# Rialto Holdings, LLC and Subsidiaries

## Fiscal Year 2013 Annual Report

## Including Management's Discussion and Analysis of Financial Condition and Results of Operations
## and
## Audited Consolidated Financial Statements

## PART I

### Item 1. Business.

### Overview of Rialto Holdings, LLC and Subsidiaries

We are a leading commercial real estate investment, investment management, and finance company focused on raising, investing and managing third party capital, as well as investing our own capital, in real estate related mortgage loans, properties and related securities, and, in addition, originating commercial mortgage loans, which we sell to securitization vehicles. We have a vertically-integrated operating platform consisting of over 290 professionals located in 9 offices across the U.S. We were founded in 2007 and are a wholly-owned subsidiary of Lennar Corporation ("Lennar" or "Parent"), one of the largest homebuilders in the U.S. At November 30, 2013, Lennar had $539 million of capital invested in our business to support our growth.

Our primary business strategy has been to raise, invest and manage third-party capital, as well as to invest our own capital, in three major business lines:

- **Asset and Investment Management**: our asset and investment management business allows us to be a sponsor of and an investor in private equity vehicles that invest in and manage real estate related assets;
- **Loan Origination and Securitization**: the origination of first mortgage loans secured by commercial real estate and the eventual securitization of these loans through third party issuers; and
- **Direct Investments in Real Estate Related Assets**: direct investments in distressed and value-add real estate related assets including mortgage loans and properties and primarily new-issue commercial mortgage-backed securities ("CMBS").

We apply a comprehensive risk management approach across our business lines, which is rooted in our management's deep understanding of fundamental real estate values and proven ability to manage these complementary business lines through multiple economic and credit cycles. To date, many of our investment and management opportunities have arisen from the dislocation in the U.S. real estate markets from 2007 to 2010 and the efforts to restructure and recapitalize those markets. Going forward, we believe that we are well-positioned to capitalize on the opportunities arising from the diminished supply of commercial real estate capital and the substantial demand for new financings in the commercial real estate sector. We believe our comprehensive, highly experienced management team of industry veterans, supplemented by Lennar's knowledge of regional and local real estate conditions in many parts of the country, will allow us to continue to grow our business prudently as we endeavor to capitalize on opportunities in the real estate finance market.

### Description of Business

#### *Asset and Investment Management*

We have 160 professionals in our real estate investment and asset management business line who manage approximately $4 billion of equity capital, service over $30 billion of real estate loans and real estate related securities and manage the ongoing workout of over 9,000 real estate mortgage loans. We also have obtained a CMBS special servicer rating of CSS2- by Fitch and an "Above Average" ranking by S&P rating services. Our real estate investment and asset management business allows us to be a sponsor of and an investor in private equity vehicles that invest in and manage real estate related assets. Beginning in 2009, we became a sub-advisor to AllianceBernstein L.P. in its role as one of the eight firms selected by the U.S. Treasury to manage investment funds created under a Public-Private Investment Program ("PPIP") that was designed to invest in legacy commercial and residential mortgage securities in order to help provide liquidity to the nation's banks. As part of this arrangement, we participated in the successful deployment of $4.3 billion of capital that generated a total net internal rate of return of 18.7% for the U.S. Treasury and participating private investors. During 2012, all of the securities in the investment portfolio underlying the AB PPIP fund were monetized in connection with the final unwinding of its operations. In addition, we raised and are managing two private distressed real estate funds and one real estate related mezzanine loan fund with total capital commitments as of November 30, 2013 of approximately $1.9 billion and are currently at approximately $2.1 billion. We earn recurring management fees for our role as a manager of real estate related private equity and debt funds and for providing investment management and other services to those vehicles and other third parties. Our vertically integrated loan underwriting and loan and REO asset management platform, our extensive relationships with loan originators, brokers and other third parties, and our access to Lennar's regional and local real estate expertise, provide unique insight into local markets nationwide and allow us to develop customized investment management solutions that should enable us to generate superior results.

***Loan Origination and Securitization***

We began commercial mortgage loan origination activities in 2013 by hiring a group of 22 seasoned professionals. This platform is focused on originating first mortgage loans, secured by stabilized, income-producing commercial real estate properties, and selling those loans in quarterly or more frequent securitizations. We source lending opportunities by leveraging a deep network of direct borrower and broker relationships in the real estate industry, including local, regional and national developers, mortgage brokers, asset managers and other institutional property owners, and through correspondent originators.

***Direct Investments in Real Estate Related Assets***

Through our direct investments business line, we have been among the most active acquirers of portfolios of distressed real estate loans and assets from banks, government entities and other financial institutions. We partnered with the Federal Deposit Insurance Corporation ("FDIC") in February 2010 to invest in and manage non-performing and distressed real estate loans with an aggregate unpaid principal balance of $3 billion that the FDIC had acquired through its conservatorship of 22 banks. Through a structured transaction with the FDIC, we acquired 40% managing member equity interests in each of two limited liability companies ("LLCs") for an investment of $243 million while the FDIC contributed the loans and retained 60% equity interests in each of the LLCs. The FDIC provided the LLCs with $626.9 million of debt financing with 0% interest, which was non-recourse to the LLCs and to us, in the form of purchase money notes, to finance the $1.2 billion in total investment value. Cash collected on the loans, net of expenses and other items, went first to pay down the $626.9 million in purchase money notes, which were fully repaid during 2013, after which the remaining cash flow is being shared 60% for the FDIC and 40% for us.

***The Investor Companies***

The Investor Companies were formed solely to make investments in funds or entities managed or advised by the Rialto Companies.

At November 30, 2013, the Investor Companies had the following investments (dollars in thousands):

| Subject of Investment | November 30, 2013 Balance |
|---|---|
| FDIC LLCs [(1)] | $ 283,765 |
| Real Estate Fund I | 75,729 |
| Real Estate Fund II | 53,103 |
| Mezzanine Fund | 16,724 |
| Total | $ 429,321 |

(1) Because the accounts of the FDIC LLCs are consolidated in our financial statements, this is not reflected as a joint venture investment in those financial statements.

At November 30, 2013, the Investor Companies had the following commitments to make investments (dollars in thousands):

| Subject of Commitment | Total Commitment | Balance Not Yet Funded |
|---|---|---|
| Real Estate Fund I | $ 75,000 | $ - |
| Real Estate Fund II | 100,000 | 49,421 |
| Mezzanine Fund | 25,000 | 8,629 |
| Total | $ 200,000 | $ 58,050 |

Until November 2013, the Investor Companies obtained all their funds through equity contributions by Lennar, and the Investor Companies have distributed any excess cash to Lennar. However, Lennar has no commitment to make additional funds available to the Investor Companies. The Investor Companies anticipate that all or most of the funds they use for future investments will be proceeds of investments they have already made, supplemented by proceeds of the sale in November 2013 of the 7.00% Senior Notes due 2018 (the "7.00% Senior Notes") and fees and carried interests received by Rialto. The indenture relating to the 7.00% Senior Notes limits the ability of the Company or any of our Restricted Subsidiaries to make distributions, other than the repayment of indebtedness owed, to Lennar. However, these limits will not apply at any time when the Company and its Restricted Subsidiaries have a Consolidated Non-Funding Debt to Equity Ratio of 1.50 to 1.00 or less.

***Risk Management***

We have a robust infrastructure with many layers of risk management and oversight of our operations. This provides a rigorous and detailed framework within which we operate our business. We are a subsidiary of a publicly traded company which subjects us to significant oversight requirements. Additionally, we are registered as an investment advisor with the SEC and are a rated special servicer with ratings of "Above Average" from S&P and CSS2- by Fitch. To complement this infrastructure, we actively manage the risk of our diverse lines of business through numerous committees, including our executive committee which meets weekly to discuss business initiatives; our investment committee that monitors and approves transactions for our investment management business; our credit committee that monitors and approves our conduit mortgage origination business; and our risk management committee that meets weekly to review and discuss hedging activities, portfolio composition, credit quality and general market conditions and trends. Additionally, our high-touch servicing platform allows for utmost flexibility in monitoring, managing and working out assets. We believe this infrastructure coupled with a rigorous approach to risk management is a competitive advantage and allows us to generate superior risk adjusted returns for our investors and our own capital.

Our principal tool of risk management is a rigorous underwriting of each asset in which we are considering investing for our own account or for the account of investment funds we manage. This includes underwriting each loan in a loan portfolio we are thinking of acquiring, including each loan in the asset pool underlying a CMBS issue for which we are considering bidding. In a large majority of instances with regard to loans in excess of $100,000, the underwriting generally includes an inspection of the property that secures the loan. A substantial portion of the underwriting is done by people who also are involved in working out non-performing loans or managing and disposing of foreclosed real estate that we acquire, which enables them to apply the experience they obtain in working out loans or managing and disposing of properties to estimating the likelihood that particular loans will become delinquent and how much is likely to be recovered with regard to foreclosed properties when they are sold (including amounts that can be obtained from guarantors, in instances in which there are guarantors).

We have a group of approximately 79 people who are responsible for working out non-performing loans and another group of approximately 74 people who are responsible for overseeing the management and sale of REO we obtain either as parts of distressed real estate asset portfolios we acquire or through foreclosures of non-performing loans.

We have convened a credit committee, comprised of senior executives from us and our Parent, to evaluate new loans originated by our commercial mortgage finance subsidiary, Rialto Mortgage Finance ("RMF"), monitor existing investments and oversee the Company's derivatives and hedging process. Rialto has also convened a risk committee that consists of senior members of the RMF management team, as well as Rialto legal, management and finance associates and members of Lennar management. On a bi-weekly basis, the risk committee reviews the associated risks of credit hedging, the existing hedge ratio, pricing surrounding new issues that occurred within the market, upcoming securitizations as well as new originations which are in the pipeline.

***Relationship with Lennar***

The Company is a wholly owned subsidiary of Lennar. Until the Company was formed in August 2013, Rialto Capital Management, LLC and Rialto Investments, LLC were direct wholly owned subsidiaries of Lennar. Prior to the 7.00% Senior Notes offering, Lennar had provided all the funds that had been used by the Company, other than funds generated from assets that were owned, or fees or proceeds of management fees the Company received. On November 14, 2013, the day the 7.00% Senior Notes were issued, Lennar contributed to the Company's equity the entire outstanding balance of the amount it had invested in the Company (an amount previously classified as "Due to Parent") in excess of $235 million. The $235 million remaining constituted indebtedness of the Company to Lennar. However, the Company applied $100 million of the gross proceeds of the sale of the 7.00% Senior Notes and $135 million of working capital to fully retire this indebtedness as of November 30, 2013.

The 7.00% Senior Notes indenture limits the ability of the Company or any of the Company's Restricted Subsidiaries (as defined) to make distributions, other than the repayment of indebtedness owed, to Lennar. However, these limits will not apply at any time when the Company and its Restricted Subsidiaries have a Consolidated Non-Funding Debt to Equity Ratio (as such term is defined in the 7.00% Senior Notes Indenture dated November 14, 2013) of 1.50 to 1.00 or less.

Pursuant to the Company's Operating Agreement, the Company's sole member, Lennar, has the authority, power, and discretion to manage and control the business, affairs, and properties of the Company, to make all decisions regarding those matters and to perform any and all other acts customary or incident to the management of the Company's business. Additionally, in the Company's Operating Agreement, the Company agrees to indemnify the Company's members, manager, officers, and employees against losses, claims, damages and liabilities except in certain circumstances outlined in the

Operating Agreement (i.e., in instances of gross negligence, willful misconduct or fraud).

*Revolving Credit Agreement* – Lennar will have no obligation to provide additional funds to the Company, other than pursuant to a revolving credit agreement between Lennar and the Company. Under the revolving credit agreement, Lennar will, subject to customary lending conditions, make advances to the Company on a revolving basis of up to $75 million. The maturity date will be November 22, 2015 and the Company will pay interest on advances at LIBOR plus 3.5% for the applicable interest period. The Company is subject to certain customary covenants, including, but not limited to, limitations on fundamental changes, limitations on changes to line of business and transactions with affiliates. The Company may repay outstanding amounts at any time, without premium or penalty, on 10 business days' prior notice, and may re-borrow sums it repays. At November 30, 2013, no amounts were outstanding under this agreement and no amounts had been borrowed or repaid under this agreement during 2013.

*Support Services and Expense Reimbursement Agreement* – Prior to the 7.00% Senior Notes offering, Lennar had provided management, treasury, information technology, income tax, payroll and administrative services to the Company and to its subsidiaries. In the past, Lennar has not charged the Company for those services (although Lennar did require the Company to reimburse it for rent and other operating costs it advanced on the Company's behalf). However, on November 26, 2013, Lennar and the Company entered into a Support Services and Expense Reimbursement Agreement under which Lennar has agreed to provide specified accounting, information technology, tax, legal, human resources, treasury, occupancy, office and other administrative services to the Company and its subsidiaries and the Company will pay a fee equal to the lower of the actual cost or fair market value of those services to Lennar. As of November 30, 2013, no amounts were charged or paid by the Company under this agreement.

*Tax Reimbursement Agreement* – The Company and most of its subsidiaries are not recognized as taxpayers for Federal income tax purposes or for income tax purposes in some states. Instead, its taxable income and the taxable income of its subsidiaries that are limited liability companies and other types of non-corporate entities, is treated as taxable income of Lennar. Because Lennar, as the Company's sole member, is required to include at least most of the Company's Federal taxable income in Lennar's Federal taxable income, the Company entered into a Tax Reimbursement Agreement on November 26, 2013, which was effective September 1, 2013, pursuant to which the Company will pay Lennar, each time the Company would be required to pay Federal or state income taxes if it were a taxable corporation, the sum equal to the Federal or state income tax the Company would have been required to pay if it and its subsidiaries were all taxable corporations, minus any Federal or state income taxes the Company or its subsidiaries actually pay. The Company will make such payment to Lennar 5 days prior to the date on which Lennar files applicable tax returns. This agreement will terminate if the Company is no longer a subsidiary of Lennar. As of November 30, 2013, the Company has $12.4 million recorded as a liability to Lennar under this Tax Reimbursement Agreement, which constitutes the entire Due to Parent on the accompanying 2013 Consolidated Balance Sheet.

*Prior to the 7.00% Senior Notes Offering* – Prior to November 2013, cash funding had been provided for operating capital on an as-needed basis. Excess operating funds generated by the Company and any cash distributions from unconsolidated entities had been swept back to Lennar. No interest had been charged for the use of funds provided by the Parent. All cash funding, net of amounts swept back to Lennar were recorded as Due to Parent in the accompanying consolidated balance sheets for periods prior to November 2013.

## Seasonality

We do not feel that seasonality is an important factor in our results of operations.

## Competition

Our business, and that of some of the funds we manage, of purchasing distressed assets is highly competitive and fragmented. A number of entities and funds have been formed in recent years for the purpose of acquiring real estate related assets at prices that reflect the depressed and changing state of the real estate market and subsequent recovery, and it is likely that additional entities and funds will be formed for this purpose during the next several years. We compete with other purchasers of distressed and value-add assets. We compete in the marketplace for assets based on many factors, including purchase price, representations, warranties and indemnities, timeliness of purchase decisions and reputation. In marketing of real estate investment funds we sponsor, we compete with a large variety of asset managers, including investment banks and other financial institutions and real estate investment firms. Our recently formed loan origination and securitization business competes with other commercial mortgage lenders in a competitive market and our profitability depends on our ability to originate and securitize commercial real estate loans at attractive prices.

Some of our competitors are substantially larger and have greater financial, technical, marketing and other resources than we do. Some competitors have a lower cost of funds than we have and access to funding sources that are not available to us. In addition, some of our competitors may have higher risk tolerances or different risk assessments than we do, which could allow them to consider a wider variety of investments and establish more relationships than we have.

We believe that our major distinction from the competition with regard to distressed debt investments is that our team is made up of existing managers who engage in working out and adding value to real estate assets and have been for several years. Our loan origination and securitization business is made up of highly seasoned managers who have been originating and securitizing loans for over 25 years with long-standing relationships. Additionally, because we are a lender or capital provider to developers, we believe having Lennar's homebuilding team participating in the underwriting process provides us with a distinct advantage in our evaluation of these assets. We believe that our experienced team and the infrastructure already in place give us an advantage and position us well when compared to a number of our competitors.

## Regulation

Our operations are subject, in certain instances, to supervision and regulation by state and federal governmental authorities and may be subject to laws and judicial and administrative decisions imposing various requirements and restrictions. In addition, certain of our subsidiaries' businesses may rely on exemptions from various requirements of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Employee Retirement Income Security Act ("ERISA"). These exemptions are sometimes highly complex and may in certain circumstances depend on compliance by third-parties who we do not control.

We are a wholly owned subsidiary of a publicly traded company. Our Parent is subject to the reporting requirements under the Securities Exchange Act of 1934, as amended.

*Regulation as an investment adviser*

We conduct investment advisory activities in the U.S. as a registered investment adviser under the Investment Advisers Act which is administered by the Securities and Exchange Commission (the "SEC"). A registered investment adviser is subject to federal and state laws and regulations primarily intended to benefit its clients. These laws and regulations include requirements relating to, among other things, fiduciary duties to clients, maintaining an effective compliance program, solicitation agreements, conflicts of interest, record keeping and reporting, advertising, political contributions and "pay-to-play" arrangements, as well as transactions between an investment adviser and its advisory clients and contain general anti-fraud prohibitions. These laws and regulations generally grant supervisory agencies broad administrative powers, including the power to limit or restrict us from conducting our advisory activities in the event we fail to comply with the laws and regulations. Sanctions that may be imposed for a failure to comply with applicable legal requirements include the suspension of individual employees, limitations on our engaging in various advisory activities for specified periods of time, the revocation of registrations, other censures and fines.

We may become subject to additional regulatory and compliance burdens as we expand our product offerings and investment platform. For example, if we were to advise a company that is registered as an investment company under the Investment Company Act, we would be subject to the Investment Company Act and the rules under it, which, regulate the relationship between a registered investment company and its investment adviser. This additional regulation could increase our compliance costs and create the potential for additional liabilities and penalties.

*Investment Company Act Exemption*

We presently attempt to conduct our operations so that we are not required to register as an investment company under the Investment Company Act, because of an exception for companies that are engaged primarily in acquiring mortgages and other liens on and interests in real estate. However, because many forms of indirect real estate related investments are not considered for purposes of the Investment Company Act to be mortgages or other interests in real estate, we may have difficulty qualifying for that exception. Additionally, in August of 2011, the SEC solicited public comment on a wide range of issues relating, among other things, to the nature of the assets that qualify for purposes of the exception from the definition of an investment company in the Investment Company Act for companies that are engaged primarily in acquiring mortgages and other liens on and interests in real estate. Some of the possible changes as to which the SEC sought comment could make it even more difficult for us to qualify for that exception than currently is the case. Given the uncertainty as to this real estate related exception, we may also rely on the exception provided under Section 3(c)(7) of the Investment Company Act.

Pursuant to Section 3(c)(7) of the Investment Company Act, we currently are excepted from the definition of "investment company" under the Investment Company Act because: (i) our securities are owned exclusively by persons who we reasonably believe were, at the time they acquired our securities, Qualified Purchasers (or "knowledgeable employees" within the meaning of Rule 3c-5 under the Investment Company Act); and (ii) we have not made (and currently do not propose to make) a public offering of our securities.

*Licensing*

We are currently licensed, or in the process of obtaining licenses, to act as a commercial mortgage lender in jurisdictions that require licensing. In the future, we may be required to obtain, maintain or renew certain licenses and authorizations (including "doing business" authorizations and licenses to act as a commercial mortgage lender) from federal or state governmental authorities, government sponsored entities or similar bodies in connection with some or all of our mortgage-related activities.

***Dodd-Frank***

Dodd-Frank imposes certain regulatory requirements that may affect our operations in the future. Dodd-Frank generally requires sponsors of securitizations and, in certain circumstances, originators of assets being securitized, to retain not less than five percent of the credit risk for any asset transferred into a securitization unless certain asset tests or underwriting standards are met. These requirements of Dodd-Frank are not yet in effect, pending adoption of implementing regulations. For additional information, see “Risk Factors — We may be adversely impacted by legal and regulatory changes.”

**Compliance Policy**

Because we are a wholly owned subsidiary of Lennar, all of our employees are subject to Lennar’s Code of Business and Ethics. However, because we are registered under the Investment Advisers Act of 1940, as amended, we are required to have our own Compliance Manual and have a Supplemental Code of Ethics that applies to our employees.

Lennar’s Code of Business and Ethics requires that every associate (i.e., employee) at all times deal fairly with the company’s customers, subcontractors, suppliers, competitors and associates, and states that all Lennar (and therefore our) associates, officers and directors are expected to comply at all times with all applicable laws, rules and regulations. Lennar’s Code of Business and Ethics also has procedures that allow whistleblowers to submit their concerns regarding its (which includes our) operations, financial reporting, business integrity or any other matter anonymously to the Audit Committee of Lennar’s Board of Directors or to the non-management members of that Board of Directors, which is intended to give whistleblowers a means of making their concerns known without a possibility of retaliation.

The Rialto Capital Management Compliance Manual (i) sets forth the compliance-related policies and procedures of the Company; (ii) designates certain individuals with supervisory responsibilities for compliance processes; (iii) describes the relevant laws, rules and regulations governing Rialto’s business; and (iv) sets forth certain record keeping and reporting requirements. The Compliance Manual contains policies and procedures relating to, among other things, the role of the Chief Compliance Officer, marketing, custody, principal transactions, valuation, electronic communications, and information security.

The Rialto Capital Management Supplemental Code of Ethics establishes the standards of business conduct that all associates must follow and, among other things, specifically addresses insider trading, market manipulation, front-running and rumors. The Supplemental Code of Ethics also sets forth specific policies and procedures associates must adhere to when engaging in certain activities, including but not limited to, personal trading, outside business activities, making political contributions and the giving or receiving of business-related gifts and entertainment.

**Associates**

At November 30, 2013, we had 293 associates in nine offices. Of these 293 associates, 160 are in our asset and investment management business line, 25 are in our loan origination and securitization business line and the remaining 108 serve in corporate or administrative roles.

**Legal Proceedings**

We are subject to legal proceedings in the ordinary course of our business. Our management believes that the final disposition of such matters will not have a material adverse effect on our business, financial position, results of operations, liquidity or cash flows.

**Available Information**

Our principal offices are at 790 Northwest 107th Avenue Suite 400, Miami, Florida 33172. Our telephone number at these offices is (305) 485- 2077. Our website address is www.rialtocapital.com.

**Item 1A. Risk Factors.**

The following are what we believe to be principal risks that might materially affect us and our business:

***Although our investments in distressed real estate assets normally are acquired at significant discounts, if the real estate markets deteriorate significantly, we could suffer losses.***

Rialto Capital Management, LLC ("Rialto Capital") and its subsidiaries (the "Rialto Companies") focus on identifying and underwriting real estate related investment opportunities, making real estate related investments, directly or through funds they manage, and overseeing those investments, including in particular the workout of non-performing or underperforming loans and improvement and disposition of properties acquired through foreclosure or in a similar manner. Until 2011, the principal activity of the Rialto Companies involved acquisitions of portfolios of, or interests in portfolios of, distressed debt instruments and foreclosed properties, using primarily funds provided by Lennar through Rialto Investments, LLC ("Rialto Investments") and its subsidiaries (the "Investor Companies"). Rialto Capital and Rialto Investments are wholly-owned subsidiaries of Rialto Holdings, LLC ("Rialto" or "we" or "us" or "our"). Since 2011, distressed asset investments have been made primarily by investment funds managed by the Rialto Companies, but the Investor Companies have been investors in these funds. Investing in distressed debt and foreclosed properties presents many risks in addition to those inherent in normal lending activities, including the risk that the anticipated restructuring and recapitalization of the United States real estate markets will not be completed for many years, the risk that defaults on debt instruments in which the Rialto Companies and the funds they manage and invest will be greater than anticipated and the risk that if the Rialto Companies or any of the funds they manage has to liquidate its investments into the market, it will suffer severe losses in doing so. There is also the possibility that, even if the investments made by the Rialto Companies or the funds they manage perform as expected, absence of a liquid market for these investments will result in a need to reduce the values at which they are carried on our financial statements.

***Our concentration on real estate related investments makes us vulnerable to changes in real estate markets and in the value of real estate related investments.***

Although we and the funds we manage invest in a wide variety of real estate assets and real estate related securities, almost everything we do involves investments in real estate. Real estate markets are generally viewed as being cyclical, and, as happened in 2007 and 2008, there can be abrupt changes in the value and the liquidity of real estate related investments. These can be caused by a variety of factors, many of which are related to financial markets at least as much as they are to real estate markets. If there is an abrupt decline in values with regard to a significant segment of the real estate market, and we are unable to respond rapidly and effectively, the value of the funds we manage, and of our investments in those funds, could fall sharply. That would affect both the proceeds we could obtain with regard to assets we own and our ability to create new funds as a source of future fee income.

***Most of our activities are sensitive to changes in interest rates.***

Almost all of our activities are sensitive to changes in interest rates. The value of mortgage loans and mortgage-backed securities is affected by the level of market interest rates. Similarly, when we originate loans, either for ourselves or for funds we manage, the yields on those loans will depend to a significant extent on market interest rates. Also, when our loan origination and securitization business commits to make a mortgage loan with regard to a particular property, it usually specifies a formula for determining what the interest rate will be, and when it makes the loan, it fixes the interest rate. However, the price for which the loan can be sold to a securitization trust will depend on market interest rates at the time the loan is sold, which may be several months after the loan is made. We try to hedge exposures to interest rate changes with regard to at least some of our assets and with regard to the loans we originate, but those hedges are not perfect, and we could be adversely affected by unexpected changes in interest rates.

***Because the Investor Companies invest in funds and entities managed by the Rialto Companies, if those funds and entities do poorly, both the Investor Companies and the Rialto Companies could be hurt.***

All the investments currently held by the Investor Companies are interests in funds or entities that are managed by the Rialto Companies. At November 30, 2013, the Investor Companies had $141.9 million invested, and commitments to invest an additional $158.1 million, in funds and entities managed by the Rialto Companies. If those funds and entities do poorly, the value of the Investor Companies' investments could fall, and, in addition, it could become difficult for the Rialto Companies to find third party investors in future funds it sponsors, which could adversely affect their ability to generate fee income.

***Because many of the assets held by us or by funds we manage are or will be contractually or structurally subordinated to other indebtedness, we and those funds could be particularly severely hurt if those assets perform badly.***

We and the funds advised by the Rialto Companies have substantial investments in subordinated tranches of CMBS issuances. Under the subordination provisions, all principal received with regard to the assets underlying the CMBS must be paid to holders of more senior tranches until the senior tranches are fully paid. Only after the more senior tranches are fully paid will we receive distributions with regard to the principal of the tranches we hold. Further, during 2013, we had an initial closing of a fund that will invest in mezzanine loans. Those are loans secured by equity of the entities that own particular real estate assets, but not by the assets themselves. Therefore, the security for the loans we make is structurally subordinated to any liens on the assets themselves. Debt that is subordinated to other debt, whether by contract or structurally, bears the first risk of loss if the assets on which the lenders are relying do not perform well. Because of that, the yields on subordinated debt are substantially higher than the yields on senior debt or debt that is secured by first liens on assets. We believe that our experience in underwriting loans and in working out non-performing loans enable us to reduce the losses on the assets underlying debt that we hold below what is anticipated when that debt is priced. However, if we are not able to minimize the losses on those assets, we could suffer serious losses due to the subordination of the positions we hold.

***If our investments in real estate are not properly valued or sufficiently reserved to cover actual losses and we are required to increase our valuation reserves, our earnings would be reduced.***

When a loan is foreclosed upon and we take title to the property, we obtain a valuation of the property and base its book value on that valuation. The book value of the foreclosed property is periodically compared to the updated market value of the foreclosed property if it is classified as held-and-used, or the market value of the foreclosed property less estimated selling costs if it is classified as held-for-sale (fair value), and a charge-off is recorded for any excess of the property's book value over its fair value. If the valuation we establish for a property proves to be too high, we may have to record charge-offs, or additional charge-offs, in subsequent periods. Material charge-offs could have an adverse effect on our results of operations, and possibly even on our financial condition.

***There is substantial competition for the types of investments on which we are focused, and this may limit our ability or that of the investment funds we manage to make investments on terms that are attractive to us or them.***

The Rialto Companies and the funds that they create and manage have been focused in substantial part on investments in distressed mortgage debt, foreclosed properties and other real estate related assets that have been adversely affected by the dislocations during the last several years in the markets for real estate, mortgage loans and real estate related securities (although they have recently expanded their activities beyond that). Some of the opportunities to acquire distressed assets have arisen under programs involving co-investments with and financing provided by agencies of the Federal government. There are many firms and investment funds that are trying to acquire the types of assets on which the Rialto Companies and the investment funds they manage are focused, and it is likely that a significant number of additional investment funds will be formed in the future with the objective of acquiring those types of assets. At least some of the firms with which the Rialto Companies compete, or will compete, for investment opportunities have, or will have, a cost of capital that is lower than that of the Rialto Companies or the investment funds they manage, and therefore those firms may be able to pay more for investment opportunities than would be prudent for the Rialto Companies or the investment funds they manage.

***We could be adversely affected by court and governmental responses to improper mortgage foreclosure procedures.***

During recent years, it appears that mortgage lenders and mortgage loan servicers have in a number of instances failed to comply with the requirements for obtaining and foreclosing mortgage loans. Although we own or manage entities that own large numbers of mortgage loans, those loans all were acquired by us and the entities we manage within the past three years, and we have training programs designed to ensure that all mortgage foreclosures which we undertake will comply with all applicable requirements. However, even if neither we nor any servicing organization we use does anything improper in foreclosing mortgages held by us or by entities we manage, reaction by courts and regulatory agencies against apparently widespread instances of improper mortgage foreclosure procedures could make it more difficult and more expensive for us to foreclose mortgages that secure loans that we or entities we manage own.

***We may be adversely impacted by legal and regulatory changes.***

New or modified regulations and related regulatory guidance focused on the regulation of the financial industry, including those under the Dodd-Frank Wall Street Reform Act, may have adverse effects on our industry. For example, the Dodd-Frank Act requires the federal banking agencies to promulgate rules requiring mortgage lenders to retain a portion of the credit risk related to securitized loans. Although those rules have not yet been finalized, there appears to be a substantial possibility that they will apply to our mortgage origination and securitization activities. If we are required to retain a portion of the mortgages that we originate, that may have a significant adverse effect on the profitability of those activities. Laws, regulations or policies, including accounting standards and interpretations, currently affecting us may change at any time. Regulatory authorities may also change their interpretation of these statutes and regulations. Our business could be adversely affected by changes in laws, regulations, policies or interpretations or by our inability to comply with them without making significant changes in our business.

***We may be required to repurchase loans or indemnify securitization trusts or other purchasers if representations and warranties we give in connection with sales of loans are not correct.***

When we sell loans to securitization trusts or other purchasers, we give limited industry standard representations and warranties about the loans. If those representations and warranties prove to be incorrect as to particular loans, we may be required to repurchase the loans or replace them with substitute loans. Additionally, in the case of loans and real estate that we have sold, we may be required to indemnify persons for losses or expenses incurred as a result of breaches of representations and warranties we give. Any significant repurchases or indemnification payments could adversely affect our business or financial condition.

***Our ability to collect upon mortgage loans may be limited by the application of state laws.***

Our mortgage loans typically permit us to accelerate the debt upon default by the borrower. The courts of all states will enforce acceleration clauses in the event of a material payment default, subject in some cases to a right of the court to revoke the acceleration and reinstate the mortgage loan if a payment default is cured. The equity courts of a state, however, may refuse to allow the foreclosure of a mortgage or to permit the acceleration of the indebtedness in instances in which they decide that the exercise of those remedies would be inequitable or unjust or the circumstances would render an acceleration unconscionable.

Further, the ability to collect upon mortgage loans may be limited by the application of state and federal laws. For example, Nevada has enacted a law providing that if an assignee of a note secured by real property paid less than the face amount of the note, the creditor cannot recover more in a deficiency action than the amount it paid for the note. If the Nevada law is upheld, or similar laws are enacted in other jurisdictions, that could materially and adversely affect our results of operations.

***We may face difficulties in obtaining required authorizations or licenses to do business.***

In order to implement our business strategies, we have to maintain certain licenses and authorizations from governmental entities (including licenses with respect to loan origination). While we have or expect to be able to obtain reasonably expeditiously at least most of the licenses and other authorizations we need, if we are unable to obtain or to maintain any licenses or other authorizations we need, that could delay or prevent us from engaging in activities in areas where those licenses or authorizations are needed.

***Our new commercial loan origination business may not be as successful as we anticipate.***

In July 2013, we began commercial loan origination activities through our new loan origination and securitization business by hiring a group of 22 professionals. The mortgage origination business represents a new business line for us distinct from the direct investments and asset and investment management activities upon which we have traditionally focused. Going forward, we anticipate that the loan origination and securitization business will constitute a significant portion of our business. Although the team we hired to start and run the mortgage origination business is seasoned, this business may not be as successful as we anticipate or as successful as our existing businesses.

***As our business model continues to evolve, our future results of operations may not be comparable to our historic results of operations.***

Our initial focus when we began operations at the end of 2009 was directly acquiring distressed loan portfolios and real estate related assets at a discount and turning them into profits for us. In 2010, we continued to work through these direct investments and added a second type of revenue stream by investing in and managing real estate funds. During 2013, we continued our focus on raising investment capital from third parties. In addition, in July 2013, we began to originate and securitize commercial first mortgage loans, earning profits by selling the loans to securitization trusts for more than what we invest in them. The limited liability companies in which we have invested along with the Federal Deposit Insurance Corporation ("FDIC") began distributions of capital in 2013, and those distributions will increase in 2014. However, revenues and earnings from these limited liability companies, and the direct investments we have made will decrease as the assets underlying these investments continue to wind down. As our business model continues to evolve and our business mix changes, our future results of operations may not be comparable to our historic results of operations.

***We may be subject to potential liabilities under environmental laws.***

Under various U.S. federal, state and local environmental laws, ordinances and regulations, a current or previous owner of real estate (including, in certain circumstances, a secured lender that succeeds to ownership or control of a property) may become liable for the costs of removal or remediation of hazardous or toxic substances at, on, under or in its property. Those laws typically impose cleanup responsibility and liability without regard to whether the owner or control party knew of or was responsible for the release or presence of the hazardous or toxic substances. The costs of investigation, remediation or removal of those substances may be substantial. The owner or control party of a site also may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from a site that affects other properties. Certain environmental laws also impose liability in connection with the handling of or exposure to asbestos-containing materials, and enable persons to seek recovery from owners of real properties for personal illnesses associated with asbestos-containing materials. While a secured lender is not likely to be subject to these forms of environmental liability, when we foreclose on real property, we become an owner and are subject to the risks of environmental liability.

***Our ability to profit from the investments we make may depend to a significant extent on our ability to manage resolution of distressed mortgages and other real estate related assets.***

A principal factor in a prospective purchaser's decision regarding the price it will pay for a portfolio of mortgage loans or other real estate related assets is the cash flow the prospective purchaser expects the portfolio to generate. The cash flow a portfolio of distressed mortgage loans and related assets will generate can be affected by the way the assets in the portfolio are managed. We believe the backgrounds and experience of our personnel frequently enable us to generate better cash flows from the distressed assets we manage than what is generally expected with regard to similar assets. When we decide whether to purchase particular distressed assets and what we are willing to pay for them, one consideration is whether, and to what extent, we think we will be able to obtain above average returns in resolving the assets. If we are not able to achieve those above average returns, we probably will not generate the level of profits we seek.

***The supply of real estate related assets available at discounts from normal prices will likely decrease if the real estate markets continue to improve, which could require us to change our investment strategy.***

A significant part of our current strategy has been to seek above normal risk adjusted returns for us and for the investment funds we manage by focusing on investments in real estate related assets that are available at below market prices because of the effects of the dislocations in the United States real estate markets over the past several years. A continued recovery of the real estate markets would probably benefit the investments we and the funds we manage have made, but it probably would substantially reduce or end the availability of the types of distressed asset investments we seek. We are currently beginning to engage in activities that are more suitable for periods of recovery and more robust real estate markets. But those types of activities may not offer the same profit potential as investing in distressed real estate assets.

***We are dependent on debt financing and securitizations to operate our mortgage origination and securitization business, and our inability to access this funding or to securitize the loans we originate could force us to curtail, or even to discontinue, that business.***

We are building a business of originating loans secured by income producing properties and selling those loans to CMBS trusts and other securitization vehicles. We anticipate that normally we will sell loans within two or three months after we originate them. We use warehouse borrowing lines to finance the mortgage origination activities of our loan origination and securitization business until we are able to securitize them, and then use the proceeds of the securitizations to repay the borrowings, which makes the warehouse lines available for more loan originations. We have, or are in the process of arranging, warehouse financing arrangements that would enable us to make up to $1 billion of loans before we securitize them. And currently, there are adequate securitization vehicles to enable us to operate at that volume. However, if we were unable to obtain warehouse financing, or were unable to securitize mortgage loans we originate and use the proceeds to repay the borrowings, we would have to curtail significantly our mortgage originations.

***A widespread decline in the value of commercial real estate could require us to provide cash to avoid defaults under our loan origination and securitization business' warehouse lending facilities.***

Our loan origination and securitization business' current warehouse lending agreements provide, and any future warehouse lending agreements are likely to provide, that if the lenders determine that the value of the real estate that secures loans that are collateral for borrowings under the warehouse lending agreement is less than specified percentages of the sums borrowed, our loan origination and securitization business must either provide additional collateral (probably in the form of cash) or reduce the amount of the borrowings. Because our loan origination and securitization business' borrowings with regard to mortgages secured by particular properties are expected to be outstanding for a maximum of only two or three months, the risk of a significant decline in the value of a property while the mortgage loan secured by that property is collateral for borrowings under a warehouse lending agreement is relatively small. However, if there were a sharp and widespread decline in the value of commercial properties, that might both reduce the value of properties while the mortgage loans they secure are collateral under the warehouse financing lines and delay the securitizations of those mortgage loans that are expected to provide the funds with which to repay the borrowings under the warehouse lending lines. If that occurred, our loan origination and securitization business might not have the cash it needs to increase the collateral, or reduce the borrowings, under the warehouse financing lines in order to prevent defaults under the warehouse financing lines.

***We may not be able to fully hedge our exposure to changes in interest rates between the time we commit to make mortgage loans at specified rates and the time we actually make the loans and sell them to securitization pools.***

Our loan origination and securitization business often commits to a potential borrower the interest rate on a loan we propose to make before we make the loan. That creates a risk that by the time we actually fund the loan and sell it into a securitization pool, interest rates will have increased, and therefore, the spread between the amount we lend and the price for which we can sell the loan into a securitization pool (which declines as market interest rates rise), as well as interest on the borrowings we use to make the loan, will be less than we had anticipated. We use hedging techniques to reduce this risk, but hedges are costly and it is difficult to obtain hedges that will fully protect against the effects of changes in interest rates.

***The illiquidity of our portfolio assets may make it difficult for us, or the funds we manage, to sell assets.***

While there are markets for various types of mortgages and mortgage backed securities, those markets do not provide complete liquidity, and in times of financial stress, may provide very little liquidity. As a result, if we or a fund we advise has to liquidate all or a significant portion of our or its portfolio quickly, in order to do that we or it may realize significantly less than the amount we or it paid for those investments or the value at which we or it carry those investments on our or its books.

***We may overvalue real estate related assets when we invest in them.***

We carefully underwrite each investment in mortgage loans or other real estate related investments before we make, or cause a fund we manage to make, the investments. We believe our ability to underwrite investments is one of our great strengths. However, because underwriting investments involves predicting the future (for us, future borrower performance and asset values), no matter how diligent we are, there will be instances in which investments do not live up to our expectations. When it turns out that the value of assets in which we or a fund we manage has invested is less than the amount we paid for them, we or the fund may have to write down the carrying value of the investment and or it may suffer a loss when the investment is liquidated or sold. This is particularly a risk with regard to distressed investments, because the amount that will be received with regard to distressed investments often depends in part on the extent to which we can convince borrowers to make their own funds available to help liquidate the loans. To the extent we must write down the carrying value of investments we make, it will adversely affect our earnings.

***The loss of the services of our senior management or key employees could seriously affect our business.***

One of what we consider to be our key assets is the long experience of our senior management and other key employees in dealing with real estate assets. Many of the assets in which we or funds we manage invest are difficult to deal with, and a key part of our strategy is our belief that the extensive experience of our senior managements enables us to generate returns from these assets that exceed what is expected by the market as reflected in the prices for which these assets can be acquired. However, we do not have employment contracts with the members of our senior management or other key employees, and even if we had employment contracts with them, we could not compel them to work for us if they did not want to do so. If we were to lose a significant number of our senior managers and other key employees, we could have a great deal of difficulty finding replacements with the same level of experience, and our inability to find those replacements could negatively affect our ability to generate profits from the investments we or funds we manage make.

***Covenants relating to the 7.00% Senior Notes and warehouse repurchase facilities could adversely affect our business.***

Covenants relating to the 7.00% Senior Notes and warehouse repurchase facilities impose significant restrictions on our activities. This may prevent us from doing things that are in our long-term, and even in our short-term, interest. Among other things, these restrictions could place us at a disadvantage compared to some of our competitors and could prevent us from making acquisitions, obtaining financing and making investments. This in turn could restrict our growth or otherwise hamper our ability to take advantage of opportunities, and could make it more difficult for us to withstand economic downturns affecting us or affecting the general economy.

***The incentive distributions we receive in the future from the investment funds we manage may not be as significant as we expect.***

After fiscal 2015, we expect to begin receiving performance based incentive fees in our Asset and Investment and Management business line as the distributions by the funds we manage begin to exceed the sums invested in them. Incentive fees are earned, and we receive distributions with regard to carried interests, when distributions by investment vehicles exceed specified threshold returns on investors' capital, which generally begins to occur approximately six years after an investment fund begins. The first fund we formed should begin making incentive distributions to us in 2015. However, if the revenues to that fund from its assets are less than expected, the time when we begin receiving incentive distributions may be delayed, or we might not receive any incentive distributions at all.

***The timing of our securitization activities will greatly affect our quarterly financial results.***

We generate profits from our loan origination activities primarily by selling loans to securitization pools for more than we pay for them. Our quarterly revenue, operating results and profitability could vary substantially from quarter to quarter based on the timing of our securitizations. The timing of our securitization activities will be affected by a number of factors, including our loan origination volumes, changes in loan values, quality and performance during the period such loans are on our books and conditions in the securitization and credit markets generally and at the time sponsors seek to launch our securitizations.

***The market value of our investments in CMBS could fluctuate materially as a result of various risks that are out of our control and may result in significant losses.***

We and the funds we manage have invested, and may continue to invest, in CMBS, which are securities backed by commercial mortgage loans (i.e., securities secured by commercial or multi-family residential real estate). The market value of our CMBS investments could fluctuate materially over time as the result of changes in mortgage spreads, treasury bond interest rates, capital market supply and demand factors, and many other factors that affect high-yield fixed income products. These factors are out of our control, but could affect our ability to finance purchases of CMBS and to sell CMBS which we own. In the recent past, the market for CMBS essentially disappeared for a substantial period of time. Marketability of CMBS that we or fund we manage own will also be affected in many instances by restrictions on transfer. Anything that reduces the liquidity of the market for CMBS is likely adversely to affect the price at which we or funds we manage can dispose of CMBS we or they own.

***Our due diligence of originated loans or potential investments may not reveal all of the liabilities associated with such investments and may not reveal other weaknesses in our investments, which could lead to losses.***

Before originating a loan or making, or causing a fund to make, an investment, we assess the strengths and weaknesses of the borrowers, guarantors and the underlying property values, as well as other factors and characteristics that are material to the performance of the investment. In making the assessment and otherwise conducting due diligence, we rely on resources available to us and, in some cases, an investigation by third parties. However, there can be no assurance that our due diligence process will uncover all facts that are relevant to whether our investment will be successful.

***We may be required to report taxable income for certain investments in excess of the economic income we ultimately realize from them.***

We may acquire debt instruments in the secondary market for less than their face amount. The amount of such discount will generally be treated as "market discount" for U.S. federal income tax purposes. Accrued market discount is reported as income when, and to the extent that, any payment of principal of the debt instrument is made, unless we elect to include accrued market discount in income as it accrues. Principal payments on certain loans are made monthly, and consequently accrued market discount may have to be included in income each month as if the debt instrument were assured of ultimately being collected in full. If we collect less on the debt instrument than our purchase price plus the market discount we had previously reported as income, we may not be able to benefit from any offsetting loss deductions.

Similarly, some of the CMBS that we may acquire may have been issued with original issue discount ("OID"). We will be required to amortize that OID for tax purposes based on a constant yield method and will be taxed based on the assumption that all future projected payments due on the CMBS will be made. If such CMBS turns out not to be fully collectable, an offsetting loss deduction will become available only in the later year that uncollectability is provable.

Finally, in the event that any debt instruments acquired by us are delinquent as to mandatory principal and interest payments, or in the event payments with respect to a particular debt instrument are not made when due, we may nonetheless be required to continue to recognize the unpaid interest as taxable income as it accrues, despite doubt as to its ultimate collectability. While we would in general ultimately have an offsetting loss deduction available to us when such interest was determined to be uncollectable, the utility of that deduction could depend on our having taxable income in that later year or thereafter.

***Lennar is able to control what we do.***

We are 100% owned by Lennar. That means that Lennar can replace our management and cause us to act in accordance with Lennar's interests. Lennar's interests as our equity owner may not be the same as the interests of the holders of our 7.00% Senior Notes or other securities we issue. Among other things, Lennar may purchase real property from us, and if it does so, it will have the power to compel us to agree to prices that are less than what our management believes to be the fair value of the property. The indenture relating to our 7.00% Senior Notes prohibits us or any of our subsidiaries that are guaranteeing the 7.00% Senior Notes from entering into any transaction with an affiliate (which would include Lennar) involving aggregate value in excess of $5 million, unless the terms of the transaction are not materially less favorable to us or our subsidiary than a comparable transaction with an arm's length transaction with an unaffiliated person and if it involves an aggregate value of more than $25 million, the terms of the transaction must be approved by one of our officers or by our Board. However, the indenture provisions will only be in effect while the 7.00% Senior Notes are outstanding, and they mature in 2018.

***Lennar is not committed to provide funds to us.***

Until we sold $250 million principal amount of 7.00% Senior Notes in November 2013, we received all of our general funding from Lennar, including both funding for the operations of the Rialto Companies (including funds used to originate mortgage loans) and funding for the investments made by the Investor Companies. However, aside from a credit agreement under which Lennar has agreed to advance up to $75 million on an unsecured revolving basis, Lennar has no commitment to continue providing funding to us. Since November 2013, Lennar has not advanced funds to us, and we have repaid some of the funds it had previously advanced to us.

We hope to be able to fund our activities with proceeds of distributions we receive with regard to the investments we have made and with fees and proceeds of carried interests. However, if we do not realize these revenues and Lennar does not provide us additional funding, we may not be able to make the types of investment commitments we are expecting to make or to fund the expense of conducting all the activities in which we currently are planning to engage.

***We might become required to register under the Investment Company Act of 1940.***

We try to conduct our operations so that we will not be required to register as an investment company under the Investment Company Act of 1940, because of an exception for companies that are engaged primarily in acquiring mortgages and other liens on and interests in real estate. See "Item 1. Business – Investment Company Act Exemption." However, because many forms of indirect real estate related investments are not considered for purposes of the Investment Company Act to be mortgages or other interests in real estate, we may have difficulty qualifying for that exception. Additionally, in August of 2011, the SEC solicited public comment on a wide range of issues relating, among other things, to the nature of the assets that qualify for purposes of the exception from the definition of an investment company in the Investment Company Act for companies that are engaged primarily in acquiring mortgages and other liens or interests in real estate. Some of the possible changes as to which the SEC sought comment could make it even more difficult for us to qualify for that exception than currently is the case.

Given the uncertainty as to this exception, we have imposed restrictions on transfers of our 7.00% Senior Notes so that we will qualify for the exception to the definition of our investment company for issuers whose outstanding securities, at the time of the acquisition of such securities, were held exclusively by "qualified purchasers" (as defined in the Investment Company Act). However, in order to obtain financing or for other reasons, we may in the future have to engage in transactions that could make us no longer eligible for this exemption. If we became required to register under the Investment Company Act, we could no longer engage in many of the activities described in this offering memorandum.

***If we fail to implement and maintain an effective system of internal controls, we may not be able to determine our financial results accurately or prevent fraud.***

Because we do not have publicly traded equity securities, our financial audit was performed in accordance with auditing standards generally accepted in the United States of America rather than the standards of the Public Company Accounting Oversight Board (United States) used for the audits of most publicly traded companies. Effective internal controls over financial reporting are necessary for us to provide reliable financial reports and effectively prevent fraud. Section 404 of the Sarbanes-Oxley Act requires publicly traded companies and their independent auditors to report annually on the effectiveness of internal control over financial reporting. However, as a private company we are not required to comply with the auditor attestation requirements of Section 404 (although Lennar is required to comply with those requirements with regard to itself and its subsidiaries, including us). We may in the future discover areas of our internal controls that need improvement. We cannot be certain that we will be successful in implementing or maintaining adequate internal control over our financial reporting and financial processes.

***A hospital real estate and operations we acquired in a bargain purchase acquisition as a result of loan defaults may be adversely affected by the Affordable Care Act.***

In 2013, we acquired a hospital real estate and operations as a result of defaults with regard to a loan we held. The Affordable Care Act may have an adverse effect on the operating results of the hospital operations, which even before the Affordable Care Act became effective, was unable to meet its obligations.

***We may fail to improve or integrate the operations of the hospital we acquired, which could harm our results of operations.***

Prior to its acquisition, the hospital we acquired was experiencing operating losses. Being that we are not in the business of handling hospital operations, we have contracted a well-known hospital operator to operate the hospital at a discount to their annual management fee in return for gradually acquiring an equity participation in the hospital operating company. If it is unable to improve the operating margins of the hospital, our results of operations could be harmed.

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our audited consolidated financial statements and accompanying notes included elsewhere in this Annual Report.

### Special Note Regarding Forward-Looking Statements

Some of the statements in this Management's Discussion and Analysis of Financial Condition and Results of Operations, and elsewhere in this Annual Report, are "forward-looking statements," as that term is defined in the Private Securities Litigation Reform Act of 1995. These forward-looking statements include statements regarding our business, financial condition, results of operations, cash flows, strategies and prospects. You can identify forward-looking statements by the fact that these statements do not relate strictly to historical or current matters. Rather, forward-looking statements relate to anticipated or expected events, activities, trends or results. Because forward-looking statements relate to matters that have not yet occurred, these statements are inherently subject to risks and uncertainties. Many factors could cause our actual activities or results to differ materially from the activities and results anticipated in forward-looking statements. These factors include those described under the caption "*Risk Factors*" in Item 1A of this Report. We do not undertake any obligation to update forward-looking statements, except as required by Federal securities laws.

### Outlook

During 2013, we continued our focus on raising investment capital from third party investors and have been able to produce profits by investing this third-party capital in real estate related assets.

Focusing on managing real estate related investments for third parties shifts the principal source of our earnings from loan interest and net gains on sales of foreclosed real estate ("REO") towards an investment management, asset management, and other service fee oriented business. We expect this focus to carry into the future, although our loan origination and securitization business has recently begun to originate and securitize commercial first mortgage loans, earning profits by selling the loans to securitization trusts for more than what we invest in them. In our Direct Investment business line, the limited liability companies in which we have invested along with the Federal Deposit Insurance Corporation ("FDIC") began distributions of capital in 2013, and that will increase in 2014. However, revenues and earnings from our direct investment in the FDIC LLCs and portfolios of mortgage loans we acquired from banks in 2011 will decrease as the assets underlying these investments wind down.

Looking past 2014, we expect that we will earn more management fees and begin receiving performance based incentive fees in our Asset and Investment Management business line as the investments in our Rialto Real Estate Fund I ("Fund I") are monetized. We also expect to earn significant incentive fees from, and to receive significant revenues from carried interests in, the other funds that we manage through our participation as a general partner or investment manager. Incentive fees are earned, and we receive distributions with regard to carried interests, when distributions by investment vehicles exceed specified threshold returns on investors' capital, and generally begin to be distributed approximately six years after an investment fund begins. As we increase the number of our investment funds and our investment funds age, we would expect an increasing portion of our revenues to be generated by carried interests.

If Fund I had ceased operations and liquidated all its investments for their estimated fair values on November 30, 2013, we would have received $80.8 million with regard to our carried interest. However, Fund I did not cease operations and liquidate its investments on November 30, 2013, and the actual sum we receive with regard to our carried interest in Fund I may be substantially higher or lower than $80.8 million. No amount has been accrued in our consolidated statement of operations with regard to our carried interest in Fund I or any other fund. See Note 2, Basis of Presentation in the notes to the consolidated financial statements for more information about how we record revenues attributable to carried interests.

With fewer traditional lenders, and those lenders facing stricter underwriting standards and new government-imposed regulations, we anticipate a large scale opportunity to originate commercial first mortgage loans and mezzanine debt to borrowers as a wave of commercial real estate loans matures and must be refinanced. Also, many financial institutions remain burdened by exposure to overleveraged real estate assets and must further deleverage their balance sheets before they can significantly increase new originations. Lenders have utilized distressed asset sales to rid themselves of their underwater assets, and have employed more conservative underwriting standards on new loans to transition away from riskier assets. Several balance sheet lenders have instituted hard loan-to-value caps or have been limited by regulation on what they can lend to borrowers who are searching for additional leverage to refinance their upcoming maturities. The result has created an opportunity for us to partner with a broad network of senior lenders to provide full loan packages to qualified borrowers.

Throughout the recent financial disruption, lending institutions benefitted from extensive accommodations from bank regulators, enabling loan restructuring practices that delayed a large portion of the necessary recapitalizations in the banking system. Recent regulatory attention (e.g., Basel III and the U.S. Dodd Frank Wall Street Reform and Consumer Protection Act, including the so-called "Volcker Rule") has motivated many financial institutions to implement more stringent bank capital standards, which we believe should further drive banks away from risk and toward higher underwriting standards and lower senior loan amounts. We believe this dynamic will continue to lead to an increasing number of lending opportunities for us.

**Overview**

We are a leading commercial real estate investment, investment management, and finance company focused on raising, investing and managing third party capital, originating and securitizing commercial mortgage loans, as well as investing our own capital in real estate related mortgage loans, properties and related securities. We have a vertically-integrated operating platform consisting of over 290 professionals located in 9 offices across the U.S. We were founded in 2007 and are a wholly-owned subsidiary of Lennar Corporation ("Lennar" or "Parent"), one of the largest homebuilders in the U.S. At November 30, 2013, Lennar had $539 million of capital invested in our business to support our growth.

We apply a comprehensive risk management approach across our business lines, which is rooted in our management's deep understanding of fundamental real estate values and proven ability to manage these complementary business lines through multiple economic and credit cycles. To date, many of our investment and management opportunities have arisen from the dislocation in the U.S. real estate markets from 2007 to 2010 and the efforts to restructure and recapitalize those markets. Going forward, we believe that we are well-positioned to capitalize on the opportunities arising from the diminished supply of commercial real estate capital and the substantial demand for new financings in the commercial real estate sector. We believe our comprehensive, highly experienced management team of industry veterans supplemented by Lennar's knowledge of regional and local real estate conditions in many parts of the country, will allow us to continue to grow our business prudently as we endeavor to capitalize on opportunities in the real estate finance market.

***Results of Operations***

Financial information relating to our operations for each of the years ended November 30, 2013, 2012 and 2011, was as follows:

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| REVENUE: | | | |
| Interest income | $ 78,907 | $ 103,913 | $ 153,186 |
| Management fees | 31,392 | 34,943 | 11,557 |
| Gains from securitizations and other | 27,761 | - | - |
| Rental income | 20,269 | 16,476 | 7,185 |
| Other revenue | 4,737 | - | - |
| Total revenue | 163,066 | 155,332 | 171,928 |
| EXPENSES: | | | |
| General and administrative expense | 79,761 | 53,730 | 43,463 |
| Servicing expense | 32,565 | 46,598 | 63,972 |
| Provision for loan losses | 16,139 | 27,966 | 13,815 |
| Costs of securitizations | 8,181 | - | - |
| Interest expense | 7,484 | 5,943 | 6,553 |
| Amortization of debt issuance costs | 5,680 | 4,565 | 4,565 |
| Other expense | 4,665 | - | - |
| REO expense (income), net | 3,554 | 46,256 | (27,283) |
| Depreciation expense | 1,262 | 188 | 215 |
| Total expenses | 159,291 | 185,246 | 105,300 |
| EQUITY IN EARNINGS FROM UNCONSOLIDATED ENTITIES | 22,353 | 41,483 | (7,914) |
| GAIN ON SALE OF INVESTMENTS HELD-TO-MATURITY | - | - | 4,743 |
| NET EARNINGS (INCLUDING NET EARNINGS ATTRIBUTABLE TO NONCONTROLLING INTERESTS) | 26,128 | 11,569 | 63,457 |
| LESS: NET EARNINGS (LOSS) ATTRIBUTABLE TO NON-CONTROLLING INTERESTS | 6,238 | (14,383) | 28,930 |
| NET EARNINGS ATTRIBUTABLE TO RIALTO BEFORE PROVISION FOR INCOME TAXES | 19,890 | 25,952 | 34,527 |
| PROVISION FOR INCOME TAXES | 8,028 | 10,484 | 11,811 |
| NET EARNINGS ATTRIBUTABLE TO RIALTO | $ 11,862 | $ 15,468 | $ 22,716 |

**2013 versus 2012**

In the year ended November 30, 2013, net earnings before provision for income taxes was $19.9 million (which included $26.1 million of net earnings offset by $6.2 million of net earnings attributable to non-controlling interests), compared to net earnings before provision for income taxes of $26.0 million (which included $11.6 million of net earnings and an add back of $14.4 million of net loss attributable to non-controlling interests) in 2012. Revenues were $163.1 million in 2013, which consisted primarily of accretable interest income associated with our portfolio of real estate loans, fees for managing and servicing assets, and gains from securitizations and other from our loan origination and securitization business, compared to revenues of $155.3 million in 2012. Revenues increased primarily due to the new streams of revenue from our loan origination and securitization business, slightly offset by our lower interest income as a result of a decrease in the portfolio of loans we own. Expenses were $159.3 million in 2013, which consisted primarily of costs related to our loan portfolio operations, provision for loan losses of $16.1 million primarily associated with the business line's FDIC loan portfolio (before non-controlling interests) and other general and administrative expenses. Included in expenses is our REO operations of $3.5 million, which consisted primarily of expenses related to owning and maintaining REO and net REO impairments of $16.1 million, partially offset by realized gains on the sale of REO of $48.8 million and an unrealized provisional gain of $8.5 million relating to a bargain purchase acquisition of a hospital's real estate and operations. This compares with expenses of $185.2 million in 2012, which consisted primarily of costs related to our portfolio operations, provision for loan losses of $28.0 million primarily associated with the FDIC loan portfolio (before non-controlling interests), and other general and administrative expenses. That included expenses of our REO operations of $46.3 million, which consisted primarily of expenses related to owning and maintaining REO and REO impairments of $9.3 million, partially offset by realized gains on the sale of REO of $21.6 million. Expenses decreased primarily due to a decrease in loan servicing expenses and in REO expenses.

In the year ended November 30, 2013, we had equity in earnings from unconsolidated entities of $22.4 million in 2013, which was mostly related to our share of earnings from Fund I and Fund II. Equity in earnings from unconsolidated entities was $41.5 million in 2012, which included $17.0 million of net gains primarily related to our investment in the portfolio underlying the AB PPIP fund, $6.1 million of interest income earned by the AB PPIP fund and $21.0 million of equity in earnings related to the our share of earnings from Fund I. During 2012, all of the securities in the investment portfolio underlying the AB PPIP fund were monetized in connection with the final unwinding of its operations, resulting in liquidating distributions of $83.5 million to us. As our role as sub-advisor to the AB PPIP fund has been completed, no further management fees will be received for these services.

During 2013, the LLCs we own in partnership with the FDIC finished repaying the $627 million of loans ahead of schedule and thus, were able to start distributing capital back to investors. During the year ended November 30, 2013, $46.7 million had been distributed by the LLCs, of which, $28.4 million was paid to the FDIC and $18.3 million was paid to us.

In 2013, we formed a loan origination and securitization business line, which originates and securitizes five, seven and ten year commercial first mortgage loans on stabilized producing properties. Generally those loans are between $2 and $75 million in size. As of November 30, 2013, we had originated loans with a total principal balance of $690.3 million and sold $537.0 million of these loans into three separate securitization trusts. As of November 30, 2013, we had an additional $109.3 million in originated loans that were transferred to receivables, net as they had been sold into a fourth securitization trust but had not been settled as of the balance sheet date. Additionally, as of November 30, 2013, we had arranged two warehouse repurchase facilities of $250 million each to use in our loan origination and securitization business, of which, $76.0 million was outstanding.

At the end of 2013, we successfully sold $250 million of 7.00% Senior Notes due 2018 (the "7.00% Senior Notes"). On November 14, 2013, the day the 7.00% Senior Notes were issued, Lennar contributed to our equity the entire outstanding balance of the amount it had invested in the Company (an amount previously classified as "Due to Parent") in excess of $235 million. The remaining $235 million constituted indebtedness of the Company to Lennar. However, we applied $100 million of the net proceeds of the sale of our 7.00% Senior Notes and $135 million of working capital to fully retire this indebtedness as of November 30, 2013.

After repaying $235 million to our Parent, the remaining capital Lennar had invested in our business was $539.4 million as of November 30, 2013.

During the year, Lennar committed to us a $75 million unsecured interest bearing revolving credit facility to be used for general operating and investing activity. As of November 30, 2013, we had yet to borrow on this facility.

During the year, we also began managing a $200 million separate account for an insurance company.

**2012 versus 2011**

In the year ended November 30, 2012, net earnings before provision for income taxes was $26.0 million (which was comprised of $11.6 million of net earnings and an add back of $14.4 million of net loss attributable to non-controlling interests), compared to net earnings before provision for income taxes of $34.5 million (which included $63.5 million of net earnings offset by $28.9 million of net earnings attributable to non-controlling interests) in the prior year. In the year ended November 30, 2012, revenues were $155.3 million, which consisted primarily of accretable interest income associated with our portfolio of real estate loans and fees for managing and servicing assets, compared to revenues of $171.9 million in the prior year. Revenues decreased primarily due to lower interest income as a result of a decrease in the portfolio of loans slightly offset by an increase in management fee income. In the year ended November 30, 2012, expenses were $185.2 million, which consisted primarily of costs related to our portfolio operations, provision for loan losses of $28.0 million primarily associated with the FDIC loan portfolio (before non-controlling interests) and other general and administrative expenses, compared to expenses of $105.3 million in the same period the prior year, which consisted primarily of costs related to our loan portfolio operations, provision for loan losses of $13.8 million primarily associated with the FDIC loan portfolio (before non-controlling interests), due diligence expenses related to both completed and abandoned transactions, and other general and administrative expenses. Also included in expenses is the cost of REO operations, which for the year ended November 30, 2012, was $46.3 million, consisting primarily of expenses related to owning and maintaining REO and impairments to REO, partially offset by gains from sales of REO. In the year ended November 30, 2011, REO operations had income of $27.3 million, which consisted primarily of gains from acquisition of REO through foreclosure, as well as gains from sales of REO, partially offset by expenses related to owning and maintaining those assets,

In the year ended November 30, 2012, equity in earnings from unconsolidated entities was $41.5 million, which included $17.0 million of net gains primarily related to unrealized gains from investments in the portfolio underlying the AB PPIP fund, $6.1 million of interest income earned by the AB PPIP fund and $21.0 million of equity in earnings related to our share of earnings from Fund I. During the second half of 2012, all of the securities in the investment portfolio underlying the AB PPIP fund were monetized in connection with the final unwinding of its operations, resulting in liquidating distributions of $83.5 million to us. As our role as sub-advisor to the AB PPIP fund was completed, no further management fees will be received for these services. This compared to equity in (loss) from unconsolidated entities of ($7.9) million in the same period in the prior year, consisting primarily of

$21.4 million of unrealized losses related to our share of the mark-to-market adjustments of the investment portfolio underlying the AB PPIP fund, partially offset by $10.7 million of interest income earned by the AB PPIP fund and $2.9 million of equity in earnings related to Fund I. During this time period, the Company also had a $4.7 million gain on the sale of investment securities.

**Business Lines**

The Company operates in three business lines, Asset and Investment Management, Loan Origination and Securitization and Direct Investments in Real Estate Related Assets. Our business lines are identified based upon how management operates and manages our activities as well as the types of products sold and services performed.

***Asset and Investment Management***

We are the sponsor of and an investor in private funds and other investment vehicles that invest in and manage real estate related assets. In addition to receiving earnings on our investments, we also earn fees for our role as an investment manager and general partner of these vehicles and for providing investment management and other services to those vehicles and other third parties. As discussed in the Overview Section, these types of revenues are becoming increasingly important to us as we move away from using a greater portion of our own capital to invest in real estate and real estate related assets as we have done in our Direct Investments in Real Estate Related Asset, and instead, focus on raising capital for investments and then earning revenue through management and servicing fees, as well as by participating in the ownership as an investor and participating in distributions, or carried interest, as a general partner after distributions to investors have met specified investment return thresholds. The general partner distributions (i.e., carried interest) normally will not be received until an investment fund matures and a significant portion of the assets are monetized (projected to generally be approximately six years after inception). Our current projections have us exceeding these investment thresholds in Fund I and we anticipate receiving significant revenues in the future from our carried interest in Fund I and carried interest in other current and future investment funds.

*Fund I* — In 2010, we completed the first closing of Fund I, which had as its objective investing in distressed real estate assets and making other related investments that fit within its investment parameters. Fund I targeted a net internal rate of return exceeding 20% and a net cash flow multiple on invested equity exceeding 2.0x. Investors committed and contributed a total of $700 million of equity (including $75 million by us). All capital commitments were called during the year ended November 30, 2012. During the year ended November 30, 2012, we contributed $41.7 million (of which $13.9 million was distributed back to us as a return of excess contributions). As it was fully funded, there were no investor contributions during the year ended November 30, 2013. For the years ended November 30, 2013 and 2012, our share of earnings of Fund I were $19.4 million and $21.0 million, respectively. Through November 30, 2013, a total of $586.5 million in distributions, equal to over 80% of their invested capital, had been made to investors (including $69.9 million distributed to us).

If Fund I had ceased operations and liquidated all its investments for their estimated fair values on November 30, 2013, we would have received $80.8 million with regard to our carried interest. However, Fund I did not cease operations and liquidate its investments on November 30, 2013, and the ultimate sum we will receive with regard to our carried interest in Fund I may be substantially higher or lower than $80.8 million. No amount has been recorded in our consolidated statement of operations with regard to our carried interest in Fund I. See Note 2, Summary of Significant

Accounting Policies in the notes to the consolidated financial statements for more information on how we record revenues attributable to carried interests.

*Fund II* — In 2013, we conducted the first closing of commitments of our second real estate investment fund, Fund II. Fund II's objective during its commitment period is to acquire and manage distressed and other value-add real estate assets and other related investments that fit Fund II's investment parameters (which are a targeted gross internal rate of return of 18% to 20%). Among other things, Fund II's documents prohibit us from acquiring real estate assets that might be suitable for Fund II, before Fund II is fully invested or committed. As of November 30, 2013, Fund II had received equity commitments of approximately $1.1 billion, including $100.0 million committed by us. Subsequent to November 30, 2013, Fund II was closed to additional commitments, with total equity commitments totaling $1.3 billion. As of November 30, 2013, $511.4 million in capital contributions have been funded (including $50.6 million by us). For the year ended November 30, 2013, our share of earnings of Fund II was $2.5 million.

*Mezzanine Fund* — In 2013, we began raising capital and investing in mezzanine commercial real estate loans (usually loans secured by the equity of our entity that owns real estate that is already subject to a first mortgage loan). These loans are notably shorter in life and carry a higher interest rate than a typical commercial mortgage real estate loan. We created the Rialto Mezzanine Partners Fund, LP ("Mezzanine Fund") with a target of $300 million in raised capital to invest in what are expected to be fully performing mezzanine commercial loans ranging in size from $3 million to $15 million, with a targeted gross internal rate of return of 10% – 14%. As of November 30, 2013, the Mezzanine Fund had total equity commitments of $82.0 million, including $25.0 million committed by us. Total capital invested in the Mezzanine Fund was $53.5 million through November 30, 2013 (including $16.4 million by us). For the year ended November 30, 2013, our share of earnings of the Mezzanine Fund was $0.4 million.

***Loan Origination and Securitization***

During 2013, we created our loan origination and securitization business to originate and securitize 5, 7 and 10 year fixed rate commercial first mortgage loans, generally with principal amounts between $2 million and $75 million, which are secured by income producing properties. As of November 30, 2013, we had secured two warehouse repurchase facilities, with total borrowing capacity of $500 million, for loan originations, and we are seeking $500 million of additional warehouse financing. This would give our loan origination and securitization business total lending capacity of approximately $1 billion. Our goal is to securitize loans through third party issuers at least quarterly, thus keeping them on our balance sheet for just a short period of time. As of November 30, 2013, we had originated loans with a total principal balance of $690.3 million. As of November 30, 2013, we had sold and closed $537.0 million of these originated loans into three separate securitization trusts. An additional $109.3 million of these originated loans were sold into a securitization trust but not yet closed as of November 30, 2013, and thus, were included in Receivables, net in the accompanying consolidated balance sheet.

***Direct Investments in Real Estate Related Assets***

We began making Direct Investments in Real Estate Related Assets in 2010, when the economy and housing sector were still performing poorly and had not yet started to recover. Because of this, we were able to purchase loan portfolios and real estate related assets at significant discounts. However, investing in assets of this type requires a concentrated use of our capital, and therefore, beginning in 2011, we began to focus more on managing third party capital, primarily by sponsoring and managing real estate related investment funds and during

2013, using our two warehouse repurchase facilities to originate and securitize commercial first mortgage loans.

*FDIC Portfolios* — In February 2010, we acquired 40% managing member equity interests in two limited liability companies ("LLCs") that had been formed by the LLC to hold performing and non-performing loans formerly owned by 22 failed financial institutions. The FDIC retained 60% equity interests in the LLCs and provided $626.9 million of financing with 0% interest, which was non-recourse to us and to the LLCs. When we acquired our interests in the two LLCs, their portfolios consisted of approximately 5,500 distressed residential and commercial real estate loans.

*Bank Portfolios* — In September 2010, we acquired from three financial institutions portfolios consisting of a total of approximately 400 distressed commercial and residential mortgage loans and over 300 properties that had been obtained through foreclosures of loans. We paid $310 million for the distressed real estate and real estate related assets of which $124 million was financed through a 5-year senior unsecured loan provided by one of the selling institutions. Our hospital investment, discussed below, is part of a workout on a loan from this portfolio.

In November 2013, in settlement of a loan acquired in our Bank Portfolios, we acquired the real estate and operating entity of a hospital (the "Hospital"). This transaction was the result of a Chapter 11 reorganization plan approved on November 7, 2013. The reorganization plan required us to make a $10 million cash investment that will be used to improve the hospital and emergency room facilities, provide for working capital requirements and begin to repay secured and unsecured court approved claims per the reorganization plan. The Hospital guaranteed the payment of bankruptcy administrative claims of approximately $17.5 million owed to three groups of secured and unsecured creditors. As of November 30, 2013, approximately $5.6 million of the $10.0 million cash investment had been made. In return, we acquired 100% of the Hospital operating entity effective November 8, 2013. The Hospital is included in our consolidated financial statements as of November 30, 2013, and its operating results from the date of acquisition are included in our Consolidated Statement of Operations for the year ended November 30, 2013.

We have contracted with a third party hospital operating company to operate and manage the hospital (the "Third Party Operator") at a 50% discount to its normal management fee in return for it gradually acquiring an equity participation in the hospital operating company. Additionally, the reorganization plan awarded a 20% interest in the entity owning the Hospital real estate to three doctors who practiced at the hospital. However this minority interest is not distributed to the doctors until certain conditions are met that satisfy both State and Federal regulatory requirements.

Starting in 2014, the three secured creditor groups will receive payments totaling 75% of the Hospital's net income plus 50% of the discount on the fees to the hospital management company towards their claims, some of which bear interest of 3% to 5%. In addition, all excess cash flows beyond the scheduled payments to secured creditors must be used to accelerate payment in full of these claims. Neither we nor the hospital management company will receive any distribution from operations other than the reduced management fee until all three groups of secured creditors have been paid in full, which management of the hospital believes can occur within 2 to 3 years.

As a result of this transaction, the Company recorded a provisional gain on acquisition of $8.5 million, primarily consisting of the difference between the carrying value of the Hospital real estate collateral acquired and the carrying value of the loan receivable.

*CMBS Investment* — In 2010, we purchased approximately $43 million face amount of non-investment grade commercial mortgage-backed securities ("CMBS") for $19.4 million, representing a 55% discount from par value.

*Other* — As of November 30, 2013, we also had an approximately a 5% investment in a financial services company that has a business segment that provides service and infrastructure to the residential home loan market (the "Service Provider"), which provides loan servicing support for all of our owned and managed portfolios and asset management services for Rialto's small balance loan program. As of November 30, 2013 and 2012, the carrying value of our investment in the Service Provider was $8.3 million and $8.4 million, respectively. In January 2014, we acquired 100% of the loan servicing business segment of the Service Provider in exchange for our 5% interest mentioned above.

## Selected Business Line Financial and Operational Data

Business line financial and operational data does not include an allocated portion of the Company's general and administrative expense at the corporate level of $74.7 million, $49.9 million and $37.6 million for the years ending November 30, 2013, 2012 and 2011.

### *Asset and Investment Management*

Overview

| ($ in thousands) | 2013 | 2012 | 2011 |
|---|---|---|---|
| Total Assets | $ 145,701 | $ 112,988 | $ 120,269 |
| Revenue | 33,137 | 34,866 | 11,589 |
| Equity in earnings (loss) from unconsolidated entities | 22,204 | 41,877 | (7,317) |
| Net Earnings Before Income Taxes | 55,341 | 76,743 | 4,272 |

**2013 versus 2012**

Revenue decreased 10% in our Asset and Investment Management business line due mainly to the AB PPIP fund unwinding its operations in 2012 and as a result, we earned $9.1 million in fees from our role as a sub-advisor for the year ended November 30, 2012, that we did not receive in 2013. This was slightly offset by earning additional investment management fees as Fund II and the Mezzanine Fund began operations in 2013. Net earnings before income taxes decreased mainly because 2012 net earnings had benefitted from $17.0 million of net gains consisting primarily of gains realized by the AB PPIP fund from the sale of investments in its portfolio and $6.1 million of interest income earned by the AB PPIP fund which we did not receive in 2013. Included in net earnings before income taxes for 2013 was the Company's share of earnings from Fund I of $19.4 million and Fund II of $2.5 million, respectively, compared to $21.0 million for Fund I in 2012.

**2012 versus 2011**

Revenue increased 201% in our Asset and Investment Management business line due in 2012 to an increase in our management fee income from both Fund I and the AB PPIP fund. Net earnings before income taxes also increased significantly due to an increase in earnings from unconsolidated entities as the AB PPIP fund increased its gains and interest income as it unwound its operations in 2012 and Fund I had large realized and unrealized gains and became fully invested during 2012. Included in net earnings before income taxes for 2012 was the Company's share of earnings from AB PPIP and Fund I of $20.9 million and $21.0 million, respectively, compared to a loss of $10.2 million for AB PPIP and a gain of $2.9 million for Fund I in 2011.

***Loan Origination and Securitization***

Overview

| ($ in thousands) | 2013 | 2012 | 2011 |
|---|---|---|---|
| Total Assets | $ 269,577 | $ - | $ - |
| Revenue | 33,772 | - | - |
| Net Earnings Before Income Taxes | 21,977 | - | - |

**2013 versus 2012**

Our loan origination and securitization business began operations during 2013 and had revenues of $33.8 million comprised mostly of gains from four securitizations as well as interest income on the originated loans. Revenue was partially offset by costs of securitizations on the four securitizations to arrive at net earnings before income taxes of $22.0 million.

***Direct Investments in Real Estate Related Assets***

Overview

| ($ in thousands) | 2013 | 2012 | 2011 |
|---|---|---|---|
| Total Assets | $ 1,010,385 | $ 1,534,372 | $ 1,776,879 |
| Revenue | 96,157 | 120,389 | 160,339 |
| Net Earnings (Loss) Before Income Taxes | 19,386 | (814) | 68,958 |

**2013 versus 2012**

Revenue decreased 19% in our Direct Investments in Real Estate Related Assets business line due entirely to interest income decreasing as its portfolio of loans has decreased through loan collections, payoffs and REO conversions, slightly offset by revenue from the hospital we acquired in November 2013 as a result of a defaulted loan. Net earnings (loss) before income taxes increased significantly due to a decrease in REO expenses, a decrease in loan servicing expenses as the portfolio of loans has decreased and a decrease in our provision for loan losses. REO expenses decreased mostly due to higher realized gains on the sale of REO in 2013 than 2012 as well as lower operating expenses in 2013 when compared to 2012. Additionally, we recorded a provisional gain on the bargain purchase acquisition of the hospital of $8.5 million in 2013.

**2012 versus 2011**

Revenue decreased 25% in our Direct Investments in Real Estate Related Assets business line due mainly to interest income decreasing as its portfolio of loans decreased through loan collections, payoffs and REO conversions. This was partially offset by an increase in rental income from our REO operations. Net (loss) earnings before income taxes decreased largely due to an increase in expenses related to our REO operations and an increase in our provision for loan losses related to loans held by the two LLCs that we own together with the FDIC. These increased expenses were slightly offset by a decrease in our loan servicing expense and our earnings (loss) allocable to the FDIC as the non-controlling interest in the two LLCs, as their portfolios were profitable in 2011 but not in 2012. We also sold a portion of our CMBS during 2011 for $11.1 million, resulting in a gain on sale of CMBS of $4.7 million, that we did not have in 2012. This was partially offset by a decrease in our loan servicing expenses as the portfolio of loans has decreased through loan collections, payoffs and REO conversions.

**Financial Condition and Capital Resources**

***Liquidity – November 30, 2013***

At November 30, 2013, we had approximately $201.5 million in cash.

Our notes payables consisted of the following at November 30, 2013 and 2012 (in thousands):

| | 2013 | 2012 |
|---|---|---|
| Senior Notes | $ 250,000 | $ - |
| Bank Portfolios | 90,933 | 90,933 |
| Warehouse Repurchase Facilities | 76,017 | - |
| Notes payable - other | 24,933 | 13,547 |
| FDIC Financing | - | 470,000 |
| Total notes payable | $ 441,883 | $ 574,480 |

The FDIC financing had a 0% interest rate. The Bank Portfolios' notes payable have an interest rate of the higher of 4.5% or 1 month LIBOR plus 3.75%. The warehouse repurchase facilities' interest rate is the higher of 2.5% or 1 month LIBOR plus 2.25%. The 7.00% Senior Notes bear interest at 7%. Other notes payable have interest rates ranging from 0.0% to 6.9%.

During the year, the two LLCs repaid the remaining balance of the FDIC financing.

During 2013, we exercised our right to extend the maturity date of the Bank Portfolio's note payable originally due September 30, 2013 to September 30, 2016, as well as pushing back the next payment with payments in the amount of $33 million now due on both December 15, 2014, and December 15, 2015, with the remaining principal balance to be paid in full on September 30, 2016.

The first $250 million warehouse loan facility originated during 2013 has a maturity date of August 9, 2015 with an option for a one time, one year extension. The second $250 million warehouse loan facility originated during 2013 has a maturity date of October 8, 2015 with an option for a one time, one year extension. These facilities are in the form of two separate repurchase agreement lines, and are secured by in the loans that are funded with these facilities. The borrowings are repaid with proceeds from the sales of loans into securitizations. The interest rate on both the facilities is at one month LIBOR plus 2.25% (with a one month LIBOR floor of 0.25%) and is calculated on the principal amount that is outstanding from time to time.

We used $100 million of the net proceeds of the sale of the 7.00% Senior Notes and $135 million of working capital to repay $235 million that had been advanced to us by Lennar. Interest on the 7.00% Senior Notes is due semi-annually beginning June 1, 2014.

Prior to our issuance of the 7.00% Senior Notes, our Asset and Investment Management business line and our Direct Investments business line were funded largely by Lennar. Our loan origination and securitization business is funded by our two warehouse repurchase facilities and the proceeds of the sale of the 7.00% Senior Notes in excess of the $100 million that was paid to Lennar. As a result of the 7.00% Senior Notes offering, we have become substantially self-sustaining, and we will request funding from Lennar only to the extent, if any, it is required to supplement our own resources (which Lennar has no obligation to provide, aside from up to $75 million we can borrow under a Revolving Credit Agreement Lennar entered into in 2013). During 2013, we repaid $235 million that Lennar had provided to us (including the $100 million repaid with proceeds of the sale of the 7.00% Senior Notes). After that repayment, the remaining capital Lennar had invested in us, which all is in the form of equity, was $539.4 million as of November 30, 213. As we receive proceeds of the winding down of the FDIC LLCs and our Bank Portfolios, we expect to return at least a portion of Lennar's remaining investment.

During 2013, Lennar entered into a Revolving Credit Agreement with us under which, subject to customary lending conditions, Lennar will at any time make advances to us on a revolving basis up to a maximum of $75 million at any time. The revolving facility will terminate in November 2015. Borrowings bear interest at LIBOR plus 3.5%. At November 30, 2013, no amounts had been borrowed or repaid under this agreement.

***Cash Flows***

Cash provided by (used in) our operating, investing and financing activities is summarized as follows:

| ($ in thousands) | **2013** | **2012** |
|---|---|---|
| Operating activities | $ (186,462) | $ (19,652) |
| Investing activities | 488,283 | 286,972 |
| Financing activities | (205,635) | (245,948) |
| Total cash flows | $ 96,186 | $ 21,372 |

*Operating Cash Flow Activities*

Cash used in operating activities was $186.5 million, an 849% increase over prior year. This increase is due largely to our new loan origination and securitization business that used cash for loan originations of $690.3 million partially offset by the sale of a portion of those loan originations into three separate securitization trusts for a cash inflow of $537.0 million. These cash uses are slightly offset by net earnings attributable to Rialto of $11.9 million. Included in net earnings attributable to Rialto were non-cash items such as realized gains on the sale of REO of $48.8 million and a provisional gain of $8.5 million on a bargain purchase acquisition. Other cash provided by operating activities amounted to $12.2 million.

*Investing Cash Flow Activities*

Cash provided by investing activities was $488.3 million, a 70% increase over prior year. Cash provided by investing consisted of receipts of principal payments on our loans receivable, net of $74.2 million, proceeds from the sale of REO of $239.2 million, return of capital from unconsolidated entities of $42.6 million and a decrease in our defeasance cash of $223.8 million due to the payoff of the FDIC Notes. This is slightly offset by a $67.0 million contribution to our investments in unconsolidated entities and other uses of cash of $24.5 million.

*Financing Cash Flow Activities*

Cash used in financing activities was $205.6 million, a 16% decrease over prior year. Cash used in financing consisted of the payoff of the FDIC Notes of $471.3 million, total repayments of indebtedness to Lennar of $235.0 million and distributions to the FDIC of $28.4 million. This was offset by proceeds from the Senior Notes of $250.0 million, an increase in due to Parent of $210.2 million due to their funding of the loan securitization and origination business and net borrowings under the warehouse repurchase facilities of $76.0 million. Other cash used in financing amounted to $7.1 million.

**Off-Balance Sheet Arrangements**

***Investments in Unconsolidated Entities***

Financial information on a consolidated 100% basis regarding unconsolidated entities in which we have investments that are accounted for by the equity method was as follows as of and for the years ended November 30, 2013 and 2012 (in thousands):

| Balance Sheets | 2013 | 2012 |
|---|---|---|
| **Assets:** | | |
| Cash and cash equivalents | $ 332,968 | $ 299,172 |
| Loans receivable | 523,249 | 361,286 |
| Real estate owned | 285,565 | 161,964 |
| Investment securities | 381,555 | 182,399 |
| Investments in real estate partnerships | 149,350 | 72,903 |
| Other assets | 191,624 | 199,839 |
| | $ 1,864,311 | $ 1,277,563 |
| **Liabilities and equity:** | | |
| Accounts payable and other liabilities | $ 108,514 | $ 155,928 |
| Notes payable | 398,445 | 120,431 |
| Partner loans | 163,940 | 163,516 |
| Equity | 1,193,412 | 837,688 |
| | $ 1,864,311 | $ 1,277,563 |

| Statements of Operations | 2013 | 2012 | 2011 |
|---|---|---|---|
| Revenues | $ 251,533 | $ 414,027 | $ 470,282 |
| Costs and expenses | 252,563 | 243,483 | 183,326 |
| Other income (expense) - net [(1)] | 187,446 | 713,710 | (614,014) |
| Net earnings of unconsolidated entities | $ 186,416 | $ 884,254 | $ (327,058) |
| Equity in earnings (loss) from unconsolidated entities | $ 22,353 | $ 41,483 | $ (7,914) |

(1) Other income – net for the year ended November 30, 2013, includes Fund I and Fund II's realized and unrealized gains on investments as well as other income from REO. Other income - net for the years ended November 30, 2012 and 2011, includes the AB PPIP Fund's mark-to-market unrealized gains and losses. Our portion of these items was a small percentage. For the year ended November 30, 2012, other income (expense) – net also includes realized gains from the sale of investments in

the portfolio underlying the AB PPIP fund, of which the Company's portion was a small percentage.

***Contractual Obligations and Commercial Commitments***

The following table summarizes certain of our contractual obligations at November 30, 2013:

| | | Payments Due by Period | | | |
|---|---|---|---|---|---|
| | Total | Less than 1 year | 1 to 3 years | 3 to 5 years | More than 5 years |
| Notes payable [1] | $ 365,866 | $ 7,983 | $ 105,448 | $ 252,323 | $ 112 |
| Warehouse repurchase facilities | 76,017 | 76,017 | - | - | - |
| Investment commitments [2] | 58,050 | 58,050 | - | - | - |
| Operating leases | 9,030 | 1,008 | 3,340 | 2,428 | 2,254 |
| Total contractual obligations | $ 508,963 | $ 143,058 | $ 108,788 | $ 254,751 | $ 2,366 |

(1) Amount includes $250.0 million from the 7.00% Senior Notes.
(2) Amount includes the Company's capital commitments to Fund II and the Mezzanine Fund.

**Economic Conditions**

Rialto believes that the Company will benefit from the market opportunity to acquire real estate loans, assets, and debt securities through its investment funds resulting from (i) the need for financial institutions and government entities to reduce their exposure to commercial real estate debt and distressed assets; (ii) the unprecedented volume of near-term loan maturities on overleveraged assets; and (iii) the overall decrease in the availability of debt financing from traditional lending sources. In the decade leading up to the 2007-2009 global financial crisis, the real estate capital markets experienced an aggressive expansion in debt capitalization and a proliferation of new debt products, while commercial property values escalated to historic peak levels. As a result of the significant market correction that began in 2008, many financial institutions and government entities are currently burdened by significant exposure to overleveraged and distressed assets.

As of March 2012, total outstanding U.S. commercial real estate debt equated to $3.1 trillion, of which $229 billion was categorized as distressed and that Rialto believes will likely need to be recapitalized over the next several years. Lending institutions are undergoing a deleveraging process, including through the sale of legacy debt positions, to improve their balance sheets and restore healthy capital ratios. An estimated $1.8 trillion of U.S. commercial real estate debt matures between 2012 and 2016, of which approximately $510 billion or 30% is estimated to have loan-to-value ("LTV") ratios in excess of 100% and therefore may face refinancing challenges. Moreover, as the volume of maturing debt has been accelerating, the global pool of available capital for debt financing has diminished as many traditional lenders (including European banks, specialty finance companies, and conduit lenders) have reduced lending activity due to balance sheet, regulatory or other pressures. Through its investment funds, Rialto is attempting to capitalize on this market environment in part by focusing on acquiring and managing complex, diversified portfolios of distressed loans and assets.

We believe that we will benefit from the market opportunity to originate first mortgage loans through our loan origination and securitization business and through our investment funds, resulting from (i) rising real estate values, (ii) the unprecedented near-term loan maturities, (iii) low interest rates; and (iv) an evolving lending landscape that we believe will make debt opportunities attractive to borrowers. The global financial crisis has had a severe impact on the commercial real estate sector, but the U.S. property markets have rebounded from their lows and continue to edge further into recovery. However, we expect that the significant wave of commercial real estate loans will mature in the near future will require capital beyond what senior lenders are able to provide. We expect that demand to refinance maturing debt will remain elevated through 2017, and because many of these maturing loans were made during the peak of the last cycle, with low equity requirements, inflated valuations, and/or aggressive underwriting standards, many credit-worthy borrowers will struggle to refinance their overleveraged assets. To encourage new lending, the U.S. Federal Reserve (the "Fed") has enacted accommodative monetary policies to keep senior mortgage rates historically low, creating a favorable dynamic for mezzanine and other first mortgage lenders to fill the capital void while preserving attractive all-in costs for borrowers. While we expect that the Fed's strategy will assist with the surge of maturing debt, we believe that the lending landscape is dramatically different following the market dislocation.

**Market and Financing Risk**

We finance our contributions to investing activities, general operating needs and REO improvements primarily with cash generated from operations and borrowings including a debt issuance as well as borrowings from our Parent. Until we did a debt issuance in early November 2013, we received a large portion of the funding for our operations and investments from our Parent. However, our Parent has no commitment to continue providing funding to us, aside from up to $75 million in interest bearing loans under a Revolving Credit Agreement.

We engage in the business of originating commercial mortgage loans that by their nature are vulnerable to interest rate risk, credit risk and market risk. Variability in asset values and cash flows might significantly impact our results of operations and financial.

Our hedging strategy is intended to reduce, to the extent possible, the risk of unpredictable financial changes within applicable markets and to sustain the values of financial instruments that may be sold prior to maturity. Areas that we believe are exposed to market risk include the following:

- The portfolio of loans held-for-sale
- The underlying collateral of for mortgage loans and mortgage-backed securities
- The purchase of hedges to mitigate both interest and credit risk
- The access to revolving credit facilities (repurchase agreements)

Our loan origination and securitization business uses various hedging instruments and techniques in an attempt to mitigate interest rate risk from the time a borrower rate locks a loan until the time the loan is securitized. While a perfect hedge (assuring zero loss) is rarely attainable, the goal is to minimize any losses. We also manage a portion of our credit exposure by buying protection within the CMBX and CDX markets. All hedging is performed on a portfolio basis as opposed to a loan by loan basis. Hedging instruments are executed only with dealers approved by our credit committee. Only individuals authorized by the credit committee can execute trades. The credit committee resolution listing all authorized traders is provided to all dealers. Trades are executed based on a daily position using sequentially numbered trade tickets. Trades are executed using a competitive bidding process generally involving at least three dealers unless market conditions do not allow this. A separate Rialto associate will independently verify all trades. All hedging activities are documented to provide independent parties the ability to verify the process. Hedge positions are monitored daily. On a monthly basis, we assess the effectiveness of existing hedges and ensure the appropriate accounting treatment is reflected in the financial statements.

**Interest Rates and Changing Prices**

Until 2011, our principal activity involved acquisitions of portfolios of, or interests in portfolios of, distressed debt instruments and foreclosed properties, using primarily funds provided by Lennar through the Investor Companies. Since 2011, investments in portfolios and single assets have been made primarily by investment funds we manage, but the Investor Companies have been investors in these funds. This can cause management fees and earnings from unconsolidated entities to be effected by changing conditions.

While the market has seen some significant upward movement in interest rates over the past several months, the purchase of non-performing loans ("NPL") is not highly sensitive to market conditions and interest rate movements, as the underlying loans and assets are purchased at a significant discount (generally 40% - 50% of unpaid principal balance) and are typically acquired based on the underlying real estate value. Recently, we have seen a higher percentage of partially performing loans included in the NPL pools. The borrowers on these categories of loans are making monthly interest and principal payments. As most of the NPL's monthly payments are based on LIBOR, small increases in LIBOR should increase the investment's monthly cash flows.

However, a very large increase in interest rates (+/- 400 basis points) may have a negative impact on the value of the underlying real estate for portfolio or single assets (absent any recovery in the economy or increase in inflation). These large increases in interest rates may increase real estate capitalization rates thereby decreasing the potential proceeds from a refinance or the sale of the underlying property. This is largely mitigated by underwriting assumptions that include capitalization rate sensitivities due to higher interest rates. Furthermore, for most acquisitions we include higher capitalization rates at sale (in anticipation of higher interest rates).

In addition, some of our acquired assets may be financed with floating rate debt. In these cases, increases in short term interest rates will increase monthly debt service payments and reduce the underlying investment's cash flows. Rialto manages this direct interest rate exposure on a case by case (via the purchase of LIBOR caps) and on a portfolio basis.

**New Accounting Pronouncements**

In June 2011, the Financial Accounting Standards Board ("FASB") FASB issued ASU 2011-05, *Presentation of Comprehensive Income,* ("ASU 2011-05"). ASU 2011-05 requires the presentation of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. ASU 2011-05 was effective for our fiscal year beginning December 1, 2012. The adoption of ASU 2011-05 did not have a material effect on our consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities,* ("ASU 2011-11"), which requires entities to disclose information about offsetting and related arrangements of financial instruments and derivative instruments. In January 2013, this guidance was amended by ASU 2013-01, *Clarifying the Scope of Disclosures about Offsetting assets and Liabilities* ("ASU 2013-01"). ASU 2013-01 limits the scope of ASU 2011-11 to certain derivatives, repurchase and reverse repurchase agreements, and securities borrowing and lending transactions. The guidance is effective for our fiscal year beginning December 1, 2013 and subsequent interim periods. The adoption of this guidance, which is related to disclosure only, is not expected to have a material effect on our consolidated financial statements.

In April 2013, the FASB issued ASU 2013-04, *Liabilities,* (“ASU 2013-04”). ASU 2013-04 provides guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date. ASU 2013-04 will be effective for our fiscal year beginning December 1, 2014 and subsequent interim periods. The adoption of ASU 2013-04 is not expected to have a material effect on our consolidated financial statements.

In July 2013, the FASB issued ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a similar Tax Loss, or a Tax Credit Carryforward Exists,* (“ASU 2013-11”). ASU 2013-13 is intended to end inconsistent practices regarding the presentation of an unrecognized tax benefits when a net operating loss ("NOL"), a similar tax loss or a tax credit carryforward is available to reduce the taxable income or tax payable that would result from the disallowance of a tax position. ASU 2013-11 will be effective for our fiscal year beginning December 1, 2014 and subsequent interim periods. The adoption of ASU 2013-11 is not expected to have a material effect on our consolidated financial statements.

## Critical Accounting Policies and Estimates

Preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions about future events that affect the amounts reported in our consolidated financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results could differ from those estimates, and such differences may be material to our consolidated financial statements. Listed below are those policies and estimates that we believe are critical and require the use of significant judgment in their application.

### *Management Fee Revenue*

We provide investment management services to a variety of legal entities and investment vehicles such as funds, joint ventures, co-invests, and other private equity structures. As a result, we earn and receive management fees, underwriting fees and due diligence fees. These fees are recorded over the period in which the services are performed, fees are determinable and collectability is reasonably assured. We receive investment management fees from investment vehicles based on (1) a percentage of committed or called capital during the commitment period and called capital after the commitment period ends, and (2) a percentage of invested capital less the portion of such invested capital utilized to acquire investments that have been sold (in whole or in part) or liquidated . Also after meeting certain investment return thresholds, we earn carried interest that will be paid out as assets are monetized (generally approximately six years after inception). We currently are exceeding these investment thresholds in Fund I and anticipate booking in the future significant revenues from our carried interest in Fund I and from other current and future investment funds. Fees earned for underwriting and due diligence services are based on actual costs incurred or market. We believe this to be a significant accounting policy because it represents a material portion of our revenue and is expected to comprise a growing portion of our future revenue as we manage more assets and sponsor new investment funds.

### ***Loans Receivable — Revenue Recognition***

All of the acquired loans for which (1) there was evidence of credit quality deterioration since origination and (2) for which it was deemed probable that we would be unable to collect all contractually required principal and interest payments were accounted for under ASC Topic 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*, ("ASC 310-30"). For loans accounted for under ASC 310-30, management determined upon acquisition the loan's value based on due diligence on each of the loans, the underlying properties and the borrowers. We determined fair value by discounting the cash flows expected to be collected adjusted for factors that a market participant would consider when determining fair value. Factors considered in the valuation were projected cash flows for the loan, the type of loan and related collateral, classification status and current discount rates. Since the estimates are based on projections, all estimates are subjective and can change due to unexpected changes in economic conditions or loan performance.

Under ASC 310-30, loans were pooled together according to common risk characteristics. A pool is then accounted for as a single asset with a single component interest rate and based on aggregate expectation of cash flows. The excess of the cash flows expected to be collected over the cost of the loans acquired is referred to as the accretable yield and is recognized in interest income over the remaining life of the loans using the effective yield method. The difference between the contractually required payments and the cash flows expected to be collected at acquisition is referred to as the nonaccretable difference. This difference is neither accreted into income nor recorded on our consolidated balance sheets.

We periodically evaluate our estimate of cash flows expected to be collected on our portfolios. These evaluations require the continued use of key assumptions and estimates, similar to those used in the initial estimate of fair value of the loans to allocate purchase price. Subsequent changes in the estimated cash flows expected to be collected may result in changes in the accretable yield and nonaccretable difference or reclassifications from nonaccretable yield to accretable yield. Increases in the cash flows expected to be collected will generally result in an increase in interest income over the remaining life of the loan or pool of loans. Decreases in expected cash flows due to further deterioration will generally result in an impairment recognized as a provision for loan losses, resulting in an increase to the allowance for loan losses. Prepayments are treated as a reduction of cash flows expected to be collected and a reduction of contractually required payments such that the nonaccretable difference is not affected.

We believe that the accounting related to loans with deteriorated credit quality and the accounting for accretable yield are critical accounting policies because of the significant judgment involved.

### ***Nonaccrual Loans — Revenue Recognition & Impairment***

At November 30, 2013 and 2012, there were loans receivable with a carrying value of $8.3 million and $40.4 million, respectively, for which interest income was not being recognized as they were classified as nonaccrual. When forecasted principal and interest cannot be reasonably estimated at the loan acquisition date, management classifies the loan as nonaccrual and accounts for these assets in accordance with ASC 310-10, *Receivable*, ("ASC 310-10"). When a loan is classified as nonaccrual, any subsequent cash receipt is accounted for using the cost recovery method. In accordance with ASC 310-10, a loan is considered impaired when based on current information and events; it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. A provision for loan losses is recognized when the recorded investment in the loan is in excess of its fair value. The fair value of the loan is determined by using either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral less estimated costs to sell. For these reasons, we believe that the accounting for nonaccrual loans is a critical accounting estimate.

***Real Estate Owned***

REO is real estate of which we have taken control or effective control in partial or full satisfaction of loans receivable. At the time of acquisition of a property through foreclosure of a loan, REO is recorded at fair value less estimated costs to sell if classified as held-for-sale or at fair value if classified as held-and-used, which becomes the property's new basis. The fair values of these assets are determined in part by placing reliance on third party appraisals of the properties and/or internally prepared analyses of recent offers or prices on comparable properties in the proximate vicinity. The third party appraisals and internally developed analyses are significantly impacted by the local market economy, market supply and demand, competitive conditions and prices on comparable properties, adjusted for date of sale, location, property size, and other factors. Each REO is unique and is analyzed in the context of the particular market where the property is located. In order to establish the significant assumptions for a particular REO, we analyze historical trends, including trends achieved by Lennar's local homebuilding operations, if applicable, and current trends in the market and economy impacting the REO. Using available trend information, we then calculate our best estimate of fair value, which can include projected cash flows discounted at a rate we believe a market participant would determine to be commensurate with the inherent risks associated with the assets and related estimated cash flow streams.

Changes in economic factors, consumer demand and market conditions, among other things, could materially impact estimates used in the third party appraisals and/or internally prepared analyses of recent offers or prices on comparable properties. Thus, estimates can differ significantly from the amounts ultimately realized by us from disposition of these assets. The amount by which the recorded investment in the loan is less than the REO's fair value (net of estimated cost to sell if held-for-sale), is recorded as an unrealized gain on foreclosure in our consolidated statement of operations. The amount by which the recorded investment in the loan is greater than the REO's fair value (net of estimated cost to sell if held-for- sale) is recorded as a provision for loan losses for nonaccrual loans and as an unrealized loss within REO expense, net, for accrual loans in our consolidated statement of operations.

Additionally, REO includes real estate which we have purchased directly from financial institutions. These REOs are recorded at cost or allocated cost if purchased in a bulk transaction. Subsequent to obtaining REO via foreclosure or directly from a financial institution, management periodically performs valuations using the methodologies described above such that the real estate is carried at the lower of its cost basis or current fair value, less estimated costs to sell if classified as held-for- sale, or at the lower of its cost basis or current fair value if classified as held-and-used. Any subsequent valuation adjustments, operating expenses or income, and gains and losses on disposition of such properties are also recognized in our Rialto Investments other income, net. REO assets classified as held- and-used are depreciated using a useful life of forty years for commercial properties and twenty seven and a half years for residential properties. Our REO assets classified as held-for-sale are not depreciated. Occasionally an asset will require certain improvements to yield a higher return. In accordance with ASC 970-340-25, *Real Estate*, construction costs incurred prior to acquisition or during development of the asset may be capitalized.

We believe that the accounting for REO is a critical accounting policy because of the significant judgment required in the third party appraisals and/or internally prepared analysis of recent offers or prices of comparable properties in the proximate vicinity used to estimate the fair value of the REOs.

***Loans Held-For-Sale***

These originated mortgage loans are accounted for in accordance with ASC Topic 825, *Financial Instruments*, and consist of commercial loans that are carried at fair value in the accompanying balance sheets. Changes in fair values of the loans and the derivative instruments used to hedge their economic exposure are reflected in gains from securitizations and other in the accompanying consolidated statements of operations. Interest income on these loans is calculated based on the interest rate of the loan and is recorded in revenue in the accompanying consolidated statements of operations. Substantially all of the mortgage loans originated are sold within a short period of time in a securitization on a servicing released, non-recourse basis; although, the Company remains liable for certain limited industry-standard representations and warranties related to loan sales. The Company recognizes gains on the sale of loans into securitizations trusts when control of the loans has been relinquished.

In the normal course of business, the Company uses derivative financial instruments to hedge its exposure to risks during the period from when the Company has originated a loan until the time in which the loan is sold. These derivatives are used for risk management purposes to reduce the Company's exposure to fluctuations in mortgage-related interest rates as well as lessen its credit risk. The Company hedges its interest rate exposure through entering into interest rate swap futures. Credit exposure is managed at a portfolio level through entering into credit default swaps consisting of both single "A", "AAA" and "BBB" rated CMBX swaps as well as CDX swaps. The Company does not enter into or hold derivatives for trading or speculative purposes.

***Derivatives and Hedging***

Our loan origination and securitization business engages in the business of originating commercial mortgage loans that by their nature are vulnerable to interest rate risk, credit risk and market risk. Resulting variability in asset values and cash flows might impact the results of operations and financial position of our loan origination and securitization business. The hedging strategy is intended to reduce, to the extent possible, unpredictable financial changes within the markets and to sustain the values of certain financial instruments that may be sold prior to maturity. Areas where our loan origination and securitization business is exposed to market risk include the following: the portfolio of loans held-for-sale; the underlying collateral of portfolio loans; the purchase of hedges to mitigate both interest and credit risk; and the access to revolving credit facilities (repurchase agreements). To mitigate risk, we use various derivative products such as interest rate swaps, interest rate futures and credit default swaps. We also have processes in place to monitor compliance with loan covenants and to monitor the cash flow of the underlying collateral.

Our loan origination and securitization business follows a structured internal control process that requires a set of specific authorizations and procedures. Included in the process are unique policies outlining levels of authority granted to associates to negotiate review approve and execute derivative transactions. The policies and procedures governing derivative activities must be communicated to all associates involved and such communication is formally acknowledged. Procedures and controls for recording and monitoring all derivative transactions are specifically outlined, including how the underlying asset and risk components of derivative instruments are analyzed, records will be maintained, counter-parties will be prequalified and approved, and derivative exposure will be proactively reviewed.

We have a credit committee, comprised of senior executives from us and our Parent, to evaluate new investments, monitor existing investments and oversee the Company's derivatives and hedging process. We also have a risk committee that consists of senior members of the loan origination and securitization business management, as well as Rialto legal, management and finance associates and representatives of our Parent. On a bi-weekly basis, the risk committee reviews the risks associated with our credit hedging, the existing hedge ratio, pricing surrounding new issues that have taken place in the market, upcoming securitizations, and new originations which are in the pipeline.

Our loan origination and securitization business uses various hedging instruments and techniques in an attempt to mitigate interest rate risk from the time a borrower rate locks the loan until the time the loan is securitized. While a perfect hedge (resulting in assurance of zero gain or loss) is rarely attainable, the goal is to minimize any gains or losses. We also manage a portion of our credit exposure through buying protection within the CMBX market. All hedging is performed on a portfolio basis as opposed to a loan by loan basis. Hedging instruments are executed only with dealers authorized by the credit committee. Only individuals authorized by the credit committee can execute trades. The credit committee resolution listing all authorized traders is provided to all dealers. Trades are executed based on a daily position using sequentially numbered trade tickets. Trades are executed using a competitive bidding process generally involving at least three dealers unless market conditions do not allow this. A separate Rialto associate independently verifies all trades. All hedging activities are documented to provide independent parties the ability to verify the process. Hedge positions are monitored daily. On a monthly basis, we assess the effectiveness of existing hedges and ensure the appropriate accounting treatment is reflected in the financial statements.

***Consolidations of Variable Interest Entities***

In 2010, the Company acquired indirectly 40% managing member equity interests in two limited liability companies ("LLCs"), with the FDIC owning the other 60%. We determined that each of the LLCs met the definition of a variable interest entity ("VIE") and we were the primary beneficiary. In accordance with ASC 810-10-65-2, *Consolidations*, ("ASC 810-10-65-2"), we identified the activities that most significantly impact the LLCs' economic performance and determined that we have the power to direct those activities. The economic performance of the LLCs is most significantly impacted by the performance of the LLCs' portfolios of assets, which consist primarily of distressed residential and commercial mortgage loans. Thus, the activities that most significantly impact the LLCs' economic performance are the servicing and disposition of mortgage loans and real estate obtained through foreclosure of loans, restructuring of loans, or other planned activities associated with the monetizing of loans.

The FDIC does not have the unilateral power to terminate our role in managing the LLCs and servicing the loan portfolio. While the FDIC has the right to prevent certain types of transactions (i.e., bulk sales, selling assets with recourse back to the selling entity, selling assets with representations and warranties and financing the sales of assets without the FDIC's approval), the FDIC does not have full voting or blocking rights over the LLCs' activities, making their voting rights protective in nature, not substantive participating voting rights. Other than as described in the preceding sentence, which are not the primary activities of the LLCs, we can cause the LLCs to enter into both the disposition and restructuring of loans without any involvement of the FDIC. Additionally, the FDIC has no voting rights with regard to the operation/management of the operating properties that are acquired upon foreclosure of loans (e.g. REO) and no voting rights over the business plans of the LLCs. The FDIC can make suggestions regarding the business plans, but we can decide not to follow the FDIC's suggestions and not to incorporate them in the business plans. Since the FDIC's voting rights are protective in nature and not substantive participating voting rights, we have the power to direct the activities that most significantly impact the LLCs' economic performance. In accordance with ASC 810-10-65-2, we determined that we had an obligation to absorb losses of the LLCs that could potentially be significant to the LLCs or the right to receive benefits from the LLCs that could potentially be significant to the LLCs based on the following factors:

- Rialto/Lennar owns 40% of the equity of the LLCs and has the power to direct activities of the LLCs that most significantly impact their economic performance through loan resolutions and the sale of REO.

- Rialto/Lennar has a management/servicer contract under which we earn a 0.5% servicing fee.

- Rialto/Lennar has guaranteed, as the servicer, its obligations under the servicing agreement up to $10.0 million.

We are aware that the FDIC, as the owner of 60% of the equity of each of the LLCs, may also have an obligation to absorb losses of the LLCs that could potentially be significant to the LLCs. However, in accordance with ASC Topic 810-10-25-38A, only one enterprise, if any, is expected to be identified as the primary beneficiary of a VIE. Since both criteria for consolidation in ASC 810-10-65-2 are met, we consolidated the LLCs. We believe that our assessment that we are the primary beneficiary of the LLCs is a critical accounting policy because of the significant judgment required in evaluating all of the key factors and circumstances in determining the primary beneficiary.

***Valuation of Deferred Taxes***

The Company records income taxes under the asset and liability method, whereby deferred tax assets and liabilities are recognized based on the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and attributable to operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply in the years in which the temporary differences are expected to be recovered or paid. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in earnings in the period when the changes are enacted. Interest related to unrecognized tax benefits is recognized as a component of provision for income taxes in the accompanying consolidated statements of operations.

A reduction of the carrying amounts of deferred tax assets by a valuation allowance is required if, based on the available evidence, it is more likely than not that such assets will not be realized. Accordingly, the need to establish valuation allowances for deferred tax assets is assessed each reporting period by the Company based on the more-likely-than-not realization threshold criterion. In the assessment for a valuation allowance, appropriate consideration is given to all positive and negative evidence related to the realization of the deferred tax assets. This assessment considers, among other matters, the nature, frequency and severity of current and cumulative losses, forecasts of future profitability, the duration of statutory carryforward periods, the Company's experience with loss carryforwards not expiring unused and tax planning alternatives.

We believe that the accounting estimate for the valuation of deferred tax assets and liabilities is a critical accounting estimate because judgment is required in assessing the likely future tax consequences of events that have been recognized in our financial statements or tax returns. We base our estimate of deferred tax assets and liabilities on current tax laws and rates and, in certain cases, business plans and other expectations about future outcomes. Changes in existing tax laws or rates could affect actual tax results and future business results, which may affect the amount of deferred tax liabilities or the valuation of deferred tax assets over time. Our accounting for deferred tax consequences represents our best estimate of future events.

**RIALTO HOLDINGS, LLC AND SUBSIDIARIES**

## TABLE OF CONTENTS

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## INDEPENDENT AUDITORS' REPORT

To the Stockholder of
Rialto Holdings, LLC
Miami, Florida

We have audited the accompanying consolidated financial statements of Rialto Holdings, LLC and its subsidiaries (the "Company"), which comprise the consolidated balance sheets as of November 30, 2013 and 2012, and the related consolidated statements of operations, equity, and of cash flows for each of the three years in the period ended November 30, 2013, and the related notes to the consolidated financial statements.

### Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

## Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Rialto Holdings, LLC and its subsidiaries as of November 30, 2013 and 2012, and the results of their operations and their cash flows for each of the three years in the period ended November 30, 2013 in accordance with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

February 12, 2014

## RIALTO HOLDINGS, LLC AND SUBSIDIARIES

**CONSOLIDATED BALANCE SHEETS**
**AS OF NOVEMBER 30, 2013 AND 2012**
**(In thousands)**

| | 2013 | 2012 |
|---|---|---|
| **ASSETS** | | |
| Cash | $ 201,496 | $ 105,310 |
| Restricted cash | 2,593 | - |
| Defeasance cash to retire notes payable | - | 223,813 |
| Receivables, net | 111,833 | - |
| Loans receivable, net | 278,392 | 436,535 |
| Loans held-for-sale | 44,228 | - |
| Real estate owned - held-for-sale | 197,851 | 134,161 |
| Real estate owned - held-and-used, net | 428,989 | 601,022 |
| Investments in unconsolidated entities | 154,573 | 108,140 |
| Investments held-to-maturity | 16,070 | 15,012 |
| Other assets - net | 43,288 | 23,367 |
| Total assets | $ 1,479,313 | $ 1,647,360 |
| **LIABILITIES AND EQUITY** | | |
| LIABILITIES: | | |
| Accounts payable | $ 3,729 | $ 1,958 |
| Accrued expenses and other liabilities | 43,580 | 24,164 |
| Deferred income tax liability, net | 7,815 | 22,180 |
| Due to Parent | 12,447 | 526,129 |
| Notes payable and other debts payable | 441,883 | 574,480 |
| Total liabilities | 509,454 | 1,148,911 |
| COMMITMENTS AND CONTINGENT LIABILITIES (Note 14) | | |
| PARENT'S EQUITY | 539,446 | 53,163 |
| NONCONTROLLING INTERESTS | 430,413 | 445,286 |
| Total equity | 969,859 | 498,449 |
| Total liabilities and equity | $ 1,479,313 | $ 1,647,360 |

See notes to consolidated financial statements.

## RIALTO HOLDINGS, LLC AND SUBSIDIARIES

**CONSOLIDATED STATEMENTS OF OPERATIONS**
**FOR EACH OF THE YEARS ENDED NOVEMBER 30, 2013, 2012 AND 2011**
**(In thousands)**

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| REVENUE: | | | |
| Interest income | $ 78,907 | $ 103,913 | $ 153,186 |
| Management fees | 31,392 | 34,943 | 11,557 |
| Gains from securitizations and other | 27,761 | - | - |
| Rental income | 20,269 | 16,476 | 7,185 |
| Other revenue | 4,737 | - | - |
| Total revenue | 163,066 | 155,332 | 171,928 |
| EXPENSES: | | | |
| General and administrative expense | 79,761 | 53,730 | 43,463 |
| Servicing expense | 32,565 | 46,598 | 63,972 |
| Provision for loan losses | 16,139 | 27,966 | 13,815 |
| Costs of securitizations | 8,181 | - | - |
| Interest expense | 7,484 | 5,943 | 6,553 |
| Amortization of debt issuance costs | 5,680 | 4,565 | 4,565 |
| Other expense | 4,665 | - | - |
| REO expense (income), net | 3,554 | 46,256 | (27,283) |
| Depreciation expense | 1,262 | 188 | 215 |
| Total expenses | 159,291 | 185,246 | 105,300 |
| EQUITY IN EARNINGS (LOSS) FROM UNCONSOLIDATED ENTITIES | 22,353 | 41,483 | (7,914) |
| GAIN ON SALE OF INVESTMENTS HELD-TO-MATURITY | - | - | 4,743 |
| NET EARNINGS (INCLUDING NET EARNINGS (LOSS) ATTRIBUTABLE TO NONCONTROLLING INTERESTS) | 26,128 | 11,569 | 63,457 |
| LESS: NET EARNINGS (LOSS) ATTRIBUTABLE TO NONCONTROLLING INTERESTS | 6,238 | (14,383) | 28,930 |
| NET EARNINGS ATTRIBUTABLE TO RIALTO BEFORE PROVISION FOR INCOME TAXES | 19,890 | 25,952 | 34,527 |
| PROVISION FOR INCOME TAXES | 8,028 | 10,484 | 11,811 |
| NET EARNINGS ATTRIBUTABLE TO RIALTO | $ 11,862 | $ 15,468 | $ 22,716 |

See notes to consolidated financial statements.

## RIALTO HOLDINGS, LLC AND SUBSIDIARIES

**CONSOLIDATED STATEMENTS OF EQUITY**
**FOR EACH OF THE YEARS ENDED NOVEMBER 30, 2013, 2012 AND 2011**
**(In thousands)**

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| **PARENT'S EQUITY** | | | |
| Beginning balance | $ 53,163 | $ 37,695 | $ 14,979 |
| Noncash contribution from Parent | 474,421 | - | - |
| Net earnings attributable to Rialto | 11,862 | 15,468 | 22,716 |
| Ending balance | $ 539,446 | $ 53,163 | $ 37,695 |
| **NONCONTROLLING INTERESTS** | | | |
| Beginning balance | $ 445,286 | $ 459,669 | $ 430,739 |
| Net earnings (loss) attributable to noncontrolling interests | 6,238 | (14,383) | 28,930 |
| Reclassification of noncontrolling interest from due to Parent | 5,000 | - | - |
| Acquisition of noncontrolling interest | 2,243 | - | - |
| Distributions of capital to noncontrolling interests | (28,354) | - | - |
| Ending balance | $ 430,413 | $ 445,286 | $ 459,669 |
| **TOTAL EQUITY** | $ 969,859 | $ 498,449 | $ 497,364 |

See notes to consolidated financial statements.

# RIALTO HOLDINGS, LLC AND SUBSIDIARIES

**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**FOR EACH OF THE YEARS ENDED NOVEMBER 30, 2013, 2012 AND 2011**
**(In thousands)**

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net earnings attributable to Rialto | $ 11,862 | $ 15,468 | $ 22,716 |
| Adjustment to reconcile net earnings attributable to Rialto to net cash used in operating activities: | | | |
| Amortization of debt issuance costs | 5,680 | 4,565 | 4,565 |
| Depreciation expense | 5,345 | 6,988 | 2,628 |
| Net losses (gains) on loan foreclosure | 427 | 1,878 | (78,936) |
| Gains on sale of real estate owned | (48,785) | (21,649) | (6,035) |
| Provisional gain on bargain purchase acquisition | (8,532) | - | - |
| Equity in (earnings) loss from unconsolidated entities | (22,353) | (41,483) | 7,914 |
| Impairment on real estate owned | 16,090 | 9,282 | 8,157 |
| Deferred income tax (benefit) provision | (14,365) | 10,707 | 2,134 |
| Provision for loan losses | 16,139 | 27,966 | 13,815 |
| Distributions of earnings from unconsolidated entities | 648 | 18,399 | 5,298 |
| Noncontrolling interest earnings (loss) | 6,238 | (14,383) | 28,930 |
| Accretion of discount on investments held-to-maturity | (1,058) | (916) | (942) |
| Gain on sale of investments held-to-maturity | - | - | (4,743) |
| Originations of loans held-for-sale | (690,266) | - | - |
| Proceeds from sale of loans held-for-sale | 536,951 | - | - |
| Fair value adjustment on loans held-for-sale | (2,550) | - | - |
| Changes in operating assets and liabilities: | | | |
| Restricted cash from loan originations | (2,593) | - | - |
| Loans receivable, net | (9,050) | (19,775) | (36,299) |
| Accounts payable | (391) | (3,927) | 3,542 |
| Other assets | (2,955) | (12,242) | (4,120) |
| Accrued expenses and other liabilities | 17,056 | (530) | 7,147 |
| Net cash used in operating activities | (186,462) | (19,652) | (24,229) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Bargain purchase acquisition | (5,623) | - | - |
| Purchase of operating equipment | (4,053) | - | (174) |
| Receipts of principal payments on loans receivable | 74,185 | 81,648 | 74,888 |
| Proceeds from sales of real estate owned | 239,215 | 183,883 | 91,034 |
| Acquisition of loans receivable | (5,450) | - | - |
| Proceeds from sale of investments held-to-maturity | - | - | 11,127 |
| Improvements to real estate owned | (9,407) | (13,945) | (20,623) |
| Distributions of capital from unconsolidated entities | 42,556 | 83,368 | 14,063 |
| Investments in unconsolidated entities | (66,953) | (43,555) | (64,360) |
| Decrease (increase) in defeasance cash to retire notes payable | 223,813 | (4,427) | (118,077) |
| Net cash provided by (used in) investing activities | 488,283 | 286,972 | (12,122) |

(Continued)

## RIALTO HOLDINGS, LLC AND SUBSIDIARIES

**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**FOR EACH OF THE YEARS ENDED NOVEMBER 30, 2013, 2012 AND 2011**
**(In thousands)**

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Proceeds from 7.00% Senior Notes | 250,000 | - | - |
| Repayment of notes payable | (471,255) | (191,221) | (399) |
| Net borrowings under warehouse repurchase facilities | 76,017 | - | - |
| Debt issuance costs | (7,262) | - | - |
| Distributions of capital to noncontrolling interest | (28,354) | - | - |
| Increase (decrease) in due to Parent | 210,219 | (54,727) | 44,276 |
| Repayment of indebtedness to Parent | (235,000) | - | - |
| Net cash (used in) provided by financing activites | (205,635) | (245,948) | 43,877 |
| NET INCREASE IN CASH | 96,186 | 21,372 | 7,526 |
| CASH — Beginning of year | 105,310 | 83,938 | 76,412 |
| CASH — End of year | $ 201,496 | $ 105,310 | $ 83,938 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | | |
| Cash paid for interest on notes payable and other debts payable | $ 7,074 | $ 5,943 | $ 6,553 |
| SUPPLEMENTAL DISCLOSURES OF NON-CASH INVESTING AND FINANCING ACTIVITIES: | | | |
| Real estate owned acquired through loan foreclosure | $ 70,237 | $ 183,911 | $ 467,662 |
| Equity contribution from Parent | $ 474,421 | $ - | $ - |
| Real estate owned acquired in bargain purchase acquisition | $ 31,818 | $ - | $ - |
| Net liabilities assumed in bargain purchase acquisition | $ 6,200 | $ - | $ - |
| Transfer of REO assets to Parent | $ 9,480 | $ 11,335 | $ 3,926 |
| Reductions in loans receivable from deficiency settlements | $ 619 | $ 3,068 | $ 5,274 |
| Notes payable and other liabilities assumed from deficiency settlement | $ - | $ 194 | $ 16,152 |

See notes to consolidated financial statements. (Concluded)

## 1. ORGANIZATION AND DESCRIPTION OF BUSINESS

Rialto Holdings, LLC is a holding company that owns 100% of the legal entities Rialto Investments, LLC (formerly Lennar Distressed Investments, LLC) and Rialto Capital Management, LLC and conducts its activities through those entities and their subsidiaries (collectively, "Rialto" or the "Company"). The Company is operated as a separate business segment of Lennar Corporation ("Lennar" or the "Parent"). Rialto focuses on real estate investments and asset management. Rialto utilizes its vertically integrated investment and operating platform to underwrite, diligence, acquire, manage, workout and add value to diverse portfolios of real estate loans, properties and securities, as well as providing strategic real estate capital. Rialto's primary focus is to manage third party capital and has invested in or commenced the workout and/or oversight of billions of dollars of real estate assets across the United States, including commercial and residential real estate loans and properties, as well as mortgage backed securities with the objective of generating superior, risk-adjusted returns. In addition, beginning in 2013, Rialto commenced operations of its commercial mortgage loan origination and securitization business. To date, many of the Company's opportunities have arisen from the dislocation in the United States real estate markets and the restructuring, recapitalization and financing of those markets.

*Asset and Investment Management*

The Company's real estate Asset and Investment Management business allows the Company to be a sponsor of and an investor in private equity vehicles that invest in and manage real estate related assets. This has included the Rialto Real Estate Fund, LP ("Fund I") that was initially formed in 2010 in which investors committed and contributed a total of $700 million of equity (including the $75 million by the Company), the Rialto Real Estate Fund II, LP ("Fund II") that was formed in 2013 with investor commitments at November 30, 2013, of $1.1 billion (including the $100 million by the Company) and the Rialto Mezzanine Partners Fund, LP (the "Mezzanine Fund") that was formed in 2013 with a target of raising $300 million in capital (including $25 million committed by the Company) to invest in and originate performing mezzanine commercial loans. Rialto also earns fees for its role as a manager of these vehicles and for providing asset management and other services to those vehicles and other third parties.

At the end of 2009, a subsidiary of the Company was a sub-advisor to the AllianceBernstein L.P. ("AB") fund formed under the Federal government's Public-Private Investment Program ("PPIP") to purchase real estate related securities from banks and other financial institutions. The sub-advisor received management fees for sub-advisory services. At the end of 2012, the AB PPIP fund finalized the last sales of the underlying securities in the fund and made substantially all of the final liquidating distributions to the partners, including the Company. As the Company's role as sub-advisor to the AB PPIP fund has been completed, no further management fees will be received for these services. During the year ended November 30, 2012, the Company contributed $1.9 million and received distributions of $87.6 million. Of the distributions received during the year ended November 30, 2012, $83.5 million related to the unwinding of the AB PPIP fund's operations. During the year ended November 30, 2011, the Company contributed $3.7 million and received distributions of $5.7 million. As of November 30, 2012 and 2011, the Company also earned $9.1 million and $0.8 million, respectively, in fees from the Company's role as sub-advisor to the AB PPIP fund. As of November 30, 2012, the carrying value of the Company's investment in the AB PPIP fund was $0.2 million (see Note 8).

*Loan Origination and Securitization*
The Company's loan origination and securitization business started in 2013 as the Company began originating and securitizing five, seven and ten year fixed rate commercial first mortgage loans, generally with principal amounts between $2 million and $75 million, which are secured by income producing properties.

*Direct Investments in Real Estate Related Assets*
In 2010, the Company acquired indirectly 40% managing member equity interests in two limited liability companies ("LLCs"), in partnership with the Federal Deposit Insurance Corporation ("FDIC"). The FDIC retained 60% equity interests in the LLCs. The LLCs hold performing and non-performing loans formerly owned by 22 failed financial institutions and when the Company acquired its interests in the LLCs, the two portfolios consisted of approximately 5,500 distressed residential and commercial real estate loans ("FDIC Portfolios"). The FDIC retained 60% equity interests in the LLCs and provided $626.9 million of financing with 0% interest, which is non-recourse to the Company and the LLCs (see Note 10).

The LLCs meet the accounting definition of a variable interest entity ("VIE") and since the Company was determined to be the primary beneficiary, the Company consolidated the LLCs. At November 30, 2013, these consolidated LLCs had total combined assets and liabilities of $727.1 million and $20.2 million, respectively. At November 30, 2012, these consolidated LLCs had total combined assets and liabilities of $1,236.4 million and $493.4 million, respectively.

Also in 2010, the Company acquired approximately 400 distressed residential and commercial real estate loans ("Bank Portfolios") and over 300 real estate owned ("REO") properties from three financial institutions. The Company paid $310 million for the Bank portfolios and real estate related assets of which $124 million was financed through a 5-year senior unsecured note provided by one of the selling institutions.

In addition, in 2010, the Company purchased approximately $43 million face amount of non-investment grade commercial mortgage-backed securities ("CMBS") for $19.4 million, representing a 55% discount from par value.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Significant accounting principles and practices used in the preparation of the consolidated financial statements are as follows:

*Basis of Presentation* - The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("GAAP"). The accompanying consolidated financial statements include the accounts of the Company and all of its subsidiaries. All intercompany transactions and balances have been eliminated.

*Use of Estimates* - The preparation of financial statements in conformity with GAAP requires the Company's management to make estimates and assumptions that affect the reported amounts of assets and liabilities, at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Significant items subject to such estimates and assumptions include expected cash flows on distressed loans, allowances for loan losses, and the valuation of loans held-for-sale, real estate acquired in connection with foreclosures or in satisfaction of loans, and fair value of loans held-for-sale and derivative instruments. Actual results could differ from those estimates.

*Restricted Cash* - The Company has established a restricted cash account related to the Company's loan origination and securitization business. These funds are restricted as they are upfront deposits and application fees the Company receives before originating the loans. Once the loan has been originated the Company recognizes the income and the cash is no longer restricted.

*Defeasance Cash* - The Company had established defeasance accounts for the benefit of the FDIC. These funds were restricted and were distributed pursuant to a priority of payments (see Note 3).

*Loans Receivable - Revenue Recognition and Impairment* - All of the acquired loans for which (1) there was evidence of credit quality deterioration since origination and (2) for which it was deemed probable that the Company would be unable to collect all contractually required principal and interest payments were accounted under Accounting Standards Codification (ASC) Topic 310-30, *Loans and Debt Securities*

*Acquired with Deteriorated Credit Quality*, (ASC 310-30). For loans accounted for under ASC 310-30, management determined upon acquisition the loan's value based on due diligence on each of the loans, the underlying properties, and the borrowers. The Company determined fair value by discounting the cash flows expected to be collected adjusted for factors that a market participant would consider when determining fair value. Factors considered in the valuation were projected cash flows for the loans, type of loan and related collateral, and current discount rates.

Under ASC 310-30, loans were pooled together according to common risk characteristics. A pool is then accounted for as a single asset with a single component interest rate and an aggregate expectation of cash flows. The excess of the cash flows expected to be collected from the loans receivable at acquisition over the initial investment for those loans receivable is referred to as the accretable yield and is recognized as interest income over the expected life of the pools primarily using the effective yield method. The difference between contractually required payments at acquisition and the cash flows expected to be collected is referred to as the nonaccretable difference. This difference is neither accreted into income nor recorded on the Company's consolidated balance sheets. Changes in the expected cash flows of loans receivable from the date of acquisition will either impact the accretable yield or result in a charge to the provision for loan losses in the period in which the changes become probable. Prepayments are treated as a reduction of cash flows expected to be collected and a reduction of contractually required payments such that the nonaccretable difference is not affected. Subsequent significant decreases to the expected cash flows will generally result in a charge to the provision for loan losses, resulting in an increase to the allowance for loan losses, and a reclassification from accretable yield to nonaccretable difference. Subsequent probable and significant increases in cash flows will result in a recovery of any previously recorded allowance for loan losses, to the extent applicable, and a reclassification from nonaccretable difference to accretable yield. Amounts related to the ASC 310-30 loans are estimates and may change as the Company obtains additional information related to the respective loans and the inherent uncertainty associated with estimating the amount and timing of the expected cash flows associated with distressed residential and commercial real estate loans. The timing and amount of expected cash flows and related accretable yield can also be impacted by disposal of loans, loan payoffs or expected foreclosures, which result in removal of the loans from the pools. Since the cash flows are based on projections, they are subjective and can change due to unexpected changes in economic conditions and loan performance.

*Nonaccrual Loans - Revenue Recognition and Impairment* - For loans in which forecasted principal and interest could not be reasonably estimated at the loan acquisition date, management classified these loans as nonaccrual and accounts for these assets in accordance with ASC 310-10, *Receivables*, (ASC 310-10). When a loan is classified as nonaccrual, any subsequent cash receipt is accounted for using the cost recovery method. In accordance with ASC 310-10, a loan is considered impaired when based on current information and events it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. A provision for loan losses is recognized when the recorded investment in the loan is in excess of its fair value. The fair value of the loan is determined by using either the present value of expected future cash flows discounted at the loan's effective interest rate, the loans obtainable market price, or the fair value of the collateral less estimated costs to sell.

*Loans Held-for-sale and Derivative Instruments* – The originated commercial mortgage loans are classified as Loans held-for-sale on the consolidated balance sheet and are recorded at fair value. The Company elected the fair value option for its loans held-for-sale in accordance with ASC Topic 825, *Financial Instruments*, which permits entities to measure various financial instruments and certain other items at fair value on a contract-by-contract basis. Management believes that carrying loans held-for-sale at fair value improves financial reporting by mitigating volatility in reported earnings caused by measuring the fair value of the loans and the derivative instruments used to economically hedge them without having to apply complex hedge accounting provisions. Changes in fair values of the loans and the derivative instruments are reflected in gains from securitizations and other in the accompanying consolidated statements of operations. Interest income on these loans is calculated based on the interest rate of the loan and is recorded within revenue as Interest income in the accompanying consolidated statements of operations. Substantially all of the mortgage loans originated are sold within a short period of time in a securitization on a servicing released, non-recourse basis; although, the Company remains liable for certain limited industry-standard representations and warranties related to loan sales. The Company recognizes gains on the sale of loans into securitizations trusts when control of the loans has been relinquished. As of November 30, 2013, the Company had $109.3 million in originated loans that were transferred to receivables, net in the accompanying 2013 consolidated balance sheet as they had been sold into a securitization trust but not yet closed.

In the normal course of business, the Company uses derivative financial instruments on these loans during the period from when the Company has originated the loan until the time in which the loan is sold. These derivatives, which are carried at fair value, are used for risk management purposes to reduce its exposure to fluctuations in mortgage-related interest rates as well as lessen its credit risk. The Company hedges its interest rate exposure through entering into interest rate swap futures and as of November 30, 2013 had fair values of approximately $31,000 in a loss position as of November 30, 2013. Credit exposure is managed at a portfolio level through entering into credit default swaps consisting of both single "A", "AAA" and "BBB" rated CMBX swaps as well as CDX swaps, and as of November 30, 2013, had a fair value of $0.8 million in contracts in a gain position and $0.3 million in a loss position. The Company does not enter into or hold derivatives for trading or speculative purposes (see Note 12). Derivative instruments in gain positions are recorded in Other assets-net in the consolidated balance sheets (see Note 9), while derivative instruments in loss positions are recorded within Accrued expenses and other liabilities in the consolidated balance sheets.

*Deficiency Interest Income* - Deficiency recoveries from foreclosed loans is a component of the Company's operations. Upon receipt of consideration from a deficiency settlement, the Company determines the fair value of the net assets received and records interest income. During the years ended November 30, 2013, 2012 and 2011, the Company recorded $15.8 million, $20.1 million and $22.6 million, respectively, in deficiency interest income.

*Variable Interest Entities* - In 2010, the Company acquired indirectly 40% managing member equity interests in two limited liability companies ("LLCs"), in partnership with the FDIC. The Company determined that each of the LLCs met the definition of a VIE and that the Company was the primary beneficiary. In accordance with ASC 810-10-65-2, *Consolidations*, ("ASC 810-10-65-2"), the Company identified the activities that most significantly impact the LLCs' economic performance and determined that it has the power to direct those activities. The economic performance of the LLCs is most significantly impacted by the performance of the LLCs' portfolios of assets, which consisted primarily of distressed residential and commercial mortgage loans. Thus, the activities that most significantly impact the LLCs' economic performance are the servicing and disposition of mortgage loans and real estate obtained through foreclosure of loans, restructuring of loans, or other planned activities associated with the monetizing of loans.

The FDIC does not have the unilateral power to terminate the Company's role in managing the LLCs and servicing the loan portfolio. While the FDIC has the right to prevent certain types of transactions (i.e., bulk sales, selling assets with recourse back to the selling entity, selling assets with representations and warranties and financing the sales of assets without the FDIC's approval), the FDIC does not have full voting or blocking rights over the LLCs' activities, making their voting rights protective in nature, not substantive participating voting rights. Other than as described in the preceding sentence, which are not the primary activities of the LLCs, the Company can cause the LLCs to enter into both the disposition and restructuring of loans without any involvement of the FDIC. Additionally, the FDIC has no voting rights with regard to the operation/management of the operating properties that are acquired upon foreclosure of loans (e.g. REO) and no voting rights over the business plans of the LLCs. The FDIC can make suggestions regarding the business plans, but the Company can decide not to follow the FDIC's suggestions and not to incorporate them in the business plans. Since the FDIC's voting rights are protective in nature and not substantive participating voting rights, the Company has the power to direct the activities that most significantly impact the LLCs' economic performance.

In accordance with ASC 810-10-65-2, the Company determined that it had an obligation to absorb losses of the LLCs that could potentially be significant to the LLCs or the right to receive benefits from the LLCs that could potentially be significant to the LLCs based on the following factors:

- Rialto/Lennar owns 40% of the equity of the LLCs and has the power to direct the activities of the LLCs that most significantly impact their economic performance through loan resolutions and the sale of REO.
- Rialto/Lennar has a management/servicer contract under which the Company earns a 0.5% servicing fee.
- Rialto/Lennar has guaranteed, as the servicer, its obligations under the servicing agreement up to $10 million.

The Company is aware that the FDIC, as the owner of 60% of the equity of each of the LLCs, may also have an obligation to absorb losses of the LLCs that could potentially be significant to the LLCs. However, in accordance with ASC Topic 810-10-25-38A, only one enterprise, if any, is expected to be identified as the primary beneficiary of a VIE.

Since both criteria for consolidation in ASC 810-10-65-2 are met, the Company consolidated the LLCs.

During 2011, the Company acquired an equity interest in several joint ventures as part of a deficiency settlement. Management determined that each of the joint ventures met the definition of a VIE. In accordance with ASC 810-10-65-2, *Consolidations*, (ASC 810-10-65-2), management identified the activities that most significantly impact the joint ventures' economic performance and determined whether it has the power to direct those activities in the joint venture. The activities that most significantly impact the joint ventures' economic performance is the servicing and maintenance of the entity's underlying asset, which consists of commercial real estate. Although the Company has no obligation to provide financial support to any of its VIE's and has only its equity investment at risk, the Company has determined it has the right to direct the activities and to potentially receive significant benefits from one of the joint venture entities due to its majority ownership and equity position in the entity. Since both criteria for consolidation in ASC 810-10-65-2 are met, the Company has consolidated the joint venture in its financial statements.

*Real Estate Owned* - Real estate owned (REO) represents real estate which the Company has taken control or has effective control of in partial or full satisfaction of loans receivable. At the time of acquisition through foreclosure of a loan, REO is recorded at fair value less estimated costs to sell if classified as held for sale and at fair value if classified as held and used, which becomes the property's new basis. The fair values of these assets are determined in part by placing reliance on third-party appraisals of the properties and/or internally prepared analysis of recent offers or prices on comparable properties in the proximate vicinity. The third-party appraisals and internally developed analysis are significantly impacted by local market economy, market supply and demand, competitive conditions, and prices on comparable properties, adjusted for date of sale, location, property size, and other factors. Each REO is unique and is analyzed in the context of the particular market where the property is located. In order to establish the significant assumptions for a particular REO, the Company analyzes historical and current trends in the market and economy impacting the REO. Using available trend information, the Company then calculates its best estimate of fair value, which can include projected cash flows discounted at a rate that management believes a market participant would determine to be commensurate with the inherent risks associated with the assets and related estimated cash flow streams.

Changes in economic factors, consumer demand, and market conditions, among other things, could materially impact estimates used in the third-party appraisals and/or internally prepared analysis of recent offers or prices on comparable properties. Thus, estimates can differ significantly from the amounts ultimately realized by the Company from disposition of these assets. The amount by which the recorded investment in the loan is less than the REO's value (net of estimated cost to sell if held for sale), is recorded as a gain on foreclosure within REO expense in the accompanying consolidated statements of operations. The amount by which the recorded investment in the loan is greater than the REO's fair value (net of estimated cost to sell if held for sale), is initially recorded as impairment within REO expense in the accompanying consolidated statement of operations.

Subsequent to obtaining REO via foreclosure or directly from a financial institution, management periodically performs valuations using the methodologies described above such that the real estate is carried at the lower of its carrying value or current fair value, less estimated costs to sell if classified as held for sale. Held and used assets are tested for recoverability whenever changes in circumstances indicate that its carrying value may not be recoverable, and impairment losses are recorded for any amount by which the carrying value exceeds its fair value. Any subsequent impairment losses, operating expenses or income, and gains and losses on disposition of such properties are also recognized in income. REO assets classified as held and used are depreciated using a useful life of 40 years for commercial properties and 27 1/2 years for residential properties. REO assets classified as held for sale are not depreciated. Occasionally an asset will require certain improvements to yield a higher return. In accordance with ASC 970-340-25, *Real Estate*, construction costs incurred prior to acquisition or during development of the asset are capitalized.

*Operating Equipment* – Operating equipment is recorded at cost and are included in other assets in the consolidated balance sheets. The assets are depreciated over their estimated useful lives using the straight-line method. At the time operating properties and equipment are disposed of, the asset and related accumulated depreciation are removed from the accounts and any resulting gain or loss is credited or charged to earnings. The estimated useful life for equipment is two to ten years and for leasehold improvements is five years or the life of the lease, whichever is shorter.

*Management Fees Revenue* - The Company provides services to a variety of legal entities and investment vehicles such as funds, joint ventures, co-investment partnerships, and other private equity structures to manage their respective investments. As a result, the Company earns and receives investment management fees, underwriting fees and due diligence fees. These fees are recorded over the period in which the services are performed, fees are determinable and collectability is reasonably assured. The Company receives investment management fees from investment vehicles based on 1) a percentage of committed or called capital during the commitment period called capital after the commitment period ends, 2) a percentage of invested capital less the portion of such invested capital utilized to acquire investments that have been sold (in whole or in part) or liquidated. Fees earned for underwriting and due diligence services are based on actual costs incurred.

In certain situations, the Company may earn additional fees when the return on assets managed exceeds contractual thresholds (i.e., carried interest). Such revenue is only booked when substantially all of the contract terms are met, the contract is at or near completion and the amounts are known and collectability is reasonably assured. Since such revenue is recognized at the end of the life of the investment vehicle, after substantially all of the assets have been sold and investment gains and losses realized, the possibility of claw back provisions is limited.

*Debt Issuance Costs* - Certain issuance costs were incurred for the financing of the FDIC notes payable ("Notes"). These costs were approximately 3% of the principal balance of the Notes and any unamortized balance was written-off during 2013 as a result of the repayment of the Notes (see Note 10). Additionally, certain issuance costs were incurred for the financing of the 7.00% Senior Notes. These costs were approximately 2% of the principal balance of the 7.00% Senior Notes. The Company also secured two warehouse repurchase facility ("Facilities") agreements and incurred $2.5 million of fees associated with the Facilities. Such costs associated with the Notes and the Facilities were deferred and are amortized to interest expense over the expected term of the underlying debt using the straight-line method, which approximates the effective-interest method. These costs are reflected as other assets, net in the accompanying consolidated balance sheets.

*Income Tax* - The Company records income taxes under the asset and liability method, whereby deferred tax assets and liabilities are recognized based on the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and attributable to operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply in the years in which the temporary differences are expected to be recovered or paid. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in earnings in the period when the changes are enacted. Interest related to unrecognized tax benefits is recognized as a component of provision for income taxes in the accompanying consolidated statements of operations.

A reduction of the carrying amounts of deferred tax assets by a valuation allowance is required if, based on the available evidence, it is more likely than not that such assets will not be realized. Accordingly, the need to establish valuation allowances for deferred tax assets is assessed each reporting period by the Company based on the more-likely-than-not realization threshold criterion. In the assessment for a valuation allowance, appropriate consideration is given to all positive and negative evidence related to the realization of the deferred tax assets. This assessment considers, among other matters, the nature, frequency and severity of current and cumulative losses, forecasts of future profitability, the duration of statutory carryforward periods, the Company's experience with loss carryforwards not expiring unused and tax planning alternatives.

*Concentration of Risk* - The Company's success depends to a certain extent on the general economic conditions of the geographic markets of the Company's acquired loans and foreclosed assets. At November 30, 2013, assets held by the Company were primarily concentrated in the states of Georgia, Florida, Arizona, North Carolina, Nevada, and South Carolina. Adverse changes in the economic conditions of these geographical areas may have a significant impact on the Company's commercial and residential real estate loans, the ability of borrowers to repay these loans, and the value of the collateral securing these loans. The aforementioned may have a negative effect on the Company's business, financial condition, and results of operations. A significant portion of the Company's management fee revenue is derived from investment funds that the Company sponsors and manages. For the years ended November 30, 2013, 2012 and 2011, respectively, 94%, 67% and 79% of the Company's management fee revenue was earned from investment funds that the Company sponsored and managed.

*Recent Accounting Pronouncements* –In June 2011, the Financial Accounting Standards Board ("FASB") issued ASU 2011-05, *Presentation of Comprehensive Income,* ("ASU 2011-05"). ASU 2011-05 requires the presentation of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. ASU 2011-05 was effective for the Company's fiscal year beginning December 1, 2012. The adoption of ASU 2011-05 did not have a material effect on the Company's consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities,* ("ASU 2011-11"), which requires entities to disclose information about offsetting and related arrangements of financial instruments and derivative instruments. In January 2013, this guidance was amended by ASU 2013-01, *Clarifying the Scope of Disclosures about Offsetting assets and Liabilities* ("ASU 2013-01"). ASU 2013-01 limits the scope of ASU 2011-11 to certain derivatives, repurchase and reverse repurchase agreements, and securities borrowing and lending transactions. The guidance is effective for the Company's fiscal year beginning December 1, 2013 and subsequent interim periods. The adoption of this guidance, which is related to disclosure only, is not expected to have a material effect on the Company's consolidated financial statements.

In April 2013, the FASB issued ASU 2013-04, *Liabilities,* ("ASU 2013-04"). ASU 2013-04 provides guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date. ASU 2013-04 will be effective for the Company's fiscal year beginning December 1, 2014 and subsequent interim periods. The adoption of ASU 2013-04 is not expected to have a material effect on the Company's consolidated financial statements.

In July 2013, the FASB issued ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a similar Tax Loss, or a Tax Credit Carryforward Exists,* ("ASU 2013-11"). ASU 2013-13 is intended to end inconsistent practices regarding the presentation of an unrecognized tax benefits when a net operating loss ("NOL"), a similar tax loss or a tax credit carryforward is available to reduce the taxable income or tax payable that would result from the disallowance of a tax position. ASU 2013-11 will be effective for the Company's fiscal year beginning December 1, 2014 and subsequent interim periods. The adoption of ASU 2013-11 is not expected to have a material effect on the Company's consolidated financial statements.

## 3. DEFEASANCE CASH TO RETIRE NOTES PAYABLE

The Company had established defeasance accounts for the benefit of the FDIC. Funds were deposited into the defeasance accounts, pursuant to a priority of payments (which first required loan proceeds to be used for various fees, expenses, and working capital prior to any excess being deposited in the defeasance accounts), until the amount of the funds held in the defeasance accounts is equal to the sum of the outstanding principal balances of the Notes. No funds from any other source could commingle in the defeasance accounts. The Company could not prepay all or any portion of the Notes without the prior written consent of the FDIC. During the years ended November 30, 2013 and 2012, the LLCs retired $470.0 million and $156.9 million, respectively, of principal amount of the notes payable under the agreement with the FDIC through the defeasance account. The defeasance cash balance as of November 30, 2012, was $223.8 million. As a result of the repayment of the Notes during 2013, the defeasance accounts were closed.

## 4. LOANS RECEIVABLE AND ACCRETABLE YIELD

The following table displays the loan portfolio by aggregate-level collateral-type classifications at November 30, 2013 and 2012 (in thousands):

| | 2013 | 2012 |
|---|---|---|
| Land | $ 166,950 | $ 216,095 |
| Single family homes | 59,647 | 93,207 |
| Commercial properties | 38,060 | 96,226 |
| Multifamily homes | - | 12,776 |
| Other | 13,735 | 18,231 |
| Loans receivable, net | $ 278,392 | $ 436,535 |

With regard to loans accounted for under ASC 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality,* ("ASC 310-30"), the Company estimated the cash flows, at acquisition, it expected to collect on the FDIC Portfolios and Bank Portfolios. In accordance with ASC 310-30, the difference between the contractually required payments and the cash flows expected to be collected at acquisition is referred to as the nonaccretable difference. This difference is neither accreted into income nor recorded on the Company's condensed consolidated balance sheets. The excess of cash flows expected to be collected over the cost of the loans acquired is referred to as the accretable yield and is recognized in interest income over the remaining life of the loans using the effective yield method.

The Company periodically evaluates its estimate of cash flows expected to be collected on its FDIC Portfolios and Bank Portfolios. These evaluations require the continued use of key assumptions and estimates, similar to those used in the initial estimate of fair value of the loans to allocate purchase price. Subsequent changes in the estimated cash flows expected to be collected may result in changes in the accretable yield and nonaccretable difference or reclassifications from nonaccretable yield to accretable yield. Increases in the cash flows expected to be collected will generally result in an increase in interest income over the remaining life of the loan or pool of loans. Decreases in expected cash flows due to further credit deterioration will generally result in an impairment charge recognized as a provision for loan losses, resulting in an increase to the allowance for loan losses.

The outstanding contractual payments and cash flows expected to be collected on the date of acquisition were $4.2 billion and $2.0 billion, respectively.

As of November 30, 2013 and 2012, the outstanding balance and carrying value of loans accounted for under ASC 310-30 was as follows (in thousands):

| | 2013 | 2012 |
|---|---|---|
| Outstanding principal balance | $ 586,901 | $ 812,187 |
| Carrying value | $ 270,075 | $ 396,200 |

The activity in the accretable yield for the FDIC Portfolios and Bank Portfolios during the years ended November 30, 2013 and 2012 were as follows (in thousands):

| | 2013 | 2012 |
|---|---|---|
| Beginning balance | $ 112,899 | $ 209,480 |
| Net additions | 70,077 | 65,151 |
| Accretions | (60,582) | (73,399) |
| Deletions | (49,250) | (88,333) |
| Ending balance | $ 73,144 | $ 112,899 |

Additions primarily represent reclasses from nonaccretable yield to accretable yield on the portfolios. Deletions represent loan impairments and disposal of loans, which includes foreclosure of underlying collateral and result in the removal of the loans from the accretable yield portfolios. As the Company continues to obtain additional information related to the expected cash flows on the acquired loans, the accretable yield may change. Therefore, the amounts of accretable income recorded for the year ended November 30, 2013, are not necessarily indicative of the results to be expected in the future.

## 5. ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is a valuation reserve established through provisions for loan losses charged against income. The allowance for loan losses is maintained at a level that management deems sufficient to absorb probable losses inherent in the loan portfolio. Loans deemed to be uncollectible are charged against the allowance for loan losses, while recoveries of previously charged-off amounts are credited to the allowance for loan losses.

The following table shows the activity related to allowance for loan losses for the years ended November 30, 2013 and 2012 (in thousands):

| | 2013 | | | 2012 | | |
|---|---|---|---|---|---|---|
| | Accrual | Nonaccrual | Total | Accrual | Nonaccrual | Total |
| Beginning balance | $ 12,178 | $ 3,722 | $ 15,900 | $ - | $ 801 | $ 801 |
| Provision for loan losses | 14,241 | 1,898 | 16,139 | 18,650 | 9,316 | 27,966 |
| Charge-offs | (7,467) | (4,407) | (11,874) | (6,472) | (6,395) | (12,867) |
| Ending balance | $ 18,952 | $ 1,213 | $ 20,165 | $ 12,178 | $ 3,722 | $ 15,900 |

At November 30, 2013 and 2012, the carrying value of loans accounted for under ASC 310-30 totaled approximately $270.1 million and $396.2 million, respectively, and was assessed for impairment at the pool level. The Company's homogeneous pools are comprised of loans with similar characteristics such as loan type and the geographical location of the underlying collateral. At November 30, 2013 and 2012, the Company had approximately $19.0 million and $12.2 million, respectively, of allowance for loan losses against loans of this type.

At November 30, 2013 and 2012, there were loans receivable with a carrying value of approximately $8.3 million and $40.3 million, respectively, which are considered impaired under ASC 310-10, and for which interest income was not being recognized as they were classified as nonaccrual. At November 30, 2013 and 2012, the Company had approximately $1.2 million and $3.7 million, respectively, of allowance for loan losses against the nonaccrual loans.

When forecasted principal and interest cannot be reasonably estimated at the loan acquisition date, management classifies the loan as nonaccrual and accounts for these assets in accordance with ASC 310-10, *Receivables* ("ASC 310-10"). When a loan is classified as nonaccrual, any subsequent cash receipt is accounted for using the cost recovery method. In accordance with ASC 310-10, a loan is considered impaired when based on current information and events it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. Although these loans met the definition of ASC 310-10, these loans were not considered impaired relative to the Company's recorded investment at the time of acquisition since they were acquired at a substantial discount to their unpaid principal balance. A provision for loan losses is recognized when the recorded investment in the loan is in excess of its fair value. The fair value of the loan is determined by using either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral less estimated costs to sell.

The following tables represent nonaccrual loans in the FDIC Portfolios and Bank Portfolios accounted for under ASC 310-10 aggregated by collateral type at November 30, 2013 and 2012 (in thousands):

| | 2013 | | | |
|---|---|---|---|---|
| | Unpaid | Recorded Investment | | Total |
| **Collateral Type** | **Principal Balance** | **With Allowance** | **Without Allowance** | **Recorded Investment** |
| Land | $ 6,791 | $ 249 | $ 2,304 | $ 2,553 |
| Single family homes | 15,125 | 519 | 4,119 | 4,638 |
| Commercial properties | 3,400 | 498 | 628 | 1,126 |
| Total | $ 25,316 | $ 1,266 | $ 7,051 | $ 8,317 |

| | 2012 | | | |
|---|---|---|---|---|
| | Unpaid | Recorded Investment | | Total |
| **Collateral Type** | **Principal Balance** | **With Allowance** | **Without Allowance** | **Recorded Investment** |
| Land | $ 23,163 | $ 4,983 | $ 2,844 | $ 7,827 |
| Single family homes | 18,966 | 8,311 | 2,244 | 10,555 |
| Commercial properties | 35,996 | 1,006 | 20,947 | 21,953 |
| Total | $ 78,125 | $ 14,300 | $ 26,035 | $ 40,335 |

The average recorded investment in impaired loans totaled approximately $24 million and $57 million, respectively, for the years ended November 30, 2013 and 2012.

The loans receivable portfolios consist of loans acquired at a discount. Based on the nature of these loans, the portfolios are managed by assessing the risks related to the likelihood of collection of payments from borrowers and guarantors, as well as monitoring the value of the underlying collateral. The following are the risk categories for the loans receivable portfolios:

*Accrual* - Loans in which forecasted cash flows under the loan agreement, as it might be modified from time to time, can be reasonably estimated at the date of acquisition. The risk associated with loans in this category relates to the possible default by the borrower with respect to principal and interest payments and thus a decline in the forecasted cash flows used to determine accretable yield income and the recognition of impairment through an allowance for loan losses.

*Nonaccrual* - Loans in which forecasted principal and interest could not be reasonably estimated at the date of acquisition. Although the Company believes the recorded investment balance will ultimately be realized, the risk of nonaccrual loans relates to a decline in the value of the collateral securing the outstanding obligation and the recognition of impairment through an allowance for loan losses if the recorded investment in the loan exceeds the fair value of the collateral.

Risk categories net of allowance for loan losses at November 30, 2013 and 2012 (in thousands):

| | 2013 | | |
|---|---|---|---|
| **Collateral Type** | **Accrual** | **Nonaccrual** | **Total** |
| Land | $ 164,397 | $ 2,553 | $ 166,950 |
| Single family homes | 55,009 | 4,638 | 59,647 |
| Commercial properties | 36,934 | 1,126 | 38,060 |
| Multifamily homes | - | - | - |
| Other | 13,735 | - | 13,735 |
| Total | $ 270,075 | $ 8,317 | $ 278,392 |

| | 2012 | | |
|---|---|---|---|
| **Collateral Type** | **Accrual** | **Nonaccrual** | **Total** |
| Land | $ 208,268 | $ 7,827 | $ 216,095 |
| Single family homes | 82,652 | 10,555 | 93,207 |
| Commercial properties | 74,273 | 21,953 | 96,226 |
| Multifamily homes | 12,776 | - | 12,776 |
| Other | 18,231 | - | 18,231 |
| Total | $ 396,200 | $ 40,335 | $ 436,535 |

In order to assess the risk associated with each risk category, the Company evaluates the forecasted cash flows and the value of the underlying collateral securing loans receivable on a quarterly basis or when an event occurs that suggests a decline in the assets' fair value.

## 6. REAL ESTATE OWNED

The acquisition of properties acquired through, or in lieu of, loan foreclosure are reported within the consolidated balance sheets as REO held-and-used, net and REO held-for-sale. When a property is determined to be held-and-used, net, the asset is recorded at fair value and depreciated over its useful life using the straight line method. When certain criteria set forth in ASC 360, *Property, Plant and Equipment*, are met; the property is classified as held-for-sale. When a real estate asset is classified as held-for-sale, the property is recorded at the lower of its cost basis or fair value less estimated costs to sell. The fair value of REO held-for-sale are determined in part by placing reliance on third party appraisals of the properties and/or internally prepared analyses of recent offers or prices on comparable properties in the proximate vicinity.

Upon the acquisition of REO through loan foreclosure, gains and losses are recorded in REO expense in the accompanying consolidated statements of operations. The amount by which the recorded investment in the loan is less than the REO's fair value (net of estimated cost to sell if held-for-sale), is recorded as an unrealized gain upon foreclosure. The amount by which the recorded investment in the loan is greater than the REO's fair value (net of estimated cost to sell if held-for-sale) is recorded as a provision for loan losses for nonaccrual loans and as an unrealized loss within REO expense, net for accrual loans.

At times, the Company may foreclose on a loan from an accrual loan pool in which the removal of the loan does not cause an overall decrease in the expected cash flows of the loan pool, and as such, no provision for loan losses is required to be recorded. However, the amount by which the recorded investment in the loan is greater than the REO's fair value (net of estimated cost to sell if held-for-sale) is recorded as an unrealized loss upon foreclosure.

Included in real estate owned held-and-used, net is real estate acquired in a bargain purchase acquisition of $31.8 million (see Note 7).

The following tables present the activity in REO for the years ended November 30, 2013 and 2012 (in thousands):

| | 2013 | 2012 |
|---|---|---|
| REO held-for-sale, beginning balance | $ 134,161 | $ 143,677 |
| Additions | 15,985 | 9,987 |
| Improvements | 5,791 | 9,605 |
| Sales | (190,430) | (161,253) |
| Impairments | (5,573) | (2,579) |
| Transfers to Parent | (9,480) | (11,335) |
| Transfer from held-and-used, net [1] | 247,397 | 146,059 |
| REO held-for-sale, ending balance | $ 197,851 | $ 134,161 |

| | 2013 | 2012 |
|---|---|---|
| REO held-and-used, net,beginning balance | $ 601,022 | $ 582,111 |
| Additions | 86,262 | 175,114 |
| Improvements | 3,616 | 4,340 |
| Sales | - | (981) |
| Impairments | (10,517) | (6,703) |
| Depreciation | (3,997) | (6,800) |
| Transfer to held-for-sale [1] | (247,397) | (146,059) |
| REO held-and used, net,ending balance | $ 428,989 | $ 601,022 |

(1) During the years ended November 30, 2013 and 2012, the Company transferred certain properties to/from REO held-and-used, net to/from REO held-for-sale as a result of changes in the disposition strategy of the real estate assets.

For the years ended November 30, 2013, 2012 and 2011, the Company recorded $48.8 million, $21.6 and $6.0 million, respectively, of net gains from sales of REO. For the years ended November 30, 2013, 2012 and 2011, the Company recorded $(0.4) million, $(1.9) million and $78.9 million, respectively, of net (losses) gains from acquisitions of REO through foreclosure. In addition, during the year ended November 30, 2013, the Company recorded a provisional gain of $8.5 million related to a bargain purchase acquisition which included cash and a loan receivable as consideration (see Note 7). These gains (losses) are recorded in REO expense (income), net, in the consolidated statements of operations.

## 7. BARGAIN PURCHASE ACQUISITION

In November 2013, in settlement of a loan acquired in the Company's Bank Portfolios, the Company acquired the real estate and operating entity of a hospital (the "Hospital"). This transaction was the result of a Chapter 11 reorganization plan approved on November 7, 2013. The first part of the reorganization plan required Rialto to make a $10 million cash investment that will be used to improve the hospital and emergency room facilities, provide for working capital requirements and begin to repay secured and unsecured court approved claims per the reorganization plan. The Hospital guaranteed the payment of bankruptcy administrative claims of approximately $17.5 million owed to three groups of secured and unsecured creditors. As of November 30, 2013, approximately $6 million of these payments were made, with $4 million remaining. In return, the Company acquired 100% of the Hospital operating entity effective November 8, 2013. The Hospital is a fully consolidated entity as of November 30, 2013, and the operating results are included from the date of acquisition as other revenue and expenses in the Consolidated Statement of Operations for the year ended November 30, 2013.

The Company has contracted a third party hospital operating company to operate and manage the hospital (the "Third Party Operator") at a discount to their normal management fee in return for gradually acquiring an equity participation in the hospital operating company. Additionally, the reorganization plan awarded a 20% interest in the entity owning the Hospital building to three doctors who practiced at the hospital. However this noncontrolling interest will not be distributed to the doctors until certain conditions are met that satisfy both State and Federal regulatory requirements. Rialto has the right to withhold the distribution of this noncontrolling interest until such requirements are satisfied.

Starting in 2014, each of the three secured creditor groups will receive payments of one-third of 75% of the Hospital's net income plus 50% of the earned management fees withheld from Third Party Operator towards their claims, some of which bear interest of 3% to 5%. In addition, all excess operating cash flow beyond the scheduled payments to secured creditors shall be used to accelerate payment in full of all of these claims. Neither Rialto nor the Third Party Operator shall receive any distribution from operations other than the reduced management fee and payments until all three groups of secured creditors have been paid in full, which management believes can occur within 2 to 3 years.

As a result of this transaction, the Company recorded a provisional gain on acquisition of $8.5 million, primarily consisting of the difference between the carrying value of the Hospital real estate collateral acquired and the carrying value of the loan receivable, recorded in REO expense (income), net in the consolidated statements of operations (see Note 11).

The following table outlines the assets and liabilities of the acquired entity, net at November 7, 2013 (in thousands):

| | | 2013 |
|---|---|---|
| **Assets acquired** | | |
| Real estate owned - held-and-used, net | $ | 31,818 |
| Operating equipment | | 9,412 |
| Other assets | | 3,792 |
| **Assets acquired** | $ | 45,022 |
| | | |
| **Liabilties assumed** | | |
| Accounts payable and accruals and other liabilities | $ | 4,521 |
| Notes payable | | 12,641 |
| Noncontrolling interest | | 2,242 |
| **Liabilities assumed** | $ | 19,404 |
| | | |
| **Net Assets Acquired** | $ | 25,618 |

The Company is in the process of finalizing the purchase price allocations, including valuations of the acquired property and equipment; therefore, the purchase price allocations are subject to adjustment once the valuations are completed.

## 8. INVESTMENTS

### Investments Held-to-Maturity

*Commercial Mortgage Backed Securities* - A $43 million of non-investment grade CMBS was acquired in 2010 for $19.4 million, representing a 55% discount to par value. These securities bear interest at a coupon rate of 4% and have a stated and assumed final distribution date of November 2020 and a stated maturity date of October 2057. The Company reviews changes in estimated cash flows periodically, to determine if other-than-temporary impairment has occurred on its investment securities. Based on the Company's assessment, no impairment charges were recorded during the years ended November 30, 2013, 2012 and 2011. The carrying value of the investment securities at November 30, 2013 and 2012 was $16.1 million and $15.0 million, respectively. The fair value of the investment securities at November 30, 2013 and 2012 was $16.0 million and $14.9 million, respectively. The Company classified these securities as held-to-maturity based on its intent and ability to hold the securities until maturity.

In a CMBS transaction, monthly interest received from all of the pooled loans is paid to the investors, starting with those investors holding the highest rated bonds and progressing in an order of seniority based on the class of security. Based on the aforementioned, the principal and interest repayments of a particular class are dependent upon collections on the underlying mortgages, which are affected by prepayments, extensions and defaults.

### Investments in Unconsolidated Entities

*Investment Funds* - In 2010, the Company completed its first closing of Fund I. Fund I's objective was to invest in distressed real estate assets and other related investments that fit within Fund I's investment parameters. As of November 30, 2013, the equity commitments of Fund I were $700 million (including $75 million committed and contributed by the Company.) All capital commitments have been called, funded and invested. In addition, approximately $321 million of proceeds from underlying asset activities and financings were recycled and invested. Fund I has been closed to additional commitments. During the year ended November 30, 2013, the Company received distributions of $42.6 million. During the year ended November 30, 2012, the Company contributed $41.7 million of which $13.9 million was distributed back to the Company, as a return of capital contributions due to a securitization within Fund I.

As of November 30, 2013 and 2012, the carrying value of the Company's investment in Fund I was $75.7 million and $98.9 million, respectively. During the years ended November 30, 2013 and 2012, the Company's share of earnings from Fund I was $19.4 million and $21.0 million, respectively. If Fund I had ceased operations and liquidated all its investments for their estimated fair values on November 30, 2013, the Company would have received $80.8 million with regard to the Company's carried interest. However, Fund I did not cease operations and liquidated its investments on November 30, 2013, and the ultimate sum the Company will receive with regard to the Company's carried interest in Fund I may be substantially higher or lower than $80.8 million. No amount has been recorded in the Company's consolidated statement of operations with regard to the Company's carried interest in Fund I. See Note 2, Summary of Significant Accounting Policies in the notes to the consolidated financial statements for more information on how the Company records revenues attributable to carried interests.

In 2013, the Company conducted the first closing of commitments of Fund II. Fund II's objective during its commitment period is to acquire and manage distressed and other value-add real estate assets and other related investments that fit Fund II's investment parameters. Among other things, Fund II's documents prohibit the Company from acquiring real estate assets that might be suitable for Fund II, before Fund II is fully invested or committed. As of November 30, 2013, the equity commitments of Fund II were $1.1 billion, including the $100 million by the Company. Subsequent to November 30, 2013, Fund II was closed to additional commitments, with equity commitments totaling $1.3 billion. During the year ended November 30, 2013, $511.4 million of the $1.1 billion in equity commitments was called, of which, the Company contributed its portion of $50.6 million. As of November 30, 2013, the carrying value of the Company's investment in Fund II was $53.1 million. For the year ended November 30, 2013, the Company's share of earnings from Fund II was $2.5 million.

In 2013, the Company began raising capital and investing in mezzanine commercial real estate loans creating the Mezzanine Fund with a target of $300 million (including $25 million committed by the Company) in raised capital. As of November 30, 2013, the Mezzanine Fund had total equity commitments of $82 million, including $25 million committed by the Company. As of November 30, 2013, capital invested in the Mezzanine Fund was $53.5 million, including $16.4 million invested by the Company. For the year ended November 30, 2013, the Company's share of earning was $0.4 million.

Fund I, Fund II and the Mezzanine Fund are unconsolidated entities and are accounted for under the equity method of accounting. They were determined to have the attributes of an investment company in accordance with ASC Topic 946, *Financial Services - Investment Companies*, the attributes of which are different from the attributes that would cause a company to be an investment company for purposes of the Investment Company Act of 1940. As a result, Fund I, Fund II and the Mezzanine Fund's assets and liabilities are recorded at fair value with increases/decreases in fair value recorded in their respective statement of operations, the Company's share of which will be recorded in equity in earnings from unconsolidated entities in the accompanying consolidated statements of operations. The Company determined that Fund I, Fund II and the Mezzanine Fund are not variable interest entities but rather voting interest entities due to the following factors:

- The Company determined that Rialto's general partner interest and all the limited partners' interests qualify as equity investment at risk.

- Based on the capital structure of Fund I, Fund II and the Mezzanine Fund (100% capitalized via equity contributions), the Company was able to conclude that the equity investment at risk was sufficient to allow Fund I, Fund II and the Mezzanine Fund to finance its activities without additional subordinated financial support.
- The general partner and the limited partners in Fund I, Fund II and the Mezzanine Fund, collectively, have full decision-making ability as they collectively have the power to direct the activities of Fund I, Fund II and the Mezzanine Fund, due to the fact that Rialto, in addition to being a general partner with a substantive equity investment in Fund I, Fund II and the Mezzanine Fund, also provides services to Fund I, Fund II and the Mezzanine Fund under a management agreement and an investment agreement, which are not separable from Rialto's general partnership interest.
- As a result of all these factors, the Company has concluded that the power to direct the activities of Fund I, Fund II and the Mezzanine Fund reside in its general partnership interest and thus with the holders of the equity investment at risk.
- In addition, there are no guaranteed returns provided to the equity investors and the equity contributions are fully subjected to Fund I, Fund II and the Mezzanine Fund's operational results, thus the equity investors absorb the expected negative and positive variability relative to Fund I, Fund II and the Mezzanine Fund.
- Finally, substantially all of the activities of Fund I, Fund II and the Mezzanine Fund are not conducted on behalf of any individual investor or related group that has disproportionately few voting rights (i.e., on behalf of any individual limited partner).

Having concluded that Fund I, Fund II and the Mezzanine Fund are voting interest entities, the Company evaluated the funds under the voting interest entity model to determine whether, as general partner, it has control over Fund I, Fund II and the Mezzanine Fund. The Company determined that it does not control Fund I, Fund II and the Mezzanine Fund as its general partner, because the unaffiliated limited partners have substantial kick-out rights and can remove Rialto as general partner at any time for cause or without cause through a simple majority vote of the limited partners. In addition, there are no significant barriers to the exercise of these rights. As a result of determining that the Company does not control Fund I, Fund II and the Mezzanine Fund under the voting interest entity model, Fund I, Fund II and the Mezzanine Fund are not consolidated in the Company's financial statements.

In addition to the acquisition and management of the FDIC and Bank Portfolios, the Company was a sub-advisor in the AB PPIP fund. The Company, as the sub-advisor, received management fees for sub-advisory services. At the end of 2012, the AB PPIP fund finalized the last sales of the underlying securities in the fund and made substantially all of the final liquidating distributions to the partners, including Lennar. As the Company's role as sub-advisor to the AB PPIP fund has been completed, no further management fees will be received for these services. During the year ended November 30, 2011, the Company contributed $3.7 million and received distributions of $5.7 million. During the year ended November 30, 2012, the Company contributed $1.9 million and received distributions of $87.6 million. Of the distributions received during the year ended November 30, 2012, $83.5 million related to the unwinding of the AB PPIP fund's operations. As of November 30, 2012 and 2011, the Company also earned $9.1 million and $0.8 million, respectively, in fees from its role as sub-advisor to the AB PPIP fund. As of November 30, 2012 and 2011, the carrying value of the Company's investment in the AB PPIP fund was $0.2 million and $65.2 million, respectively.

Additionally, Rialto has approximately a 5% investment in a financial services company that has a business segment that provides service and infrastructure to the residential home loan market (the "Service Provider"), which provides loan servicing support for all of Rialto's owned and managed portfolios and asset management services for Rialto's small balance loan program. As of November 30, 2013 and 2012, the carrying value of the Company's investment in the Service Provider was $8.3 million and $8.4 million, respectively. In January 2014, the Company acquired 100% of the loan servicing business segment of the Service Provider in exchange for the Company's 5% interest mentioned above.

A summary of Rialto's investment in unconsolidated entities as of November 30, 2013 and 2012 is as follows (in thousands):

| | 2013 | 2012 |
|---|---|---|
| Fund I | $ 75,729 | $ 98,892 |
| Fund II | 53,103 | - |
| Mezzanine Fund | 16,724 | - |
| Service Provider | 8,323 | 8,403 |
| AB PPIP | - | 172 |
| Other | 694 | 673 |
| | $ 154,573 | $ 108,140 |

**Summarized Condensed Financial Information**

On a consolidated 100% basis related to Rialto's investments in unconsolidated entities that are accounted for by the equity method was as follows as of and for the years ended November 30, 2013 and 2012 (in thousands):

**Balance Sheets**

| | 2013 | 2012 |
|---|---|---|
| **Assets:** | | |
| Cash and cash equivalents | $ 332,968 | $ 299,172 |
| Loans receivable | 523,249 | 361,286 |
| Real estate owned | 285,565 | 161,964 |
| Investments in real estate partnerships | 149,350 | 72,903 |
| Investment securities | 381,555 | 182,399 |
| Other assets | 191,624 | 199,839 |
| | $ 1,864,311 | $ 1,277,563 |
| **Liabilities and equity:** | | |
| Accounts payable and other liabilities | $ 108,514 | $ 155,928 |
| Notes payable | 398,445 | 120,431 |
| Partner loans | 163,940 | 163,516 |
| Equity | 1,193,412 | 837,688 |
| | $ 1,864,311 | $ 1,277,563 |

**Statements of Operations**

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| Revenues | $ 251,533 | $ 414,027 | $ 470,282 |
| Costs and expenses | 252,563 | 243,483 | 183,326 |
| Other income (expense), net (1) | 187,446 | 713,710 | (614,014) |
| Net earnings of unconsolidated entities | $ 186,416 | $ 884,254 | $ (327,058) |
| Equity in earnings (loss) from unconsolidated entities | $ 22,353 | $ 41,483 | $ (7,914) |

(1) Other income, net for the year ended November 30, 2013, includes Fund I and Fund II's realized and unrealized gains on investments as well as other income from REO. Other income, net for the years ended November 30, 2012 and 2011, includes the AB PPIP Fund's mark-to-market unrealized gains and losses, all of which the Company's portion was a small percentage. For the year ended November 30, 2012, other income (expense) – net, also includes realized gains from the sale of investments in the portfolio underlying the AB PPIP Fund, of which the Company's portion was a small percentage.

## 9. OTHER ASSETS

The Company's other assets consisted of the following at November 30, 2013 and 2012 (in thousands):

| | 2013 | 2012 |
|---|---|---|
| Management fee receivables from related parties | $ 8,200 | $ 8,783 |
| Debt issuance costs - net | 6,910 | 5,326 |
| Operating equipment | 14,959 | 159 |
| Accounts receivable | 7,653 | 4,298 |
| Deposits and other | 5,566 | 4,801 |
| Total other assets | $ 43,288 | $ 23,367 |

## 10. NOTES PAYABLE

The Company's notes payable consisted of the following at November 30, 2013 and 2012 (in thousands):

| | 2013 | 2012 |
|---|---|---|
| Senior Notes | $ 250,000 | $ - |
| Bank Portfolios | 90,933 | 90,933 |
| Warehouse Repurchase Facilities | 76,017 | - |
| Notes payable - other | 24,933 | 13,547 |
| FDIC Financing | - | 470,000 |
| Total notes payable | $ 441,883 | $ 574,480 |

In November 2013, the Company issued $250 million aggregate principal amount of 7.00% senior notes due 2018 (the "7.00% Senior Notes"), at a price of 100% in a private placement. Proceeds from the offering, after payment of expenses, were approximately $245 million. The Company used $100 million of the net proceeds from the sale of the 7.00% Senior Notes and $135 million of working capital to repay sums that were advanced to the Company by Lennar. Interest on the 7.00% Senior Notes is due semi-annually beginning June 1, 2014. At November 30, 2013, the carrying amount of the 7.00% Senior Notes were $250 million.

The 7.00% Senior Notes issued at par will mature on December 1, 2018. The Senior Notes requires the Company to make interest only payments each June 1 and December 1, 2015, the Company may redeem all or a portion of the 7% Senior Notes at the following redemption prices (expressed as a percentage of principal):

| Year | Percentage |
|---|---|
| 2015 | 103.50% |
| 2016 | 101.75% |
| 2017 | 100.00% |

The Company must also pay any accrued and unpaid interest through, but not including, the date of redemption. The Company may redeem some or all of the 7.00% Senior Notes, at any time, before December 1, 2015, at a redemption price equal to 100% of the principal amount, plus a make-whole premium and accrued and unpaid interest. Before December 1, 2015, the Company may redeem up to 35% of the aggregate principal amount of the 7.00% Senior Notes with the proceeds of public offerings of equity at a redemption price equal to 107% of the principal amount of the 7.00% Senior Notes, plus accrued and unpaid interest.

Under the indenture, the Company is subject to certain covenants limiting, amongst other things, the Company's ability to incur indebtedness, to make investments, to make distributions to, or enter into transactions with, Lennar or to create liens subject to certain exceptions and qualifications. The Company is in compliance with all debt covenants as of November 30, 2013.

The 7.00% Senior Notes are Rialto's senior unsecured and unsubordinated obligations, and rank equally with all of Rialto's other unsecured and unsubordinated indebtedness, and are senior to any of Rialto's future indebtedness that is expressly subordinated in right of payment of the 7.00% Senior Notes and junior to any of Rialto's secured indebtedness to the extent of the value of the assets securing that indebtedness. The 7.00% Senior Notes are guaranteed by Rialto and will be guaranteed by other existing and future directly or indirectly 100% owned subsidiaries of Rialto unless such subsidiary is an unrestricted subsidiary. The Company can withdraw the designation of a subsidiary as a guarantor (other than a principal guarantor), if such subsidiary becomes an unrestricted subsidiary, in which case, the subsidiary will cease to guarantee the 7.00% Senior Notes. A 100% owned subsidiary can only become an unrestricted subsidiary if it is a borrower under a warehouse repurchase facility from guaranteeing the 7.00% Senior Notes by any applicable law, regulation or contractual restriction which cannot be removed through commercially reasonable efforts.

Upon a Change of Control Triggering Event, the Company will be required to make an offer to repurchase all the outstanding 7.00% Senior Notes at a price in cash equal to 101% of the principal amount of the 7.00% Senior Notes, plus any accrued and unpaid interest to, but not including, the repurchase date. See further discussion on how the 7.00% Senior Notes affected the Company's relationship with Lennar in Note 15.

During 2013 the Company also secured an additional $75 million revolving credit agreement with Lennar. Under the revolving credit agreement, Lennar will, as requested by the Company and subject to customary lending conditions, make advances to the Company on a revolving basis of up to $75 million. The maturity date will be two years from the date of signing and the Company will pay an interest rate on the advances of LIBOR plus 3.5% for the applicable interest period. The Company is subject to certain customary covenants, including, but not limited to, limitations on fundamental changes, limitations on changes to line of business and transactions with affiliates. The Company may prepay outstanding amounts at any time, without premium or penalty, on 10 business days' prior notice. The Company and Lennar may mutually agree to amend or terminate such credit agreement at any time. At November 30, 2013, no amounts were outstanding under this agreement and no amounts had been borrowed or repaid under this agreement during 2013.

As of November 30, 2013, the Company had a liability of $12.4 million to Lennar under a Tax Reimbursement agreement (see Note 15).

In September 2010, the Company acquired approximately 400 distressed residential and commercial real estate loans (“Bank Portfolios”) and over 300 REO properties from three financial institutions. The Company paid $310 million for the distressed real estate and real estate related assets of which $124 million was financed through a 5-year senior unsecured note provided by one of the selling institutions of which $33.0 million of principal amount was retired in 2012. The Bank Portfolios’ notes payable have an interest rate of the higher of 4.5% or 1 month LIBOR plus 3.75%. As of both November 30, 2013 and 2012, there was $90.9 million outstanding.

In January 2014, the Company amended the maturity date of the Bank Portfolio’s note payable originally due September 30, 2013 to September 30, 2016. Additionally, the Company rescheduled principal payments of $33 million due on both December 15, 2014 and December 15, 2015, with the remaining principal balance to be paid in full on September 30, 2016.

As of November 30, 2013, the Company had secured two warehouse repurchase financing agreements for use in the Company’s loan origination and securitization business that mature in in fiscal year 2015 totaling $500 million to help finance the loans the Company originates. The first facility has a maturity date of August 9, 2015 with an option for a one time, one year extension. The second Facility has a maturity date of October 8, 2015 with an option for a one time, one year extension. These Facilities are in the form of two separate repurchase agreements, and therefore, are secured by a 75% interest in the originated commercial loans financed under the Facilities. These Facilities bear interest at LIBOR plus 2.25% (with a LIBOR floor of 0.25%) and is calculated on the then outstanding principal amount (2.5% at November 30, 2013). The Facilities require the Company to maintain a minimum liquidity, tangible net worth, interest coverage and debt to equity ratios. The Company is in compliance with all debt covenants as of November 30, 2013. The Facilities require immediate repayment of the 75% interest in the secured commercial loans upon the event that such loans are sold in a securitization. For the year ended November 30, 2013, the Company originated loans with a total principal balance of $690.3 million. As of November 30, 2013, the Company sold and closed $537.0 million of these originated loans into three separate securitizations. An additional $109.3 million of these originated loans were sold into a securitization trust but not yet closed as of November 30, 2013, and thus, were included as receivables, net in the accompanying consolidated balance sheet. As of November 30, 2013, the Company had $76.0 million outstanding under the Facilities.

On January 31, 2011, the Company obtained a monetary judgment on an unpaid principal balance of a loan receivable. Effective May 2, 2011, the Company entered into a settlement agreement in consideration for a stay of execution on the monetary judgment and agreed to accept the conveyance of full and partial ownership interests in entities that own numerous real estate assets. The real estate assets are comprised primarily of commercial office buildings. At the time the Company acquired these ownership interests, the underlying assets had a fair value of approximately $20.5 million including the assumption of notes payable totaling approximately $15.1 million which are reflected within Notes payable – other, in the table below. As part of the settlement agreement, the Company also accepted a secured promissory note receivable in the amount of $2.5 million from the obligor which is included in the Company’s consolidated balance sheet within loans receivable, net. The note bears interest at 5% per annum and requires interest only payments of $125,000 over the next five years with the principal amount due on May 30, 2016. The $2.5 million promissory note is secured by a stock pledge and pledge of cash distributions from additional commercial office building assets, of which the obligor is an owner.

See Note 7 for further discussion on the remaining notes payable included in the notes payable – other line item above.

In connection with the acquisition of the FDIC Portfolios, the FDIC provided $626.9 million of financing with 0% interest, which was non-recourse to the Company and the LLCs. Pursuant with ASC Topic 835-30, *Imputed Interest*, interest was not imputed, as the Notes were issued and guaranteed by a governmental agency. The notes were secured by the loans held by the LLCs. Additionally, if the LLCs exceed expectations and meet certain internal rate of return and distribution thresholds, the Company's equity interest in the LLCs could be reduced from 40% down to 30%, with a corresponding increase to the FDIC's equity interest from 60% to 70%. As of November 30, 2013, the notes payable had been fully paid and the remaining cash collected on the loans and REO properties, net of expenses and other items, will be shared 60% / 40% with the FDIC. As of November 30, 2012, the Notes balance was $470.0 million, however, $223.8 million of cash collections on loans in excess of expenses were deposited in a defeasance account, established for the repayment of the Notes, under the agreement with the FDIC. The funds in the defeasance account were used to retire the Notes upon their maturity. In February 25, 2013, the Company paid $302.8 million of the $314.0 million due to the FDIC on the notes payable. The Company and the FDIC entered into a forbearance agreement whereby the FDIC temporarily waived its right to reissue a new purchase money note for the remaining $11.2 million balance of the portion of the notes payable that was due on February 25, 2013 until July 25, 2013. This forbearance did not meet the definition of an extension in the financing agreement and thus, no triggering event was deemed to have occurred. The Company agreed to disburse all available funds in the defeasance account on a monthly basis to the FDIC until the remaining $11.2 million balance of the portion of the Notes that was due on February 25, 2013 was paid in full, but no later than July 25, 2013. In March 2013, the Company paid the remaining balance of the Notes that was due on February 25, 2013 with cash disbursed from the defeasance account. In July 2013, the Company paid off the remaining balance of one of the notes in the amount of $46.0 million, seven months ahead of schedule. In October 2013, the Company paid off the remaining balance on the Note in the amount of $110.0 million. During the years ended November 30, 2013 and 2012, the LLCs retired $470.0 million and $156.9 million, respectively, of principal amount of notes payable under the agreement with the FDIC through the defeasance account. During the year ended November 30, 2013, $46.7 million had been distributed by the LLCs, of which $28.4 million was paid to the FDIC and $18.3 million was paid to the Company.

Notes payable have interest rates ranging from 0.00% to 7.00%, and mature as follows (in thousands):

| Year | Amount |
|---|---|
| 2014 | $ 84,000 |
| 2015 | 38,453 |
| 2016 | 66,995 |
| 2017 | 1,153 |
| 2018 | 251,170 |
| Thereafter | 112 |
| Total notes payable | $ 441,883 |

## 11. REO EXPENSE (INCOME), NET

The Company's REO expense (income), net consisted of the following for the years ended November 30, 2013, 2012 and 2011 (in thousands):

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| Realized gains on the sale of REO | $ (48,785) | $ (21,649) | $ (6,035) |
| Unrealized losses (gains) on loan foreclosure | 427 | 1,878 | (78,936) |
| Provisional gain on bargain purchase acquisition | (8,532) | - | - |
| Impairment on REO | 16,090 | 9,282 | 8,157 |
| REO expenses | 44,354 | 56,745 | 49,531 |
| REO expense (income), net | $ 3,554 | $ 46,256 | $ (27,283) |

## 12. FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

The following table presents the carrying amounts and estimated fair values of financial instruments held by the Company at November 30, 2013 and 2012 (in thousands), respectively, using available market information and what the Company believes to be appropriate valuation methodologies. Considerable judgment is required in interpreting market data to develop the estimates of fair value. The use of different market assumptions and/or estimation methodologies might have a material effect on the estimated fair value amounts. The table excludes cash, restricted cash, defeasance cash to retire notes payable, receivables, net, accounts payable and due to Parent, which had fair values approximating their carrying amounts due to the short maturities and liquidity of these instruments.

| | | 2013 | | 2012 | |
|---|---|---|---|---|---|
| **Assets** | Fair Value Hierarchy | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Loans receivable, net | Level 3 | $ 278,392 | $ 305,810 | $ 436,535 | $ 450,281 |
| Investments held-to-maturity | Level 3 | $ 16,070 | $ 15,952 | $ 15,012 | $ 14,904 |
| **Liabilities** | | | | | |
| Notes payable | Level 2 | $ 365,866 | $ 362,356 | $ 574,480 | $ 568,702 |
| Warehouse repurchase facilities | Level 2 | $ 76,017 | $ 76,017 | $ - | $ - |

The following methods and assumptions are used by the Company in estimating fair value:

*Loans Receivable, net* - The fair value of loans receivable is based on discounted cash flows as of November 30, 2013 and 2012, respectively, or the fair value of the underlying collateral less estimated cost to sell.

*Investments Held-to-Maturity* - The fair value for investments held-to-maturity is based on discounted cash flows.

*Notes Payable* - The fair value of the zero percent notes guaranteed by the FDIC, which was paid off during 2013, was calculated based on a two-year treasury yield as of November 30, 2012, and the fair value of other notes payable was calculated based on discounted cash flows using the Company's weighted average borrowing rate for both 2013 and 2012.

*Warehouse Repurchase Facilities* - The fair value of the warehouse repurchase facilities is assumed to approximate its carrying value because of its short duration and variable interest rates.

*Loans Held-for-Sale* - The fair value of loans held-for-sale is calculated from model-based techniques that use discounted cash flow assumptions and the Company's own estimates of CMBS spreads, market interest rate movements and the underlying loan credit quality. Loan values are calculated by allocating the change in value of an assumed CMBS capital structure to each loan. The value of an assumed CMBS capital structure is calculated, generally, by discounting the cash flows associated with each CMBS class at market interest rates and at the Company's own estimate of CMBS spreads. The Company estimates CMBS spreads by observing the pricing of recent CMBS offerings, secondary CMBS markets, changes in the CMBX index, and general capital and commercial real estate market conditions. Considerations in estimating CMBS spreads include comparing the Company's current loan portfolio with comparable CMBS offerings containing loans with similar duration, credit quality and collateral composition. These methods use unobservable inputs in estimating a discount rate that is used to assign a value to each loan. While the cash payments on the loans are contractual, the discount rate used and assumptions regarding the relative size of each class in the CMBS capital structure can significantly impact the valuation. Therefore, the estimates used could differ materially from the fair value determined when the loans are sold to a securitization trust.

*Interest Rate Swap Futures* – The fair value of interest rate swap futures (derivatives) is based on quoted market prices for identical investments traded in active markets.

*Credit Default Swaps* – The fair value of credit default swaps (derivatives) is based on quoted market prices for similar investments traded in active markets.

**Fair Value Measurements** - Authoritative accounting literature establishes a framework for using fair value to measure assets and liabilities and defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) as opposed to the price that would be paid to acquire the asset or received to assume the liability (an entry price). A fair value measure should reflect the assumptions that market participants would use in pricing the asset or liability, including the assumptions about the risk inherent in a particular valuation technique, the effect of a restriction on the sale or use of an asset, and the risk of nonperformance. Required disclosures include stratification of balance sheet amounts measured at fair value based on inputs the Company uses to derive fair value measurements. These levels include:

- *Level 1* valuations, where the valuation is based on quoted market prices for identical assets or liabilities traded in active markets (which include exchanges and over-the-counter markets with sufficient volume).

- *Level 2* valuations, where the valuation is based on quoted market prices for similar instruments traded in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

- *Level 3* valuations, where the valuation is generated from model-based techniques that use significant assumptions not observable in the market, but observable based on Company-specific data. These unobservable assumptions reflect the Company's own estimates for assumptions that market participants would use in pricing the asset or liability. Valuation techniques typically include discounted cash flow models and similar techniques, but may also include the use of market prices of assets or liabilities that are not directly comparable to the subject asset or liability.

**Fair Value on a Recurring Basis** - Assets accounted for under ASC 825 are initially measured at fair value. Expected gains and losses from initial measurement and subsequent changes in fair value are recognized in revenue.

The Company's financial instruments measured at fair value on a recurring basis are summarized below (in thousands):

| | 2013 | | | | |
|---|---|---|---|---|---|
| | Fair Value Hierarchy | | Fair Value | | Total Gains (Losses) |
| **Financial Assets** | | | | | |
| Loans held-for-sale [1] | Level 3 | $ | 44,228 | $ | 33 |
| Credit default swaps | Level 2 | | 788 | | - |
| **Financial Liabilities** | | | | | |
| Interest rate swap futures | Level 1 | $ | 31 | $ | (31) |
| Credit default swaps | Level 2 | | 318 | | (318) |

(1) The aggregate fair value of loans held-for-sale of $44.2 million at November 30, 2013 exceeds their aggregate principal balance of $44.0 million by $0.2 million.

The Company did not hold financial instruments measured at fair value on a recurring basis as of November 30, 2012.

The following table represents a reconciliation of the beginning and ending balance for the Company's Level 3 recurring fair value measurements of loans held-for-sale (in thousands):

| | | 2013 |
|---|---|---|
| Loans held-for-sale, beginning of period | $ | - |
| Loan originations | | 690,266 |
| Originated loans sold, including those not settled | | (646,266) |
| Interest | | 195 |
| Changes in fair value | | 33 |
| Loans held-for-sale, end of period | $ | 44,228 |

**Fair Value on a Nonrecurring Basis** - From time to time, certain assets may be recorded at fair value on a nonrecurring basis. These nonrecurring fair value adjustments typically are a result of real estate acquisition through foreclosure, the application of the lower of cost or fair value accounting and impairments. For example, if the fair value of an asset in these categories falls below its cost basis, it is considered to be at fair value at the end of the period of the adjustment. In periods where there is no adjustment, the asset is generally not considered to be at fair value. The assets measured at fair value on a nonrecurring basis are summarized below (in thousands):

| | 2013 | | |
|---|---|---|---|
| | **Fair Value Hierarchy** | **Fair Value** | **Total Losses** |
| **Financial Assets** | | | |
| Impaired loans receivable | Level 3 | $ 221,690 | $ (16,139) |
| **Non-Financial Assets** | | | |
| REO - held-and-used, net [1] | Level 3 | $ 98,488 | $ (4,030) |
| REO - held-for-sale [2] | Level 3 | 37,185 | (3,955) |

(1) REO - held-and-used, net, assets are initially recorded at fair value at the time of acquisition through, or in lieu of, loan foreclosure. Upon acquisition, the REO, held-and-used, net, had a carrying value of $79.8 million and a fair value of $86.3 million. The fair value of REO, held-and-used, net, is based upon the appraised value at the time of foreclosure or management's best estimate. The gains upon acquisition of REO, held-and-used, net, were $6.5 million. As part of management's periodic valuations of its REO, held-and-used, net, during the year ended November 30, 2013, REO, held-and-used, net, with an aggregate value of $22.7 million were written down to their fair value of $12.2 million, resulting in impairments of $10.5 million. These gains and impairments are included within Rialto Investments other income (expense), net, in the Company's consolidated statement of operations for the year ended November 30, 2013.

(2) REO - held-for-sale, assets are initially recorded at fair value less estimated costs to sell at the time of acquisition through, or in lieu of, loan foreclosure. Upon acquisition, the REO, held-for-sale, had a carrying value of $14.4 million and a fair value of $16.0 million. The fair value of REO, held-for-sale, is based upon the appraised value at the time of foreclosure or management's best estimate. The gains upon acquisition of REO, held-for-sale, were $1.6 million. As part of management's periodic valuations of its REO, held-for-sale, during the year ended November 30, 2013, REO, held-for-sale, with an aggregate value of $26.8 million were written down to their fair value of $21.2 million, resulting in impairments of $5.6 million. These gains and impairments are included within Rialto Investments other income (expense), net, in the Company's consolidated statement of operations for the year ended November 30, 2013.

| | 2012 | | |
|---|---|---|---|
| | Fair Value Hierarchy | Fair Value | Total Losses |
| **Financial Assets** | | | |
| Impaired loans receivable | Level 3 | $ 326,721 | $ (27,966) |
| **Non-Financial Assets** | | | |
| REO - held-and-used, net (1) | Level 3 | $ 201,414 | $ (4,243) |
| REO - held-for-sale (2) | Level 3 | 27,126 | (6,917) |

(1) REO - held-and-used, net, assets are initially recorded at fair value at the time of acquisition through, or in lieu of, loan foreclosure. Upon acquisition, the REO, held-and-used, net, had a carrying value of $172.6 million and a fair value of $175.1 million. The fair value of REO, held-and-used, net, is based upon the appraised value at the time of foreclosure or management's best estimate. The gains upon acquisition of REO, held-and-used, net, were $2.5 million. As part of management's periodic valuations of its REO, held-and-used, net, during the year ended November 30, 2012, REO, held-and-used, net, with an aggregate value of $33.0 million were written down to their fair value of $26.3 million, resulting in impairments of $6.7 million. These gains and impairments are included within REO expense (income) in the Company's consolidated statement of operations for the year ended November 30, 2012.

(2) REO - held-for-sale, assets are initially recorded at fair value at the time of acquisition through, or in lieu of, loan foreclosure. Upon acquisition, the REO held-for-sale, net, had a carrying value of $14.3 million and a fair value of $10.0 million. The fair value of REO held-for-sale, net, is based upon the appraised value at the time of foreclosure or management's best estimate. The losses upon acquisition of REO held-for-sale, net, were $4.3 million. As part of management's periodic valuations of its REO held-for-sale, net, during the year ended November 30, 2012, REO held-for-sale, net, with an aggregate value of $19.7 million were written down to their fair value of $17.1 million, resulting in impairments of $2.6 million. These losses and impairments are included within REO expense (income) in the Company's consolidated statement of operations for the year ended November 30, 2012.

| | 2011 | | |
|---|---|---|---|
| | Fair Value Hierarchy | Fair Value | Total Gains (Losses) |
| **Financial Assets** | | | |
| Impaired loans receivable | Level 3 | $ 73,712 | $ (13,815) |
| **Non-Financial Assets** | | | |
| REO - held-and-used, net (1) | Level 3 | $ 110,649 | $ 4,607 |
| REO - held-for-sale (2) | Level 3 | 460,214 | 66,172 |

(1) REO - held-and-used, net, assets are initially recorded at fair value at the time of acquisition through, or in lieu of, loan foreclosure. Upon acquisition, the REO, held-and-used, net, had a carrying value of $82.5 million and a fair value of $93.7 million. The fair value of REO, held-and-used, net, is based upon the appraised value at the time of foreclosure or management's best estimate. The gains

upon acquisition of REO, held-and-used, net, were $11.2 million. As part of management's periodic valuations of its REO, held-and-used, net, during the year ended November 30, 2011, REO, held-and-used, net, with an aggregate value of $23.6 million were written down to their fair value of $17.0 million, resulting in impairments of $6.6 million. These gains and impairments are included within REO expense (income) in the Company's consolidated statement of operations for the year ended November 30, 2012.

(2) REO - held-for-sale, assets are initially recorded at fair value at the time of acquisition through, or in lieu of, loan foreclosure. Upon acquisition, the REO held-for-sale, net, had a carrying value of $385.2 million and a fair value of $452.9 million. The fair value of REO held-for-sale, net, is based upon the appraised value at the time of foreclosure or management's best estimate. The gains upon acquisition of REO held-for-sale, net, were $67.7 million. As part of management's periodic valuations of its REO held-for-sale, net, during the year ended November 30, 2011, REO held-for-sale, net, with an aggregate value of $8.8 million were written down to their fair value of $7.3 million, resulting in impairments of $1.5 million. These gains and impairments are included within REO expense (income) in the Company's consolidated statement of operations for the year ended November 30, 2012.

The following is a description of the valuation methodologies used for certain assets that are potentially recorded at fair value on a nonrecurring basis:

*Loans Receivable* - If impaired, the fair value of nonaccrual loans is based on discounted cash flows, or the fair value of the collateral less estimated disposition costs. If impaired, the fair value of accrual loan pools are based on discounted cash flows. The fair value of the real estate is determined through a combination of appraisals, broker opinions of value, and management's best estimate. The fair value of the underlying collateral is determined in part by placing reliance on independent third-party appraisals of the properties and/or internally prepared analysis of recent offers or prices on comparable properties in the proximate vicinity.

*Real Estate Owned – Held-and-Used, net and Held-for-Sale* - Real estate owned classified as held and used is initially recorded at fair value and real estate classified as held for sale is recorded at fair value less estimated disposition costs at the time of acquisition. The fair values of these assets are determined in part by placing reliance on independent third-party appraisals of the properties and/or internally prepared analysis of recent offers or prices on comparable properties in the proximate vicinity.

## 13. INCOME TAXES

Rialto is included in the consolidated federal income tax return of Lennar. Although some entities in the Rialto consolidated reporting group are limited liability companies that have elected to be treated as disregarded entities or partnerships for federal income tax purposes, in accordance with the tax sharing arrangement with Lennar, income taxes have been provided as if the Rialto reporting group filed as a separate federal consolidated group. Current income tax expense is recorded as an increase in amounts due to Parent. As such, no income tax expense payments are made directly by Rialto. Income taxes are accounted for in accordance with ASC Topic 740, Income Taxes, ("ASC 740"). Under ASC 740, deferred tax assets and liabilities are determined based on temporary differences between financial reporting carrying values and tax bases of assets and liabilities, and are measured by using enacted tax rates expected to apply to taxable income in the years in which those differences are expected to reverse.

The provision for income taxes for the years ended November 30, 2013, 2012 and 2011, consists of the following (in thousands):

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| **Current:** | | | |
| Federal | $19,038 | $ (415) | $10,271 |
| State | 3,355 | 192 | (594) |
| | 22,393 | (223) | 9,677 |
| **Deferred:** | | | |
| Federal | (12,045) | 9,255 | 2,550 |
| State | (2,320) | 1,452 | (416) |
| | (14,365) | 10,707 | 2,134 |
| | $ 8,028 | $10,484 | $11,811 |

Deferred income taxes reflect the net tax effects of temporary differences between carrying amounts of the assets and liabilities for financial reporting purposes and the amount used for income tax purposes. At November 30, 2013 and 2012, the tax effects of temporary differences that give rise to deferred tax assets and deferred tax liabilities are as follows (in thousands):

| | 2013 | 2012 |
|---|---|---|
| Deferred tax assets - reversals and accruals | $ 8,453 | $ 3,970 |
| **Deferred tax liabilities:** | | |
| Investments in joint ventures | (13,588) | (19,675) |
| Loans and REO investments | (2,680) | (6,475) |
| Total deferred tax liabilities | (16,268) | (26,150) |
| Deferred tax liabilities, net | $ (7,815) | $ (22,180) |

A reduction of the carrying amounts of deferred tax assets by a valuation allowance is required if, based on the available evidence, it is more likely than not that such assets will not be realized. In accordance with the tax sharing arrangement with Lennar, income taxes have been provided as if the Rialto reporting group filed as a separate federal consolidated group. Therefore, the need to establish a valuation allowance for deferred tax assets is assessed periodically by the Company based on the more-likely-than-not realization threshold criterion. In the assessment for a valuation allowance, appropriate consideration is given to all positive and negative evidence related to the realization of the deferred tax assets. This assessment considers, among other matters, the nature, frequency and severity of current and cumulative losses, forecasts of future profitability, the duration of statutory carryforward periods.

As of November 30, 2013, the Company concluded that it was more likely than not that Rialto's deferred tax assets would be utilized. This conclusion was based on a detailed evaluation of all relevant evidence, both positive and negative. As of November 30, 2013 and 2012, Rialto has a net deferred tax liability totaling $7.8 million and $22.2 million. As a result, no valuation allowance is required.

A reconciliation of the statutory rate and the effective tax rate for each of the years ended November 30, 2013, 2012 and 2011, is as follows:

| | Percentage of Pretax Income | | |
|---|---|---|---|
| | 2013 | 2012 | 2011 |
| Statutory rate | 35.00% | 35.00% | 35.00% |
| State income taxes, net of federal income tax benefit | 3.15% | 4.00% | 0.14% |
| Meals & entertainment | 0.31% | 0.00% | 0.00% |
| Change in allocated uncertain tax positions | 0.00% | 1.40% | -0.93% |
| Change in rate applied to deferred tax assets and liabilities | 1.91% | 0.00% | 0.00% |
| Effective rate | 40.37% | 40.40% | 34.21% |

The following table summarizes the changes in gross unrecognized tax benefits for the years ended November 30, 2013, 2012 and 2011 (in thousands):

| | 2013 | 2012 | 2011 |
|---|---|---|---|
| Balance — beginning of year | $ 416 | $ 1,955 | $ 1,387 |
| (Decreases) increases of prior year items due to tax sharing arrangement with Lennar | (416) | (1,539) | 568 |
| Balance — end of year | $ - | $ 416 | $ 1,955 |

In accordance with the tax sharing arrangement with Lennar, for tax years ended November 30, 2012 and 2011, the gross unrecognized tax benefits of Lennar were allocated to the Company on a pro rata basis based on revenues. Beginning with tax year November 30, 2013, the Company has determined that an evaluation of the Company's standalone uncertain tax positions would be more meaningful than an allocation of Lennar's uncertain tax positions. Accordingly, gross unrecognized tax benefits of Lennar will no longer be allocated but rather the Company's standalone unrecognized tax benefits will be evaluated independent of the gross unrecognized tax benefits of Lennar.

At November 30, 2013, 2012 and 2011, the Company's had $0.0 million, $0.4 million and $2.0 million respectively, of gross unrecognized tax benefits. As the Company has no unrecognized tax benefit at November 30, 2013, there is no effect on the Company's effective tax rate.

During the year ended November 30, 2013, the Company's gross unrecognized tax benefits decreased by $0.4 million as a result of the decision to evaluate the Company's standalone unrecognized tax benefits independent of the gross unrecognized tax benefits of Lennar. During the year ended November 30, 2012, the Company's gross unrecognized tax benefits decreased by $1.5 million related to a reduction of the allocation of Lennar's unrecognized tax benefits.

As of November 30, 2013 and 2012, the Company has $0.0 million accrued for interest and penalties. The Company recognizes interest and penalties accrued related to unrecognized tax benefits in the provision for income taxes.

The IRS is currently examining the Lennar's federal income return for fiscal year 2012 which includes the results of the Company. Additionally, certain state taxing authorities are examining various fiscal years of Lennar. The final outcome of these examinations is not yet determinable. The statute of limitations for the Lennar and the Company's major tax jurisdictions remains open for examination for fiscal year 2005 and subsequent years. Lennar participates in an IRS examination program, Compliance Assurance Process, "CAP." This program operates as a contemporaneous exam throughout the year in order to keep exam cycles current and achieve a higher level of compliance.

## 14. COMMITMENTS AND CONTINGENT LIABILITIES

The Company is party to various claims, legal actions and complaints arising in the ordinary course of business. In the opinion of management, the disposition of these matters will not have a material adverse effect on the Company's consolidated financial statements.

The following table summarizes certain of the Company's contractual obligations at November 30, 2013 (in thousands):

| | | Payments Due by Period | | | |
|---|---|---|---|---|---|
| | Total | Less than 1 year | 1 to 3 years | 3 to 5 years | More than 5 years |
| Notes payable [1] | $ 365,866 | $ 7,983 | $ 105,448 | $ 252,323 | $ 112 |
| Warehouse repurchase facility | 76,017 | 76,017 | - | - | - |
| Investment commitments [2] | 58,050 | 58,050 | - | - | - |
| Operating leases | 9,030 | 1,008 | 3,340 | 2,428 | 2,254 |
| Total contractual obligations | $ 508,963 | $ 143,058 | $ 108,788 | $ 254,751 | $ 2,366 |

(1) Amount includes $250.0 million from the 7.00% Senior Notes.
(2) Amount includes the Company's capital commitments to Fund II and the Mezzanine Fund.

## 15. PARENT COMPANY TRANSACTIONS

The Company is a wholly owned subsidiary of Lennar. Until the Company was formed in August 2013, Rialto Capital Management, LLC and Rialto Investments, LLC were direct wholly owned subsidiaries of Lennar. Prior to the 7.00% Senior Notes offering, Lennar had provided all the funds that had been used by the Company, other than funds generated from assets that were owned, or fees or proceeds of management fees the Company received. On November 14, 2013, the day the 7.00% Senior Notes were issued, Lennar contributed to the Company's equity the entire outstanding balance of the amount it had invested in the Company (an amount previously classified as "Due to Parent") in excess of $235 million. The $235 million remaining constituted indebtedness of the Company to Lennar. However, the Company applied $100 million of the gross proceeds of the sale of the 7.00% Senior Notes and $135 million of working capital to fully retire this indebtedness as of November 30, 2013.

The 7.00% Senior Notes indenture limits the ability of the Company or any of the Company's Restricted Subsidiaries (as defined) to make distributions, other than the repayment of indebtedness owed, to Lennar. However, these limits will not apply at any time when the Company and its Restricted Subsidiaries have a Consolidated Non-Funding Debt to Equity Ratio (as such term is defined in the 7.00% Senior Notes Indenture dated November 14, 2013) of 1.50 to 1.00 or less.

Pursuant to the Company's Operating Agreement, the Company's sole member, Lennar, has the authority, power, and discretion to manage and control the business, affairs, and properties of the Company, to make all decisions regarding those matters and to perform any and all other acts customary or incident to the management of the Company's business. Additionally, in the Company's Operating Agreement, the Company agrees to indemnify the Company's members, manager, officers, and employees against losses, claims, damages and liabilities except in certain circumstances outlined in the Operating Agreement (i.e., in instances of gross negligence, willful misconduct or fraud).

*Revolving Credit Agreement* – Lennar will have no obligation to provide additional funds to the Company, other than pursuant to a revolving credit agreement between Lennar and the Company. Under the revolving credit agreement, Lennar will, subject to customary lending conditions, make advances to the Company on a revolving basis of up to $75 million. The maturity date will be November 22, 2015 and the Company will pay interest on advances at LIBOR plus 3.5% for the applicable interest period. The Company is subject to certain customary covenants, including, but not limited to, limitations on fundamental changes, limitations on changes to line of business and transactions with affiliates. The Company may repay outstanding amounts at any time, without premium or penalty, on 10 business days' prior notice, and may re-borrow sums it repays. At November 30, 2013, no amounts were outstanding under this agreement and no amounts had been borrowed or repaid under this agreement during 2013.

*Support Services and Expense Reimbursement Agreement* – Prior to the 7.00% Senior Notes offering, Lennar had provided management, treasury, information technology, income tax, payroll and administrative services to the Company and to its subsidiaries. In the past, Lennar has not charged the Company for those services (although Lennar did require the Company to reimburse it for rent and other operating costs it advanced on the Company's behalf). However, on November 26, 2013, Lennar and the Company entered into a Support Services and Expense Reimbursement Agreement under which Lennar has agreed to provide specified accounting, information technology, tax, legal, human resources, treasury, occupancy, office and other administrative services to the Company and its subsidiaries and the Company will pay a fee equal to the lower of the actual cost or fair market value of those services to Lennar. As of November 30, 2013, no amounts were charged or paid by the Company under this agreement.

*Tax Reimbursement Agreement* – The Company and most of its subsidiaries are not recognized as taxpayers for Federal income tax purposes or for income tax purposes in some states. Instead, its taxable income and the taxable income of its subsidiaries that are limited liability companies and other types of non-corporate entities, is treated as taxable income of Lennar. Because Lennar, as the Company's sole member, is required to include at least most of the Company's Federal taxable income in Lennar's Federal taxable income, the Company entered into a Tax Reimbursement Agreement on November 26, 2013, which was effective September 1, 2013, pursuant to which the Company will pay Lennar, each time the Company would be required to pay Federal or state income taxes if it were a taxable corporation, the sum equal to the Federal or state income tax the Company would have been required to pay if it and its subsidiaries were all taxable corporations, minus any Federal or state income taxes the Company or its subsidiaries actually pay. The Company will make such payment to Lennar 5 days prior to the date on which Lennar files applicable tax returns. This agreement will terminate if the Company is no longer a subsidiary of Lennar. As of November 30, 2013, the Company has $12.4 million recorded as a liability to Lennar under this Tax Reimbursement Agreement, which constitutes the entire Due to Parent on the accompanying 2013 Consolidated Balance Sheet.

*Prior to the 7.00% Senior Notes Offering* – Prior to November 2013, cash funding had been provided for operating capital on an as-needed basis. Excess operating funds generated by the Company and any cash distributions from unconsolidated entities had been swept back to Lennar. No interest had been charged for the use of funds provided by the Parent. All cash funding, net of amounts swept back to Lennar were recorded as Due to Parent in the accompanying consolidated balance sheets for periods prior to November 2013.

*Other Transactions with Lennar* – For the year ended November 30, 2013, the Company transferred $9.5 million of REO to Lennar at its carrying value and thus, no gain or loss was recognized. For the year ended November 30, 2012, the Company transferred $11.3 million of REO to Lennar and recognized a gain of $0.2

million. The payments for these properties were settled as a reduction to the due to Parent account in the respective year.

## 16. SUBSEQUENT EVENTS

In connection with the preparation of the consolidated financial statements, the Company evaluated subsequent events occurring after the balance sheet date of November 30, 2013 through February 12, 2014, the date the consolidated financial statements were available to be issued, and concluded that no events, other than those already described herein, have occurred that required recognition or disclosure in the consolidated financial statements.