



**Rialto Holdings, LLC and Subsidiaries**

**Fiscal Year 2015 Third Quarter Report**

**Including Unaudited Consolidated Financial Statements  
and  
Management's Discussion and Analysis of Financial Condition and  
Results of Operations**

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## CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report (“Quarterly Report”) includes forward-looking statements. All statements other than statements of historical facts contained in this Quarterly Report including statements regarding our future results of operations and financial position, strategy and plans, and our expectations for future operations, are forward-looking statements. The words “anticipate,” “estimate,” “expect,” “project,” “plan,” “intend,” “believe,” “may,” “might,” “will,” “should,” “can have,” “likely,” “continue,” “design,” and other words and terms of similar expressions are intended to identify forward-looking statements.

We have based these forward-looking statements largely on our current expectations and projections about future events and trends that we believe may affect our financial condition, results of operations, strategy, short-term and long-term business operations and objectives and financial needs. Although we believe that the expectations reflected in our forward-looking statements are reasonable, actual results could differ from those expressed in our forward-looking statements. Our future financial position and results of operations, as well as any forward-looking statements are subject to change and inherent risks and uncertainties. You should consider our forward-looking statements in light of a number of factors that may cause actual results to vary from our forward-looking statements including, but not limited to:

- risks discussed under the heading “*Risk Factors*” in the Company’s Annual Report, as well as our consolidated financial statements, accompanying notes, and the other financial information appearing elsewhere in this Quarterly Report;
- changes in general economic conditions, in our industry and in the commercial finance and the real estate markets;
- changes to our business and investment strategy;
- our ability to obtain and maintain financing arrangements;
- the financing and advance rates for our assets;
- our actual and expected leverage;
- the adequacy of collateral securing our loan portfolio and a decline in the fair value of our assets;
- interest rate mismatches between our assets and our borrowings used to fund such investments;
- changes in interest rates and the market value of our assets;
- changes in prepayment rates on our assets;
- the effects of hedging instruments and the degree to which our hedging strategies may or may not protect us from interest rate and credit risk volatility;
- the increased rate of default or decreased recovery rates on our assets;
- the adequacy of our policies, procedures and systems for managing risk effectively;
- a potential downgrade in the credit ratings assigned to our investments;
- the impact of and changes in governmental regulations, tax law and rates, accounting guidance and similar matters;
- our ability and the ability of our subsidiaries to maintain our and their exemptions from registration under the Investment Company Act of 1940, as amended (the “Investment Company Act”);
- potential liability relating to environmental matters that impact the value of properties we may acquire or the properties underlying our investments;
- the inability of insurance covering real estate underlying our loans and investments to cover all losses;
- the availability of investment opportunities in mortgage-related and real estate-related instruments and other securities;
- fraud by potential borrowers;
- the availability of qualified personnel;
- the degree and nature of our competition;
- the market trends in our industry, interest rates, real estate values, the debt securities markets or the

- general economy; and
- the prepayment of the mortgage and other loans underlying our mortgage-backed and other asset backed securities.

You should not rely upon forward-looking statements as predictions of future events. In addition, neither we nor any other person assumes responsibility for the accuracy and completeness of any of these forward-looking statements. The forward-looking statements contained in this Quarterly Report are made as of the date hereof, and the Company assumes no obligation to update or supplement any forward-looking statements to reflect events or circumstances after the date of those statements or to reflect the occurrence of anticipated or unanticipated events.

## **REFERENCES TO RIALTO HOLDINGS, LLC AND SUBSIDIARIES**

Rialto Holdings, LLC and Subsidiaries, is a holding company that owns 100% of the legal entities Rialto Investments, LLC and Rialto Capital Management, LLC, and conducts its activities through those entities and their subsidiaries. Unless the context suggests otherwise, references in this report to “Rialto,” the “Company,” “we,” “us” and “our” refer to Rialto Holdings, LLC and Subsidiaries.

## **PART I. Financial Information**

### **Item 1. Financial Statements (Unaudited)**

The consolidated financial statements of Rialto Holdings, LLC and Subsidiaries and the notes related to the foregoing consolidated financial statements are included in this Item 1.

### **Index to Consolidated Financial Statements (Unaudited)**

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## INDEPENDENT AUDITORS' REVIEW REPORT

To the Stockholder of  
Rialto Holdings, LLC  
Miami, Florida

We have reviewed the accompanying consolidated balance sheet of Rialto Holdings, LLC and Subsidiaries (the "Company") as of August 31, 2015, and the related consolidated statements of operations for the three-month and nine-month periods ended August 31, 2015 and 2014, the consolidated statement of equity and the consolidated statement of cash flows for the nine-month periods ended August 31, 2015 and 2014 (the "interim financial information").

### Management's Responsibility for the Interim Financial Information

The Company's management is responsible for the preparation and fair presentation of the interim financial information in accordance with accounting principles generally accepted in the United States of America; this responsibility includes the design, implementation, and maintenance of internal control sufficient to provide a reasonable basis for the preparation and fair presentation of interim financial information in accordance with accounting principles generally accepted in the United States of America.

### Auditors' Responsibility

Our responsibility is to conduct our reviews in accordance with auditing standards generally accepted in the United States of America applicable to reviews of interim financial information. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial information. Accordingly, we do not express such an opinion.

### Conclusion

Based on our reviews, we are not aware of any material modifications that should be made to the interim financial information referred to above for it to be in accordance with accounting principles generally accepted in the United States of America.

### Report on Consolidated Balance Sheet as of November 30, 2014

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of the Company as of November 30, 2014, and the related consolidated statements of operations, equity, and cash flows for the year then ended (not presented herein); and we expressed an unmodified audit opinion on those audited consolidated financial statements in our report dated February 23, 2015. In our opinion, the accompanying consolidated balance sheet of the Company as of November 30, 2014, is consistent, in all material respects, with the audited consolidated financial statements from which it has been derived.

*Deloitte & Touche LLP*

October 15, 2015

## RIALTO HOLDINGS, LLC AND SUBSIDIARIES

### CONSOLIDATED BALANCE SHEETS AS OF AUGUST 31, 2015 AND NOVEMBER 30, 2014 (In thousands) (Unaudited)

	August 31, 2015	November 30, 2014
<b>ASSETS</b>		
Cash	\$ 106,731	\$ 303,889
Restricted cash	19,599	46,975
Receivables, net	-	153,773
Loans receivable, net	123,544	137,124
Loans held-for-sale	510,133	113,596
Real estate owned - held-for-sale	185,738	190,535
Real estate owned - held-and-used, net	195,866	255,795
Investments in unconsolidated entities	211,906	175,700
Investments held-to-maturity	18,328	17,290
Due from Parent	7,308	-
Deferred income tax asset, net	11,112	-
Other assets, net	118,484	63,475
	<u>1,508,749</u>	<u>1,458,152</u>
Total assets	<u>\$ 1,508,749</u>	<u>\$ 1,458,152</u>
<b>LIABILITIES AND EQUITY</b>		
<b>LIABILITIES:</b>		
Accounts payable	\$ 4,043	\$ 3,068
Accrued expenses and other liabilities	83,510	117,395
Deferred income tax liability, net	-	3,335
Due to Parent	-	1,053
Notes payable and other debts payable	774,244	623,246
	<u>861,797</u>	<u>748,097</u>
Total liabilities	<u>861,797</u>	<u>748,097</u>
<b>COMMITMENTS AND CONTINGENT LIABILITIES (Note 12)</b>		
PARENT'S EQUITY	425,886	413,479
NONCONTROLLING INTERESTS	221,066	296,576
	<u>646,952</u>	<u>710,055</u>
Total equity	<u>646,952</u>	<u>710,055</u>
Total liabilities and equity	<u>\$ 1,508,749</u>	<u>\$ 1,458,152</u>

See notes to unaudited consolidated financial statements.

## RIALTO HOLDINGS, LLC AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE THREE AND NINE MONTHS ENDED AUGUST 31, 2015 AND 2014 (In thousands) (Unaudited)

	Three Months Ended August 31,		Nine Months Ended August 31,	
	2015	2014	2015	2014
REVENUES:				
Interest income	\$ 11,512	\$ 12,444	\$ 30,095	\$ 54,915
REO revenue:				
Hospital revenues, net	9,902	7,345	29,051	17,139
Rental income	2,929	3,399	8,139	13,451
Gains from securitizations and other loan origination revenues	18,842	15,440	68,233	50,747
Management fees	21,200	12,964	62,354	36,534
Total revenues	64,385	51,592	197,872	172,786
EXPENSES:				
General and administrative expense	28,345	26,707	93,092	76,511
REO expense, net:				
Hospital expense, net	9,341	6,776	26,905	17,659
Other REO expense, net	2,317	9,310	10,257	16,285
Provision for loan losses	4,497	4,157	7,306	44,740
Interest expense	10,211	9,121	28,695	24,492
Servicing expense	2,853	3,462	8,563	14,765
Securitization and loan origination expenses	5,931	2,705	19,054	10,512
Amortization of debt issuance costs	1,276	955	3,546	2,221
Depreciation expense	620	537	1,764	1,583
Total expenses	65,391	63,730	199,182	208,768
EQUITY IN EARNINGS FROM UNCONSOLIDATED ENTITIES	7,590	19,973	17,582	43,266
GAIN ON SALE OF INVESTMENT SECURITIES	-	-	-	378
NET EARNINGS (INCLUDING NET LOSS ATTRIBUTABLE TO NONCONTROLLING INTERESTS)	6,584	7,835	16,272	7,662
LESS: NET LOSS ATTRIBUTABLE TO NONCONTROLLING INTERESTS	(1,978)	(4,549)	(4,514)	(20,670)
NET EARNINGS ATTRIBUTABLE TO RIALTO BEFORE PROVISION FOR INCOME TAXES	8,562	12,384	20,786	28,332
PROVISION FOR INCOME TAXES	3,662	4,727	8,379	10,902
NET EARNINGS ATTRIBUTABLE TO RIALTO	\$ 4,900	\$ 7,657	\$ 12,407	\$ 17,430

See notes to unaudited consolidated financial statements.

## RIALTO HOLDINGS, LLC AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF EQUITY FOR THE NINE MONTHS ENDED AUGUST 31, 2015 AND 2014 (In thousands) (Unaudited)

	Nine Months Ended August 31,	
	2015	2014
<b>PARENT'S EQUITY</b>		
Beginning balance	\$ 413,479	\$ 539,446
Net earnings attributable to Rialto	12,407	17,430
Distributions of capital to Parent	-	(150,000)
Ending balance	<u>\$ 425,886</u>	<u>\$ 406,876</u>
<b>NONCONTROLLING INTERESTS</b>		
Beginning balance	\$ 296,576	\$ 430,413
Net loss attributable to noncontrolling interests	(4,514)	(20,670)
Distributions of capital to noncontrolling interests	(73,756)	(89,240)
Amortization of carried interest plan awards	2,760	-
Final bargain purchase acquisition adjustment	-	1,118
Ending balance	<u>\$ 221,066</u>	<u>\$ 321,621</u>
<b>TOTAL EQUITY</b>	<u>\$ 646,952</u>	<u>\$ 728,497</u>

See notes to unaudited consolidated financial statements.

## RIALTO HOLDINGS, LLC AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE NINE MONTHS ENDED AUGUST 31, 2015 AND 2014 (In thousands) (Unaudited)

	Nine Months Ended August 31,	
	2015	2014
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net earnings attributable to Rialto	\$ 12,407	\$ 17,430
Noncontrolling interest loss	(4,514)	(20,670)
Adjustment to reconcile net earnings attributable to Rialto to net cash used in operating activities:		
Amortization of debt issuance costs and premium/discount	3,351	2,015
Depreciation expense	5,137	5,078
Net (gains) losses on loan foreclosure	(1,027)	7,281
Gains on sale of real estate owned	(13,852)	(27,849)
Equity in earnings from unconsolidated entities	(17,582)	(43,266)
Impairment on real estate owned	8,919	10,535
Deferred income tax benefit	(14,447)	(10,460)
Provision for loan losses	7,306	44,740
Distributions of earnings from unconsolidated entities	11,588	354
Accretion of discount on investments held-to-maturity	(1,038)	(899)
Gain on sale of CMBS bond	-	(378)
Originations of loans held-for-sale	(1,968,692)	(1,103,839)
Proceeds from sale of loans held-for-sale	1,723,874	1,095,468
Principal payments on loans held-for-sale	805	776
Unrealized losses (gains) on loans held-for-sale	1,622	(1,326)
Gain on retirement of debt	(83)	(4,135)
Amortization of carried interest plan awards	2,760	-
Changes in operating assets and liabilities:		
Restricted cash	27,376	(12,069)
Loans receivable, net	-	(12,556)
Other assets	(33,215)	(17,092)
Accounts payable	975	(888)
Due from Parent	(8,361)	(16,849)
Accrued expenses and other liabilities	(33,387)	10,739
Net cash used in operating activities	(290,078)	(77,860)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from sales of real estate owned	88,565	168,946
Receipts of principal payments on loans receivable	14,226	20,827
Distributions of capital from unconsolidated entities	12,123	41,235
Improvements to real estate owned	(6,055)	(9,924)
Purchase of operating equipment, net	(10,316)	(4,038)
Purchase of investment carried at cost	(18,000)	-
Origination of loan receivable	(22,545)	(7,000)
Investments in unconsolidated entities	(42,335)	(28,175)
Proceeds from sale of CMBS bond	-	9,171
Acquisition of CMBS bond	-	(8,705)
Net cash provided by investing activities	15,663	182,337

(Continued)

## RIALTO HOLDINGS, LLC AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE NINE MONTHS ENDED AUGUST 31, 2015 AND 2014 (In thousands) (Unaudited)

	Nine Months Ended August 31,	
	2015	2014
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net borrowings (repayments) under warehouse repurchase facilities	180,254	(4,596)
Distributions of capital to noncontrolling interests	(73,756)	(89,240)
Repayment of notes payable and other debts payable	(28,247)	(26,512)
Debt issuance costs	(994)	(2,950)
Proceeds from 7.00% Senior Notes	-	104,525
Proceeds from securitization borrowings	-	73,830
Distributions of capital to Parent	-	(150,000)
	<u>77,257</u>	<u>(94,943)</u>
<b>NET (DECREASE) INCREASE IN CASH</b>	<b>(197,158)</b>	<b>9,534</b>
<b>CASH — Beginning of period</b>	<b>303,889</b>	<b>201,496</b>
<b>CASH — End of period</b>	<b><u>\$ 106,731</u></b>	<b><u>\$ 211,030</u></b>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>		
Cash paid for interest on notes payable and other debts payable	<u>\$ 38,449</u>	<u>\$ 19,473</u>
<b>SUPPLEMENTAL DISCLOSURES OF NON-CASH INVESTING AND FINANCING ACTIVITIES:</b>		
Real estate owned acquired through loan foreclosure	<u>\$ 14,683</u>	<u>\$ 48,256</u>
Non-cash acquisition of Service Provider	<u>\$ -</u>	<u>\$ 8,317</u>
Reductions in loans receivable from deficiency settlements	<u>\$ -</u>	<u>\$ 3,289</u>
See notes to unaudited consolidated financial statements.		(Concluded)

## **RIALTO HOLDINGS, LLC AND SUBSIDIARIES**

### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS AS OF AUGUST 31, 2015 AND NOVEMBER 30, 2014 AND FOR THE THREE AND NINE MONTHS ENDED AUGUST 31, 2015 AND 2014 (UNAUDITED)**

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#### **1. ORGANIZATION AND DESCRIPTION OF BUSINESS**

Rialto Holdings, LLC, is a holding company that owns 100% of the legal entities Rialto Investments, LLC and Rialto Capital Management, LLC, and conducts its activities through those entities and their subsidiaries (collectively, “Rialto” or the “Company”). Rialto is a leading commercial real estate investment management, asset management, and finance company focused on raising, investing and managing third-party capital, originating and securitizing commercial mortgage loans, as well as investing its own capital in real estate related mortgage loans, properties and related securities. Rialto has a vertically-integrated investment and operating platform consisting of 393 professionals operating from ten offices throughout the United States (“U.S.”) and three additional offices in Europe. Founded in 2007, the Company is a wholly owned subsidiary of Lennar Corporation (“Lennar” or the “Parent”), which is one of the largest publicly traded homebuilders in the U.S., provider of financial services and national developer of high-quality multifamily rental properties. Lennar has over 6,800 employees, with homebuilding and development operations in 17 states.

The Company’s primary business strategy is to raise, invest and manage third-party capital, as well as to invest its own capital, in its three major business lines.

##### *Investment and Asset Management*

The Company’s real estate Investment and Asset Management business is a sponsor of, and an investor in private equity vehicles that invest in and manage real estate related assets.

The Company focuses on long-term relationships with a global base of institutional investors, which include pension funds, fund-of-funds, foundations and endowments, corporations, other institutional investors, and family offices. The Company’s fund investors value the Company’s investing expertise and diverse investment strategies, combined with the Company’s strong focus on risk management and its vertically-integrated operational infrastructure, which lead to a strong performance track record to date. As an investment and asset manager, the Company has a fundamental focus on the alignment of interests with its investors in its funds, which include investing significant capital alongside its investors in each of the Company’s fund vehicles.

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 \$75 million by the Company), the Rialto Real Estate Fund II, LP (“Fund II”) that was formed in 2012 with investor commitments of \$1.3 billion (including \$100 million by the Company), the Rialto Mezzanine Partners Fund, LP (“Mezzanine Fund”) that was formed in 2013 with investor commitments of \$300 million (including \$33.8 million committed by the Company) to invest in performing mezzanine commercial loans and the Rialto CMBS Fund, LP (“CMBS Fund”) with investor commitments of \$56.5 million (including \$17.7 million by the Company), that was created in 2014 to acquire, own and/or monetize securities whose value and income payments are derived from and collateralized by specific pools of underlying assets, referred to as commercial mortgage-backed securities (“CMBS”). The Company also manages a \$400 million separate account for a global insurance company. Rialto earns fees for its role as a manager of these vehicles and for providing asset management and other services to these vehicles and other third parties. In January 2014, the

Company acquired a loan servicer which provides loan servicing support for the Company's owned and managed portfolios and asset management services for the Company's small balance loan portfolio.

The Company's vertically-integrated underwriting and loan and real estate asset management platform, along with its extensive relationship with borrowers, real estate owners, loan originators, brokers and other third parties, and its access to Lennar's regional and local real estate expertise provide unique insight into local markets nationwide and allow the Company to develop customized investment management solutions that the Company believes should enable it continue to generate superior results.

The Company's business objective is to judiciously grow its assets under management and create value from its underlying investments, and in turn increase its recurring fees, as well as its share of profits from the investments the Company makes in its fund vehicles. As of August 31, 2015, the Company had almost \$2.7 billion of equity under management overseen by 235 professionals. The Company earns management fees based on the amount of capital it manages, incentive income based on the performance of its fund vehicles and investment income from its principal investments.

Over the past two years, Rialto has become an approved and rated special servicer by all the major rating agencies for CMBS growing its platform from zero to over \$61 billion of special servicing since April 2012. The Company's servicing platform includes ongoing and active surveillance and special servicing activities.

#### *Loan Origination and Securitization*

The Company's Loan Origination and Securitization business, Rialto Mortgage Finance ("RMF"), originates fixed rate, first mortgage loans, secured by stabilized, income-producing commercial real estate properties, which are sold through securitizations. These loans generally have five, seven and ten year terms. An internal team sources lending opportunities through a network of direct borrower and third-party intermediary relationships. The Company has a standardized credit and underwriting process, which begins an initial due diligence review and continues through a legal and underwriting process. The Company's credit committee approves loans based on the credit quality of the loan as well as its anticipated execution in the credit markets. During the quarter ended August 31, 2015, the Company originated loans with a total principal balance of \$731.5 million and sold \$519.1 million of originated loans into three separate securitization trusts.

To finance its lending activities, the Company has \$1.0 billion of committed term credit facilities from three institutional counterparties, \$900 million for fixed rate lending activities and \$100 million for the floating rate loan activities. The Company seeks to sell its fixed rate loans as quickly as feasible once funded. While the Company holds its fixed rate loans on its balance sheet before securitization, it hedges underlying interest rates and credit spreads using a variety of strategies and tools available in the market.

The Company generates revenue and liquidity through the following methods: (i) the sale of its loans; (ii) the sale of servicing rights; (iii) net interest income and (iv) loan origination fees. Servicing rights to the loans the Company originates are sold to a variety of institutions that derive revenue from fees earned on the administration of these loans. Net interest income on loans is interest revenue earned from loans prior to the time that the Company sells the loans less any financing costs from its credit facilities used in loan origination. Lastly, the Company generates fees on certain loans at the time of origination.

#### *Direct Investments*

Through the Company's Direct Investments business line, Rialto has been among the most active acquirers of portfolios of distressed real estate loans and assets from banks, government entities and other financial institutions.

In 2010, the Company acquired indirectly 40% managing member equity interests in two limited liability

companies (“LLCs”), in partnership with the U.S. 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 provided \$626.9 million of financing with 0% interest, which was non-recourse to the Company and the LLCs and was paid off during fiscal 2013. 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 these thresholds have not been met, distributions will continue being shared 60% / 40% with the FDIC. During the three and nine months ended August 31, 2015, \$27.5 million and \$121.5 million, respectively, had been distributed by the LLCs, of which \$16.5 million and \$72.9 million, respectively, was distributed to the FDIC and \$11.0 million and \$48.6 million, respectively, was distributed to the Company. During the three and nine months ended August 31, 2014, \$48.5 million and \$146.7 million, respectively, had been distributed by the LLCs, of which \$29.1 million and \$88.0 million, respectively, was distributed to the FDIC and \$19.4 million and \$58.7 million, respectively, was distributed to the Company.

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. As of August 31, 2015, these consolidated LLCs had total combined assets and liabilities of \$369.9 million and \$13.3 million, respectively. At November 30, 2014, these consolidated LLCs had total combined assets and liabilities of \$508.4 million and \$21.5 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 five year senior unsecured note provided by one of the selling institutions that was subsequently extended.

In addition, in 2010, the Company purchased approximately \$43 million face amount of non-investment grade CMBS for \$19.4 million, representing a 55% discount from par value.

The Company also manages certain operating assets that are acquired through loan foreclosures, which as of November 30, 2014, includes a hospital operation.

The Company’s objective is to continue to monetize and wind down these distressed commercial real estate portfolios in order to free up the underlying capital to recycle cash to achieve higher returns elsewhere in the Company.

## 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 generally accepted accounting principles 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.

*Unaudited/Interim Periods* – These consolidated financial statements and accompanying notes as of August 31, 2015 and November 30, 2014, and for the three and nine months ended August 31, 2015 and 2014, are unaudited and should be read in conjunction with the audited consolidated financial statements and accompanying notes included in the Annual Report for the year ended November 30, 2014.

*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, valuation of loans held-for-sale, real estate acquired in connection with foreclosures or in satisfaction of loans, fair value of loans held-for-sale and derivative instruments. Actual results could differ from those estimates.

*Loans Receivable - Revenue Recognition and Impairment* – During the fourth quarter of 2014, in an effort to better reflect the performance of the FDIC Portfolios and Bank Portfolios, the Company changed from recording accretible yield income, under Accounting Standards Codification (“ASC”) 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality* (“ASC 310-30”), on a loan pool basis to recording income on a cost recovery basis per loan as the timing and amount of expected cash flows on the remaining loan portfolios could no longer be reasonably estimated. Therefore, all of the loans receivable, net, in the FDIC Portfolios and Bank Portfolios were classified and accounted for as nonaccrual loans in accordance with ASC 310-10, *Receivables* (“ASC 310-10”) at August 31, 2015 and November 30, 2014, respectively. In 2014, the Company began originating floating rate commercial loans, which are accounted for as accrual loans.

*Nonaccrual Loans - Revenue Recognition and Impairment* – For loans in which forecasted principal and interest could not be reasonably estimated at the loan acquisition date or subsequently, management classified these loans as nonaccrual and accounts for these assets in accordance with ASC 310-10. As described above, this represents the remaining portfolio of loans receivable at August 31, 2015 and November 30, 2014. 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 loan’s 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 825, *Financial Instruments*, (“ASC 825”), 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 loan origination revenues 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 into 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 securitization trusts when control of the loans has been relinquished. As of November 30, 2014, the Company had \$147.2 million in originated loans that were transferred to Receivables, net, in the accompanying consolidated balance sheets as they had been sold into a securitization trust but had not yet settled as of year-end. There were no unsettled transactions as of August 31, 2015.

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 minimize 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 swaps and swap futures and as of August 31, 2015, had fair values of approximately \$0.3 million in an asset position and \$5.7 million in a liability position. As of November 30, 2014, the Company had interest rate swaps and swap futures with fair values of approximately \$1.4 million in a liability position. 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, which as of August 31, 2015 and November 30, 2014, had a fair value of \$10.0 million and \$1.7 million, respectively, in contracts in an asset position and \$2.7 million and \$0.8 million, respectively, in a liability position. The Company does not enter into or hold derivatives for trading or speculative purposes (see Note 10). Derivative instruments in gain positions are included in Other assets, net, in the accompanying consolidated balance sheets (see Note 7), while derivative instruments in loss positions are recorded within Accrued expenses and other liabilities in the accompanying 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 three and nine months ended August 31, 2015, the Company recorded \$3.8 million and \$10.4 million, respectively, in deficiency interest income. During the three and nine months ended August 31, 2014, the Company recorded \$2.2 million and \$17.3 million, respectively, in deficiency interest income.

*Real Estate Owned* – REO represents real estate which the Company has taken control of 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.

These methods use unobservable inputs to develop fair value for the Company's REO. Due to the volume and variance of unobservable inputs, resulting from the uniqueness of each of the Company's REO, the Company does not use a standard range of unobservable inputs with respect to its evaluation of REO. However, for operating properties within REO, the Company may also use estimated cash flows multiplied by a capitalization rate to determine the fair value of the property. Generally, the capitalization rates used to estimate fair value ranged from 8% to 12% and varied based on the location of the asset, asset type, and occupancy rates for the operating properties.

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 the 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 Other REO expense, net, 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 Other REO expense, net, in the accompanying consolidated statements 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 forty years for commercial properties and twenty seven and a half 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.

*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 (i) a percentage of committed or called capital during the commitment period and called capital after the commitment period ends, (ii) 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 ("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. The Company may also receive tax distributions in order to cover income tax obligations resulting from allocations of taxable income due to the Company's carried interest in the funds. These distributions are not subject to clawbacks and therefore are recorded as revenue when received.

*Income Tax* – Rialto is included in the consolidated federal income tax return of Lennar. However, 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 payments are made directly by Rialto. 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 or 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. 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. The following table displays the primary concentration of states of on balance sheet assets held by the Company as of August 31, 2015 and November 30, 2014.

	<b>August 31, 2015</b>	<b>November 30, 2014</b>
Georgia	21.1%	22.0%
Arizona	18.8%	19.3%
Nevada	16.8%	11.7%
Florida	13.4%	13.4%
North Carolina	8.3%	6.2%
California	6.3%	4.7%

A significant portion of the Company’s management fee revenue is derived from investment funds that the Company sponsors and manages. For the three and nine months ended August 31, 2015, 78% and 88%, respectively, of the Company’s management fee revenue was earned from investment funds that the Company sponsored and managed. For both the three and nine months ended August 31, 2014, 84% of the Company’s management fee revenue was earned from investment funds that the Company sponsored and managed.

The Company purchased a loan servicer in January 2014. The loan servicer provides loan servicing and

certain asset management services for the Company's distressed loan portfolios and for the loans owned by the investment funds that the Company sponsors, which represents the entire portion of the revenues derived from this business. Consolidated revenue of \$1.3 million and \$3.9 million (after elimination of intercompany transactions) were recorded by the loan servicer for the three and nine months ended August 31, 2015, respectively, which are included in Management fee revenue in the accompanying consolidated statements of operations. Equal amounts (in millions) were recorded by the loan servicer for the three and nine months ended August 31, 2014.

*Recent Accounting Pronouncements* – In May 2014, the Financial Accounting Standards Board (“FASB”) issued ASU 2014-09, *Revenue from Contracts with Customers*, (“ASU 2014-09”). ASU 2014-09 provides a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. ASU 2014-09 will require an entity to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This update creates a five-step model that requires entities to exercise judgment when considering the terms of the contract(s) which include (i) identifying the contract(s) with the customer, (ii) identifying the separate performance obligations in the contract, (iii) determining the transaction price, (iv) allocating the transaction price to the separate performance obligations, and (v) recognizing revenue when each performance obligation is satisfied. ASU 2014-09 will be effective for the Company's fiscal year beginning December 1, 2017 and subsequent interim periods. The Company has the option to apply the provisions of ASU 2014-09 either retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of applying this ASU recognized at the date of initial application. Early adoption is not permitted. The Company is currently evaluating the method and impact the adoption of ASU 2014-09 will have on the Company's consolidated financial statements.

In February 2015, the FASB issued ASU 2015-02, *Consolidation* (Topic 810): Amendments to the Consolidation Analysis (“ASU 2015-02”). ASU 2015-02 amends the consolidation requirements and significantly changes the consolidation analysis required. ASU 2015-02 requires management to reevaluate all legal entities under a revised consolidation model specifically (i) modify the evaluation of whether limited partnership and similar legal entities are VIEs, (ii) eliminate the presumption that a general partner should consolidate a limited partnership, (iii) affect the consolidation analysis of reporting entities that are involved with VIEs particularly those that have fee arrangements and related party relationships, and (iv) provide a scope exception from consolidation guidance for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Act of 1940 for registered money market funds. ASU 2015-02 will be effective for the Company's fiscal year beginning December 1, 2016 and subsequent interim periods. The Company is currently evaluating the method and impact the adoption of ASU 2015-02 will have on the Company's consolidated financial statements.

In April 2015, the FASB issued ASU 2015-03, *Interest – Imputation of Interest* (Subtopic 835-30) (“ASU 2015-03”). ASU 2015-03 requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. ASU 2015-03 will be effective for the Company's fiscal year beginning December 1, 2016, and subsequent interim periods. Early adoption is permitted. The Company is evaluating the impact that ASU 2015-03 will have on the Company's consolidated financial statements.

### **3. LOANS RECEIVABLE, NET, AND LOANS HELD-FOR-SALE**

*Loans Receivable, net* – The loans receivable portfolios consist primarily of loans acquired at 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. As of August 31, 2015 and November 30, 2014, management classified all loans receivable with the FDIC Portfolios and Bank Portfolios as nonaccrual loans as forecasted principal and interest cannot be reasonably estimated and accounted for these assets in accordance with ASC 310-10. Prior to the fourth quarter of 2014, the Company accounted for the majority of its loans receivable under ASC 310-30.

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 table represents loans receivable, by type (in thousands):

	<u>August 31, 2014</u>	<u>November 30, 2014</u>
Accrual loans <sup>(1)</sup>	\$ 29,654	\$ 7,019
Nonaccrual loans	93,890	130,105
Loans, receivable, net	<u>123,544</u>	<u>137,124</u>

<sup>(1)</sup> As of August 31, 2015, accrual loans included loans originated of which \$11.2 million relates to a convertible land loan that matures in July 2016 and \$18.4 million relates to floating rate commercial property loans, with one loan that was repaid in September 2015 and the remainder that matures in July 2018.

The following tables represent nonaccrual loans in the FDIC Portfolios and Bank Portfolios accounted for under ASC 310-10 aggregated by collateral type at August 31, 2015 and November 30, 2014 (in thousands):

Collateral Type	<b>August 31, 2015</b>			
	<b>Unpaid Principal Balance</b>	<b>Recorded Investment</b>		<b>Total Recorded Investment</b>
		<b>With Allowance</b>	<b>Without Allowance</b>	
Land	\$ 154,573	\$ 62,312	\$ 2,771	\$ 65,083
Single family homes	46,913	11,178	2,876	14,054
Commercial properties	16,561	2,590	1,102	3,692
Other	58,013	-	11,061	11,061
Total	<u>\$ 276,060</u>	<u>\$ 76,080</u>	<u>\$ 17,810</u>	<u>\$ 93,890</u>
Collateral Type	<b>November 30, 2014</b>			
	<b>Unpaid Principal Balance</b>	<b>Recorded Investment</b>		<b>Total Recorded Investment</b>
		<b>With Allowance</b>	<b>Without Allowance</b>	
Land	\$ 228,245	\$ 85,912	\$ 3,691	\$ 89,603
Single family homes	66,183	18,096	2,306	20,402
Commercial properties	34,048	3,368	3,918	7,286
Other	64,284	5	12,809	12,814
Total	<u>\$ 392,760</u>	<u>\$ 107,381</u>	<u>\$ 22,724</u>	<u>\$ 130,105</u>

*Accretable Yield* – With regard to accrual loans that were accounted under ASC 310-30 prior to the fourth quarter of 2014, the Company estimated the cash flows, at acquisition, it expected to collect on the FDIC Portfolios and Bank Portfolios and the difference between the contractually required payments and the cash flows expected to be collected at acquisition was referred to as the nonaccretable difference. This difference was neither accreted into income nor recorded on the Company’s consolidated balance sheets. The excess of cash flows expected to be collected over the cost of the loans acquired was referred to as the accretable yield and was recognized as interest income over the remaining life of the loans using the effective yield method. During the fourth quarter of 2014, in an effort to better reflect the performance of the FDIC Portfolios and Bank Portfolios, the Company changed from recording accretable yield income on a loan pool basis to recording income on a cost recovery basis per loan as the timing and amount of expected cash flows on the remaining loan portfolios could not be reasonably estimated.

For the nine months ended August 31, 2015, there was no activity in the accretable yield for the FDIC Portfolios and Bank Portfolios as all the remaining accruing loans were classified as nonaccrual loans during the fourth quarter of 2014, as explained above. For the nine months ended August 31, 2014, the activity in the accretable yield was as follows (in thousands):

	<b>Nine Months Ended August, 31, 2014</b>
Beginning balance	\$ 73,144
Additions	8,785
Deletions	(25,621)
Accretions	(25,693)
	<hr/>
Ending balance	<u>\$ 30,615</u>

Additions primarily represented reclassifications from nonaccretable yield to accretable yield on the portfolios. Deletions represented loan impairments, net of recoveries, and disposal of loans, which includes foreclosure of underlying collateral and result in the removal of the loans from the accretable yield portfolios. Accretions represented the recognition of interest income.

*Other Accrual Loans* – As of August 31, 2015 and November 30, 2014, the other accrual loans which generally represent loans with floating rates of interest totaled approximately \$29.7 million and \$7.0 million, respectively.

*Loans Held-For-Sale* – During the nine months ended August 31, 2015, the Company originated commercial loans with a total principal balance of \$2.0 billion and sold \$1.6 billion of originated loans into eight separate securitizations. During the nine months ended August 31, 2014, the Company originated commercial loans with a total principal balance of \$1.1 billion and sold \$983.6 million of originated loans into five separate securitizations. As of November 30, 2014, \$147.2 million of the originated loans were sold into a securitization trust but had not yet settled, and thus, were included as Receivables, net, in the accompanying consolidated balance sheets. There were no unsettled transactions as of August 31, 2015.

#### **4. 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.

*Nonaccrual* – Loans in which forecasted principal and interest could not be reasonably estimated at the date

of acquisition or subsequently. Although the Company believes the recorded investment balance will ultimately be realized, the risk of nonaccrual loans relates to a decline in the fair 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.

*Accrual* – An allowance for loan losses for accruing loans is calculated based on a review of individual loans considered impaired. The analysis of impaired losses may be based on the present value of expected future cash flows discounted at the effective loan rate, an observable market price or the fair value of the underlying collateral on collateral dependent loans. In determining the collectability of certain loans, management also considers the fair value of any underlying collateral.

The following table shows the activity related to the allowance for loan losses for the three and nine months ended August 31, 2015 (in thousands):

	Three Months Ended August 31, 2015			Nine Months Ended August 31, 2015		
	Accrual	Nonaccrual	Total	Accrual	Nonaccrual	Total
Beginning balance	\$ -	\$ 40,593	\$ 40,593	\$ -	\$ 58,326	\$ 58,326
Provision for loan losses	-	4,497	4,497	-	7,306	7,306
Charge-offs	-	(6,707)	(6,707)	-	(27,249)	(27,249)
Ending balance	<u>\$ -</u>	<u>\$ 38,383</u>	<u>\$ 38,383</u>	<u>\$ -</u>	<u>\$ 38,383</u>	<u>\$ 38,383</u>

The following table shows the activity related to the allowance for loan losses for the three and nine months ended August 31, 2014 (in thousands):

	Three Months Ended August 31, 2014			Nine Months Ended August 31, 2014		
	Accrual	Nonaccrual	Total	Accrual	Nonaccrual	Total
Beginning balance	\$ 55,658	\$ 286	\$ 55,944	\$ 18,952	\$ 1,213	\$ 20,165
Provision for loan losses	4,089	68	4,157	44,577	163	44,740
Charge-offs	(6,482)	(68)	(6,550)	(10,264)	(1,090)	(11,354)
Ending balance	<u>\$ 53,265</u>	<u>\$ 286</u>	<u>\$ 53,551</u>	<u>\$ 53,265</u>	<u>\$ 286</u>	<u>\$ 53,551</u>

Risk categories net of allowance for loan losses at August 31, 2015 and November 30, 2014 (in thousands):

Collateral Type	August 31, 2015		
	Accrual	Nonaccrual	Total
Land	\$ 11,239	\$ 65,083	\$ 76,322
Single family homes	-	14,054	14,054
Commercial properties	18,415	3,692	22,107
Other	-	11,061	11,061
Total	<u>\$ 29,654</u>	<u>\$ 93,890</u>	<u>\$ 123,544</u>

  

Collateral Type	November 30, 2014		
	Accrual	Nonaccrual	Total
Land	\$ -	\$ 89,603	\$ 89,603
Single family homes	-	20,402	20,402
Commercial properties	7,019	7,286	14,305
Other	-	12,814	12,814
Total	<u>\$ 7,019</u>	<u>\$ 130,105</u>	<u>\$ 137,124</u>

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.

The average recorded investment in impaired loans totaled approximately \$112.0 million and \$6.0 million, respectively, for the nine months ended August 31, 2015 and 2014.

## 5. 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*, ("ASC 360"), 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 is 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 included in Other REO expense, net, 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 Other REO expense, net, for accrual loans.

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

unrealized loss upon foreclosure.

The following tables present the activity in REO for the three and nine months ended August 31, 2015 and 2014 (in thousands):

	Three Months Ended August 31,		Nine Months Ended August 31,	
	2015	2014	2015	2014
REO held-for-sale, beginning balance	\$ 195,386	\$ 192,829	\$ 190,535	\$ 197,851
Improvements	1,023	1,994	4,318	4,717
Sales	(26,575)	(52,431)	(74,713)	(141,097)
Impairments and unrealized losses	(3,127)	(6,087)	(7,499)	(8,910)
Transfers from held-and-used, net <sup>(1)</sup>	19,031	58,034	73,097	141,778
REO held-for-sale, ending balance	<u>\$ 185,738</u>	<u>\$ 194,339</u>	<u>\$ 185,738</u>	<u>\$ 194,339</u>

	Three Months Ended August 31,		Nine Months Ended August 31,	
	2015	2014	2015	2014
REO held-and-used, net, beginning balance	\$ 213,748	\$ 379,069	\$ 255,795	\$ 428,989
Additions	1,367	14,530	15,710	48,657
Improvements	309	1,736	1,737	5,207
Impairments	(7)	(1,333)	(1,420)	(2,836)
Depreciation	(520)	(496)	(1,895)	(2,767)
Transfers to held-for-sale <sup>(1)</sup>	(19,031)	(58,034)	(73,097)	(141,778)
Other	-	-	(964)	-
REO held-and-used, net, ending balance	<u>\$ 195,866</u>	<u>\$ 335,472</u>	<u>\$ 195,866</u>	<u>\$ 335,472</u>

<sup>(1)</sup> During the three and nine months ended August 31, 2015 and 2014, the Company transferred certain properties from REO held-and-used, net, to REO held-for-sale as a result of changes in the disposition strategy of the real estate assets.

For the three and nine months ended August 31, 2015, the Company recorded \$6.2 million and \$13.9 million, respectively, of net gains from sales of REO. For the three and nine months ended August 31, 2014, the Company recorded \$4.1 million and \$27.8 million, respectively, of net gains from sales of REO. For the three and nine months ended August 31, 2015, the Company recorded net unrealized gains of \$10 thousand and \$1.0 million, respectively, from acquisitions of REO through foreclosure. For the three and nine months ended August 31, 2014, the Company recorded net unrealized losses of \$0.2 million and \$7.3 million, respectively, from acquisitions of REO through foreclosure. These net gains (losses) are included in Other REO expense, net, in the accompanying consolidated statements of operations.

## 6. INVESTMENTS

### Short-term Investment Securities

During the second quarter of 2014, the Company purchased a CMBS bond at a cost of \$8.7 million and sold the bond for \$9.1 million, resulting in a gain of \$0.4 million, disclosed as Gain on sale of investment securities in the consolidated statement of operations.

## Investments Held-to-Maturity

*Commercial Mortgage-Backed Securities* – A CMBS B-piece totaling \$43.0 million 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 nine months ended August 31, 2015 and 2014. The carrying value of the investment securities at August 31, 2015 and November 30, 2014, was \$18.3 million and \$17.3 million, respectively. The fair value of the investment securities at August 31, 2015 and November 30, 2014, was \$18.1 million and \$17.2 million, respectively. The Company classified these securities as held-to-maturity based on its intent and ability to hold the securities until maturity.

## Investments in Unconsolidated Entities

### *Investment Funds*

As a manager of real estate funds, the Company is entitled to receive additional revenue through a carried interest if it meets certain performance thresholds. The amounts presented in the table below are advance distributions received related to the Company's carried interests in order to cover income tax obligations resulting from allocations of taxable income to its carried interests in its real estate funds. These amounts of advance distributions are not subject to clawbacks but would serve to reduce future carried interest payments earned from the Company's real estate funds. 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 Interest.

(in thousands)

	<b>Three Months Ended August 31, 2015</b>	<b>Nine Months Ended August 31, 2015</b>
Rialto Real Estate Fund I, LP	\$ 3,545	\$ 9,509
Rialto Real Estate Fund II, LP	1,051	6,342
Rialto Mezzanine Partners Fund, LP	387	387
	<u>\$ 4,983</u>	<u>\$ 16,238</u>

The following table represents amounts we would have received had the funds ceased operations and hypothetically liquidated all its investments at their estimated fair values on August 31, 2015, both gross and net of amounts received as advanced tax distributions.

(in thousands)

	<b>Hypothetical Carried Interest</b>	<b>Paid as Advanced Tax Distribution</b>	<b>Net, Hypothetical Carried Interest</b>
Rialto Real Estate Fund I, LP	\$ 156,173	\$ (44,201)	\$ 111,972
Rialto Real Estate Fund II, LP	37,018	(6,342)	30,676
Rialto Mezzanine Partners Fund, LP	465	(387)	78
	<u>\$ 193,656</u>	<u>\$ (50,930)</u>	<u>\$ 142,726</u>

In June 2015, the Company adopted a Carried Interest Incentive Plan ("Plan") which provides participants in the Plan specified percentages of distributions made to a subsidiary from funds or other investment vehicles managed by the Company (See Note 14).

The following table reflects information regarding the funds sponsored by the Company that invest in real estate related assets and other investments as of August 31, 2015 and November 30, 2014 (in thousands):

	Inception Year	Equity Commitments	Equity Commitments Called	Commitment to fund by the Company	Funds contributed by the Company	Net cash invested by the Company	
						August 31, 2015	November 30, 2014
Rialto Real Estate Fund I, LP	2010	\$ 700,006	\$ 700,006	\$ 75,000	\$ 75,000	\$ -	\$ -
Rialto Real Estate Fund II, LP	2012	1,305,000	1,150,000	100,000	88,123	71,209	49,199
Rialto Mezzanine Partners Fund, LP	2013	300,000	275,883	33,799	30,982	26,602	17,960
Rialto Capital CMBS Fund, LP	2014	56,498	56,498	17,749	17,749	4,404	4,845
						<u>\$ 102,215</u>	<u>\$ 72,004</u>

The following table reflects the carrying value of the Company's investments in funds that invest in real estate related assets and other investments, as of August 31, 2015 and November 30, 2014 (in thousands):

	August 31, 2015	November 30, 2014
Rialto Real Estate Fund I, LP	\$ 68,525	\$ 71,831
Rialto Real Estate Fund II, LP	95,195	67,652
Rialto Mezzanine Partners Fund, LP	30,431	20,226
Rialto Capital CMBS Fund, LP	16,997	15,265
Other Investments	758	726
	<u>\$ 211,906</u>	<u>\$ 175,700</u>

The Company's share of earnings from unconsolidated entities was as follows for the three and nine months ended August 31, 2015 and 2014 (in thousands):

	Three Months Ended August 31,		Nine Months Ended August 31,	
	2015	2014	2015	2014
Rialto Real Estate Fund I, LP	\$ 4,158	\$ 10,291	\$ 7,948	\$ 22,524
Rialto Real Estate Fund II, LP	2,354	7,084	5,533	9,524
Rialto Mezzanine Partners Fund, LP	637	591	1,563	1,373
Rialto Capital CMBS Fund, LP	429	1,998	2,506	9,857
Other Investments	12	9	32	(12)
	<u>\$ 7,590</u>	<u>\$ 19,973</u>	<u>\$ 17,582</u>	<u>\$ 43,266</u>

### 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 August 31, 2015 and November 30, 2014, and for the three and nine months ended August 31, 2015 and 2014 (in thousands):

## Balance Sheets

	<u>August 31,</u> <u>2015</u>	<u>November 30,</u> <u>2014</u>
<b>Assets:</b>		
Cash and cash equivalents	\$ 117,061	\$ 141,609
Loans receivable	504,675	512,034
Real estate owned	446,629	378,702
Investment securities	1,084,819	795,306
Investments in partnerships	411,182	311,037
Other assets	40,522	45,451
	<u>\$ 2,604,888</u>	<u>\$ 2,184,139</u>
<b>Liabilities and equity:</b>		
Accounts payable and other liabilities	\$ 23,421	\$ 20,573
Notes payable	357,556	395,654
Equity	2,223,911	1,767,912
	<u>\$ 2,604,888</u>	<u>\$ 2,184,139</u>

## Statements of Operations

	<u>Three Months Ended</u> <u>August 31,</u>		<u>Nine Months Ended</u> <u>August 31,</u>	
	<u>2015</u>	<u>2014</u>	<u>2015</u>	<u>2014</u>
Revenues	\$ 41,278	\$ 39,401	\$ 122,336	\$ 104,005
Costs and expenses	24,937	22,552	73,024	71,965
Other income, net <sup>(1)</sup>	60,106	181,877	121,457	334,915
Net earnings of unconsolidated entities	<u>\$ 76,447</u>	<u>\$ 198,726</u>	<u>\$ 170,769</u>	<u>\$ 366,955</u>
Equity in earnings from unconsolidated entities	<u>\$ 7,590</u>	<u>\$ 19,973</u>	<u>\$ 17,582</u>	<u>\$ 43,266</u>

<sup>(1)</sup> Other income, net, for the three and nine months ended August 31, 2015 and 2014, includes realized and unrealized gains (losses) on investments.

## **7. OTHER ASSETS, NET**

The Company's Other assets, net, consisted of the following at August 31, 2015 and November 30, 2014 (in thousands):

	<u>August 31,</u> <u>2015</u>	<u>November 30</u> <u>2014</u>
Margin receivable from brokers	\$ 20,617	\$ 6,751
Accounts receivable	20,007	16,442
Operating equipment	19,612	12,538
Investment - at cost <sup>(1)</sup>	18,000	-
Management fee receivables from sponsored investment funds	12,642	3,573
Deposits and other	12,566	15,060
Derivative contracts	10,305	1,694
Debt issuance costs - net	4,735	7,417
Total other assets, net	<u>\$ 118,484</u>	<u>\$ 63,475</u>

<sup>(1)</sup> In December 2014, the Company made an investment in an equity security of an unaffiliated, private commercial real estate related services company, in which it does not have a controlling interest or significant influence. This equity

security is carried at cost.

## 8. NOTES PAYABLE AND OTHER DEBTS PAYABLE

The Company's Notes payable and other debts payable consisted of the following at August 31, 2015 and November 30, 2014 (in thousands):

	<u>August 31, 2015</u>	<u>November 30, 2014</u>
Senior Notes, net	\$ 351,612	\$ 351,939
Bank Portfolios	60,622	60,622
Warehouse Repurchase Facilities	321,525	141,272
Structured Notes, net	31,384	57,950
Notes payable - other	9,101	11,463
Total Notes payable and other debts payable	<u>\$ 774,244</u>	<u>\$ 623,246</u>

### *Senior Notes*

In November 2013, the Company issued \$250 million aggregate principal amount of 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 subsequently an additional \$135 million of working capital, to repay sums that were previously advanced to the Company by Lennar. Interest on the 7.00% Senior Notes is due on June 1 and December 1 of each year, and the 7.00% Senior Notes will mature on December 1, 2018. In March 2014, the Company issued an additional \$100 million aggregate principal amount, as an add-on to the 7.00% Senior Notes, at a price of 102.25%, in a private placement. The terms from the add-on offering were identical to those of the 7.00% Senior Notes. Proceeds from the offering, after payment of expenses, were approximately \$101.7 million. The Company used the funds to provide additional working capital to its RMF business, fund contributions to its investment funds and for other general corporate purposes. At August 31, 2015 and November 30, 2014, the carrying amount of the 7.00% Senior Notes was \$351.6 million and \$351.9 million, respectively.

### *Bank Portfolios*

In September 2010, the Company acquired approximately 400 distressed residential and commercial real estate loans 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 \$124.0 million was financed through a five-year senior unsecured note provided by one of the selling institutions. The Bank Portfolios' notes payable have an interest rate of the higher of 4.5% or 1 month LIBOR plus 3.75%. Maturity dates have been subsequently rescheduled and the remaining principal of \$60.6 million will be due in equal installments in December 2015 and 2016.

### *Warehouse Repurchase Facilities*

The Company's RMF business is funded by its three warehouse repurchase facilities with commitments totaling \$900 million and the proceeds of the sale of the 7.00% Senior Notes in excess of the \$100 million that was paid to Lennar. At August 31, 2015, warehouse repurchase facilities financing the RMF loan origination and securitization business and warehouse repurchase facility financing floating rate accrual loans were as follows (in thousands):

	<b>Maximum Aggregate Commitment</b>
364-day warehouse repurchase facility that matures October 2015 <sup>1</sup>	\$ 400,000
364-day warehouse repurchase facility that matures March 2016	250,000
364-day warehouse repurchase facility that matures August 2016	250,000
Loan Origination and Securitization business total	<u>\$ 900,000</u>
364-day warehouse repurchase facility that matures August 2018	<u>100,000</u>
Total	<u><u>\$ 1,000,000</u></u>

<sup>(1)</sup> This facility was extended for one year on October 7, 2015.

RMF uses the three facilities totaling \$900 million to finance its loan originations until the loans are sold in a securitization and the proceeds are collected. The facilities are expected to be renewed or replaced with other facilities when they mature. As of August 31, 2015 and November 30, 2014, the Company had \$321.5 million and \$141.3 million, respectively, outstanding under the facilities. Each of these facilities is secured by a 75% interest in the originated commercial loans financed. The facilities require immediate repayment of the 75% interest in the secured commercial loans when the loans are sold in a securitization and the proceeds are collected.

On August 31, 2015, the Company entered into a separate \$100 million repurchase facility to finance the origination of floating rate loans. This facility has a maturity date of August 31, 2018, with two one-year extension options: (i) the first for an additional one year period ending one year after the initial maturity date, and (ii) the second for an additional one year period ending one year after the first extended maturity date. The facility bears interest at one-month-LIBOR plus the applicable pricing margin which ranges from 2.00% to 2.50% based on asset type. Loans financed under this new facility will be held as accrual loans within Loans receivable, net.

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 August 31, 2015.

#### *Structured Notes*

In May 2014, the Company issued \$73.8 million principal amount of notes through a securitized structured note offering (the "Structured Notes") collateralized by certain assets originally acquired in the Bank Portfolios transaction at a price of 100%, with an annual coupon rate of 2.85%. Proceeds from the offering, after payment of expenses and hold backs for cash reserves were \$69.1 million. In November 2014, Rialto sold the second tranche of the Structured Notes at a price of 99.5%. The initial principal amount of this second tranche was \$20.8 million and has an annual coupon rate of 5.00%. Proceeds from the sale, after payment of expenses, were \$20.7 million, including accrued interest. The estimated final payment date of the Structured Notes is December 15, 2015, however the final retirement the debt could extend past that date. Monthly payments of principal and interest are based on the priority of available cash per the cash management agreement. As of August 31, 2015 and November 30, 2014, the outstanding amount related to the Structured Notes was \$31.4 million and \$58.0 million, respectively. The Company is in compliance with all debt covenants as of August 31, 2015.

#### *Revolving Lines of Credit with Lennar*

The Company has two revolving credit agreements with Lennar as a supplemental source of operating funds. See Note 13 for a description of such arrangements.

#### *Notes Payable – Other*

Notes payable, other includes mortgages on commercial properties obtained in connection with a deficiency judgment in 2011. These notes payable have interest rates ranging from 5.5% to 6.9%. Notes payable, other also includes pre-petition bankruptcy judgments related to the Company's acquisition of a hospital in 2013.

Notes payable and other debts payable have interest rates ranging from 0.00% to 7.00%, and mature as follows as of August 31, 2015 (in thousands):

<b>Year</b>	<b>Amount</b>
2015	\$ 322,788
2016	67,287
2017	31,460
2018	1,096
2019	351,613
	<hr/>
Total Notes payable and other debts payable	<u><u>\$ 774,244</u></u>

## 9. OTHER REO EXPENSE, NET

The Company's Other REO expense, net, consisted of the following for the three and nine months ended August 31, 2015 and 2014 (in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>August 31,</b>		<b>August 31,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
Realized gains on the sale of REO	\$ (6,178)	\$ (4,106)	\$ (13,852)	\$ (27,849)
Unrealized (gains) losses on loan foreclosure	(10)	173	(1,027)	7,281
Impairment on REO	3,133	6,992	8,919	10,535
REO expenses	5,372	6,251	16,217	26,318
	<hr/>	<hr/>	<hr/>	<hr/>
Other REO expense, net	<u><u>\$ 2,317</u></u>	<u><u>\$ 9,310</u></u>	<u><u>\$ 10,257</u></u>	<u><u>\$ 16,285</u></u>

## 10. 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 August 31, 2015 and November 30, 2014 (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, 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.

	Fair Value Hierarchy	August 31, 2015		November 30, 2014	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Assets</b>					
Loans receivable, net	Level 3	\$ 123,544	\$ 127,933	\$ 137,124	\$ 142,900
Investments held-to-maturity	Level 3	\$ 18,328	\$ 18,131	\$ 17,290	\$ 17,155
<b>Liabilities</b>					
Notes payable and other debts payable	Level 2	\$ 452,719	\$ 479,136	\$ 481,974	\$ 499,064
Warehouse repurchase facilities	Level 2	\$ 321,525	\$ 321,525	\$ 141,272	\$ 141,272

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

*Loans receivable, net* – The fair value of loans receivable, net, is based on the fair value of the underlying collateral less estimated cost to sell or discounted cash flows, if estimable.

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

*Notes payable and other debts payable* – The fair value of notes payable and other debts payable was calculated based on discounted cash flows using the Company’s weighted average borrowing rate. For the Structured Notes, the pricing of the debt is largely dependent on the collateral risk profile, making the structure unique. While the market is currently developing around different deal structures for such a note offering, management believes carrying value approximates fair value.

*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.

During the three and nine months ended August 31, 2015, there have been no changes in the Company’s valuation methodologies.

**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:

- 1) *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).
- 2) *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.

- 3) *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 as of August 31, 2015 and November 30, 2014, are summarized below (in thousands):

	<b>August 31, 2015</b>		
	<b>Fair Value Hierarchy</b>	<b>Fair Value</b>	<b>Total Gains (Losses)</b>
<b>Financial Assets</b>			
Loans held-for-sale <sup>(1)</sup>	Level 3	\$ 510,133	\$ (1,622)
Interest rate swaps and swap futures	Level 2	294	294
Credit default swaps	Level 2	10,011	2,641
<b>Financial Liabilities</b>			
Interest rate swaps and swap futures	Level 2	\$ 5,684	\$ (4,308)
Credit default swaps	Level 2	2,709	709

<sup>(1)</sup> The aggregate fair value of loans held-for-sale of \$510.1 million at August 31, 2015, exceeds their aggregate principal balance of \$509.6 million by \$0.5 million.

	<b>November 30, 2014</b>		
	<b>Fair Value Hierarchy</b>	<b>Fair Value</b>	<b>Total Gains (Losses)</b>
<b>Financial Assets</b>			
Loans held-for-sale <sup>(1)</sup>	Level 3	\$ 113,596	\$ 1,495
Credit default swaps	Level 2	1,694	31
<b>Financial Liabilities</b>			
Interest rate swaps and swap futures	Level 2	\$ (1,376)	\$ (1,346)
Credit default swaps	Level 2	(766)	30

<sup>(1)</sup> The aggregate fair value of loans held-for-sale of \$113.6 million at November 30, 2014, exceeds their aggregate principal balance of \$111.8 million by \$1.8 million.

*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.

*Credit derivatives* – The fair value of credit derivatives is based on quoted market prices for similar investments traded in active markets.

*Interest rate swaps and swap futures* – The fair value of interest rate swaps is based on observable values for underlying interest rates and market determined risk premiums. The fair value of interest rate swap futures is based on quoted market prices for identical investments traded in active markets.

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):

	Three Months Ended August 31,		Nine Months Ended August 31,	
	2015	2014	2015	2014
Loans held-for-sale, beginning of period	\$ 318,037	\$ 45,065	\$ 113,596	\$ 44,228
Loan originations	719,998	411,683	1,968,692	1,103,839
Originated loans sold, including those not settled	(528,518)	(292,099)	(1,570,101)	(983,635)
Changes in fair value	679	1,085	(1,622)	1,326
Interest, principal paydowns and deferred fees	(63)	(811)	(432)	(835)
Loans held-for-sale, end of period	<u>\$ 510,133</u>	<u>\$ 164,923</u>	<u>\$ 510,133</u>	<u>\$ 164,923</u>

**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):

	<u>Fair Value Hierarchy</u>	<u>Three Months Ended August 31, 2015</u>		
		<u>Cost Basis <sup>(1)</sup></u>	<u>Fair Value</u>	<u>Total Net Gains (Losses)</u>
<b>Financial Assets</b>				
Impaired loans receivable	Level 3	\$ 76,138	\$ 71,641	\$ (4,497)
<b>Non-Financial Assets</b>				
REO - held-and-used, net <sup>(2)</sup>	Level 3			
Upon acquisition/transfer		\$ 1,357	\$ 1,367	\$ 10
Upon management periodic valuations		14	7	(7)
REO - held-for-sale <sup>(3)</sup>	Level 3			
Upon acquisition/transfer		\$ 4,767	\$ 4,481	\$ (286)
Upon management periodic valuations		9,146	6,305	(2,841)

	<u>Fair Value Hierarchy</u>	<u>Three Months Ended August 31, 2014</u>		
		<u>Cost Basis <sup>(1)</sup></u>	<u>Fair Value</u>	<u>Total Net Gains (Losses)</u>
<b>Financial Assets</b>				
Impaired loans receivable	Level 3	\$ 103,372	\$ 99,574	\$ (4,158)
<b>Non-Financial Assets</b>				
REO - held-and-used, net <sup>(2)</sup>	Level 3			
Upon acquisition/transfer		\$ 14,275	\$ 14,530	\$ 255
Upon management periodic valuations		8,056	6,723	(1,333)
REO - held-for-sale <sup>(3)</sup>	Level 3			
Upon acquisition/transfer		\$ 7,133	\$ 6,705	\$ (428)
Upon management periodic valuations		15,453	9,794	(5,659)

<sup>(1)</sup> Cost basis represents the carrying value of selected assets before gains or impairment.

<sup>(2)</sup> REO - held-and-used, net, assets are initially recorded at fair value at the time of acquisition through, or in lieu of, loan foreclosure. 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. In addition, management periodically performs valuations of its REO, held-and-used, net. These gains (losses) upon acquisition and impairments are included within Other REO expense, net, in the Company's consolidated statements of operations for the three months ended August 31, 2015 and 2014.

<sup>(3)</sup> REO - held-for-sale, assets are initially recorded at fair value less estimated costs to sell at the time of transfer. The fair value of REO, held-for-sale, is based upon the appraised value at the time of transfer or management's best estimate. In addition, management periodically performs valuations of its REO, held-for-sale. These gains (losses) upon transfer and impairments are included within Other REO expense, net, in the Company's consolidated statements of operations for the three months ended August 31, 2015 and 2014.

	Fair Value Hierarchy	Nine Months Ended August 31, 2015		
		Cost Basis <sup>(1)</sup>	Fair Value	Total Net Gains (Losses)
<b>Financial Assets</b>				
Impaired loans receivable	Level 3	\$ 248,250	\$ 240,944	\$ (7,306)
<b>Non-Financial Assets</b>				
REO - held-and-used, net <sup>(2)</sup>	Level 3			
Upon acquisition/transfer		\$ 14,683	\$ 15,710	\$ 1,027
Upon management periodic valuations		2,703	1,283	(1,420)
REO - held-for-sale <sup>(3)</sup>	Level 3			
Upon acquisition/transfer		\$ 18,383	\$ 17,280	\$ (1,103)
Upon management periodic valuations		26,008	19,612	(6,396)

	Fair Value Hierarchy	Nine Months Ended August 31, 2014		
		Cost Basis <sup>(1)</sup>	Fair Value	Total Net Losses
<b>Financial Assets</b>				
Impaired loans receivable	Level 3	\$ 191,471	\$ 146,731	\$ (44,740)
<b>Non-Financial Assets</b>				
REO - held-and-used, net <sup>(2)</sup>	Level 3			
Upon acquisition/transfer		\$ 54,727	\$ 48,657	\$ (6,070)
Upon management periodic valuations		20,489	17,653	(2,836)
REO - held-for-sale <sup>(3)</sup>	Level 3			
Upon acquisition/transfer		\$ 20,183	\$ 18,972	\$ (1,211)
Upon management periodic valuations		39,193	31,494	(7,699)

<sup>(1)</sup> Cost basis represents the carrying value of selected assets before gains or impairment.

<sup>(2)</sup> REO - held-and-used, net, assets are initially recorded at fair value at the time of acquisition through, or in lieu of, loan foreclosure. 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. In addition, management periodically performs valuations of its REO, held-and-used, net. These gains (losses) upon acquisition and impairments are included within Other REO expense, net, in the Company's consolidated statements of operations for the nine months ended August 31, 2015 and 2014.

<sup>(3)</sup> REO - held-for-sale, assets are initially recorded at fair value less estimated costs to sell at the time of transfer. The fair value of REO, held-for-sale, is based upon the appraised value at the time of transfer or management's best estimate. In addition, management periodically performs valuations of its REO, held-for-sale. These gains (losses) upon transfer and impairments are included within Other REO expense, net, in the Company's consolidated statements of operations for the nine months ended August 31, 2015 and 2014.

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* – REO 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 analyses of recent offers or prices on comparable properties in the proximate vicinity.

## 11. 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 material income tax payments are made directly by Rialto. Income taxes are accounted for in accordance with ASC 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 three and nine months ended August 31, 2015 and 2014, consists of the following (in thousands):

	<b>Three Months Ended August 31,</b>		<b>Nine Months Ended August 31,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
<b>Current:</b>				
Federal	\$ 751	\$ 2,420	\$ 19,500	\$ 18,142
State	(22)	421	3,326	3,220
	<u>729</u>	<u>2,841</u>	<u>22,826</u>	<u>21,362</u>
<b>Deferred:</b>				
Federal	2,471	1,626	(12,167)	(8,769)
State	462	260	(2,280)	(1,691)
	<u>2,933</u>	<u>1,886</u>	<u>(14,447)</u>	<u>(10,460)</u>
Total Provision	<u>\$ 3,662</u>	<u>\$ 4,727</u>	<u>\$ 8,379</u>	<u>\$ 10,902</u>

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 August 31, 2015 and November 30, 2014, the tax effects of temporary differences that give rise to deferred tax assets and deferred tax liabilities are as follows (in thousands):

	<u>August 31, 2015</u>	<u>November 30, 2014</u>
<b>Deferred tax assets:</b>		
Reserves and accruals	\$ 10,261	\$ 14,399
Fixed assets	-	189
Carried interest incentive awards plan	2,224	-
Loans and REO investments	1,756	2,126
Net operating losses	2,126	2,213
	<u>16,367</u>	<u>18,927</u>
<b>Deferred tax liabilities:</b>		
Investments in joint ventures	<u>(5,255)</u>	<u>(22,262)</u>
Deferred tax assets (liabilities), net	<u>\$ 11,112</u>	<u>\$ (3,335)</u>

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 and the duration of statutory carryforward periods.

As of August 31, 2015 and November 30, 2014, Rialto has a net deferred tax asset totaling \$11.1 million and a net deferred tax liability totaling \$3.3 million, respectively. The Company has concluded that it is 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 a result, no valuation allowance is required.

As of August 31, 2015, the Company has federal and state income tax net operating loss ("NOL") carryforwards of \$5.5 million and \$5.5 million, respectively. These NOLs will expire at various dates from 2029 through 2033.

A reconciliation of the statutory rate and the effective tax rate for each of the nine months ended August 31, 2015 and 2014 is as follows:

	<b>Percentage of Pretax Income</b>	
	<u>2015</u>	<u>2014</u>
Statutory rate	35.00 %	35.00 %
State income taxes, net of federal income tax benefit	3.24 %	3.46 %
Deferred adjustment related to Loan Servicer	0.84 %	(0.23)%
Return to provision trueup	0.88 %	0.00 %
Meals & entertainment	0.35 %	0.25 %
Effective rate	<u>40.31 %</u>	<u>38.48 %</u>

The Company records uncertain tax positions in accordance with ASC 740 on the basis of a two-step process whereby (i) the Company determines whether it is more-likely-than-not that the tax positions will be

sustained on the basis of the technical merits of the position and (ii) for those positions that meet the more-likely-than-not recognition threshold, the Company recognizes the largest amount of tax benefit that is more than 50 percent likely to be realized upon the ultimate settlement with the related taxing authority. The Company has determined that no uncertain tax benefits were recorded as of August 31, 2015 and 2014.

As of both August 31, 2015 and November 30, 2014, the Company had no accruals 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 Lennar's federal income tax return for fiscal year 2013 which includes the results of the Company. 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. 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 Lennar and the Company's major tax jurisdictions remains open for examination for fiscal year 2006 and subsequent years.

## 12. CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

The Company is party to various claims, legal actions and complaints arising in the ordinary course of business. In the opinion of management, the ultimate resolution of any claims or lawsuits will not have a material adverse effect on the Company's business, consolidated financial position, results of operations or cash flows.

The following table summarizes certain of the Company's contractual obligations at August 31, 2015 (in thousands):

	Total	Payments Due by Period			
		Less than 1 year	1 to 3 years	3 to 5 years	More than 5 years
Notes payable and other debts payable <sup>(1)</sup>	\$ 452,719	\$ 1,264	\$ 98,747	\$ 352,708	\$ -
Warehouse repurchase facilities <sup>(2)</sup>	321,525	321,525	-	-	-
Interest commitments under interest bearing debt <sup>(3)</sup>	88,671	994	50,900	36,777	-
Investment commitments <sup>(4)</sup>	14,693	14,693	-	-	-
RMF rate lock commitment <sup>(5)</sup>	7,500	7,500	-	-	-
Operating leases	12,371	565	3,540	2,676	5,590
Total contractual obligations	<u>\$ 897,479</u>	<u>\$ 346,541</u>	<u>\$ 153,187</u>	<u>\$ 392,161</u>	<u>\$ 5,590</u>

<sup>(1)</sup> Amount includes \$31.4 million related to the Structured Notes with an assumed final payment date of December 15, 2015.

<sup>(2)</sup> Warehouse facilities are assumed to be paid off in the short-term as soon as loans held-for-sale are securitized, which is normally within 2 to 3 months.

<sup>(3)</sup> Interest commitments on variable interest-bearing debt are determined based on the interest rate as of August 31, 2015.

<sup>(4)</sup> Amount includes the Company's capital commitments to Fund II and the Mezzanine Fund.

<sup>(5)</sup> Relates to one loan the Company is contractually obligated to fund but has yet to release the funds to the borrower.

## 13. PARENT COMPANY TRANSACTIONS

*Lennar/Rialto Revolving Credit Agreement* –Under the revolving credit agreement, Lennar, subject to customary lending conditions, makes advances to the Company on a revolving basis of up to \$75 million.

The maturity date is November 22, 2015 and the Company pays 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. As of August 31, 2015, no amounts were outstanding under this agreement; however, \$25 million had been borrowed and repaid under this agreement over a one day span in April 2015.

*Lennar/RMF Revolving Credit Agreement* – On June 30, 2015, RMF entered into a revolving credit agreement (“Credit Agreement”) with Lennar, as lender. Under the Credit Agreement, Lennar will, subject to customary lending conditions, make advances to RMF on a revolving basis of up to \$200 million, subject to certain limitations and the achievement of specified financial conditions (the “Credit Facility”). The maturity date of the Credit Agreement is June 30, 2018 and amounts borrowed under the Credit Agreement accrue interest at LIBOR plus 3.5% for the applicable interest period. RMF will be subject to certain customary covenants, including, but not limited to, limitations on fundamental changes, limitations on changes to lines of business and transactions with affiliates. RMF may prepay outstanding amounts at any time, without premium or penalty, on five business days' prior notice. This new Credit Facility is in addition to the \$75 million facility extended by Lennar to Rialto. At August 31, 2015, no amounts were outstanding under this agreement.

During the third quarter 2015, amounts aggregating to \$280 million had been drawn and repaid under this facility to fund RMF loan originations. The Company incurred and paid to Lennar \$0.4 million in interest expense related to these borrowings.

*Support Services and Expense Reimbursement Agreement* – Prior to the 7.00% Senior Notes offering, Lennar had provided limited management, treasury, information technology, income tax, payroll and administrative services to the Company and to its subsidiaries. In the past, Lennar had 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). 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 pays a fee equal to the lower of the actual cost or fair market value of those services to Lennar. As of August 31, 2015 and November 30, 2014, the Company had a \$0.3 million and a \$0.8 million receivable, respectively, from Lennar, whereby \$5.1 million was billed by Lennar to the Company and \$4.6 million was paid by the Company to Lennar under this agreement during the nine months ended August 31, 2015.

*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 five 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 August 31, 2015 and November 30, 2014, the Company has \$7.0 million recorded as a receivable from Lennar and \$1.9 million recorded as a liability to Lennar, respectively, under this Tax Reimbursement Agreement on the accompanying consolidated balance sheets. During the nine months ended August 31, 2015, the Company

paid \$31.7 million to Lennar under this agreement.

#### **14. CARRIED INTEREST INCENTIVE PLAN**

On June 9, 2015, the Board of Directors of Lennar approved the Rialto Holdings, LLC Carried Interest Incentive Plan (“Plan”) which provides participants in the Plan the opportunity to participate in distributions made by a fund or other investment vehicle (a “Fund”) managed by a subsidiary of Rialto. Under the Plan, Rialto may distribute to its employees or to employees of Lennar who are involved in the management of the Fund, units of the limited liability company (the “Carried Interest Entity”) that entitle its holder to specified percentages of distributions made from the Fund to the Carried Interest Entity. Rialto may distribute to its employees units entitling them to up to 40% of the distributions received by the Carried Interest Entity and to employees of Lennar units entitling them to up to 10% of the distributions received by the Carried Interest Entity. The Plan will be administered by a Committee comprised of two members of Lennar’s management and one member of Rialto’s management. The units issued to employees will be subject to vesting schedules and forfeiture or repurchase provisions in the case of a termination of employment. The Plan requires that each participant enter into a Non-Competition, Non-Solicitation and Confidentiality Agreement. A Carried Interest Entity will make advanced tax distributions to participants to enable them to pay taxes to the extent the taxes they are required to pay are more than the total distributions they have received.

A total of 70% of the Plan awards vest in annual increments after the date of the first closing of the related Fund, with 10% vesting during the first year and 15% during each of the next four years. The final 30% vests as the remaining distributions are received by the Carried Interest Entity. During the quarter, the Company recorded \$7.8 million of compensation expense related to the Plan, of which \$5.0 million related to an advanced tax distribution and \$2.8 million related to the amortization of the share-based compensation expense over the vesting period and is recorded as minority interest on the consolidated balance sheet at August 31, 2015.

#### **15. SUBSEQUENT EVENTS**

In connection with the preparation of the consolidated financial statements, the Company evaluated subsequent events occurring after the balance sheet date of August 31, 2015 through October 15, 2015, the date the consolidated financial statements were available to be issued, and concluded that no events, other than those already described, or described below, have occurred that required recognition or disclosure in the consolidated financial statements.

On October 7, 2015, the Company extended its \$400 million warehouse repurchase facility for one year.

## **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and the accompanying notes of Rialto Holdings, LLC and Subsidiaries included within this Quarterly Report and the Annual Report for our fiscal year ended November 30, 2014. This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements. See "*Cautionary Statement Regarding Forward-Looking Statements*" within this Quarterly report and "*Risk Factors*" within the Annual Report, for a discussion of the uncertainties, risks, and assumptions associated with these statements. Actual results may differ materially from those contained in any of the forward-looking statements as a result of various factors, including, but not limited to, those in "*Risk Factors*" set forth in the Annual Report.

### **Overview**

We are a leading commercial real estate investment management, asset 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. Our vertically-integrated investment and operating platform consists of 393 professionals operating from ten offices across the United States ("U.S.") and three additional offices in Europe. Founded in 2007, we are a wholly owned subsidiary of Lennar, which is one of the largest publicly traded homebuilders in the U.S., provider of financial services and national developer of high-quality multifamily rental properties. Lennar has over 6,800 employees, with homebuilding and development operations in 17 states. Although Rialto operates independently from Lennar, Rialto believes that its affiliation with Lennar provides several key competitive advantages in the Company's underwriting and management process, including access to local market networks that provide "just-in-time" insight on market conditions. In addition, Lennar's nationwide footprint and public company infrastructure provide an effective base on which to manage and add value to geographically diverse assets.

We conduct our business through three major business lines: investment and asset management, loan origination and securitization, and direct investments in real estate assets. A comprehensive risk management approach is applied 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. Many of our investment and asset management opportunities were initially generated from dislocations 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 will continue to be well-positioned to capitalize on the opportunities arising from the diminished supply of commercial real estate capital from traditional sources and the substantial demand for debt and equity capital in the commercial real estate sector.

### **Business Outlook**

For the first nine months of 2015, we generated \$20.8 million of pre-tax earnings, adhering to our stated goals to focus on high return-on-capital businesses and the wind down and monetization of our direct investments business. Our investment and asset management business has generated significant returns for us and our investors, generating increased fees as the funds we sponsor and manage have grown to over \$7.1 billion in assets under management. Since 2009, Rialto has participated in over \$5.4 billion of equity investments, acquiring over \$10 billion of real estate loans, securities, commercial and residential properties. As we have been focusing on managing real estate related investments for others as well as ourselves, this not only increases our return on capital but also shifts the principal sources of our earnings from loan interest and net gains on sales of foreclosed real estate ("REO") resulting from direct investments, to a business

model oriented towards producing investment management, asset management, and other servicing fees. We are currently raising capital for our third fund vehicle with targeted investment capital of \$1.75 billion, expected to have its first closing at the end of October 2015.

Looking forward, we expect to grow our management fees and receive performance based incentive fees (“carried interest”) as the investments in our real estate funds are monetized in the future. In addition, we expect to participate as an investor in the funds we sponsor, earning our share of earnings from the underlying investments as compared to making direct investments. We typically earn carried interest in the investment vehicles we sponsor when distributions in those vehicles exceed the amount the investors contributed plus specified threshold returns on the investors’ capital. If the funds we sponsor had ceased operations and hypothetically liquidated all their investments for their estimated fair values on August 31, 2015, we would have received \$142.7 million with regard to our carried interest, which is net of \$50.9 million already received as advanced distributions to cover income tax obligations since inception. These advanced distributions are not subject to clawbacks and would serve to reduce future carried interest payments that are earned from the funds. As we increase the number of our investment funds and our investment funds age, if we continue to be successful, we anticipate an increasing portion of our revenues to be generated by carried interest.

We have become a leading commercial mortgage-backed securities (“CMBS”) special servicer, approved and rated by all the major rating agencies for commercial mortgage-backed securities and growing our platform from zero to over \$61 billion of special servicing billion of special servicing rights on over 4,100 underlying CMBS loans in just the last few years. This includes commercial real estate properties across all property types – office, retail, industrial, apartments and hotels, in all 50 states. We expect this portion of our business to generate a greater proportion of our management fees going forward.

Our Loan Origination and Securitization business is now the largest non-bank, non-broker/dealer commercial loan originators and contributors to CMBS transactions, and is generating margins among the best in the industry. We believe the commercial real estate finance market currently presents substantial opportunities for new originations, as it is characterized by stabilizing property values, a low interest rate environment, and a supply/demand imbalance for financing. With a number of institutions no longer in the real estate lending business and those remaining facing stricter underwriting standards and new government-imposed regulations, we anticipate a large scale opportunity to continue to originate commercial first mortgage loans. This opportunity is magnified by the fact that over the next five years, \$1.7 trillion of commercial real estate debt is scheduled to mature (according to Trepp) and must be refinanced. In addition, 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. In addition, these lenders have been limited by regulators as to how much they can lend at a time when borrowers are searching for additional proceeds to refinance their upcoming maturities. As a result, we believe there is a tremendous opportunity in this environment for us to further expand our senior lending business.

In our Direct Investment business line, the limited liability companies in which we have invested along with the Federal Deposit Insurance Corporation (“FDIC”) have continued to distribute cash. And while we expect to liquidate a majority of these assets by the end of 2016, we do not expect significant revenues and earnings from our direct investment in the FDIC LLCs, and the portfolios of loans we acquired from banks in 2010 (the “Bank Portfolios”).

## (1) Results of Operations

Financial information relating to our operations for the three and nine months ended August 31, 2015 and 2014, was as follows:

	Three Months Ended August 31,		Nine Months Ended August 31,	
	2015	2014	2015	2014
REVENUES:				
Interest income	\$ 11,512	\$ 12,444	\$ 30,095	\$ 54,915
REO revenue:				
Hospital revenues, net	9,902	7,345	29,051	17,139
Rental income	2,929	3,399	8,139	13,451
Gains from securitizations and other loan origination revenues	18,842	15,440	68,233	50,747
Management fees	21,200	12,964	62,354	36,534
Total revenues	<u>64,385</u>	<u>51,592</u>	<u>197,872</u>	<u>172,786</u>
EXPENSES:				
General and administrative expense	28,345	26,707	93,092	76,511
REO expense, net:				
Hospital expense, net	9,341	6,776	26,905	17,659
Other REO expense, net	2,317	9,310	10,257	16,285
Provision for loan losses	4,497	4,157	7,306	44,740
Interest expense	10,211	9,121	28,695	24,492
Servicing expense	2,853	3,462	8,563	14,765
Securitization and loan origination expenses	5,931	2,705	19,054	10,512
Amortization of debt issuance costs	1,276	955	3,546	2,221
Depreciation expense	620	537	1,764	1,583
Total expenses	<u>65,391</u>	<u>63,730</u>	<u>199,182</u>	<u>208,768</u>
EQUITY IN EARNINGS FROM UNCONSOLIDATED ENTITIES	<u>7,590</u>	<u>19,973</u>	<u>17,582</u>	<u>43,266</u>
GAIN ON SALE OF INVESTMENT SECURITIES	<u>-</u>	<u>-</u>	<u>-</u>	<u>378</u>
NET EARNINGS (INCLUDING NET LOSS ATTRIBUTABLE TO NONCONTROLLING INTERESTS)	<u>6,584</u>	<u>7,835</u>	<u>16,272</u>	<u>7,662</u>
LESS: NET LOSS ATTRIBUTABLE TO NONCONTROLLING INTERESTS	<u>(1,978)</u>	<u>(4,549)</u>	<u>(4,514)</u>	<u>(20,670)</u>
NET EARNINGS ATTRIBUTABLE TO RIALTO BEFORE PROVISION FOR INCOME TAXES	<u>8,562</u>	<u>12,384</u>	<u>20,786</u>	<u>28,332</u>
PROVISION FOR INCOME TAXES	<u>3,662</u>	<u>4,727</u>	<u>8,379</u>	<u>10,902</u>
NET EARNINGS ATTRIBUTABLE TO RIALTO	<u>\$ 4,900</u>	<u>\$ 7,657</u>	<u>\$ 12,407</u>	<u>\$ 17,430</u>

### **Three Months Ended August 31, 2015 versus Three Months Ended August 31, 2014**

In the three months ended August 31, 2015, net earnings before provision for income taxes were \$8.6 million (which included \$6.6 million of operating earnings and an add back of \$2.0 million of net loss attributable to noncontrolling interests), compared to net earnings before provision for income taxes of \$12.3 million (which included \$7.8 million of operating earnings and an add back of \$4.5 million of net loss attributable to noncontrolling interests) in the third quarter of 2014.

In the three months ended August 31, 2015, revenues were \$64.4 million compared to \$51.6 million in the third quarter of 2014. Revenues increased \$12.8 million primarily due to an increase in gains from securitizations and other loan origination revenues and interest income from Rialto Mortgage Finance (“RMF”) as the origination volume and number of securitizations increased. Additionally, management fees benefitted from the receipt of \$5.0 million of advanced tax distributions from Rialto Real Estate Fund, LP (“Fund I”), Rialto Real Estate Fund II, LP (“Fund II”) and Rialto Mezzanine Partners Fund, LP (“Mezzanine Fund”) in order to cover income tax obligations resulting from the allocations of taxable income related to our carried interests in these funds. Hospital revenues increased \$2.6 million due to increased patient volume. These increases were partially offset by decreases in interest income and rental income of \$1.0 million and \$0.5 million, respectively, as a result of a decrease in the portfolio of loans we own due to loan collections, resolutions, payoffs, and the change from the accretion method of accounting for interest income recognition to the nonaccrual cost recovery method.

In the three months ended August 31, 2015, expenses were \$65.4 million compared to \$63.7 million in the third quarter of 2014. During the quarter, the Company recorded \$7.8 million of compensation expense related to the Carried Interest Incentive Plan (“Plan”), of which \$5.0 million related to an advanced tax distribution, as mentioned previously, and \$2.8 million related to the amortization of the share-based compensation expense over the vesting period. This additional expense in 2015 was offset by lower accrued bonus costs compared to the same quarter in 2014. Expenses also increased due to an increase in securitization and loan origination expenses from having two additional securitizations during the third quarter of 2015 compared to the same period of 2014. Additionally, there was an increase in interest expense related to greater borrowing under the RMF warehouse repurchase facilities due to increased volume. This increase was mostly offset by a decrease in other REO expense, net, which had a decrease in REO impairment as well as decreases in REO expenses, commensurate with the decline in the number of REO properties.

In the three months ended August 31, 2015, we had equity in earnings from unconsolidated entities of \$7.6 million, which primarily included \$4.2 million of our share of earnings from Fund I, \$2.4 million of our share of earnings from Fund II, \$0.6 million of our share of earnings from the Mezzanine Fund and \$0.4 million of our share of earnings from the Rialto Capital CMBS Fund (the “CMBS Fund”). Equity in earnings from unconsolidated entities was \$20.0 million in the third quarter of 2014, which included \$10.3 million of our share of earnings from Fund I, \$7.1 million of our share of earnings from Fund II, \$2.0 million of our share of earnings from the CMBS Fund and \$0.6 million of our share of earnings from the Mezzanine Fund. While realized results continue to be strong across our sponsored investment funds, unrealized gains recognized on CMBS investments being marked up to fair value were largely recognized during the 2014 period and did not occur to the same extent during 2015 as market yields have somewhat stabilized and are more consistent with current levels.

As of August 31, 2015 and November 30, 2014, we had three and two warehouse repurchase facilities, respectively, that mature in fiscal year 2015 and 2016 with commitments totaling \$900 million and \$650 million, respectively, to use in our Loan Origination and Securitization business. Borrowings under these facilities were \$321.5 million and \$141.3 million, respectively, as of August 31, 2015 and November 30, 2014, respectively. On August 31, 2015, the Company entered into a separate \$100 million repurchase

facility to finance the origination of floating rate loans. Loans financed under this facility are held as accrual loans within Loans receivable, net. As of August 31, 2015 and November 30, 2014, these loans totaled approximately \$29.7 million and \$7.0 million, respectively.

During 2013, the LLCs we own in partnership with the FDIC finished repaying the \$626.9 million of loans from the FDIC ahead of schedule and thus, were able to start distributing capital back to investors. During the three months ended August 31, 2015 and 2014, \$27.5 million and \$48.5 million, respectively, had been distributed by the LLCs, of which \$16.5 million and \$29.1 million, respectively, was distributed to the FDIC and \$11.0 million and \$19.4 million, respectively, was distributed to us.

On June 30, 2015, RMF entered into a revolving credit agreement (“Credit Agreement”) with Lennar, as lender. Under the Credit Agreement, Lennar will, subject to customary lending conditions, make advances to RMF on a revolving basis of up to \$200 million, subject to certain limitations and the achievement of specified financial conditions (the “Credit Facility”). The maturity date of the Credit Agreement is June 30, 2018 and amounts borrowed under the Credit Agreement accrue interest at LIBOR plus 3.5% for the applicable interest period. RMF will be subject to certain customary covenants, including, but not limited to, limitations on fundamental changes, limitations on changes to lines of business and transactions with affiliates. RMF may prepay outstanding amounts at any time, without premium or penalty, on five business days’ prior notice. This new Credit Facility is in addition to the \$75 million facility extended by Lennar to Rialto. At August 31, 2015, no amounts were outstanding under this agreement.

#### **Nine Months Ended August 31, 2015 versus Nine Months Ended August 31, 2014**

In the nine months ended August 31, 2015, net earnings before provision for income taxes were \$20.8 million (which included \$16.3 million of operating earnings and an add back of \$4.5 million of net loss attributable to noncontrolling interests), compared to net earnings before provision for income taxes of \$28.3 million (which included \$7.6 million of operating earnings and an add back of \$20.7 million of net loss attributable to noncontrolling interests) in the same period of 2014.

In the nine months ended August 31, 2015, revenues were \$197.9 million compared to \$172.8 million in the same period of 2014. Revenues increased \$25.1 million primarily due to an increase management fees, increased revenues due to larger sales volume in our RMF business and improvement in our hospital operations. Management fees benefitted from the receipt of \$16.2 million of advanced tax distributions from Fund I, Fund II and Mezzanine Fund in order to cover income tax obligations resulting from the allocations of taxable income related to our carried interests in these funds. Additionally, hospital revenues increased \$11.9 million due to increased patient volume. These increases were offset by decreases in interest income and rental income of \$24.8 million and \$5.3 million, respectively, as a result of a decrease in the portfolio of loans we own due to loan collections, resolutions, payoffs and reduced income producing REO from sales of those properties as well as no longer recognizing interest income under the accretable yield method. Instead, interest income is recognized to the extent that loan collections exceed their carrying value.

In the nine months ended August 31, 2015, expenses were \$199.2 million compared to \$208.8 million in the same period of 2014. Expenses decreased \$9.6 million primarily due to a decrease in loan impairments of \$37.4 million due to the change from the accretable yield method and because of a reduction in the number of loans outstanding in the FDIC Portfolios and Bank Portfolios. This was partially offset by an increase general and administrative expenses relating to an increase in compensation expense as well as an increase in hospital expenses stemming from increased patient volume. Additionally, securitization and loan origination expenses increased \$8.5 million due to additional seller specific expenses required by the increase in both the number and volume of securitizations period over period. The overall decrease was also offset by an increase in interest expense related to the 7.00% Senior Notes as the March 2014 \$100 million add-on offering was outstanding for only a portion of the 2014 period (compared to a full period in 2015)

and increased RMF warehouse repurchase facility borrowings and the Credit Agreement as a result of the increased volume.

In the nine months ended August 31, 2015, we had equity in earnings from unconsolidated entities of \$17.6 million, which primarily included \$7.9 million of our share of earnings from Fund I, \$5.5 million of our share of earnings from Fund II, \$1.6 million of our share of earnings from the Mezzanine Fund and \$2.5 million of our share of earnings from the CMBS Fund. Equity in earnings from unconsolidated entities was \$43.3 million in the same period of 2014, which included \$22.5 million of our share of earnings from Fund I, \$9.9 million of our share of earnings from the CMBS Fund, \$9.5 million of our share of earnings from Fund II and \$1.4 million of our share of earnings from the Mezzanine Fund. Again, unrealized gains recognized on CMBS investments being marked up to fair value were largely recognized during the 2014 period and did not occur to the same extent during 2015 as market yields have somewhat stabilized and are more consistent with current levels.

During the nine months ended August 31, 2015 and 2014, \$121.5 million and \$146.7 million, respectively, had been distributed by the LLCs, of which \$72.9 million and \$88.0 million, respectively, was distributed to the FDIC and \$48.6 million and \$58.7 million, respectively, was distributed to us. From inception to August 31, 2015, \$353.1 million has been distributed by the LLCs, of which \$211.9 million was distributed to the FDIC and \$141.2 million was distributed to us.

## **Business Lines**

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

### ***Investment and Asset 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 Business Outlook, 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 business line. We are instead focusing more on raising capital for investments and then earning revenue through management and servicing fees, as well as by participating in the ownership as a co-investor and earning carried interest after distributions to investors that have met specified investment return thresholds. Carried interest on the funds in place today generally will not be received (with the exception of advances for related tax liabilities) until those funds mature and a significant portion of the assets are monetized (this can range from a few years for some of our smaller funds and co-invest vehicles to 5 to 7 years for our larger opportunistic funds).

The following table reflects information regarding the funds sponsored by the Company that invest in real estate related assets and other investments as of August 31, 2015 and November 30, 2014 (in thousands):

	Inception Year	Equity Commitments	Equity Commitments Called	Commitment to fund by the Company	Funds contributed by the Company	Net cash invested by the Company	
						August 31, 2015	November 30, 2014
Rialto Real Estate Fund I, LP	2010	\$ 700,006	\$ 700,006	\$ 75,000	\$ 75,000	\$ -	\$ -
Rialto Real Estate Fund II, LP	2012	1,305,000	1,150,000	100,000	88,123	71,209	49,199
Rialto Mezzanine Partners Fund, LP	2013	300,000	275,883	33,799	30,982	26,602	17,960
Rialto Capital CMBS Fund, LP	2014	56,498	56,498	17,749	17,749	4,404	4,845
						<u>\$ 102,215</u>	<u>\$ 72,004</u>

The following table reflects the carrying value of the Company's investments in funds that invest in real estate related assets and other investments, as of August 31, 2015 and 2014 (in thousands):

	August 31, 2015	November 30, 2014
Rialto Real Estate Fund I, LP	\$ 68,525	\$ 71,831
Rialto Real Estate Fund II, LP	95,195	67,652
Rialto Mezzanine Partners Fund, LP	30,431	20,226
Rialto Capital CMBS Fund, LP	16,997	15,265
Other Investments	758	726
	<u>\$ 211,906</u>	<u>\$ 175,700</u>

The Company's share of earnings from unconsolidated entities was as follows for the three and nine months ended August 31, 2015 and 2014 (in thousands):

	Three Months Ended August 31,		Nine Months Ended August 31,	
	2015	2014	2015	2014
Rialto Real Estate Fund I, LP	\$ 4,158	\$ 10,291	\$ 7,948	\$ 22,524
Rialto Real Estate Fund II, LP	2,354	7,084	5,533	9,524
Rialto Mezzanine Partners Fund, LP	637	591	1,563	1,373
Rialto Capital CMBS Fund, LP	429	1,998	2,506	9,857
Other Investments	12	9	32	(12)
	<u>\$ 7,590</u>	<u>\$ 19,973</u>	<u>\$ 17,582</u>	<u>\$ 43,266</u>

As a manager of real estate funds, we are entitled to receive additional revenue through a carried interest if they meet certain thresholds. The amounts presented in the table below are advance distributions received related to the Company's carried interests in order to cover income tax obligations resulting from allocations of taxable income to its carried interests in its real estate funds. These amounts of advance distributions are not subject to clawbacks but would serve to reduce future carried interest payments earned from the Company's real estate funds.

(in thousands)

	Three Months Ended August 31, 2015	Nine Months Ended August 31, 2015
Rialto Real Estate Fund I, LP	\$ 3,545	\$ 9,509
Rialto Real Estate Fund II, LP	1,051	6,342
Rialto Mezzanine Partners Fund, LP	387	387
	<u>\$ 4,983</u>	<u>\$ 16,238</u>

The following table represents amounts we would have received had our funds ceased operations and hypothetically liquidated all its investments at their estimated fair value on of August 31, 2015, both gross

and net of amounts received as advanced tax distributions.

(in thousands)

	<b>Hypothetical Carried Interest</b>	<b>Paid as Advanced Tax Distribution</b>	<b>Net Hypothetical Carried Interest</b>
Rialto Real Estate Fund I, LP	\$ 156,173	\$ (44,201)	\$ 111,972
Rialto Real Estate Fund II, LP	37,018	(6,342)	30,676
Rialto Mezzanine Partners Fund, LP	465	(387)	78
	<u>\$ 193,656</u>	<u>\$ (50,930)</u>	<u>\$ 142,726</u>

On June 9, 2015, the Board of Directors of Lennar approved the Rialto Holdings, LLC Carried Interest Incentive Plan (“Plan”) which provides participants in the Plan the opportunity to participate in distributions made by a fund or other investment vehicle (a “Fund”) managed by a subsidiary of Rialto. Under the Plan, Rialto may distribute to its employees or to employees of Lennar who are involved in the management of the Fund, units of the limited liability company (the “Carried Interest Entity”) that entitle its holder to specified percentages of distributions made from the Fund to the Carried Interest Entity. Rialto may distribute to its employees units entitling them to up to 40% of the distributions received by the Carried Interest Entity and to employees of Lennar units entitling them to up to 10% of the distributions received by the Carried Interest Entity. The Plan will be administered by a Committee comprised of two members of Lennar’s management and one member of Rialto’s management. The units issued to employees will be subject to vesting schedules and forfeiture or repurchase provisions in the case of a termination of employment. The Plan requires that each participant enter into a Non-Competition, Non-Solicitation and Confidentiality Agreement. A Carried Interest Entity will make advanced tax distributions to participants to enable them to pay taxes to the extent the taxes they are required to pay are more than the total distributions they have received.

During the quarter, the Company recorded \$7.8 million of compensation expense related to the Plan, of which \$5.0 million related to an advanced tax distribution, as mentioned above, and \$2.8 million related to the amortization of the share-based compensation expense over the vesting period and is recorded as minority interest on the consolidated balance sheet at August 31, 2015.

### ***Loan Origination and Securitization***

We originate fixed rate, first mortgage loans, secured by stabilized, income-producing commercial real estate properties, which are sold through securitizations. These loans generally have five, seven and ten year terms. Generally those loans are between \$2 and \$75 million in size. Our goal has been to securitize loans through third-party issuers at least quarterly, thus keeping them on our balance sheet for a relatively short period of time. Our loans are directly originated by an internal team that has longstanding and strong relationships with borrowers and mortgage brokers throughout the U.S. We follow a rigorous investment process, which begins with an initial due diligence; continues through a comprehensive legal and underwriting process incorporating multiple internal and external checks and balances; and culminates in approval or disapproval of each prospective investment by our Credit Committee. During the nine months ended August 31, 2015, we originated loans with a total principal balance of \$2.0 billion and sold \$1.6 billion of originated loans into eight separate securitization trusts.

As of August 31, 2015, we had three warehouse repurchase facilities that mature in fiscal year 2015 and 2016 with commitments totaling \$900 million to help finance our lending activities. Borrowings under these facilities were \$321.5 million as of August 31, 2015. We seek to sell loans as quickly as feasible once funded. In addition, while we hold loans on our balance sheet before securitization, we hedge underlying interest rates and credit spreads using a variety of strategies and tools available in the market.

We also originate and invest in floating rate loans secured by commercial real estate properties that are

sometimes undergoing transition, including lease-up, sell-out and renovation or repositioning. As of August 31, 2015 and November 30, 2014, these loans totaled approximately \$29.7 million and \$7.0 million, respectively. On August 31, 2015, the Company entered into a separate \$100 million repurchase facility to finance the origination of floating rate accrual loans. Loans financed under this facility are held as accrual loans within Loans receivable, net.

*Net profit from loans sold into securitizations*

Income from loans sold into securitizations, a non-GAAP measure, represents gross proceeds from the sale of loans into securitization trusts, less the book value of those loans at the time they were sold, plus the sale of servicing rights.

We present net profit from loans sold into securitizations, a non-GAAP measure, as a supplemental measure of the performance of our Loan Origination and Securitization business. Net profit from loans sold into securitizations is a key component of our results.

Below are the results from sales of loans held-for-sale into securitizations for the three and nine months ended August 31, 2015 and 2014 (dollars in thousands):

	Three Months Ended August 31,		Nine Months Ended August 31,	
	2015	2014	2015	2014
Number of loans	55	32	150	89
Originated loans sold, including those not settled	\$ 519,149	\$ 292,411	\$ 1,558,232	\$ 983,635
Number of securitizations	3	1	8	5
Net margin	3.1%	4.5%	3.6%	4.5%
Income from sale of securitized loans <sup>(1)</sup>	\$ 21,247	\$ 15,755	\$ 72,889	\$ 52,322
Expenses from sale of securitized loans	\$ 5,931	\$ 2,705	\$ 19,054	\$ 10,512
Net securitization profit	<u>\$ 15,316</u>	<u>\$ 13,050</u>	<u>\$ 53,835</u>	<u>\$ 41,810</u>

<sup>(1)</sup> The following is a reconciliation of the non-GAAP measure of income from the sale of securitized loans to gains from securitizations and other loan origination revenues, which is the closest GAAP measure, as reported in our consolidated statements of operations included herein.

	Three Months Ended August 31,		Nine Months Ended August 31,	
	2015	2014	2015	2014
Total securitization revenues	\$ 21,247	\$ 15,755	\$ 72,889	\$ 52,322
Loan origination and processing fees	374	338	1,255	802
Net realized and unrealized losses on loans and hedging instruments	(2,779)	(653)	(5,911)	(2,377)
Gain from securitizations and other loan origination revenues	<u>\$ 18,842</u>	<u>\$ 15,440</u>	<u>\$ 68,233</u>	<u>\$ 50,747</u>

***Direct Investments***

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

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. Our objective is to continue to monetize and wind down these distressed commercial real estate portfolios in order to free up the underlying capital to recycle cash to achieve higher returns elsewhere in the Company.

*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. The financing from the FDIC has been repaid and the two LLCs are now making distributions to members, of which we receive 40%.

*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 five year senior unsecured loan provided by one of the selling institutions.

In November 2013, in settlement of a loan acquired as part of the 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 was used to complete improvements in 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. 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 August 31, 2015, and its operating results are included in our consolidated statements of operations for the three and nine months ended August 31, 2015 and 2014.

Neither we nor the hospital management company will receive any distribution from operations other than the reduced management fee until all creditors have been paid in full. As of August 31, 2015, \$1.5 million remains payable to pre-petition bankruptcy creditors.

#### *Other*

*CMBS Investment* — In 2010, we purchased approximately \$43 million face amount of non-investment grade CMBS for \$19.4 million, representing a 55% discount from par value.

*Primary Servicer* — In January 2014, we acquired 100% of the loan servicing business segment of a real estate services company (the “Service Provider”) in exchange for the approximately 5% investment we owned in that company as of November 30, 2013. This acquired operation had previously provided loan servicing support for our owned and managed portfolios, as well as asset management services for our small balance loan workout program.

*Other* — In December 2014, we made an investment of \$18.0 million in a non-marketable equity security of an unaffiliated, private commercial real estate services company, in which we do not have a controlling interest or significant influence. This equity security is carried at cost and included in Other assets, net, in the accompanying consolidated balance sheets.

## 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 expenses at the corporate level as well as interest and other expenses for the three and nine months ended August 31, 2015 and 2014 as follows (in thousands):

	Three Months Ended August 31,		Nine Months Ended August 31,	
	2015	2014	2015	2014
General and administrative expenses	\$ 26,728	\$ 25,145	\$ 88,677	\$ 71,024
Interest and other expenses	7,595	7,915	21,766	22,198

General and administrative costs increased for both the three and the nine month periods due to increases in personnel costs due to the growth of our Loan Origination and Securitization business and accruals for performance-based compensation and expenses related to the Carried Interest Plan. During the quarter, the Company recorded \$7.8 million of compensation expense related to the Carried Interest Plan, of which \$5.0 million related to an advanced tax distribution, and \$2.8 million related to the amortization of the share-based compensation expense over the vesting period and is recorded as minority interest on the consolidated balance sheet at August 31, 2015.

## Investment and Asset Management

### Overview

(in thousands)

	As of			
	August 31, 2015	November 30, 2014		
Total Assets	\$ 211,148	\$ 175,726		
	Three Months Ended August 31,		Nine Months Ended August 31,	
	2015	2014	2015	2014
Revenues	\$ 22,987	\$ 15,290	\$ 67,813	\$ 42,913
Equity in earnings from unconsolidated entities	7,579	19,964	17,550	43,279
Gain on sale of investment securities	-	-	-	378
Net earnings before income taxes and overhead	30,566	35,254	85,363	86,570

### Three Months ended August 31, 2015 versus Three Months Ended August 31, 2014

Investment and Asset Management revenues increased 50% quarter over quarter mainly due to increases in fees derived from growing equity and assets under management in Fund II, the Mezzanine Fund and the CMBS Fund, as well as the \$5.0 million of advanced distributions from Fund I, Fund II and the Mezzanine Fund to cover income tax obligations, resulting from allocations of taxable income from our carried interest in Fund I, Fund II and the Mezzanine Fund. These advanced distributions are not subject to repayment or adjustment.

Equity in earnings declined quarter over quarter due to decreases in the Company's share of earnings from the funds. The Company's share of earnings from Fund I were \$4.2 million compared to \$10.3 million in the

third quarter of 2014. The decrease in earnings from Fund I was primarily due to lower unrealized gains from fair value mark-ups on CMBS investments. The Company's share of earnings from Fund II were \$2.4 million compared to \$7.1 million in the third quarter of 2014. The decrease in earnings from Fund II was primarily due to the lower unrealized gains from fair value mark-ups on CMBS investments. In addition, the Company's share of earnings in the CMBS Fund was \$0.4 million compared to \$2.0 million in the third quarter of 2014 which was significantly more active in partial sales of certain underlying investment securities at gains. The Company's share of earnings in the Mezzanine Fund for the third quarter of 2015 remained relatively constant compared to the third quarter of 2014.

### **Nine Months ended August 31, 2015 versus Nine Months Ended August 31, 2014**

Investment and Asset Management revenues increased 58% year over year mainly due to increases in fees derived from growing equity and assets under management in Fund II, the Mezzanine Fund and the CMBS Fund, as well as the \$16.2 million of advanced distributions from Fund I, Fund II and the Mezzanine Fund to cover tax obligations, resulting from allocations of taxable income from our carried interest in Fund I, Fund II and the Mezzanine Fund. These advanced distributions are not subject to repayment or adjustment.

Equity in earnings declined year over year due to decreases in the Company's share of earnings from the funds. The Company's share of earnings from Fund I were \$7.9 million compared to \$22.5 million in the same period prior year. The decrease in earnings From Fund I was primarily due lower unrealized gains from fair value mark-ups on CMBS investments. The Company's share of earnings in Fund II was \$5.5 million compared to \$9.5 million in the same period prior year. The decrease in earnings in Fund II was due to lower unrealized gains from fair value mark-ups on CMBS investments. In addition, the Company's share of earnings in the CMBS Fund was \$2.5 million compared to \$9.9 million in the same period prior year which was significantly more active in partial sales of certain underlying investment securities at gains. The Company's share of earnings for the Mezzanine Fund was \$1.6 million compared to \$1.4 million in the same period prior year. The increase in earnings was due to an increase in interest income on loans resulting from a larger invested base of loans.

### **Loan Origination and Securitization**

#### Overview

(in thousands)

	<u>As of</u>			
	August 31, 2015	November 30, 2014		
Total Assets	\$ 605,311	\$ 322,361		
	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	August 31,		August 31,	
	2015	2014	2015	2014
Revenues	\$ 24,254	\$ 18,186	\$ 82,171	\$ 58,904
Net earnings before income taxes and overhead	14,247	13,145	52,928	41,193

### **Three Months ended August 31, 2015 versus Three Months Ended August 31, 2014**

Loan Origination and Securitization revenues increased 33% quarter over quarter mainly due to an increase in revenues from higher securitization volume as well as an increase in interest income on originated loans. During the three months ended August 31, 2015, the Company originated loans with a total principal balance

of \$731.5 million and sold \$519.1 million of originated loans into three separate securitizations at an average net margin of 3.1% whereas for the same period in 2014, the Company originated loans with a total principal balance of \$418.7 million and sold \$292.4 million of loans into one separate securitization at an average net margin of 4.5%. Additionally, interest income increased from \$2.7 million in the third quarter of 2014 to \$5.4 million in the third quarter of 2015.

### **Nine Months ended August 31, 2015 versus Nine Months Ended August 31, 2014**

Loan Origination and Securitization revenues increased 40% year over year mainly due to an increase in revenues from higher securitization volume as well as an increase in interest income on originated loans. During the nine months ended August 31, 2015, the Company originated loans with a total principal balance of \$2.0 billion and sold \$1.6 billion of originated loans into eight separate securitizations at an average net margin of 3.6% whereas for the same period in 2014, the Company originated loans with a total principal balance of \$1.1 billion and sold \$983.6 million of loans into five separate securitizations at an average net margin of 4.5%. As the number and volume of loan originations increased year over year, interest income has increased from \$8.2 million for the nine months ended August 31, 2014, to \$13.9 million for the nine months ended August 31, 2015.

### ***Direct Investments***

#### Overview

(in thousands)

	As of		Three Months Ended		Nine Months Ended	
	August 31, 2015	November 30, 2014	August 31,		August 31,	
	2015	2014	2015	2014	2015	2014
Total Assets	\$ 586,250	\$ 730,646				
Revenues	\$ 18,931	\$ 20,441	\$ 53,347	\$ 76,894		
Equity in earnings (loss) from unconsolidated entities	11	9	32	(13)		
Net loss before income taxes and overhead	(1,928)	(2,955)	(7,062)	(6,208)		

### **Three Months ended August 31, 2015 versus Three Months Ended August 31, 2014**

Direct Investments revenues decreased 7% quarter over quarter mainly due to decreases in interest income and rental income as a result of a decrease in the portfolio of loans and REO the Company owns as a result of loan collections, resolutions and reduced income producing REO from sales of those properties. Additionally, revenues declined as interest income is no longer being recognized under the accretable yield accounting method in 2015 as it was during 2014. Rather, interest income is recognized only to the extent that loan collections exceed carrying value. Expenses in this business line also decreased due to a decrease in the amount of loan impairments recorded in the current year. A larger amount of loan losses were recorded last year as a result of changes in the estimated cash flows expected in the FDIC Portfolios. The decrease in revenues was slightly offset by an increase in hospital revenues due to an increase in patient volume quarter over quarter.

## Nine Months ended August 31 2015 versus Nine Months Ended August 31, 2014

Direct Investments revenues decreased 30% year over year mainly due to decreases in interest income and rental income as a result of a decrease in the portfolio of loans and REO the Company owns as a result of loan collections, resolutions and REO foreclosures. Additionally, revenues declined as interest income is no longer being recognized under the accretible yield accounting method in 2015 as it was during 2014. Rather, interest income is recognized only to the extent that loan collections exceed carrying value. Expenses in this business line also decreased due to a decrease in the amount of loan impairments recorded in the current year. A larger amount of loan losses were recorded last year as a result of changes in the estimated cash flows expected in the FDIC Portfolios. The decrease in revenues was slightly offset by an increase in hospital revenues due to an increase in patient volume year over year.

Below is a summary of the business lines' financial results to arrive at the Company's consolidated financial results (in thousands):

	As of and for the Three Months Ended August 31, 2015					
	Investment and Asset Management	Loan Origination & Securitization	Direct Investments	Corporate	Eliminations	Total Consolidated
Total Assets	\$ 211,148	\$ 605,311	\$ 586,250	\$ 794,845	\$ (688,805)	\$ 1,508,749
Revenues	22,987	24,254	18,931	-	(1,787)	64,385
Equity in earnings from unconsolidated entities	7,579	-	11	-	-	7,590
Net earnings (loss) before income taxes and overhead	30,566	14,247	(1,928)	(34,323)	-	8,562

	As of November 30, 2014 and for the Three Months Ended August 31, 2014					
	Investment and Asset Management	Loan Origination & Securitization	Direct Investments	Corporate	Eliminations	Total Consolidated
Total Assets at November 30, 2014	\$ 175,726	\$ 322,361	\$ 730,646	\$ 918,149	\$ (688,730)	\$ 1,458,152
Revenues	15,290	18,186	20,441	-	(2,325)	51,592
Equity in earnings from unconsolidated entities	19,964	-	9	-	-	19,973
Net earnings (loss) before income taxes and overhead	35,254	13,145	(2,955)	(33,060)	-	12,384

	For the Nine Months Ended August 31, 2015					
	Investment and Asset Management	Loan Origination & Securitization	Direct Investments	Corporate	Eliminations	Total Consolidated
Revenues	\$ 67,813	\$ 82,171	\$ 53,347	\$ -	\$ (5,459)	\$ 197,872
Equity in earnings from unconsolidated entities	17,550	-	32	-	-	17,582
Net earnings (loss) before income taxes and overhead	85,363	52,928	(7,062)	(110,443)	-	20,786

**For the Nine Months Ended August 31, 2014**

	<b>Investment and Asset Management</b>	<b>Loan Origination &amp; Securitization</b>	<b>Direct Investments</b>	<b>Corporate</b>	<b>Eliminations</b>	<b>Total Consolidated</b>
Revenues	\$ 42,913	\$ 58,904	\$ 76,894	\$ -	\$ (5,925)	\$ 172,786
Equity in earnings from unconsolidated entities	43,279	-	(13)	-	-	43,266
Gain on sale of investment securities	378	-	-	-	-	378
Net earnings (loss) before income taxes and overhead	86,570	41,193	(6,208)	(93,223)	-	28,332

The Total Asset elimination amount in the table above represents corporate's investment in the other business lines and the Revenue elimination largely represents the elimination of primary loan servicing fee revenues charged by our Service Provider to our Direct Investments business line.

## **(2) Liquidity and Capital Resources**

Our financing strategies are critical to the success and growth of our business. We manage our financing to complement our asset composition and to diversify our exposure across multiple capital sources and counterparties.

We require substantial amounts of capital to support our business. The management team establishes our overall liquidity and capital allocation strategies. A key objective of those strategies is to support the execution of our business strategy while maintaining sufficient ongoing liquidity throughout the business cycle to service our financial obligations as they become due. When making funding and capital allocation decisions, members of our senior management consider business performance; the availability of, and costs and benefits associated with, different funding sources, current and expected capital markets and general economic conditions; our balance sheet and capital structure, and our targeted liquidity profile and risks relating to our funding needs.

Our primary sources of liquidity have been (1) cash and cash equivalents, (2) cash generated from our business activities, including proceeds from the sale of commercial loans into securitization vehicles, management fees and distributions from the funds we manage and invest in, and proceeds from the sale of real estate related assets we own, (3) proceeds from the issuance of the 7.00% Senior Notes, (4) borrowings under the warehouse repurchase facilities and (5) proceeds from the Structured Notes.

Our primary uses of liquidity are for (1) the funding of loan and real estate-related investments including our contributions to the funds we sponsor, (2) the repayment of short-term and long-term borrowings and related interest, (3) the funding of our operating expenses and (4) distributions to Lennar.

At August 31, 2015, we had \$106.7 million in cash.

Our notes payable and other debts payable consisted of the following at August 31, 2015 and November 30, 2014 (in thousands):

	<b>2015</b>	<b>2014</b>
Senior Notes, net	\$ 351,612	\$ 351,939
Bank Portfolios	60,622	60,622
Warehouse Repurchase Facilities	321,525	141,272
Structured Notes, net	31,384	57,950
Notes payable - other	9,101	11,463
Total Notes payable and other debts payable	<u>\$ 774,244</u>	<u>\$ 623,246</u>

### *Senior Notes*

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 subsequently an additional \$135 million of working capital, to repay sums that were previously advanced to the Company by Lennar. Interest on the 7.00% Senior Notes is due on June 1 and December 1 of each year, and the 7.00% Senior Notes will mature on December 1, 2018. In March 2014, the Company issued an additional \$100 million aggregate principal amount, as an add-on to the 7.00% Senior Notes, at a price of 102.25%, in a private placement. The terms from the add-on offering have identical terms as the 7.00% Senior Notes. Proceeds from the offering, after payment of expenses, were approximately \$101.7 million. The Company used most of the funds to provide additional working capital to its Loan Origination and Securitization business, fund contributions to its investment funds or for other general corporate purposes. At August 31, 2015 and November 30, 2014, the carrying amount of the 7.00% Senior Notes was \$351.6 million and \$351.9 million, respectively.

The Company may redeem all or a portion of the 7.00% Senior Notes at the following redemption prices (expressed as a percentage of principal) beginning December 1 of each of the years indicated below:

<b>Year</b>	<b>Percentage</b>
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. Interest on the 7.00% Senior Notes is due semi-annually, with the first payment made on June 1, 2014. The Company may redeem all or a portion 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 governing the 7.00% Senior Notes, the Company is subject to certain covenants limiting, among 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 August 31, 2015.

The 7.00% Senior Notes are Rialto’s senior unsecured and unsubordinated obligations, 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 to 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 existing and future directly or indirectly 100% owned subsidiaries other than subsidiaries which Rialto designates as unrestricted subsidiaries (which subject those subsidiaries to limits on investments by the Company and other restrictions). A 100% owned subsidiary can only become an unrestricted subsidiary if it is a borrower under a warehouse repurchase facility or is prevented 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.

Prior to our issuance of the 7.00% Senior Notes, our Investment and Asset Management business line and our Direct Investments business line were funded largely by 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 what we can borrow under a Revolving Credit Agreement). 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. The revolving facility will terminate in November 2015. Borrowings bear interest at LIBOR plus 3.5%. At August 31, 2015, no amounts were outstanding; however, \$25 million had been borrowed and repaid under this agreement over a one day span in April 2015.

On June 30, 2015, RMF entered into a revolving credit agreement (“Credit Agreement”) with Lennar, as lender. Under the Credit Agreement, Lennar will, subject to customary lending conditions, make advances to RMF on a revolving basis of up to \$200 million, subject to certain limitations and the achievement of specified financial conditions (the “Credit Facility”). The maturity date of the Credit Agreement is June 30, 2018 and amounts borrowed under the Credit Agreement accrue interest at LIBOR plus 3.5% for the applicable interest period. RMF will be subject to certain customary covenants, including, but not limited to, limitations on fundamental changes, limitations on changes to lines of business and transactions with affiliates. RMF may prepay outstanding amounts at any time, without premium or penalty, on five business days’ prior notice. This new Credit Facility is an addition to the \$75 million facility extended by Lennar to Rialto. At August 31, 2015, no amounts were outstanding under this agreement. During the third quarter 2015, amounts aggregating to \$280 million had been drawn and repaid under this facility to fund RMF loan originations. The Company incurred and paid to Lennar \$0.4 million in interest expense related to these borrowings.

During 2014, we used our excess cash to pay \$167 million of dividends to Lennar. The remaining capital that Lennar had invested in us, which all is in the form of equity, was \$425.9 million as of August 31, 2015. 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.

#### *Bank Portfolios*

In September 2010, the Company acquired approximately 400 distressed residential and commercial real estate loans 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 \$124.0 million was financed through a five-year senior unsecured note provided by one of the selling institutions. The Bank Portfolios’ notes payable have an interest rate of the higher of 4.5% or 1 month LIBOR plus 3.75%.

In January 2014, the Company extended the maturity date of the Bank Portfolios’ notes payable. Maturity dates have been subsequently rescheduled and the remaining principal of \$60.6 million will be due in equal installments in December 2015 and 2016.

#### *Warehouse Repurchase Facilities*

The Company’s RMF business is funded by its three warehouse repurchase facilities with commitments totaling \$900 million and the proceeds of the sale of the 7.00% Senior Notes in excess of the \$100 million that was paid to Lennar. At August 31, 2015, the warehouse repurchase facilities financing the RMF loan origination and securitization business were as follows (in thousands):

	<b>Maximum Aggregate Commitment</b>
364-day warehouse repurchase facility that matures October 2015 <sup>1</sup>	\$ 400,000
364-day warehouse repurchase facility that matures March 2016	250,000
364-day warehouse repurchase facility that matures August 2016	250,000
Loan Origination and Securitization business total	<u>\$ 900,000</u>
364-day warehouse repurchase facility that matures August 2018	<u>100,000</u>
Total	<u><u>\$ 1,000,000</u></u>

<sup>(1)</sup> This facility was extended for one year on October 7, 2015.

RMF uses the three facilities totaling \$900 million to finance its loan originations until the loans are sold in a securitization and the proceeds are collected. The facilities are expected to be renewed or replaced with other facilities when they mature. As of August 31, 2015 and November 30, 2014, the Company had \$321.5 million and \$141.3 million, respectively, outstanding under the facilities. Each of these facilities is secured by a 75% interest in the originated commercial loans financed. The facilities require immediate repayment of the 75% interest in the secured commercial loans when the loans are sold in a securitization and the proceeds are collected.

On August 31, 2015, the Company entered into a separate \$100 million repurchase facility to finance the origination of floating rate loans. This facility has a maturity date of August 31, 2018, with two one-year extension options: (i) the first for an additional one year period ending one year after the initial maturity date, and (ii) the second for an additional one year period ending one year after the first extended maturity date. The facility bears interest at one-month-LIBOR plus the applicable pricing margin which ranges from 2.00% to 2.50% based on asset type. Loans financed under this facility are held as accrual loans within Loans receivable, net.

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 August 31, 2015.

#### *Structured Notes*

In May 2014, the Company issued \$73.8 million principal amount of notes through a securitized structured note offering (the "Structured Notes") collateralized by certain assets originally acquired in the Bank Portfolios transaction at par, with an annual coupon rate of 2.85%. Proceeds from the offering, after payment of expenses and hold backs for cash reserves were \$69.1 million. In November 2014, Rialto sold the second tranche of the Structured Notes at a price of 99.5%. The initial principal amount of this second tranche was \$20.8 million and has an annual coupon rate of 5.00%. Proceeds from the sale, after payment of expenses, were \$20.7 million, including accrued interest. The estimated final payment date of the Structured Notes is December 15, 2015. Monthly payments of principal and interest are based on the priority of available cash per the cash management agreement. The overcollateralization percentage required by the structure is 125% and is defined as the ratio of the aggregated allocated basis and the balance in the interest reserve account divided by the outstanding principal balance of the notes on each payment date. As of August 31, 2015 and November 30, 2014, the outstanding amount related to the Structured Notes was \$31.4 million and \$58.0 million, respectively. The Company is in compliance with all debt covenants as of August 31, 2015.

#### *Revolving Lines of Credit with Lennar*

The Company has two revolving credit agreements with Lennar as a supplemental source of operating funds. See Note 13 in financial statements for a description of such arrangements.

#### *Notes Payable – Other*

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 above. 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. These notes payable have interest rates ranging from 5.5% to 6.9%.

In November 2013, in settlement of a loan acquired as part of the Company’s Bank Portfolios, the Company acquired the real estate and operating entity of a 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 complete improvements in 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. In return, the Company acquired 100% of the hospital operating entity effective November 8, 2013, which became a fully consolidated entity of the Company.

The Company has contracted the Third-party Operator to operate and manage the hospital. Additionally, a 20% equity interest in the real estate entity that owns the hospital’s land and building was exchanged for the administrative bankruptcy claims of several doctors who were original shareholders of the hospital. As of August 31, 2015, the exact amount of the claims that will be allowed has not yet been determined, therefore, the noncontrolling interest has not been distributed. Rialto has the right to withhold the distribution of this noncontrolling interest until all such requirements are satisfied.

Neither Rialto nor the Third-party Operator shall receive any distribution from operations other than the reduced management fee and payments until all creditors have been paid in full, which management believes can occur within two years.

*Lennar/RMF Revolving Credit Agreement* – On June 30, 2015, RMF entered into a revolving credit agreement (“Credit Agreement”) with Lennar, as lender. Under the Credit Agreement, Lennar will, subject to customary lending conditions, make advances to RMF on a revolving basis of up to \$200 million, subject to certain limitations and the achievement of specified financial conditions (the “Credit Facility”). The maturity date of the Credit Agreement is June 30, 2018, and amounts borrowed under the Credit Agreement accrue interest at LIBOR plus 3.5% for the applicable interest period. RMF will be subject to certain customary covenants, including, but not limited to, limitations on fundamental changes, limitations on changes to lines of business and transactions with affiliates. RMF may prepay outstanding amounts at any time, without premium or penalty, on five business days’ prior notice. This new Credit Facility is in addition to the \$75 million facility extended by Lennar to Rialto. At August 31, 2015, no amounts were outstanding under this agreement.

## ***Cash Flows***

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

(in thousands)

	Nine Months Ended August 31,	
	2015	2014
Operating activities	\$ (290,078)	\$ (77,860)
Investing activities	15,663	182,337
Financing activities	77,257	(94,943)
(Decrease) increase in cash	<u>\$ (197,158)</u>	<u>\$ 9,534</u>

### ***Operating Cash Flow Activities***

Cash used in operating activities totaled \$290.1 million and \$77.9 million, respectively, representing an increase of 272% year over year. During the nine months ended August 31, 2015, cash used in operating activities was impacted largely by our Loan Origination and Securitization business that used cash for loan originations of \$2.0 billion partially offset by the sale of these loan originations into eight separate securitization trusts for a cash inflow of \$1.6 billion as well as the settlement of \$165.6 million of loans sold which included \$153.8 million of loans that had not settled as of prior year end and \$11.8 million of other originated loans sold. There was a decrease in accruals and other liabilities of \$33.4 million largely related to accrued compensation from 2014 paid in 2015. Additionally, there were \$14.4 million in deferred income tax benefits for the quarter (as an operating cash usage) representing relatively large current income tax payments to Lennar under our Tax Sharing Agreement for the first three quarters of 2015.

During the nine months ended August 31, 2014, our cash used in operating activities was impacted largely by our Loan Origination and Securitization business that used cash for loan originations of \$1.1 billion partially offset by the sale of a portion of these loan originations into five separate securitization trusts for a cash inflow of \$983.6 million as well as the settlement of \$111.8 million of loans that had settled as of prior year end. There were also a decrease in due to Parent of \$16.8 million, an increase in accruals and other liabilities of \$10.7 million and an increase in other assets of \$17.1 million. Additionally, there was \$43.3 million in equity in earnings from unconsolidated entities and \$10.5 million deferred income taxes. These cash uses were offset by net earnings attributable to Rialto of \$17.4 million.

### ***Investing Cash Flow Activities***

Cash provided by investing activities was \$15.7 million and \$182.3 million, respectively, representing a 91% decrease year over year. The decline was driven by an approximately 50% reduction in proceeds from the sales of REO, as the volume of properties owned has declined and the pipeline of properties from foreclosures on loans has also declined. This is commensurate with the decline in the number of loans outstanding period over period, which is the result of our loan work-out efforts. Cash from investing has also decreased as distributions from investments have declined period over period, while capital has been called for the ramp up in Fund II, the Mezzanine Fund and the CMBS Fund. Additionally, we originated \$22.5 million of loans held-to-maturity and we made an \$18.0 million investment in a private commercial real estate services company during 2015.

### ***Financing Cash Flow Activities***

Cash provided by and used in financing activities was \$77.3 million and \$94.9 million, respectively, representing a 181% improvement year over year. Cash provided by financing consisted of the paydown of

the Notes payable of \$28.2 million, predominantly the Structured Notes, distributions to the FDIC of \$73.8 million (compared to \$89.2 million in the prior year period) and net borrowings under the warehouse repurchase facilities of \$180.3 million, compared to net repayments of \$4.6 million. The net increase in cash provided by financing was largely due to the excess borrowing on the warehouse repurchase facilities.

## 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 August 31, 2015 and November 30, 2014, and for each of the three and nine months ended August 31, 2015 and 2014 (in thousands):

#### **Balance Sheets**

	<b>August 31, 2015</b>	<b>November 30 2014</b>
<b>Assets:</b>		
Cash and cash equivalents	\$ 117,061	\$ 141,609
Loans receivable	504,675	512,034
Real estate owned	446,629	378,702
Investment securities	1,084,819	795,306
Investments in partnerships	411,182	311,037
Other assets	40,522	45,451
	<u>\$ 2,604,888</u>	<u>\$ 2,184,139</u>
<b>Liabilities and equity:</b>		
Accounts payable and other liabilities	\$ 23,421	\$ 20,573
Notes payable	357,556	395,654
Equity	2,223,911	1,767,912
	<u>\$ 2,604,888</u>	<u>\$ 2,184,139</u>

#### **Statements of Operations**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>August 31,</b>		<b>August 31,</b>	
	<b>2015</b>	<b>2014</b>	<b>2015</b>	<b>2014</b>
Revenues	\$ 41,278	\$ 39,401	\$ 122,336	\$ 104,005
Costs and expenses	24,937	22,552	73,024	71,965
Other income, net <sup>(1)</sup>	60,106	181,877	121,457	334,915
Net earnings of unconsolidated entities	<u>\$ 76,447</u>	<u>\$ 198,726</u>	<u>\$ 170,769</u>	<u>\$ 366,955</u>
Equity in earnings from unconsolidated entities	<u>\$ 7,590</u>	<u>\$ 19,973</u>	<u>\$ 17,582</u>	<u>\$ 43,266</u>

<sup>(1)</sup> Other income, net, for the three and nine months ended August 31, 2015 and 2014 included realized and unrealized gains (losses) on investments.

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

The following table summarizes certain of our contractual obligations at August 31, 2015 (in thousands):

	Total	Payments Due by Period			
		Less than 1 year	1 to 3 years	3 to 5 years	More than 5 years
Notes payable and other debts payable <sup>(1)</sup>	\$ 452,719	\$ 1,264	\$ 98,747	\$ 352,708	\$ -
Warehouse repurchase facilities <sup>(2)</sup>	321,525	321,525	-	-	-
Interest commitments under interest bearing debt <sup>(3)</sup>	88,671	994	50,900	36,777	-
Investment commitments <sup>(4)</sup>	14,693	14,693	-	-	-
RMF rate lock commitment <sup>(5)</sup>	7,500	7,500	-	-	-
Operating leases	12,371	565	3,540	2,676	5,590
Total contractual obligations	<u>\$ 897,479</u>	<u>\$ 346,541</u>	<u>\$ 153,187</u>	<u>\$ 392,161</u>	<u>\$ 5,590</u>

<sup>(1)</sup> Amount includes \$31.4 million related to the Structured Notes with an assumed final payment date of December 15, 2015.

<sup>(2)</sup> Warehouse facilities are assumed to be paid off in the short-term as soon as loans held-for-sale are securitized, which is normally within 2 to 3 months.

<sup>(3)</sup> Interest commitments on variable interest-bearing debt are determined based on the interest rate as of August 31, 2015.

<sup>(4)</sup> Amount includes the Company's capital commitments to Fund II and the Mezzanine Fund.

<sup>(5)</sup> Relates to one loan the Company is contractually obligated to fund but has yet to release the funds to the borrower.

## 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. Up until our 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 \$275 million in interest-bearing loans under the Revolving Credit Agreements.

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 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 potential 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 risk 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 not permitted by market conditions. 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 and foreclosed properties, using primarily funds provided by Lennar through the Investor Companies. Since 2011, investments have been made primarily through 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 affected by changing conditions.

Generally, 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 30% - 50% of unpaid principal balance) and are typically acquired at a discount to 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) basis.

Also, our loan origination and securitization activities are sensitive to changes in interest rates. The value of mortgage loans and mortgage-backed securities are affected by the level of market interest rates. Similarly, when we originate loans, either for ourselves or for our managed funds, 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 the interest rate, and fixes the interest rate when it makes the loan. 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. 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 utilize to make the loan, will be less than we had anticipated. The Company generally seeks to close loans as closely to the sale date as possible and mitigates interest rate risk through utilization of hedging instruments, but those hedges are not perfect, and we could be adversely affected by unexpected changes in interest rates.

Additionally, in regards to our CMBS investments, the market value of these investments could fluctuate materially over time as the result of changes in mortgage spreads, treasury bond yields, capital market supply and demand factors, the performance of the underlying properties and loans in the CMBS trust and many other factors that affect high-yield fixed income products. These factors are out of our control, but could affect our ability to sell CMBS classes which we own or cause values to fluctuate, which may have an impact on our unrealized gains or losses on those securities held by our funds and that value of our investment in those funds.

### **(3) New Accounting Pronouncements**

See Note 2 of the notes to our unaudited consolidated financial statements included under Item 1 of this quarterly report for a comprehensive discussion of new accounting pronouncements applicable to our Company.

### **(4) Critical Accounting Policies and Estimates**

We believe that there have been no significant changes to our critical accounting policies during the three and nine months ended August 31, 2015, as compared to those we disclosed in Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report for the year ended November 30, 2014. Even though our critical accounting policies have not changed in any significant way during the three and nine months ended August 31, 2015, the following provides additional disclosures about our management fee revenue accounting policy.

#### ***Management Fee Revenue***

We provide investment management services to a variety of legal entities and investment vehicles such as funds, joint ventures, co-investment vehicle and other private equity structures to manage their respective investments. 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 (i) a percentage of committed or called capital during the commitment period and called capital after the commitment period ends, and (ii) 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, we may earn additional fees when the return on assets managed exceeds contractual thresholds ("Carried Interest"), which is generally approximately six years after inception. Such revenue is only booked when 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 clawbacks is limited. We may also receive tax distributions to cover income tax obligations resulting from allocations of taxable income due to our Carried Interest in the funds. These distributions are not subject to clawbacks and therefore are recorded as revenue when received.

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.

## **PART II. Other Information**

### **Item 1. Legal Proceedings**

The Company is involved in legal proceedings in the ordinary course of business. Although Company management cannot predict the ultimate outcome of such matters, we believe the final disposition will not have a material adverse effect on our business, consolidated financial position, results of operations, liquidity or cash flows.

### **Item 1A. Risk Factors**

There have been no material changes in our risk factors from those disclosed in our Annual Report for the year ended November 30, 2014.