

PMC COMMERCIAL TRUST /TX

Form 10-K

March 16, 2009

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K**

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Fiscal Year Ended December 31, 2008
OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Transition Period From _____ to _____
Commission File Number: 1-13610
PMC COMMERCIAL TRUST
(Exact name of registrant as specified in its charter)

Texas

75-6446078

(State or other jurisdiction of incorporation or organization)

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

17950 Preston Road, Suite 600, Dallas, TX 75252

(972) 349-3200

(Address of principal executive offices)

(Registrant's telephone number)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class

Name of Each Exchange on Which Registered

Common shares of beneficial interest, \$.01 par value

NYSE Alternext US

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark whether the Registrant is a well-known seasoned issuer (as defined in Rule 405 of the Securities Act). YES NO

Indicate by check mark whether the Registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. YES NO

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

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the Registrant is a shell company (as defined in Exchange Act Rule 12b-2). YES NO

The aggregate market value of common shares held by non-affiliates of the Registrant, based upon the closing sale price of the Common Shares of Beneficial Interest on June 30, 2008 as reported on the American Stock Exchange, was approximately \$76 million. Common Shares of Beneficial Interest held by each officer and trust manager and by each person who owns 10% or more of the outstanding Common Shares of Beneficial Interest have been excluded because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of February 28, 2009, the Registrant had outstanding 10,639,733 Common Shares of Beneficial Interest.

DOCUMENTS INCORPORATED BY REFERENCE:

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

PMC COMMERCIAL TRUST
Form 10-K
For the Year Ended December 31, 2008

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

PART I**Item 1. BUSINESS****INTRODUCTION**

PMC Commercial Trust (PMC Commercial) and together with its wholly-owned subsidiaries, the Company, our or w is a real estate investment trust (REIT) organized in 1993 that primarily originates loans to small businesses collateralized by first liens on the real estate of the related business. Our outstanding loans are primarily to borrowers in the limited service hospitality industry. As a REIT, we seek to maximize shareholder value through long-term growth in dividends paid to our shareholders. We must distribute at least 90% of our REIT taxable income to shareholders to maintain our REIT status. See Tax Status. We pay dividends from the cash flow generated from our operations. Our common shares are traded on the NYSE Alternext US under the symbol PCC.

Our mission is to derive income primarily from the origination of real estate collateralized loans. Through conservative underwriting and exceptional service, we strive to provide our shareholders with the highest dividend, consistent with the focus on preservation of investment capital.

We generate revenue primarily from the yield and other fee income earned on our investments. Our operations are located in Dallas, Texas and include originating, servicing and selling commercial loans. During the years ended December 31, 2008 and 2007, our total revenues were approximately \$23.1 million and \$27.3 million, respectively, and our net income was approximately \$9.8 million and \$13.1 million, respectively. See Item 8. Financial Statements and Supplementary Data for additional financial information.

In addition to loans originated by PMC Commercial, we also originate loans through our subsidiaries. Our principal wholly-owned lending subsidiaries are: First Western SBLC, Inc. (First Western), PMC Investment Corporation (PMIC) and Western Financial Capital Corporation (Western Financial). First Western is licensed as a small business lending company (SBLC) that originates loans through the Small Business Administration's (SBA) 7(a) Guaranteed Loan Program (SBA 7(a) Program). PMIC and Western Financial are small business investment companies (SBICs).

First Western is a Preferred Lender nationwide, as designated by the SBA, and originates, sells and services small business loans throughout the continental United States. As a non-bank SBA 7(a) Program lender, First Western is able to originate loans on which a substantial portion of the loan (currently 75% to 85%) is guaranteed as to payment of principal and interest by the SBA. When we sell the government guaranteed portion of First Western's loans, we may receive cash premiums at the time of sale. Due to the existence of the SBA guarantee which generally provides us with premiums upon sale, we are able to originate loans that meet the criteria of the SBA 7(a) Program and have less

stringent underwriting criteria than our non-SBA 7(a) Program loan originations. See Lending Activities SBA Programs.

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Our ability to generate interest income is dependent upon economic, regulatory and competitive factors that influence interest rates and loan originations and our ability to secure financing for our investment activities. The amount of income earned varies based on the volume of loans funded, the volume of loans which prepay and the resultant applicable prepayment fees, if any, the interest rate on loans originated and the general level of interest rates. During periods of falling interest rates, due to the significant level of our variable-rate loans, our interest income is subject to interest rate risk. See Item 7a. Quantitative and Qualitative Disclosures About Market Risk.

Generally, in order to fund new loans, we need to borrow funds or sell loans. Since 2004, our working capital has been provided through credit facilities and the issuance of junior subordinated notes. Prior to that, our primary source of funds was structured loan transactions/securitizations. In structured loan transactions, we contributed loans to special purpose entities (SPEs) in exchange for cash and a subordinate financial interest in that entity. See Structured Loan Transactions. At the current time, there is no market for commercial loan asset-backed securitizations. Due to the lack of this market for our type of securitization and the prospect that this market may never recover to its prior form or may return with costs or structures that we may not be able to accept, and the uncertainty surrounding extension of our revolving credit facility, we have refocused our lending activities and are now focusing almost exclusively on originating loans under the SBA 7(a) Program. In addition, our revolving credit facility expires on December 31, 2009. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Sources and Uses of Funds Liquidity Summary. There can be no assurance that we can extend the maturity date of the facility or that its terms will not change. If the revolving credit facility is not extended or replaced, we may have to reduce our commitments to fund loans under the SBA 7(a) Program.

Prior to 2007, we operated in two identifiable reporting segments: (1) the lending division, which originates loans to small businesses primarily in the limited service hospitality industry and (2) the property division, which owned and operated our hotel properties. As of June 30, 2007, we had sold or leased all of our hotel properties. All revenues and expenses of the properties sold were included in discontinued operations. However, as the down payments received were not sufficient to qualify for full accrual gain treatment on certain of the sales, we recorded initial installment gains and deferred the remaining gains. Deferred gains are recorded to income as principal is received on the related loans receivable until the required amount of cash proceeds are obtained from the purchaser to qualify for full accrual gain treatment. As deferred gains on hotel property sales are recorded, they are included within the property division.

LENDING ACTIVITIES**Overview**

We are a national lender that primarily originates loans to small businesses, principally in the limited service hospitality industry. In addition to first liens on real estate of the related business, our loans are typically personally guaranteed by the principals of the entities obligated on the loans.

We identify loan origination opportunities through personal contacts, internet referrals, attendance at trade shows and meetings, direct mailings, advertisements in trade publications and other marketing methods. We also generate loans through referrals from real estate and loan brokers, franchise representatives, existing borrowers, lawyers and accountants. Payments are sometimes made to non-affiliated individuals who assist in generating loan applications, with such payments generally not exceeding 1% of the principal amount of the originated loan.

Limited Service Hospitality Industry

Our outstanding loans are generally collateralized by first liens on limited service hospitality properties and are typically for owner-operated facilities operating under national franchises, including, among others, Comfort Inn, Hampton Inn & Suites, Holiday Inn Express, Best Western and Clarion. We believe that franchise operations offer attractive lending opportunities because such businesses generally employ proven business concepts, have national reservation systems and advertising, consistent product quality, are screened and monitored by franchisors and generally have a higher rate of success when compared to other independently operated hospitality businesses.

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Lodging demand in the United States generally appears to correlate to changes in U.S. GDP, with typically a two to three quarter lag. As a result of the current economic turmoil, leading lodging industry analysts, including PricewaterhouseCoopers LLP, have noted the following:

The industry will likely feel a pronounced negative impact during 2009 as businesses and consumers take steps to reduce discretionary spending;

Lodging demand is expected to contract more rapidly in 2009 than the overall economy; and

Average daily room rates are expected to retreat during 2009.

The most abrupt effects of reduced travel are expected to be concentrated in the first three quarters of 2009.

Loan Originations and Underwriting

We believe that we successfully compete in certain sectors of the commercial real estate finance market due to our understanding of our borrowers' businesses, the flexible loan terms that we offer and our responsive customer service. We consider the underlying cash flow of the tenant or owner-occupant as well as more traditional real estate underwriting criteria such as:

The components, value and replacement cost of the borrower's collateral (primarily real estate);

The industry and competitive environment in which the borrower operates;

The financial strength of the guarantors;

Analysis of local market conditions;

The ease with which the collateral can be liquidated;

The existence of any secondary repayment sources;

Analysis of the property operator; and

The existence of a franchise relationship.

Upon receipt of a completed loan application, our credit department conducts: (1) a detailed analysis of the potential loan, which typically includes an appraisal and a valuation by our credit department of the property that will collateralize the loan to ensure compliance with loan-to-value percentages, (2) a site inspection for real estate collateralized loans, (3) a review of the borrower's business experience, (4) a review of the borrower's credit history, and (5) an analysis of the borrower's debt-service-coverage, debt-to-equity and other applicable ratios. All appraisals are performed by an approved, licensed third party appraiser and based on the market value, replacement cost and cash flow value approaches. We also utilize local market economic information to the extent available.

We believe that our typical non-SBA 7(a) Program loan is distinguished from those of some of our competitors by the following characteristics:

Substantial down payments are required. We usually require an initial down payment of not less than 20% of the total cost of the project being financed. Our experience has shown that the likelihood of full repayment of a loan increases if the owner/operator is required to make an initial and substantial financial commitment to the project being financed.

Cash outs are typically not permitted. Generally, we will not make a loan in an amount greater than the lesser of 80% of either the replacement cost or current appraised value of the property which is collateral for the loan. For example, a hotel property may have been originally constructed for a cost of \$2,000,000, with the owner/operator initially borrowing \$1,600,000 of that amount. At the time of the borrower's loan refinancing request, the property securing the loan is appraised at \$4,000,000. Some of our competitors might loan from 70% to 90% or more of the new appraised value of the property and permit the owner/operator to receive a cash distribution from the proceeds. Generally, we would not permit this type of cash-out distribution.

The obligor is personally liable for the loan. We typically require the principals of the borrower to personally guarantee the loan.

Our non-SBA 7(a) Program has been inactive since the middle of 2008 and we are currently originating primarily variable-rate loans based on the prime rate under our SBA 7(a) Program.

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

		At December 31,					
		2008		2007			
		Loans Receivable, net		Weighted Average Interest Rate	Loans Receivable, net		Weighted Average Interest Rate
		Amount	%	Rate	Amount	%	Rate
		<i>(Dollars in thousands)</i>					
Variable-rate	LIBOR	\$ 123,081	68.4%	7.5%	\$ 129,650	78.1%	9.0%
Fixed-rate		39,297	21.9%	9.0%	22,794	13.8%	8.6%
Variable-rate	prime	17,429	9.7%	6.9%	13,525	8.1%	9.6%
Total		\$ 179,807	100.0%	7.7%	\$ 165,969	100.0%	9.0%

Our variable-rate loans generally require monthly payments of principal and interest, reset on a quarterly basis, to amortize the principal over the remaining life of the loan. Fixed-rate loans generally require level monthly payments of principal and interest calculated to amortize the principal over the remaining life of the loan.

Loan Activity

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

		Years Ended December 31,				
		2008	2007	2006	2005	2004
		<i>(In thousands)</i>				
Loans receivable, net	beginning of year	\$ 165,969	\$ 169,181	\$ 157,574	\$ 128,234	\$ 50,534
Loans originated (1)		55,950	44,419	71,530	58,852	53,659
Loans acquired (2)						55,144
Principal collections (3)		(33,268)	(32,559)	(47,240)	(13,826)	(23,196)
Repayments of SBA 504 program loans (4)		(4,699)	(8,085)	(2,342)	(2,180)	(1,621)
Loans sold (5)		(4,059)	(1,971)	(6,373)	(7,785)	(6,222)
Loans transferred to AAL (6)			(4,917)	(3,730)	(5,657)	(2,115)
Loan deemed to be repurchased (7)						2,126
Other adjustments (8)		(86)	(99)	(238)	(64)	(75)
Loans receivable, net	end of year	\$ 179,807	\$ 165,969	\$ 169,181	\$ 157,574	\$ 128,234

(1) During 2008, includes \$21,363 of loans from the exercise of the clean-up call provisions of two of our

*structured loan
sale
transactions.*

*(2) Represents the
estimated fair
value of loans
acquired in the
merger with
PMC Capital,
Inc. (PMC
Capital), our
affiliate through
common
management.*

*(3) Represents
scheduled
principal
payments,
maturities and
prepayments.*

*(4) Represents
second
mortgages
originated
through the SBA
504 Program
which are
repaid by
certified
development
companies.*

*(5) Represents the
government
guaranteed
portion of SBA
7(a) Program
loans sold
through private
placements to
either dealers in
government
guaranteed
loans or
institutional
investors.*

(6)

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

(7) Represents a loan at its estimated fair value deemed to be repurchased from a qualified SPE as a result of a delinquent loan on which we initiated foreclosure on the underlying collateral and were contractually allowed to repurchase from the qualified SPE.

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

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

	Years Ended December 31,				
	2008	2007	2006	2005	2004
	<i>(In thousands)</i>				
First Quarter	\$ 17,136	\$ 15,401	\$ 17,630	\$ 8,251	\$ 6,609
Second Quarter (1)	32,331	18,632	13,536	11,236	17,255
Third Quarter	2,467	2,150	5,710	15,010	14,998
Fourth Quarter	4,016	8,236	34,654	24,355	14,797
Total	\$ 55,950	\$ 44,419	\$ 71,530	\$ 58,852	\$ 53,659

(1) For 2008, includes \$21,363 of loans from the exercise of the clean-up call provisions of two of our structured loan sale transactions.

Loan Portfolio Statistics

Information on our loans receivable (Retained Portfolio), loans which have been sold (either to the qualified SPEs or secondary market sales of SBA 7(a) Program loans) and on which we have retained interests (the Sold Loans) and our Retained Portfolio combined with our Sold Loans (the Aggregate Portfolio) was as follows:

	At December 31,					
	2008		2007			
	Aggregate Portfolio	Sold Loans	Retained Portfolio	Aggregate Portfolio	Sold Loans	Retained Portfolio
	<i>(Dollars in thousands)</i>					
Portfolio outstanding (1)	\$ 275,530	\$ 94,925	\$ 180,605	\$ 326,368	\$ 159,945	\$ 166,423
Weighted average interest rate	7.9%	8.2%	7.7%	9.2%	9.4%	9.0%
Annualized average yield (2)	8.4%	8.2%	8.4%	10.5%	10.9%	10.1%
Weighted average contractual maturity in years	14.7	12.1	16.0	14.8	12.6	17.0
Impaired loans (3)	\$ 13,339	\$ 1,544	\$ 11,795	\$ 4,135	\$ 1,022	\$ 3,113
Hospitality industry concentration %	88.9%	85.2%	90.8%	90.9%	88.1%	93.5%
Texas concentration % (4)	22.9%	22.2%	23.2%	25.3%	25.7%	25.0%

(1) Loan portfolio outstanding

before loan loss reserves and deferred commitment fees.

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

(3) *Includes loans on which the collection of the balance of principal is considered unlikely and on which the fair value of the collateral is less than the remaining unamortized principal balance (Problem Loans) and the principal balance of loans which have been identified as potential problem loans for which it is expected that a full recovery of the principal balance will be received*

through either collection efforts or liquidation of collateral (Special Mention Loans, and together with Problem Loans, Impaired Loans). We do not include the remaining outstanding principal of serviced loans pertaining to the government guaranteed portion of loans sold into the secondary market since the SBA has guaranteed payment of principal on these loans.

- (4) *In addition, at December 31, 2008, approximately 10% of our Retained Portfolio was collateralized by properties in Arizona. No other concentrations greater than or equal to 10% existed at December 31, 2008 for our Retained Portfolio, Sold Loans or Aggregate*

Portfolio.

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The distribution of our loan portfolio by industry was as follows at December 31, 2008:

	Retained Portfolio			Aggregate Portfolio		
	Number of Loans	Cost (1)	% of Total Cost (Dollars in thousands)	Number of Loans	Cost (1)	% of Total Cost
Hotels and motels	139	\$ 163,901	90.8%	201	\$ 244,814	88.9%
Convenience stores/service stations	13	7,882	4.4%	17	13,288	4.8%
Restaurants	22	3,142	1.7%	22	4,838	1.8%
Services	19	1,124	0.6%	22	4,448	1.6%
Retail	10	1,363	0.7%	10	1,901	0.7%
Other	16	3,193	1.8%	21	6,241	2.2%
	219	\$ 180,605	100.0%	293	\$ 275,530	100.0%

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

SBA Programs**General**

We utilize programs established by the SBA to generate loan origination opportunities and provide us with a funding source as follows:

We have an SBLC that originates loans through the SBA's 7(a) Program;

We participate as a private lender in the SBA 504 Program which allows us to originate first mortgage loans with lower loan-to-value ratios;

We have two licensed SBICs regulated under the Small Business Investment Act of 1958, as amended. Our SBICs use long-term funds provided by the SBA, together with their own capital, to provide long-term collateralized loans to eligible small businesses, as defined under SBA regulations.

Our regulated SBA subsidiaries are periodically examined and audited by the SBA to determine compliance with SBA regulations.

SBA 7(a) Program

Under the SBA 7(a) Program, the SBA typically guarantees 75% of qualified loans over \$150,000. While the eligibility requirements of the SBA 7(a) Program vary by the industry of the borrower and other factors, the general eligibility requirements are that: (1) gross sales of the borrower cannot exceed size standards set by the SBA (*i.e.*, \$7.0 million for limited service hospitality properties, etc.), (2) liquid assets of the borrower and affiliates cannot exceed specified limits, and (3) the maximum aggregate SBA loan guarantees to a borrower cannot exceed \$1.5 million. Maximum maturities for SBA 7(a) Program loans are 25 years for real estate and between seven and 10 years for the purchase of machinery, furniture, fixtures and/or equipment. In order to operate as an SBLC, a licensee is required to maintain a minimum net worth (as defined by SBA regulations) of the greater of (1) 10% of its outstanding loans receivable and other investments or (2) \$1.0 million, and is subject to certain other regulatory restrictions such

as change in control provisions. See Item 1A. Risk Factors.

SBA 504 Program

The SBA 504 Program assists small businesses in obtaining subordinated, long-term financing by guaranteeing debentures available through certified development companies (CDCs) for the purpose of acquiring land, building, machinery and equipment and for modernizing, renovating or restoring existing facilities and sites. A typical finance structure for an SBA 504 Program project would include a first mortgage covering 50% of the project cost from a private lender, a second mortgage obtained from a CDC covering up to 40% of the project cost and a contribution of at least 10% of the project cost by the principals of the small businesses being assisted. We typically require at least a 20% contribution of the equity in a project by our borrowers. The SBA does not guarantee the first mortgage. Although the total sizes of projects utilizing the SBA 504 Program are unlimited, currently the maximum amount of subordinated debt in any individual project is generally \$1.5 million (or \$2 million for certain projects). Typical project costs range in size from \$1 million to \$6 million.

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SBIC Program

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

STRUCTURED LOAN TRANSACTIONS

General

While the securitization market is not currently a viable financing vehicle, prior to 2004, structured loan transactions were our primary method of obtaining funds for new loan originations. In structured loan transactions, we contributed loans to an SPE in exchange for a subordinated financial interest in that entity and obtained an opinion of counsel that the contribution of the loans to the SPE constituted a true sale of the loans. The SPE issued notes payable through a private placement to third parties and then distributed a portion of the notes payable proceeds to us. The notes payable are collateralized solely by the assets of the SPE. Since the SPEs met the definition of qualified SPEs (QSPEs), we accounted for the structured loan transactions as sales of our loans; and as a result, neither the loans contributed to the QSPE nor the notes payable issued by the QSPE were included in our consolidated financial statements. The terms of the notes payable issued by the QSPEs provide that the partners of these QSPEs are not liable for any payment on the notes. Accordingly, if the QSPEs fail to pay the principal or interest due on the notes, the sole recourse of the holders of the notes is against the assets of the QSPEs. We have no obligation to pay the notes, nor do the holders of the notes have any recourse against our assets. We service the loans pursuant to the transaction documents and are paid a fee of 30 basis points per year based on the principal outstanding.

When structured loan sale transactions were completed, our ownership interests in the QSPEs were accounted for as retained interests in transferred assets (Retained Interests) and recorded at the present value of the estimated future cash flows to be received from the QSPE. The difference between (1) the carrying value of the loans sold and (2) the sum of (a) the cash received and (b) the relative fair value of our Retained Interests, constituted the gain or loss on sale.

All of our securitization transactions provide a clean-up call . A clean-up call is an option to repurchase the remaining transferred assets when the amount of the outstanding assets (or corresponding notes payable outstanding) falls to a level at which the cost of servicing those assets becomes burdensome. At the time we are entitled to exercise the clean-up call, we consolidate the assets and liabilities of the securitization.

Retained Interests

General

As of December 31, 2008, the QSPEs consisted of:

PMC Capital, L.P. 1998-1 (the 1998 Partnership);

PMC Joint Venture, L.P. 2000-1 (the 2000 Joint Venture);

PMC Joint Venture, L.P. 2002-1 (the 2002 Joint Venture); and,

PMC Joint Venture, L.P. 2003-1 (the 2003 Joint Venture, and together with the 2000 Joint Venture and the 2002 Joint Venture, the Joint Ventures).

The 2002 Joint Venture reached its clean-up call option during January 2009 becoming a non-qualifying SPE; however, based on our current liquidity needs, the option was not exercised. The 2002 Joint Venture will be consolidated in our financial statements beginning in the first quarter of 2009.

In addition, First Western has Retained Interests related to the sale of loans originated pursuant to the SBA 7(a) Program.

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At December 31, 2008, the cost of our Retained Interests was approximately \$32.6 million with an estimated fair value of \$33.2 million. Our Retained Interests primarily consist of (1) the required overcollateralization (the overcollateralized piece), which is the retention of a portion of each of the Sold Loans, (2) the reserve fund, which represents the required cash balance owned by the QSPE and (3) the interest-only strip receivable (the interest-only strip receivable), which represents the future excess funds to be generated by the QSPE after payment of all obligations of the QSPE.

Our Retained Interests are subject to credit, prepayment and interest rate risks. The estimated fair value of our Retained Interests is determined based on the present value of estimated future cash flows that we will receive from the QSPEs. The estimated future cash flows are calculated based on assumptions concerning, among other things, loan losses and prepayment speeds. On a quarterly basis, we measure the fair value of, and record income relating to, the Retained Interests based upon the future anticipated cash flows discounted based on an estimate of market interest rates for investments of this type. Any appreciation of the Retained Interests is included in our balance sheet in beneficiaries' equity. Any depreciation of Retained Interests is either included in our statement of income as either a permanent impairment or on the balance sheet in beneficiaries' equity as an unrealized loss.

We retain a portion of the default and prepayment risk associated with the underlying loans of our Retained Interests. Actual defaults and prepayments, with respect to estimating future cash flows for purposes of valuing our Retained Interests will vary from our assumptions, possibly to a material degree, and slower (faster) than anticipated prepayments of principal or lower (higher) than anticipated loan losses will increase (decrease) the fair value of our Retained Interests and related cash flows. We regularly measure our loan loss, prepayment and other assumptions against the actual performance of the loans sold. Although we believe that assumptions made as to the future cash flows are reasonable, actual rates of loss or prepayments will vary from those assumed and the assumptions may be revised based upon changes in facts or circumstances. See Item 1A - Risk Factors Investment Risks General There is no market for our Retained Interests and the value is volatile.

Determination of what a willing buyer would pay for our Retained Interests is complicated due to, among other reasons, the following:

- The historical lack of buyers for small business loan asset-backed securities similar to ours;

- More recently, the lack of a liquid market for asset-backed securities;

- The composition of our Retained Interests which has a high concentration of hard collateral such as restricted cash and the net difference (or overcollateralization) between the loans from the borrowers and the structured notes payable;

- The limited number of companies that have securitized our type of loans;

- The relatively small size of our Retained Interests; and

- The short remaining lives of the QSPEs until reaching clean-up calls.

As a result of the lack of available market inputs, at the time our securitization transactions were completed and for each quarterly valuation update, we utilized a cash flow model to determine the estimated fair value of our Retained Interests. The turmoil in the credit markets has spotlighted the use of cash flow models and management has evaluated the complexities and range of judgments inherent in using cash flow models in light of the current market illiquidity. Our cash flow models require significant assumptions and judgments that reflect the current market illiquidity and, as a result, we have increased the discount rates utilized in our cash flow models and have reevaluated our expectation of future prepayments and loan losses on the underlying securitized loans in light of the current illiquid markets.

In accordance with generally accepted accounting principles, our consolidated financial statements do not include the assets, liabilities, partners' capital, revenues or expenses of the QSPEs. As a result, at December 31, 2008 and 2007, our consolidated balance sheets do not include \$77.6 million and \$141.8 million in assets, respectively, and \$44.0 million and \$94.4 million in liabilities, respectively, related to these structured loan sale transactions recorded

by the QSPEs. At December 31, 2008, the aggregate partners' capital of the QSPEs was approximately \$33.6 million compared to the estimated value of the associated Retained Interests of approximately \$32.9 million.

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TAX STATUS

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

PMC Commercial may, however, be subject to certain Federal excise taxes and state and local taxes on its income and property. If PMC Commercial fails to qualify as a REIT in any taxable year, it will be subject to Federal income taxes at regular corporate rates (including any applicable alternative minimum tax) and will not be able to qualify as a REIT for four subsequent taxable years. REITs are subject to a number of organizational and operational requirements under the Code. See Item 1A Risk Factors REIT Related Risks for additional tax status information.

EMPLOYEES

We employed 31 individuals including marketing professionals, investment professionals, operations professionals and administrative staff as of December 31, 2008. In addition, we have employment agreements with our executive officers. Our operations are conducted from our Dallas, Texas office. We believe the relationship with our employees is good.

COMPETITION

When originating loans we compete with other specialty commercial lenders, banks, broker dealers, other REITs, savings and loan associations, insurance companies and other entities that originate loans. Many of these competitors have greater financial and managerial resources than us, are able to provide services we are not able to provide (*i.e.*, depository services), and may be better able to withstand the impact of economic downturns.

Variable-rate lending: For our variable-rate loan product, we believe we compete effectively on the basis of interest rates, our long-term maturities and payment schedules, the quality of our service, our reputation as a lender, timely credit analysis and greater responsiveness to renewal and refinancing requests from borrowers.