Joint Venture | | 2002 Joint Venture | |
|---|---|---|---|---|---|---|
| | June 30, 2003 | December 31, 2002 | June 30, 2003 | December 31, 2002 | June 30, 2003 | December 31, 2002 |
| | (In thousands) | | | | | |
| Loans Receivable, Net | $ 66,734 | $ 70,627 | $ 72,168 | $ 73,220 | $ 67,489 | $ 69,025 |
| Asset Acquired in Liquidation, Net | $ | $ 1,411 | $ | $ | $ | $ |
| Total Assets | $ 73,376 | $ 76,434 | $ 77,864 | $ 81,302 | $ 72,548 | $ 74,322 |
| Notes Payable | $ 60,187 | $ 62,658 | $ 66,065 | $ 69,146 | $ 60,601 | $ 62,152 |
| Total Liabilities | $ 60,369 | $ 62,848 | $ 66,240 | $ 69,329 | $ 60,770 | $ 62,325 |
| Partners Capital | $ 13,007 | $ 13,586 | $ 11,624 | $ 11,973 | $ 11,778 | $ 11,997 |

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

The following information summarizes the results of operations of our SPEs.

Summary of Operations (1):

| | Six Months Ended June 30, | | | |
|---|---|---|---|---|
| | 1998 Partnership | | 1999 Partnership | |
| | 2003 | 2002 | 2003 | 2002 |
| | ( In thousands) | | | |
| Interest Income | $ 729 | $ 909 | $ 1,764 | $ 2,181 |
| Total Revenues | $ 733 | $ 936 | $ 1,912 | $ 2,374 |
| Interest Expense | $ 397 | $ 518 | $ 1,134 | $ 1,414 |
| Provision for (Reduction of) Losses | $ (50 ) | $ 49 | $ | $ 81 |
| Total Expenses | $ 509 | $ 619 | $ 1,198 | $ 1,573 |

| | | | | |
|---|---|---|---|---|
| Net Income | $ 224 | $ 317 | $ 714 | $ 801 |

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

| | Six Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2000 Joint Venture | | 2001 Joint Venture | | 2002 Joint Venture | |
| | 2003 | 2002 | 2003 | 2002 | 2003 | 2002 (2) |
| | (In thousands) | | | | | |
| Interest Income | $ 3,329 | $ 3,612 | $ 3,532 | $ 3,756 | $ 3,192 | $ 1,448 |
| Total Revenues | $ 3,395 | $ 3,848 | $ 3,555 | $ 3,802 | $ 3,256 | $ 1,460 |
| Interest Expense | $ 2,256 | $ 2,559 | $ 2,121 | $ 2,251 | $ 2,049 | $ 913 |
| Provision for (Reduction of) Losses | $ 45 | $ | $ (140) | $ | $ | $ |
| Total Expenses | $ 2,430 | $ 2,687 | $ 2,099 | $ 2,375 | $ 2,161 | $ 991 |
| Net Income | $ 965 | $ 1,161 | $ 1,456 | $ 1,427 | $ 1,095 | $ 469 |

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

*(2) Represents the period from April 12, 2002 (inception) to June 30, 2002.*

Our ownership of the Joint Ventures is based on our share of the capital of the respective Joint Ventures. Our share of the cash flows from the Joint Ventures is allocated based on the cash flows from the underlying loans receivable contributed by us to the respective Joint Venture less allocated costs based on the remaining principal on the underlying loans receivable contributed by us divided by all loans receivable held by the respective Joint Venture.

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

| | 2000 Joint Venture | | 2001 Joint Venture | | 2002 Joint Venture | |
|---|---|---|---|---|---|---|
| | June 30, 2003 | December 31, 2002 | June 30, 2003 | December 31, 2002 | June 30, 2003 | December 31, 2002 |
| | (In thousands) | | | | | |
| Loans Receivable, Net | $ 18,957 | $ 20,783 | $ 43,837 | $ 44,269 | $ 40,984 | $ 42,199 |
| Asset Acquired in Liquidation, Net | $ | $ 1,411 | $ | $ | $ | $ |
| Total Assets | $ 21,919 | $ 22,727 | $ 47,110 | $ 50,232 | $ 44,116 | $ 45,484 |
| Total Liabilities | $ 17,767 | $ 18,141 | $ 40,085 | $ 42,875 | $ 36,889 | $ 38,123 |
| Partners Capital | $ 4,152 | $ 4,586 | $ 7,025 | $ 7,357 | $ 7,227 | $ 7,361 |

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

| | Six Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2000 Joint Venture | | 2001 Joint Venture | | 2002 Joint Venture | |
| | 2003 | 2002 | 2003 | 2002 | 2003 | 2002 (1) |
| | (In thousands) | | | | | |
| Net Income | $ 193 | $ 302 | $ 945 | $ 901 | $ 685 | $ 322 |

*(1) Represents the period from April 12, 2002 (inception) to June 30, 2002.*

In accordance with SFAS No. 140, our consolidated financial statements do not include the SPE assets, liabilities, partners capital, revenues or expenses. As a result, at June 30, 2003 and December 31, 2002 our consolidated balance sheets do not include the $180.4 million and $189.4 million of assets, respectively, and $152.4 million and $160.1 million of liabilities, respectively, related to our structured loan sale transactions recorded by the SPEs. Our Retained Interests related to these structured loan sale transactions were $35.0 million and $37.3 million at June 30, 2003 and December 31, 2002, respectively.

The net unrealized appreciation on our Retained Interests at June 30, 2003 and December 31, 2002 was $3.2 million and $3.5 million, respectively. Any appreciation of our Retained Interests is included in the accompanying statements of operations as unrealized gain on investments. Any depreciation of our Retained Interests is included in the accompanying statements of operations as either realized loss (if there is a reduction in expected future cash flows) or an unrealized loss on investments.

The income from our Retained Interests consists of the yield earned on our Retained Interests which is determined based on estimates of future cash flows and includes any fees collected (*i.e.,* late fees, prepayment fees, etc.) by the SPEs in excess of anticipated fees. We update our cash flow assumptions on a quarterly basis and any changes to cash flow assumptions impact the yield on our Retained Interests. The annualized yield on our Retained Interests was as follows:

| | Six Months Ended June 30, | | Three Months Ended June 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Annualized Yield | 11.8% | 14.0% | 11.7% | 14.0% |

We are the servicer for all loans held by the SPEs. Servicing fee income for the three and six months ended June 30, 2003 and 2002 related to loans receivable held by the SPEs was approximately $128,000 and $134,000 and $259,000 and $251,000, respectively. Servicing fee income is included in other income, net in our consolidated statements of operations. We have not established a servicing asset or liability as our servicing fees are considered adequate compensation.

We received approximately $4.1 million and $5.4 million in cash distributions from our SPEs during the six months ended June 30, 2003 and 2002, respectively. In addition, in May 2003, a limited service hospitality property with an aggregate estimated value of $1.5 million at June 30, 2003 was transferred from the 2000 Joint Venture to Asset Holding.

**Note 8. Assets Acquired in Liquidation:**

At June 30, 2003 and December 31, 2002, the aggregate value of our assets acquired in liquidation, as reduced for anticipated selling costs, was estimated to be approximately $3.2 million and $2.3 million, respectively. Our assets acquired in liquidation at June 30, 2003 consist primarily of three operating limited service hospitality properties. We are currently marketing to sell these assets. In addition, effective April 1, 2003, one of these limited service hospitality properties was leased, under an operating lease, to the subsidiary of PMC Advisers.

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

We acquired a limited service hospitality property through foreclosure in May 2003. The aggregate value of this property, as reduced for anticipated selling costs, was estimated to be approximately $1.1 million. During July 2003, we sold this limited service hotel property for approximately $1.1 million; therefore, no gain or loss was recorded on the sale. We financed the sale through the origination of a loan of $900,000 at an interest rate of LIBOR plus 4.5%. The loan matures in 2023.

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

| | Six Months Ended June 30, | | Three Months Ended June 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| | (In thousands) | | | |
| Room revenue | $ 64 | $ 49 | $ 25 | $ 49 |
| Salaries and wages | (45) | (37) | (27) | (37) |
| Other operating expenses | (170) | (119) | (52) | (109) |
| Loss from operations of assets acquired in liquidation | $ (151) | $ (107) | $ (54) | $ (97) |

Assets have also been transferred or leased to our non-consolidated non-investment company subsidiaries. At June 30, 2003, the aggregate value of assets acquired in liquidation of Asset Holding was estimated to be approximately $2.9 million, consisting of a golf facility and a limited service hospitality property both acquired during 2003 and recorded at estimated value at the time of transfer. Upon transfer of the assets acquired in liquidation to Asset Holding, we recorded a corresponding due from affiliate which represents the estimated net proceeds to be received upon sale. We are currently marketing to sell these assets. During both the three and six months ended June 30, 2003, our non-consolidated subsidiaries incurred operating losses of approximately $57,000.

**Note 9. Revolving Credit Facility and Notes and Debentures Payable:**

We have an uncollateralized revolving credit facility which expires in May 2004. The aggregate amount outstanding pursuant to this facility cannot exceed $15 million through the earlier of the closing of our next structured loan sale transaction or October 28, 2003, and $10 million thereafter. When the facility reverts to $10 million, we also have available a guidance line facility of $5 million, subject to bank approval. Advances pursuant to the facility bear interest at our option of the bank s prime rate less 50 basis points or LIBOR plus 175 basis points. The credit facility requires us to meet certain covenants (terms as defined in the agreement), the most restrictive of which requires that (i) the ratio of net charge-offs to net loans receivable not exceed 2%, (ii) the ratio of assets to debt may not fall below 110% for PMC Capital and 135% including our consolidated subsidiaries and (iii) the problem loans percentage cannot exceed 10% of our serviced loan portfolio. At June 30, 2003, we were in compliance with all covenants of this facility. As of June 30, 2003, we had approximately $6.3 million outstanding under this facility with interest based primarily on LIBOR. The weighted average interest rate on our revolving credit facility as of June 30, 2003 was 2.9% and our weighted average borrowings during the six months ended June 30, 2003 were $3.9 million. As of December 31, 2002, we had no borrowings outstanding under this facility.

Our uncollateralized notes payable (the Notes Payable ) outstanding at both June 30, 2003 and December 31, 2002 were $40.0 million. The Notes Payable, as amended, mature from July 2003 to July 2006 with a weighted average interest rate of 4.6% at June 30, 2003. These Notes Payable require us to meet certain covenants (terms as defined in the agreement), the most restrictive of which require (i) that net loans receivable must exceed 150% of senior funded debt, (ii) loan losses for any twelve-month period must not exceed 3% of net loans receivable and (iii) our consolidated earnings plus interest expense must exceed 150% of interest expense. At June 30, 2003, we were in compliance with all covenants of these Notes Payable.

During July 2003, we repaid $5.0 million of our Notes Payable at maturity with an interest rate of 8.6%.

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Debentures payable represent amounts due to the SBA as a result of borrowings made pursuant to the SBIA. Debentures outstanding at both June 30, 2003 and December 31, 2002 were $14.3 million. The weighted average interest rate on our SBA debentures as of June 30, 2003 was 7.7%.

**Note 10 Net Unrealized Appreciation (Depreciation) on Investments and Realized and Unrealized Gain (Loss) on Investments:**

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

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

| | June 30, 2003 | December 31, 2002 |
|---|---|---|
| | (In thousands) | |
| Loans receivable | $ (333) | $ (711) |
| Retained Interests | 3,235 | 3,462 |
| Mortgage-backed security of affiliate | 72 | 68 |
| Assets acquired in liquidation | (593) | (421) |
| | $ 2,381 | $ 2,398 |

| | Six Months Ended June 30, 2003 (In thousands) | | | |
|---|---|---|---|---|
| | Retained Interests (1) | Assets Acquired in Liquidation | Loans Receivable | Total |
| Realized losses | $ (129) | $ | $ (453) | $ (582) |
| Change in unrealized appreciation (depreciation) on investments | (223) | (172) | 378 | (17) |
| Total realized and unrealized loss on investments | $ (352) | $ (172) | $ (75) | $ (599) |

| | Six Months Ended June 30, 2002 (In thousands) | | | |
|---|---|---|---|---|
| | Retained Interests (1) | Assets Acquired in Liquidation | Loans Receivable | Total |
| Realized losses | $ (302) | $ | $ (163) | $ (465) |

| | | | | |
|---|---|---|---|---|
| Sale of assets | | | 1,463 | 1,463 |
| Change in unrealized appreciation (depreciation) on investments | 350 | (460) | (84) | (194) |
| Total realized and unrealized gain (loss) on investments | $ 48 | $ (460) | $ 1,216 | $ 804 |

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

| | Three Months Ended June 30, 2003 (In thousands) | | | |
|---|---|---|---|---|
| | Retained Interests (1) | Assets Acquired in Liquidation | Loans Receivable | Total |
| Realized losses | $ | $ | $ (367) | $ (367) |
| Change in unrealized appreciation (depreciation) on investments | 17 | (110) | 349 | 256 |
| Total realized and unrealized gain (loss) on investments | $ 17 | $ (110) | $ (18) | $ (111) |

| | Three Months Ended June 30, 2002 (In thousands) | | | |
|---|---|---|---|---|
| | Retained Interests (1) | Assets Acquired in Liquidation | Loans Receivable | Total |
| Realized losses | $ (302) | $ | $ (7) | $ (309) |
| Sale of assets | | | 1,463 | 1,463 |
| Change in unrealized appreciation (depreciation) on investments | 593 | (386) | (118) | 89 |
| Total realized and unrealized gain (loss) on investments | $ 291 | $ (386) | $ 1,338 | $ 1,243 |

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

**Note 11. Taxable Income:**

We qualify as a regulated investment company ( RIC ) under the Internal Revenue Code of 1986, as amended. If we meet certain diversification and distribution requirements, we qualify for pass-through tax treatment. We would cease to qualify for pass-through tax treatment if we were unable to comply with these requirements or if we ceased to qualify as an investment company under the 1940 Act. We would also be subject to a 4% excise tax (and, in certain cases, corporate level income tax) if we fail to make certain distributions. Failure to qualify as a RIC would subject us to Federal income tax as if we were an ordinary corporation, resulting in a substantial reduction in both our net assets and the amount of income available for distribution to our shareholders.

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The following reconciles net income available to common shareholders to taxable income available to common shareholders:

| | Six Months Ended June 30, | | Three Months Ended June 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| | (In thousands, except per share data) | | | |
| Net income | $ 1,746 | $ 4,144 | $ 1,088 | $ 2,464 |
| Preferred dividends | (125) | (124) | (63) | (62) |
| Net income available to common shareholders | 1,621 | 4,020 | 1,025 | 2,402 |
| Book/tax differences: | | | | |
| Retained Interests, net | 621 | 302 | 374 | 305 |
| Sale of assets | | (1,463) | | (1,463) |
| Merger related costs | 519 | | 197 | |
| Valuation adjustments | 146 | 495 | (256) | 213 |
| Other, net | (44) | 92 | (22) | 46 |
| Taxable income available to common shareholders | $ 2,863 | $ 3,446 | $ 1,318 | $ 1,503 |
| Distributions to common shareholders | $ 2,846 | $ 4,267 | $ 1,423 | $ 1,896 |
| Dividends declared per share | $ 0.24 | $ 0.32 | $ 0.12 | $ 0.16 |

**Note 12. Earnings Per Common Share:**

The computations of basic earnings per common share are based on our weighted average shares outstanding. The weighted average shares outstanding were approximately 11,854,000 for the three and six months ended June 30, 2003 and 2002. There was no change in the weighted average shares outstanding for the effect of stock options during the three and six months ended June 30, 2003 since the stock options were anti-dilutive. The weighted average shares outstanding were increased by approximately 1,000 and 2,000 shares for the dilutive effect of stock options during the three and six months ended June 30, 2002, respectively.

Earnings are defined as net income and are reduced by the preferred stock dividend requirements of PMCIC to determine earnings per common share.

**Note 13. Dividends Paid and Declared:**

On January 13, 2003 and April 14, 2003, we paid quarterly dividends of $0.12 per share to common shareholders of record on December 31, 2002 and March 31, 2003. The Board of Directors declared a quarterly dividend of $0.12 per share to common shareholders of record on June 30, 2003, which was paid on July 14, 2003.

**Note 14. Commitments and Contingencies:**

*Loan Commitments*
Loan commitments outstanding at June 30, 2003 were approximately $20.9 million. Of these commitments, $4.9 million are for loans to be originated by First Western, a portion of which we expect to be sold into the secondary market. All of these commitments are for variable-rate loans based on the prime rate or LIBOR at spreads over prime ranging from 2.0% to 2.75% and over LIBOR ranging from 3.5% to 4.5%. Commitments generally have fixed expiration dates and require payment of a fee to us. Since some commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*Structured Loan Sale Transactions*
PMC Capital and PMC Commercial have entered into cross indemnification agreements regarding the performance of their respective loans receivable sold to the Joint Ventures. To the extent that poor performance by either PMC Capital s or PMC Commercial s sold loans receivable (the Underperforming Company ) is pervasive enough to cause the other company (the Performing Company ) to not receive cash flow that it otherwise would have received, then the Underperforming Company must make the Performing Company whole. If the cash flow reduction is considered to be temporary, then interest will be paid as compensation to the Performing Company. In general, when a loan is liquidated, it may cause a deferral of cash flow to the Performing Company and, as a result, interest would be charged to the Underperforming Company until the cash flow from the Joint Venture repays the Performing Company. If the reduction of cash flows is deemed permanent, (*i.e.,* to the extent that the Underperforming Company will not be able to satisfy the shortfall with the assets they have contributed to the related structured loan sale transaction), the reduction in cash flows must be paid to the Performing Company by the Underperforming Company. At June 30, 2003, the maximum potential amount of future payments to PMC Commercial (undiscounted and without consideration of any proceeds from the collateral underlying the loans receivable) we could be required to make under these cross indemnification agreements was approximately $32.8 million and the discounted amount was $22.7 million, which represents the estimated fair value of the Retained Interests reflected on PMC Commercial s consolidated balance sheet for the Joint Ventures. Upon completion of a joint structured loan sale transaction and on each subsequent quarterly reporting date, management evaluates the need to recognize a liability associated with these cross indemnification agreements. Based on our present cash flow assumptions, including stress test analyses of increasing the anticipated losses on each of the loan pools, it does not appear that the loans receivable sold by us will cause any permanent cash flow reductions to PMC Commercial nor will the loans receivable sold by PMC Commercial cause any permanent cash flow reductions to us. Accordingly, we believe that the fair value of our obligations pursuant to these cross indemnification agreements at inception of the Joint Ventures and as of June 30, 2003 and December 31, 2002 was zero; thus, no liability was recorded. If the performance of our sold loans receivable deteriorates, it may be necessary for us to perform under these cross indemnification agreements.

When our structured loan sale transactions were completed, the transaction documents that the SPE entered into contained provisions (the Credit Enhancement Provisions ) that govern the assets and the flow of funds in and out of the SPE formed as part of the structured loan sale transactions. The Credit Enhancement Provisions include specified limits on the delinquency, default and loss rates on the loans receivable included in each SPE. If, at any measurement date, the delinquency, default or loss rate with respect to any SPE were to exceed the specified limits, the Credit Enhancement Provisions would automatically increase the level of credit enhancement requirements for that SPE. During the period in which the specified delinquency, default or loss rate was exceeded, excess cash flow from the SPE, if any, would be used to fund the increased credit enhancement levels instead of being distributed, which would delay or reduce our distribution.

*Merger*
For their services in connection with the proposed merger of PMC Capital into PMC Commercial, our external investment banker will receive a fee of $100,000, which is contingent upon consummation of the merger. The external investment banker is also paid a quarterly retainer fee of $25,000 for advisory assistance in connection with the merger. The fee commenced April 1, 2003 and terminates when the merger is consummated or terminated.

PMC Capital will pay a termination fee of $870,000 to PMC Commercial if the merger agreement is terminated because PMC Capital (i) breaches any provision of the merger agreement that PMC Commercial has not waived and PMC Capital enters into an agreement to consummate a competing transaction, (ii) withdraws or changes its recommendation that the shareholders approve the merger or (iii) terminates the merger agreement in connection with a superior proposal. In the event the merger agreement is terminated because of a breach by PMC Capital that has not been waived by PMC Commercial and PMC Capital has not entered into a competing transaction, no termination fee will be payable but termination expenses of up to $750,000 may be payable to PMC Commercial.

*Operating Leases*
We lease office space in Dallas, Texas. Future minimum lease payments remaining under this lease are approximately $166,000.

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**PMC CAPITAL, INC. AND SUBSIDIARIES**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*Employment Agreements*
We have employment agreements with certain of our officers. Future minimum payments under these contracts are approximately $1,182,000 and $934,000 for the twelve-month periods ending June 30, 2004 and June 30, 2005.

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

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**PART I**
**Financial Information**

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

*This Form 10-Q contains certain forward-looking statements. These statements include the plans and objectives of management for future operations, including plans and objectives relating to future growth of the loan portfolio and availability of funds. Such forward-looking statements can be identified by the use of forward-looking terminology such as may, will, expect, intend, believe, anticipate, estimate, continue, or the negative thereof or other variations or similar words or phrases. The forward-looking statements included herein are based on current expectations and there can be no assurance that these expectations will be attained. For a description of certain factors that could cause our future results to differ materially from those expressed in any such forward-looking statement, see Factors That May Affect Future Operating Results included elsewhere in this Form 10-Q and the information contained under the caption Risk Factors included in our Annual Report on Form 10-K for the year ended December 31, 2002. Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Form 10-Q will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved.*

**The following discussion of our financial condition at June 30, 2003 and results of operations for the three and six months ended June 30, 2003 and 2002 should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2002.**

**AGREEMENT AND PLAN OF MERGER**

On March 27, 2003, PMC Capital, Inc. ( PMC Capital ) entered into an Agreement and Plan of Merger with PMC Commercial Trust ( PMC Commercial ). Under the terms of the merger agreement, PMC Capital will be merged into PMC Commercial, with PMC Commercial continuing as the surviving entity. Each issued and outstanding share of PMC Capital common stock will be converted into 0.37 of a common share of PMC Commercial. The merger has been recommended by each company s special committee comprised of independent directors and unanimously approved by the Board of Directors of PMC Capital (the Board ) and the Board of Trust Managers of PMC Commercial. In addition, the boards and management of each company have entered into voting agreements pursuant to which they have agreed to vote their shares in favor of the merger and related transactions. Completion of the merger, which is expected to occur on January 1, 2004 but no later than February 29, 2004, is subject to approval by the shareholders of PMC Capital and PMC Commercial, certain governmental consents and customary closing conditions.

**BUSINESS**

PMC Capital (together with its consolidated subsidiaries, the Company, we, us or our ) is a national small business lender. Our operations are centralized in Dallas, Texas and include originating, servicing and selling commercial loans. We also have a business development office in Arizona. We primarily originate loans to individuals and small businesses in the limited service sector of the hospitality industry. We sell certain of our loans receivable through privately-placed structured loan transactions and sell th