PMC COMMERCIAL TRUST /TX
Form 10-K
March 16, 2006

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10 K

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

For the Fiscal Year Ended December 31, 2005

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

For the Transition Period From _______to ________

Commission File Number: 1-13610

PMC COMMERCIAL TRUST

(Exact name of registrant as specified in its charter)

Texas	**75-6446078**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
17950 Preston Road, Suite 600, Dallas, TX 75252	**(972)349-3200**
(Address of principal executive offices)	(Registrant s telephone number)

Securities registered pursuant to Section 12(b) of the Act:
Common Shares of beneficial interest, $.01 par value

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

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

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

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

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant, based upon the closing sale price of the Common Shares of Beneficial Interest on June 30, 2005 as reported on the American Stock Exchange, was approximately $129 million. Common Shares of Beneficial Interest held by each officer and trust manager and by each person who owns 10% or more of the outstanding Common Shares of Beneficial Interest have been excluded because such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of March 7, 2006, the Registrant had outstanding 10,741,921 Common Shares of Beneficial Interest.

DOCUMENTS INCORPORATED BY REFERENCE:

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

PMC COMMERCIAL TRUST

Form 10-K
For the Year Ended December 31, 2005

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Forward-Looking Statements

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

PART I

Item 1. BUSINESS

INTRODUCTION

PMC Commercial Trust (PMC Commercial and together with its wholly-owned subsidiaries, the Company, our or we) is a real estate investment trust (REIT) that primarily originates loans to small businesses collateralized by first liens on the real estate of the related business. Our loans are primarily to borrowers in the limited service hospitality industry. We also originate loans for commercial real estate primarily in the service, retail, multi-family and manufacturing industries. In addition, our investments include the ownership of commercial properties in the hospitality industry. Our common shares are traded on the American Stock Exchange under the symbol PCC. On February 29, 2004, PMC Capital, Inc. (PMC Capital), our affiliate through common management, merged with and into PMC Commercial.

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

We generated revenue primarily from the yield earned on our investments, rental income from property ownership and other fee income from our lending activities. Our operations are centralized in Dallas, Texas and include originating, servicing and selling commercial loans and property ownership. During the years ended December 31, 2005 and 2004, our total revenues were approximately $25.6 million and $21.2 million, respectively, and our net income was approximately $11.3 million and $24.8 million, respectively. Our 2004 net income includes an extraordinary gain of approximately $11.6 million from negative goodwill resulting from the merger. See Item 8. Consolidated Financial Statements and Supplementary Data for additional financial information.

Our wholly-owned lending subsidiaries are: First Western SBLC, Inc. (First Western), PMC Investment Corporation (PMCIC) and Western Financial Capital Corporation (Western Financial). First Western is licensed as a small business lending company (SBLC) that originates loans through the Small Business Administration s (SBA) 7(a) Guaranteed Loan Program (SBA 7(a) Loan Program). PMCIC and Western Financial are small business investment companies (SBICs).

First Western is currently a Preferred Lender, as designated by the SBA, in Dallas, Texas and Oklahoma City, Oklahoma and originates, sells and services small business loans throughout the continental United States. As a non-bank SBA 7(a) Loan Program lender, First Western is able to originate loans on which a substantial portion of the loan (generally 75%) is guaranteed as to payment of principal and interest by the SBA. A market exists for the sale of the guaranteed portion of First Western s loans and we receive cash premiums at the time of sale that approximate up to 10% of the principal amount of the loan sold. To the extent we were to increase our volume of loans originated by our SBLC, there should be a corresponding increase in premiums received. In addition, due to the existence of the SBA guarantee, we are able to originate loans in industries that we would typically not lend to due to the profitability of the loan including the premium received. See Lending Activities SBA Programs.

As a REIT, we seek to maximize shareholder value through long-term growth in dividends paid to our shareholders. We must distribute at least 90% of our REIT taxable income to shareholders to maintain our REIT status. See Tax Status. We pay dividends from the cash flow generated from operations.

Our ability to generate interest income, as well as other loan related fees, is dependent upon economic, regulatory and competitive factors that influence interest rates and loan originations and our ability to source financing for investment activities. The amount of income earned varies based on the volume of loans funded, the timing and amount of structured loan financings, the volume of loans which prepay and the resultant applicable prepayment fees, if any, the mix of loans (construction versus non-construction), the interest rate on loans originated and the general level of interest rates.

Generally, in order to fund new loans, we need to borrow funds or sell loans. Since 1996, our primary source of funds has been structured loan transactions. In a structured loan transaction, we contribute loans receivable to a special purpose entity (SPE) in exchange for cash and a subordinate financial interest in that entity. If the SPE meets the definition of a qualifying special purpose entity (QSPE), we account for the transaction as a sale of our loans receivable; and as a result, neither the loans receivable contributed to the QSPE nor the notes payable issued by the QSPE are included in our consolidated financial statements. See Structured Loan Transactions.

We operate in two identifiable reportable segments: (i) the lending division, which originates loans to small businesses primarily in the hospitality industry, which comprised 90% of our total assets at December 31, 2005, and (ii) the property division, which owns our hotel properties and operates certain of our hotel properties, which comprised 10% of our total assets at December 31, 2005. We are in the process of selling most of our assets in the property division to focus our operations on the lending division. See detailed financial information regarding our segments in Item 8. Consolidated Financial Statements and Supplementary Data.

LENDING ACTIVITIES

Overview

Our lending division originates loans to small businesses, primarily in the hospitality industry. For the year ended December 31, 2005, total revenues and income from continuing operations of our lending division were approximately $24.2 million (94% of our total revenues) and $12.4 million, respectively. This compares favorably with our total revenues and income from continuing operations of our lending division during 2004 of $19.9 million and $10.5 million, respectively. The increased revenues and income from continuing operations were primarily a result of increases in variable interest rates. Total assets allocated to the lending division were approximately $232.6 million (90% of our total assets) at December 31, 2005. See Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Executive Summary.

We are a national lender that primarily originates small business loans in the limited service sector of the hospitality industry. By utilizing our SBA 7(a) Loan Program, we increased our loan originations to the convenience store and gas station, restaurant, service, retail and commercial real estate industries. In addition to first liens on real estate of the related business, our loans are generally personally guaranteed by the principals of the entities obligated on the loans.

In addition to our historical underwriting criteria, we are now originating loans utilizing underwriting criteria which generally have higher loan-to-value ratios than we had prior to the merger (*i.e.,* SBA 7(a) Loan Program). As a result, our loans may incur losses in future periods in greater amounts than had historically been realized. See Item 1A Risk Factors.

We identify loan origination opportunities through personal contacts, internet referrals, attendance at trade shows and meetings, correspondence with local chambers of commerce, direct mailings, advertisements in trade publications and other marketing methods. We also generated loans through referrals from lawyers, accountants, real estate and loan brokers and existing borrowers. Payments are often made to non-affiliated individuals who

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assist in generating loan applications, with such payments generally not exceeding 1% of the principal amount of the originated loan.

Limited Service Hospitality Industry

Our loans are generally collateralized by first liens on limited service hospitality properties and are typically made for owner-operated facilities operating under national franchises. We believe that franchise operations offer attractive lending opportunities because such businesses generally employ proven business concepts, have national reservation systems, have consistent product quality, are screened and monitored by franchisors and generally have a higher rate of success when compared to other independently operated hospitality businesses.

The prevailing lodging industry perception for 2006 and 2007 is more optimistic than 2005. Lodging demand in the United States appears to correlate to changes in the United States Gross Domestic Product (U.S. GDP) growth, with typically a two to three quarter lag. Therefore, given the relatively strong U.S. GDP growth in the past year, an improvement in 2006 and 2007 lodging demand is predicted by industry analysts. Such improvement will be dependent upon several factors including: the strength of the economy, the correlation of hotel demand to new hotel supply and the impact of global or domestic events on travel and the hotel industry. Leading industry analysts, PricewaterhouseCoopers LLP, have published reports that predict the industry s results will continue to improve in 2006 and 2007.

Loan Originations and Underwriting

We originate mortgage loans to small businesses primarily collateralized by commercial real estate. We believe that we successfully compete in certain sectors of the commercial real estate finance market due to our understanding of our borrowers businesses, the flexible loan terms that we offer and our responsive customer service. Our approach to assessing new commercial mortgage loans requires an analysis of the property operator, the replacement cost of the collateral, its liquidation value and an analysis of local market conditions.

We also consider the underlying cash flow of the tenant or owner-occupant as well as more traditional real estate underwriting criteria such as:

- The components and value of the borrower s collateral (primarily real estate);
- The ease with which the collateral can be liquidated;
- The industry and competitive environment in which the borrower operates;
- The financial strength of the guarantors;
- The existence of any secondary repayment sources; and
- The existence of a franchise relationship.

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

We believe that our typical loan is distinguished from those of some of our competitors by the following characteristics:

Substantial down payments are required. We usually require an initial down payment of not less than 20% of the value of the property which is collateral for the loan at the time of such loan. Our experience has shown that the likelihood of full repayment of a loan increases if the owner/operator is required to make an initial and substantial financial commitment to the property which is collateral for the loan.

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

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appraised value of the property and permit the owner/operator to receive a cash distribution from the proceeds. Generally, we would not permit this type of cash-out distribution.

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

We are currently originating primarily variable-rate loans. Our variable-rate loans are based on (1) LIBOR or (2) the prime rate (primarily related to our SBA 7(a) Loan Program). While prior to 2003 we historically originated fixed-rate loans, we do not expect to originate a significant amount of additional fixed-rate loans in the near future since our sources of funds are primarily variable-rate and fixed-rate competitors typically have a lower cost of funds. Management continually evaluates potential sources of capital with a fixed-rate cost of funds to determine if a fixed-rate loan product would be feasible. Due to the current fixed-rate cost of funds for smaller companies like ours, it does not appear that a significant amount of fixed-rate capital is available to us with a cost that allows us to generate appropriate spreads to compensate us for the commensurate risk of the loans that could be originated. We will continue to monitor the leverage market for possible fixed-rate sources of capital and, to the extent we identify an appropriate source, we would establish a fixed-rate lending product. See Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Current Operating Overview and Economic Factors Lending Division.

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

	At December 31,					
	2005			2004		
	Loans receivable, net		Weighted Average Interest	Loans receivable, net		Weighted Average Interest
	Amount	%	Rate	Amount	%	Rate
	(Dollars in thousands)					
Variable-rate - LIBOR	$ 120,645	76.6%	8.3%	$ 84,689	66.1%	6.4%
Fixed-rate	18,651	11.8%	9.4%	28,100	21.9%	9.7%
Variable rate - prime	18,278	11.6%	8.7%	15,445	12.0%	6.6%
Total	$ 157,574	100.0%	8.5%	$ 128,234	100.0%	7.1%

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

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Loan Activity

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

	Years Ended December 31,				
	2005	2004	2003	2002	2001
	(In thousands)				
Loans receivable, net beginning of year	$ 128,234	$ 50,534	$ 71,992	$ 78,486	$ 65,645
Loans originated	58,852	53,659	31,320	32,776	51,683
Loans acquired in the merger (1)		55,144			
Principal collections (2)	(13,826)	(23,196)	(5,655)	(11,637)	(4,965)
Repayments of SBA 504 program loans (3)	(2,180)	(1,621)	(1,963)	(631)	(970)
Loans sold (4)	(7,785)	(6,222)			
Loans transferred to AAL (5)	(5,657)	(2,115)			
Structured loan sales (6)			(45,456)	(27,286)	(32,662)
Loan deemed to be repurchased from QSPE (7)		2,126			
Other adjustments (8)	(64)	(75)	296	284	(245)
Loans receivable, net end of year	$ 157,574	$ 128,234	$ 50,534	$ 71,992	$ 78,486

(1) *Represents the estimated fair value of loans acquired from PMC Capital in the merger.*
(2) *Represents scheduled principal payments and prepayments.*
(3) *Represents second mortgages obtained through the SBA 504 Program which are repaid by certified development companies.*
(4) *Represents the guaranteed portion of SBA 7(a) Loan Program loans sold through private placements to either dealers in government guaranteed loans or institutional investors.*
(5) *Loans receivable on which the collateral was foreclosed upon and the assets were subsequently classified as assets acquired in liquidation (AAL).*
(6) *Loans receivable which were sold as part of structured loan sale transactions.*
(7) *Represents a loan receivable at its estimated fair value deemed to be repurchased from one of our QSPEs as a result of a delinquent loan on which we initiated foreclosure on the underlying collateral and were contractually allowed to repurchase from our QSPE.*
(8) *Represents the change in loan loss reserves, discounts and deferred commitment fees.*

Quarterly Loan Originations

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

	Years Ended December 31,				
	2005	2004	2003	2002	2001
	(In thousands)				
First Quarter	$ 8,251	$ 6,609	$ 9,009	$ 6,346	$ 9,761
Second Quarter	11,236	17,255	12,103	6,506	22,567
Third Quarter	15,010	14,998	5,557	10,044	10,097
Fourth Quarter	24,355	14,797	4,651	9,880	9,258
Total	$ 58,852	$ 53,659	$ 31,320	$ 32,776	$ 51,683

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Loan Portfolio Statistics

Information on our loans receivable, loans which have been sold and on which we have retained interests (the Sold Loans) and our loans receivable combined with our Sold Loans (the Aggregate Portfolio) was as follows:

	At December 31,					
	2005			2004		
	Aggregate Portfolio	Sold Loans (1)	Loans Receivable	Aggregate Portfolio	Sold Loans (1)	Loans Receivable
	(Dollars in thousands, except footnotes)					
Portfolio outstanding (2)	$ 447,220	$ 288,652	$ 158,568	$ 468,158	$ 339,301	$ 128,857
Weighted average interest rate	8.8%	8.9%	8.5%	7.8%	8.0%	7.1%
Annualized average yield (3)	9.4%	9.6%	8.9%	8.9%	8.9%	8.7%
Weighted average contractual maturity (in years)	15.3	14.6	16.8	15.5	15.1	16.5
Delinquent and problem loans (4)	$ 1,587	$	$ 1,587	$ 6,861	$ 3,150	$ 3,711
Hospitality industry concentration %	91.5%	89.6%	94.9%	91.0%	89.5%	94.7%
Texas concentration % (5)	24.0%	28.9%	14.9%	24.7%	28.7%	14.3%

(1) *In addition to loans of the QSPEs, includes SBA 7(a) Loan Program loans.*

(2) *Loan portfolio outstanding before loan loss reserves and deferred commitment fees. Loans receivable includes the principal balance remaining on underlying loans receivable in our 1998 structured loan financing transaction of $10.8 million and $12.9 million at December 31, 2005 and 2004, respectively.*

(3) *For the periods ended December 31, the calculation of annualized average yield divides our interest income, prepayment fees and other loan related fees, adjusted by the provision for (reduction of) loan losses, by the weighted average outstanding portfolio.*

(4) *Includes loans which are either past due greater than 60 days or the collection of the balance of principal and interest is considered unlikely and on which the fair value of the collateral is less than the remaining unamortized principal balance (Problem Loans). The balance does not include the principal balance of loans which have been identified as potential problem loans for which it is expected that a full recovery of the principal balance will be received through either collection efforts or liquidation of collateral (Special Mention Loans).*

(5) *We also had a concentration of approximately 10% of loans receivable in Arizona at December 31, 2005. No other concentrations greater than or equal to 10% existed at December 31, 2005 for our loans receivable, Sold Loans or Aggregate Portfolio.*

Industry Concentration

The distribution of our loan portfolio by industry was as follows at December 31, 2005:

	Loans Receivable			Aggregate Portfolio		
	Number of Loans	Cost (1)	%	Number of Loans	Cost (1)	%
	(Dollars in thousands)					
Hotels and motels	160	$ 150,435	94.9%	350	$ 409,104	91.5%

Gasoline/service stations	17	2,761	1.7%	25	11,641	2.6%
Apartments	3	2,043	1.3%	9	8,752	2.0%
Restaurants	15	1,398	0.9%	16	3,237	0.7%
Retail, other	10	638	0.4%	10	2,275	0.5%
Services	19	542	0.3%	26	4,611	1.0%
Other	16	751	0.5%	22	7,600	1.7%
	240	$ 158,568	100.0%	458	$ 447,220	100.0%

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

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SBA Programs

General

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

- We participate as a private lender in the SBA 504 Program which allows us to originate first mortgage loans with lower loan-to-value ratios;
- We have an SBLC that originates loans through the SBA s 7(a) Loan Program;
- We have two licensed SBICs regulated under the Small Business Investment Act of 1958, as amended (SBIA). Our SBICs use long-term funds provided by the SBA, together with their own capital, to provide long-term collateralized loans to eligible small businesses, as defined under SBA regulations.

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

SBA 504 Program

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

SBA 7(a) Loan Program

Under the SBA 7(a) Loan Program, the SBA guarantees 75% of qualified loans over $150,000 with such individual guarantees not exceeding $1.5 million. While the eligibility requirements of the SBA 7(a) Loan Program vary by the industry of the borrower and other factors, the general eligibility requirements are that: (1) gross sales of the borrower cannot exceed $6.5 million, (2) liquid assets of the borrower and affiliates cannot exceed specified limits, and (3) the maximum aggregate SBA loan guarantees to a borrower cannot exceed $1.5 million. Maximum maturities for SBA 7(a) Loan Program loans are 25 years for real estate and between seven and 15 years for the purchase of machinery, furniture, fixtures and/or equipment. In order to operate as an SBLC, a licensee is required to maintain a minimum net worth (as defined by SBA regulations) of the greater of (1) 10% of the outstanding loans receivable and other investments or (2) $1.0 million, as well as certain other regulatory restrictions such as change in control provisions. See Item 1A. Risk Factors.

SBIC Program

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

PROPERTY OWNERSHIP

During the year ended December 31, 2005, total revenues and loss from continuing operations for our property division were approximately $1.4 million (6% of our total revenues) and $3.4 million, respectively. At December 31, 2005, we reclassified nine of our 13 hotel properties to discontinued operations as they are considered held-for-sale. Total assets allocated to the property division were approximately $26.6 million (10% of total assets) at December 31, 2005.

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At December 31, 2005, we owned 13 limited service hospitality properties (individually, a Hotel Property). These properties were part of a sale and leaseback transaction commencing in 1998 with Arlington Hospitality, Inc. (AHI) whereby we purchased the properties from AHI and then leased the properties to a wholly-owned subsidiary of AHI, Arlington Inns, Inc. (AII and together with AHI, Arlington). We concurrently entered into a Master Lease Agreement with AHI and AII covering all the properties and entered into a guaranty agreement with AHI whereby AHI guaranteed all obligations of AII under the individual property lease agreements. The Master Lease Agreement, as amended, with the individual property lease agreements being known as the Lease Agreement. AII filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code (Chapter 11) on June 22, 2005. AHI filed for bankruptcy protection under Chapter 11 on August 31, 2005.

On January 13, 2006, we received rejection notices on 12 of the individual property leases. One property was previously rejected during June 2005 and is currently being operated by us through a third party management company. As a result of the rejection of the leases, we have now taken possession of the properties and hired third party management companies to operate the properties. Accordingly, we are now subject to fluctuations in our operating results due to the underlying operations of the Hotel Properties whereas, prior to the rejection of the leases we were subject to credit risk of the underlying tenant. See Item 1A. Risk Factors Hotel Property Ownership Risks.

It is our intention to sell the properties in an orderly and efficient manner. Management believes that is it probable that we will sell the remaining Hotel Properties that are not subject to mortgages with significant prepayment penalties, within the next 12 months, although no assurances can be given that we will be able to do so. As a result, we anticipate owning no more than four of the Amerihost Hotel Properties at year-end 2006. See Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Current Operating Overview and Economic Factors Property Division.

STRUCTURED LOAN TRANSACTIONS

General

Structured loan transactions have historically been our primary method of obtaining funds for new loan originations. In a structured loan transaction, we contribute loans receivable to an SPE in exchange for a subordinate financial interest in that entity and obtain an opinion of counsel that the contribution of the loans receivable to the SPE constitutes a true sale of the loans receivable. The SPE issues notes payable (usually through a private placement) to third parties and then distributes a portion of the notes payable proceeds to us. The notes payable are collateralized solely by the assets of the SPE. If the SPE meets the definition of a QSPE, we account for the structured loan transaction as a sale of our loans receivable; and as a result, neither the loans receivable contributed to the QSPE nor the notes payable issued by the QSPE are included in our consolidated financial statements. The terms of the notes payable issued by the QSPEs provide that the partners of these QSPEs are not liable for any payment on the notes. Accordingly, if the QSPEs fail to pay the principal or interest due on the notes, the sole recourse of the holders of the notes is against the assets of the QSPEs. We have no obligation to pay the notes, nor do the holders of the notes have any recourse against our assets. We are the servicer of the loans pursuant to the transaction documents and are paid a fee of 30 basis points per year based on the principal outstanding.

When a structured loan sale transaction is completed: (1) our ownership interests in the QSPEs are accounted for as retained interests in transferred assets (Retained Interests) and are recorded at the present value of the estimated future cash flows to be received from the QSPE and (2) the difference between (i) the carrying value of the loans receivable sold and (ii) the sum of (a) the cash received and (b) the relative fair value of our Retained Interests, constitutes the gain or loss on sale. Gains or losses on these sales may represent a material portion of our net income in the period in which the transactions occur.

A structured loan financing is similar to a structured loan sale, with the exception that the transaction is not treated as a sale for financial reporting purposes. Therefore, the loans receivable contributed to the SPE and the notes payable issued by the SPE are included in our consolidated financial statements and as a result, the ownership interest in the SPE is not accounted for as a retained interest. Even though the loans receivable and the notes payable are included on our balance sheets from the structured loan financing transaction completed by PMC Commercial in 1998, PMC Commercial has no obligation to pay the notes, nor do the holders of the notes have any recourse against PMC Commercial s assets. The terms of the notes payable issued by the SPE provide that PMC Commercial is not liable for payment on the notes. Accordingly, even though the loans receivable and the notes payable of the SPE are included in our consolidated financial statements, if the SPE fails to pay the principal or interest on the notes, the sole recourse of the holders of the notes is against the loans receivable and any other assets of the SPE.

Our structured loan sale transactions and structured loan financing transactions receive opinions from outside counsel that opine to the legal sale of the loans to the legal entity formed in connection with the securitization. All of our securitization transactions provide a clean-up call. A clean-up call is an option allowed by the transaction documents to repurchase the transferred assets when the amount of the outstanding assets (or corresponding notes payable outstanding) falls to a level at which the cost of servicing those assets becomes burdensome. The clean-up call option regarding a loan in a QSPE or SPE is exercised by the party that contributed the loan to the QSPE or SPE. As a result of the characteristics underlying the structured loan transaction not satisfying the requirements of off-balance sheet accounting treatment, the 1998 securitization originated by PMC Commercial was considered a structured loan financing transaction.

Since we have historically relied on structured loan transactions as our primary source of operating capital to fund new loan originations, any adverse changes in our ability to complete this type of transaction, including any negative impact on the asset-backed securities market for the type of product we generate, could have a detrimental effect on our ability to generate funds to originate loans. See Item 1A Risk Factors.

Structured Loan Sale Transactions

General

As of December 31, 2005, the QSPEs consisted of:

PMC Capital, L.P. 1998-1 (the 1998 Partnership) and its related general partner;
PMC Capital, L.P. 1999-1 (the 1999 Partnership) and its related general partner;
PMC Joint Venture, L.P. 2000 (the 2000 Joint Venture) and its related general partner;
PMC Joint Venture, L.P. 2001 (the 2001 Joint Venture) and its related general partner;
PMC Joint Venture, L.P. 2002-1 (the 2002 Joint Venture) and its related general partner; and,
PMC Joint Venture, L.P. 2003-1 (the 2003 Joint Venture, and together with the 2000 Joint Venture, the 2001 Joint Venture and the 2002 Joint Venture, the Joint Ventures) and its related general partner.

As a result of the merger, we acquired PMC Capital s subordinate interests in the Joint Ventures and 100% of the subordinate interests in the 1998 Partnership and the 1999 Partnership (collectively, the Acquired Structured Loan Sale Transactions). We previously owned subordinate interests in the Joint Ventures (the Originated Structured Loan Sale Transactions). Even though we now own 100% of the subordinate interest in each of the Joint Ventures, since a portion was obtained through acquisition, we recorded these investments separately. At the date of acquisition, the fair value of the Acquired Structured Loan Sale Transactions became our cost.

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

2003 Structured Loan Sale Transaction

On October 7, 2003, we completed a structured loan sale transaction of a pool of variable-rate loans receivable. PMC Commercial and PMC Capital contributed loans receivable of $45.4 million and $57.8 million, respectively, to the 2003 Joint Venture. The 2003 Joint Venture issued, through a private placement, approximately $92.9 million of its 2003 Loan-Backed Floating Rate Notes (the 2003 L.P. Notes) of which approximately $40.9 million was allocated to us based on our ownership percentage in the 2003 Joint Venture. The 2003 L.P. Notes, issued at par, have a stated maturity in 2023, bear interest, reset on a quarterly basis, at the 90-day LIBOR plus 1.25%, and are collateralized by the loans receivable contributed by us and PMC Capital to the 2003 Joint Venture. We accounted for this transaction as a sale, recorded a gain of $711,000 and recorded our Retained Interests at an initial amount of $8,698,000 during 2003. At inception of the 2003 Joint Venture, we had a subordinate interest of 44% in the limited partnership based on our share of the capital.

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Originated Structured Loan Sale Transactions

Information relating to our Originated Structured Loan Sale Transactions was as follows:

	2000 Joint Venture	2001 Joint Venture	2002 Joint Venture	2003 Joint Venture
		(Dollars in thousands)		
Transaction date	12/18/00	06/27/01	04/12/02	10/07/03
Principal amount of loans sold:				
At time of sale	$ 55,675	$ 32,662	$ 27,286	$ 45,456
At December 31, 2005	$ 31,092	$ 24,075	$ 20,352	$ 31,102
Structured notes:				
At time of sale	$ 49,550	$ 30,063	$ 24,557	$ 40,910
At December 31, 2005	$ 26,756	$ 21,508	$ 17,613	$ 31,180
Weighted average interest rate on loans (1):				
At time of sale	9.63%	9.62%	9.23%	L+4.02%
At December 31, 2005	9.55%	9.67%	9.54%	L+4.02%
Required overcollateralization:				
At time of sale (2)	11.0%	8.0%	10.0%	10.0%
At December 31, 2005 (3)	17.8%	10.9%	13.4%	14.6%
Interest rate on the structured notes payable (1)	7.28%	6.36%	6.67%	L+1.25%
Rating of structured notes (4)	Aaa	Aaa	Aaa	Aaa
Cash reserve requirement (5)	6.0%	6.0%	6.0%	6.0%

(1) *Variable interest rates are denoted by the spread over the 90-day LIBOR (L).*

(2) *The required overcollateralization percentage at time of sale represents the portion of our Sold Loans retained by the QSPEs whose value is included in Retained Interests.*

(3) *The required overcollateralization percentage at December 31, 2005 was larger than the required overcollateralization percentage at time of sale since all principal payments received on the underlying loans receivable are paid to the noteholders.*

(4) *Structured notes issued by the QSPEs were rated by Moody s Investors Service, Inc.*

(5) *The cash reserve requirement is 6% of the principal amount of loans outstanding. Transactions all have minimum reserve requirements of 2% of the principal balance sold at the time of the sale.*

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Acquired Structured Loan Sale Transactions

Information relating to our Acquired Structured Loan Sale Transactions was as follows:

	1998 Partnership	1999 Partnership	2000 Joint Venture	2001 Joint Venture	2002 Joint Venture	2003 Joint Venture
			(Dollars in thousands)			
Principal amount of loans sold:						
At February 29, 2004	$ 21,702	$ 29,800	$ 17,345	$ 37,191	$ 36,102	$ 56,424
At December 31, 2005	$ 15,994	$ 20,203	$ 11,188	$ 25,100	$ 22,491	$ 44,470
Structured notes:						
At February 29, 2004	$ 21,221	$ 26,394	$ 15,636	$ 33,324	$ 32,932	$ 50,774
At December 31, 2005	$ 15,240	$ 16,795	$ 9,941	$ 21,223	$ 18,232	$ 41,602
Weighted average interest rate on loans (1):						
At February 29, 2004	P+1.22%	9.40%	9.20%	9.64%	9.58%	L+4.02%
At December 31, 2005	P+1.15%	9.09%	9.06%	9.67%	9.63%	L+4.02%
Required overcollateralization (2) (3):						
At February 29, 2004	10.5%	12.0%	15.7%	10.6%	12.0%	10.2%
At December 31, 2005	10.5%	17.7%	24.4%	15.7%	19.2%	13.0%
Mortgage-backed security (4)	5.0%					
Interest rate on structured notes (1)	P-1.00%	6.60%	7.28%	6.36%	6.67%	L+1.25%
Rating of structured notes (5)	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa
Cash reserve requirement (6)	$ 1,329	6.0%	6.0%	6.0%	6.0%	6.0%

(1) Variable interest rates are denoted by the spread over (under) the prime rate (P) or the 90-day LIBOR (L).

(2) The required overcollateralization percentage at February 29, 2004 represents the portion of our Sold Loans retained by the QSPEs whose value is included in Retained Interests.

(3) For the majority of the Acquired Structured Loan Sale Transactions, the required overcollateralization percentage at December 31, 2005 was larger than the required overcollateralization percentage at February 29, 2004 since all principal payments received on the underlying loans receivable are paid to the noteholders.

(4) Owned by PMC Commercial.

(5) Structured notes issued by the QSPEs were rated by Moody s Investors Service, Inc.

(6) The cash reserve requirement is 6% of the principal amount of loans outstanding for all transactions with the exception of the 1998 Partnership. Transactions all have minimum reserve requirements of 2% of the principal balance sold at the time of the sale. The 1998 Partnership is currently at its minimum requirement.

Retained Interests

As a result of our structured loan sale transactions, we have Retained Interests representing our residual interest in the loans sold to the QSPEs. When we securitize loans, we are required to recognize Retained Interests, which represent our right to receive net future cash flows, at their fair value. Our Retained Interests consist of (i) the required overcollateralization, which is the retention of a portion of each of the Sold Loans, (ii) the reserve fund, which represents the required cash balance owned by the QSPE and (iii) the interest-only strip receivable, which represents the future excess funds to be generated by the QSPE after payment of all obligations of the QSPE. Our Retained Interests are subject to credit, prepayment and interest rate risks. The estimated fair value of our Retained Interests is determined based on the present value of estimated future cash flows that we will receive from the QSPEs. The estimated future cash flows are calculated based on assumptions concerning, among other things, loan losses and prepayment speeds. On a quarterly basis, we measure the fair value of, and record income relating to, the Retained Interests based upon the future anticipated cash flows discounted based on an estimate of market interest rates for investments of this type. Any appreciation of the Retained Interests is included in our balance sheet in beneficiaries equity. Any depreciation of Retained Interests is either included in our statement of income as either a realized loss (if there is a reduction in expected future cash flows) or on the balance sheet in beneficiaries equity as an unrealized loss.

We retain a portion of the default and prepayment risk associated with the underlying loans of our Retained Interests. Actual defaults and prepayments, with respect to estimating future cash flows for purposes of valuing our

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

In accordance with generally accepted accounting principles, our consolidated financial statements do not include the assets, liabilities, partners capital, revenues or expenses of the QSPEs. As a result, at December 31, 2005 and 2004, our consolidated balance sheets do not include $276.1 million and $321.4 million in assets, respectively, and $220.8 million and $263.4 million in liabilities, respectively, related to these structured loan sale transactions recorded by the QSPEs. At December 31, 2005, the partners capital of the QSPEs was approximately $55.3 million compared to the value of the associated Retained Interests of $62.2 million.

TAX STATUS

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

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

EMPLOYEES

We employed 45 individuals including marketing professionals, investment professionals, operations professionals and administrative staff as of December 31, 2005. In addition, we have employment agreements with our executive officers. Annual base salary during the terms of the contracts does not exceed $350,000 for any one individual. Our operations are conducted from our Dallas, Texas office. We believe the relationship with our employees is good.

COMPETITION

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

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

While we have originated fixed-rate loans, we do not expect to originate a significant amount of fixed-rate loans in the near future since our sources of funds are primarily variable-rate and due to competitors with a lower cost of funds able to provide a fixed-rate loan at rates below what we would have to generate.

The limited service hospitality segment of the hotel business is highly competitive. As such, our Hotel Properties compete on the basis of price, quality, reputation, services and reservation systems, among other things. Other hotel owners may have greater resources than us and may be able to provide other services that we cannot. There is no assurance that we will be able to compete effectively and losses could result which could be material to our results of operations or financial condition.

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CUSTOMERS

In relation to our lending division, we are not dependent upon a single borrower, or a few borrowers, whose loss would have a material adverse effect on us. In addition, we have not loaned more than 10% of our assets to any single borrower.

Our property division is currently dependent upon third party managers to operate the Hotel Properties. The loss of our third party managers as operators of our properties could have a material adverse effect on us. As a REIT, we would be required to find tenants or third party management companies for our Hotel Properties. Until such time as a new lease could be entered into or the property was sold, we would incur additional holding costs, legal fees and possibly costs to re-franchise the properties.

AVAILABLE INFORMATION

We file annual, quarterly, current and special reports and other information with the Securities and Exchange Commission (the SEC). All documents may be located at the SEC s Public Reference Room at 100 F Street, NE, Room 1580, Washington, D.C. 20549 or you may obtain information on the operation of the Public Reference Room by calling 1-800-SEC-0330. Our SEC filings are also available to the public, free of charge, from our internet site at www.pmctrust.com, as soon as reasonably practicable after the reports are filed with, or furnished to, the SEC or at the SEC s internet site at *www.sec.gov*.

Item 1A. RISK FACTORS

Management has identified the following important factors that could cause actual results to differ materially from those reflected in forward-looking statements or from our historical results. These factors, which are not all-inclusive, could have a material impact on our asset valuations, results of operations or financial condition. In addition, these factors could impair our ability to maintain dividend distributions at current levels.

Investment Risks Lending Activities

Competition might prevent us from originating loans at favorable yields, which would harm our results of operations and our ability to continue paying dividends at current levels.

Our net income depends on our ability to originate loans at favorable spreads over our borrowing costs. In originating loans, we compete with other specialty commercial lenders, banks, other REITs, savings and loan associations, insurance companies and other entities that originate loans, many of which have greater financial resources than us. As a result, we may not be able to originate sufficient loans at favorable spreads over our borrowing costs, which would harm our results of operations and consequently, our ability to continue paying dividends at current levels.

There are significant risks in lending to small businesses.

Our loans receivable consist primarily of loans to small, privately-owned businesses. There is no publicly available information about these businesses; therefore, we must rely on our own due diligence to obtain information in connection with our investment decisions. Our borrowers may not meet net income, cash flow and other coverage tests typically imposed by banks. A borrower s ability to repay its loan may be adversely impacted by numerous factors, including a downturn in its industry or other negative economic conditions. Deterioration in a borrower s financial condition and prospects may be accompanied by deterioration in the collateral for the loan. In addition, small businesses typically depend on the management talents and efforts of one person or a small group of people for their success. The loss of services of one or more of these persons could have an adverse impact on the operations of the small business. Small companies are typically more vulnerable to customer preferences, market conditions and economic downturns and often need additional capital to expand or compete. These factors may have an impact on the ultimate recovery of our loans receivable from such businesses. Loans to small businesses, therefore, involve a high degree of business and financial risk, which can result in substantial losses and accordingly should be considered speculative.

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There is volatility in the valuation of our loans receivable which can require the establishment of loan loss reserves.

There is typically no public market or established trading market for the loans we originate. The illiquid nature of our loans may adversely affect our ability to dispose of such loans at times when it may be advantageous for us to liquidate such investments.

To the extent one or several of our borrowers experience significant operating difficulties and we are forced to liquidate the collateral underlying the loan, future losses may be substantial. The determination of whether significant doubt exists and whether a loan loss reserve is necessary for each loan requires judgment and consideration of the facts and circumstances existing at the evaluation date. Changes to the facts and circumstances of the borrower and/or the physical condition of the collateral underlying the loan, the hospitality industry and the economy may require the establishment of significant additional loan loss reserves.

Changes in interest rates could negatively affect lending operations, which could result in reduced earnings.

The net income of our lending operations is materially dependent upon the spread between the rate at which we borrow funds and the rate at which we loan these funds. During periods of changing interest rates, interest rate mismatches could negatively impact our net income, dividend yield, and the market price of our common shares.

At the present time, we primarily originate variable-rate loans and have certain debt which is long-term and at fixed interest rates and preferred stock which is long-term with a fixed dividend yield. If the yield on loans originated with funds obtained from fixed-rate borrowings or preferred stock fails to cover the cost of such funds, our cash flow will be reduced.

As a result of our dependence on variable-rate loans (all of our current commitments are for variable-rate loans), our interest income will be reduced during low interest rate environments. To the extent that LIBOR or the prime rate decreases from current levels, interest income on our currently outstanding loans receivable will decline.

Changes in interest rates do not have an immediate impact on the interest income of our fixed-rate loans receivable. Our interest rate risk on our fixed-rate loans receivable is primarily due to loan prepayments and maturities. The average maturity of our loan portfolio is less than their average contractual terms because of prepayments. The average life of mortgage loans receivable tends to increase when the current mortgage rates are substantially higher than rates on existing mortgage loans receivable and, conversely, decrease when the current mortgage rates are substantially lower than rates on existing mortgage loans receivable (due to refinancings of fixed-rate loans receivable at lower rates).

We depend on the accuracy and completeness of information about potential borrowers and guarantors.

In deciding whether or not to extend credit or enter into transactions with potential borrowers and/or their guarantors, we rely on information furnished to us by or on behalf of potential borrowers and/or guarantors, including financial statements, construction invoices and other financial information. We also rely on representations of potential borrowers and/or guarantors as to the accuracy and completeness of that information. Our financial condition and results of operations could be negatively impacted to the extent we rely on financial statements that are materially misleading.

Investment Risks General

There is no market for our Retained Interests and the value is volatile.

Due to the limited number of entities that conduct transactions with similar assets, the relatively small size of our Retained Interests and the limited number of buyers for such assets, no readily ascertainable market exists for our Retained Interests. Therefore, our estimate of the fair value may vary significantly from what a willing buyer would pay for these assets. If a ready market existed for our Retained Interests, the value would be different and such difference may be significant.

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The following is a sensitivity analysis of our Retained Interests as of December 31, 2005 to highlight the volatility that results when prepayments, loan losses and discount rates are different than our assumptions:

Changed Assumption	Estimated Fair Value	Asset Change (1)
	(In thousands)	
Losses increase by 50 basis points per annum (2)	$ 60,260	($2,731)
Losses increase by 100 basis points per annum (2)	$ 57,590	($5,401)
Rate of prepayment increases by 5% per annum (3)	$ 62,057	($934)
Rate of prepayment increases by 10% per annum (3)	$ 61,266	($1,725)
Discount rates increase by 100 basis points	$ 60,677	($2,314)
Discount rates increase by 200 basis points	$ 58,483	($4,508)

(1) *Any depreciation of our Retained Interests is either included in the accompanying statement of income as a realized loss (if there is a reduction in expected future cash flows) or on our balance sheet in beneficiaries equity as an unrealized loss.*

(2) *If we experience significant losses (i.e., in excess of anticipated losses), the effect on our Retained Interests would first be to reduce the value of the interest-only strip receivables. To the extent the interest-only strip receivables could not fully absorb the losses, the effect would then be to reduce the value of our reserve funds and then the value of our required overcollateralization.*

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

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

Changes in any of these assumptions or actual results which deviate from assumptions will affect the estimated fair value of our Retained Interests, possibly to a material degree. There can be no assurance as to the accuracy of these estimates.

We have a concentration of investments in the hospitality industry and in certain states, which may negatively impact our financial condition and results of operations.

Substantially all of our revenue is generated from loans collateralized by hospitality properties and the ownership of Hotel Properties. At December 31, 2005, our loans receivable were approximately 95% concentrated in the hospitality industry and approximately 93% of the loans sold to our QSPEs were concentrated in the hospitality industry. Any economic factors that negatively impact the hospitality industry, including terrorism, travel restrictions, bankruptcies or other political or geopolitical events, could have a material adverse effect on our financial condition and results of operations.

At December 31, 2005, approximately 15% of our loans receivable were collateralized by properties in Texas, approximately 10% were collateralized by properties in Arizona and approximately 28% of the loans sold to our QSPEs were collateralized by properties in Texas. No other state had a concentration of 10% or greater of our loans receivable, loans sold to our QSPEs or Aggregate Portfolio at December 31, 2005. See Properties in Item 2 of this Form 10-K for information on state concentrations related to our Hotel Properties. A decline in economic conditions in any state in which we have a concentration of investments could have a material adverse effect on our financial condition and results of operations.

We are subject to prepayment risk on our Retained Interests and loans receivable which could result in losses or reduced earnings and negatively affect our cash available for distribution to shareholders.

Prepayments of fixed-rate loans generally increase during times of declining interest rates. Conversely, prepayments of variable-rate loans generally increase during times of increasing interest rates. The proceeds from the prepayments we receive are either used to repay debt or invested initially in temporary investments. During reducing interest rate environments and when competition is greater, prepayments of our fixed-rate loans have generally been re-loaned or committed to be re-loaned at lower interest rates than the prepaid loans receivable. For

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prepayments on variable-rate loans, if the spread we charge over LIBOR or the prime rate were to decrease, the lower interest rates we would receive on these new loans receivable would have an adverse effect on our results of operations and depending upon the rate of future prepayments may further impact our results of operations.

Prepayments on loans sold to the QSPEs may have a negative impact on our financial condition or results of operations. Prepayments of loans receivable with higher interest rates negatively impact the value of our Retained Interests to a greater extent than prepayments of loans receivable with lower interest rates. Prepayments in excess of assumptions will cause a decline in the fair value of our Retained Interests primarily relating to a reduction in the excess funds (our interest-only strip receivable) expected from our structured loan sale transactions. For example, if a $1.0 million loan with an interest rate of 10% prepays and the all-in cost of that QSPE s structured notes was 7%, we would lose the 3% spread we had expected to receive on that loan in future periods. Our all-in costs include interest, servicing, trustee and other ongoing costs. The spread that is lost may be offset in part or in whole by any prepayment fee that we collect.

Our SBLC sells the guaranteed portion of most of its originated loans through private placements (Secondary Market Sales). These sales are particularly sensitive to prepayments. Our Retained Interests in these loan sales consists only of the spread between the interest collected from the borrower and the interest paid to the purchaser of the guaranteed portion of the loan. Therefore, to the extent the prepayments of these loans exceed estimates, we lose the estimated fair value of the associated Retained Interests.

Our Board of Trust Managers may change operating policies and strategies without shareholder approval or prior notice and such change could harm our business and results of operations and the value of our stock.

Our Board of Trust Managers has the authority to modify or waive our current operating policies and strategies, including PMC Commercial s election to operate as a REIT, without prior notice and without shareholder approval. We cannot predict the effect any changes to our current operating policies and strategies would have on our business, operating results and value of our stock; however, the effect could be adverse.

Liquidity and Capital Resources Risks

Our operating results could be negatively impacted by our inability to access certain financial markets.

We rely upon access to capital markets as a source of liquidity to satisfy our working capital needs, grow our business and invest in loans. Although we believe that we maintain sufficient access to these financial markets, adverse changes in the economy, the overall health of the limited service hospitality industry and increased loan losses could limit access to these markets and restrict us from continuing our current operating strategy or implementing new operating strategies.

The market for structured loan transactions may decline, which would decrease the availability of, and increase the cost of, working capital and negatively affect the potential for growth.

We will continue to need capital to fund loans. Historically, we have sold loans receivable as part of structured loan transactions, borrowed from financial institutions and issued equity securities to raise capital. A reduction in the availability of funds from financial institutions or the asset-backed securities market could have a material adverse effect on our financial condition and our results of operations. We must distribute at least 90% of our REIT taxable income to our shareholders to maintain our REIT status under the Code. As a result, that income will not be available to fund loans. Our long-term ability to continue to grow depends, to a large extent, on our ability to sell asset-backed securities through structured loan transactions. In certain economic markets the availability of funds may be diminished or the spread charged for funds may increase causing us to delay a structured loan transaction. In addition, terrorist attacks or political or geopolitical events could impact the availability and cost of capital.

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A number of factors could impair our ability, or alter our decision, to complete a structured loan transaction. These factors include, but are not limited to:

- As a result of certain economic conditions, investors in the type of asset-backed securities that we place may increase our cost of capital by widening the spreads (over a benchmark such as LIBOR or treasury rates) they require in order to purchase the asset-backed securities or cease acquiring our type of asset-backed security;
- A deterioration in the performance of our loans receivable or the loans receivable of our prior transactions (for example, higher than expected loan losses or delinquencies) may deter potential investors from purchasing our asset-backed securities;
- A deterioration in the operations or market perception of the limited service sector of the hospitality industry may deter potential investors from purchasing our asset-backed securities or lower the available rating from the rating agencies; and
- A change in the underlying criteria utilized by the rating agencies may cause transactions to receive lower ratings than previously issued thereby increasing the cost on our transactions.

Significant changes in any of these criteria may result in us temporarily suspending the use of structured loan transactions and we may seek other sources of financing. A reduction in the availability or an increased cost of this source of funds could have a material adverse effect on our financial condition and results of operations since working capital may not be available or available at acceptable spreads to fund future loan originations or to acquire real estate.

We use leverage to fund our capital needs which magnifies the effect of changing interest rates on our earnings.

We have borrowed funds and intend to obtain additional funds. As a result, we use leverage to fund our capital needs. Private lenders and the SBA have fixed dollar claims on our assets superior to the claims of the holders of our common shares. Leverage magnifies the effect that rising or falling interest rates have on our earnings. Any increase in the interest rate earned by us on investments in excess of the interest rate on the funds obtained from borrowings would cause our net income and earnings per share to increase more than they would without leverage, while any decrease in the interest rate earned by us on investments would cause net income and earnings per share to decline by a greater amount than they would without leverage. Leverage is thus generally considered a speculative investment technique. In order for us to repay indebtedness on a timely basis, we may be required to dispose of assets when we would not otherwise do so and at prices which may be below the net book value of such assets. Dispositions of assets could have a material adverse effect on our financial condition and results of operations.

Operating Risks

Economic slowdowns, negative political events and changes in the competitive environment could adversely affect operating results.

Several factors may impact the hospitality industry. Many of the businesses to which we have made, or will make, loans may be susceptible to economic slowdowns or recessions. During economic downturns, there may be reductions in business travel and consumers generally take fewer vacations. Terrorism, bankruptcies or other political or geopolitical events could negatively affect our borrowers or our Hotel Properties. Our non-performing assets are likely to increase during these periods. These conditions could lead to losses in our portfolio and a decrease in our interest income, net income and assets.

Another factor which affects the limited service sector of the hospitality industry is a significant rise in gasoline prices within a short period of time. Most of the limited service hospitality properties collateralizing our loans are located on interstate highways. When gas prices sharply increase, occupancy rates for properties located on interstate highways may decrease. These factors may cause a reduction in revenue per available room. If revenue for the limited service sector of the hospitality industry were to experience significant sustained reductions, (1) the ability of our borrowers to meet their obligations could be impaired and loan losses could increase and (2) revenues would decrease for our Hotel Properties and losses could result.

Many of our competitors have greater financial and managerial resources than us and are able to provide services we are not able to provide (*i.e.,* depository services). As a result of these competitors greater financial resources, they may be better able to withstand the impact of economic downturns.

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There may be significant fluctuations in our quarterly results which may adversely affect our stock price.

Our quarterly operating results fluctuate based on a number of factors, including, among others:

- Interest rate changes;
- The volume and timing of loan originations and prepayments of our loans receivable;
- The recognition of gains or losses on investments including our Hotel Properties;
- The level of competition in our markets; and
- General economic conditions, especially those which affect the hospitality industry.

As a result of the above factors, quarterly results should not be relied upon as being indicative of performance in future quarters.

We depend on our key personnel, and the loss of any of our key personnel could adversely affect our operations.

We depend on the diligence, experience and skill of our key personnel (executive officers) who provide management services to us for the selection, acquisition, structuring, monitoring and sale of our portfolio assets and the borrowings used to acquire these assets. We have entered into employment agreements with our executive officers. The loss of any executive officer could harm our business, financial condition, cash flow and results of operations.

We operate in a highly regulated environment, changes in which could adversely affect our financial condition or results of operations.

As a company whose common shares are publicly traded, we are subject to the rules and regulations of the SEC. In addition, we are regulated by the SBA. Changes in laws that govern our entities may significantly affect our business. Laws and regulations may be changed from time to time, and the interpretations of the relevant laws and regulations are also subject to change. Any change in the laws or regulations governing our business could have a material impact on our financial condition or results of operations.

At any time, U.S. Federal income tax laws governing REITs or the administrative interpretations of those laws may be amended. Any of those new laws or interpretations thereof may take effect retroactively and could adversely affect us. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the tax rate on both dividends and long-term capital gains for most non-corporate taxpayers to 15% until 2008. This reduced maximum tax rate generally does not apply to ordinary REIT dividends, which continue to be subject to tax at the higher tax rates applicable to ordinary income (a maximum rate of 35%). However, the 15% maximum tax rate does apply to certain REIT distributions. This legislation may cause shares in non-REIT corporations to be a more attractive investment to individual investors than shares in REITs and may adversely affect the market price of our common shares.

To the extent a loan becomes a problem loan, we will deliver a default notice and begin foreclosure and liquidation proceedings when we determine that pursuit of these remedies is the most appropriate course of action. Foreclosure and bankruptcy are complex and sometimes time consuming processes that are subject to Federal and state laws and regulations, as well as various guidelines imposed by mortgage investors.

In conjunction with the operations of our assets acquired in liquidation and Hotel Properties, we are subject to numerous Federal, state and local laws and government regulations including environmental, occupational health and safety, state and local taxes and laws relating to access for disabled persons.

Under various Federal, state and local laws, ordinances and regulations, a current or former owner or operator of real estate may be considered liable for the costs of remediating or removing hazardous substances found on its property, regardless of whether or not the property owner or operator was responsible for its presence. Such liability may be imposed by the Environmental Protection Agency or any state or local government authority regardless of fault. The ultimate costs under environmental laws and the timing of these costs are difficult to predict, and the liability under some environmental laws related to contaminated sites can be imposed retroactively, may be on a joint and several basis and could be material to our financial statements or results of operations.

The Americans with Disabilities Act of 1990 (ADA) requires all public accommodations and commercial facilities to meet federal requirements related to access and use by disabled persons. Compliance with the ADA requirements could require removal of access barriers. Although we believe that the properties that we own or

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finance are substantially in compliance with these requirements, a determination that the properties are not in compliance with the ADA could result in the imposition of fines by the U.S. Government or an award of damages to private litigants.

REIT Related Risks

Failure to qualify as a REIT would subject us to U.S. Federal income tax.

If a company meets certain income and asset diversification and income distribution requirements under the Code, it can qualify as a REIT and be entitled to pass-through tax treatment. We would cease to qualify for pass-through tax treatment if we were unable to comply with these requirements. PMC Commercial is also subject to a non-deductible 4% excise tax (and, in certain cases, corporate level income tax) if we fail to make certain distributions. Failure to qualify as a REIT would subject us to Federal income tax as if we were an ordinary corporation, resulting in a substantial reduction in both our net assets and the amount of income available for distribution to our shareholders.

We believe that we have operated in a manner that allows us to qualify as a REIT under the Code and intend to continue to so operate. Although we believe that we are organized and operate as a REIT, no assurance can be given that we will continue to remain qualified as a REIT. Qualification as a REIT involves the application of technical and complex provisions of the Code for which there are limited judicial or administrative interpretations and involves the determination of various factual matters and circumstances not entirely within our control. In addition, no assurance can be given that new legislation, regulations, administrative interpretations or court decisions will not significantly change the tax laws with respect to qualification as a REIT or the Federal income tax consequences of such qualification.

At any time, new laws, interpretations, or court decisions may change the Federal tax laws regarding, or the U.S. Federal income tax consequences of, qualification as a REIT. In addition, compliance with the REIT qualification tests could restrict our ability to take advantage of attractive investment opportunities in non-qualifying assets, which would negatively affect the cash available for distribution to our shareholders.

If PMC Commercial fails to qualify as a REIT, we may, among other things:

- not be allowed a deduction for distributions to our shareholders in computing our taxable income;
- be subject to U.S. Federal income tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates;
- be subject to increased state and local taxes; and,
- unless entitled to relief under certain statutory provisions, be disqualified from treatment as a REIT for the taxable year in which we lost our qualification and the four taxable years following the year during which we lost our qualification.

As a result of these factors, failure to qualify as a REIT could also impair our ability to expand our business and raise capital, substantially reduce the funds available for distribution to our shareholders and may reduce the market price of our common shares.

Ownership limitation associated with our REIT status may restrict change of control or business combination opportunities.

In order for us to qualify as a REIT, no more than 50% in value of our outstanding capital shares may be owned, directly or indirectly, by five or fewer individuals during the last half of any calendar year. Individuals include natural persons, private foundations, some employee benefit plans and trusts, and some charitable trusts.

To preserve our REIT status, our declaration of trust generally prohibits any shareholder from directly or indirectly owning more than 9.8% of any class or series of our outstanding common shares or preferred shares. The ownership limitation could have the effect of discouraging a takeover or other transaction in which holders of our common shares might receive a premium for their shares over the then prevailing market price or which holders might believe to be otherwise in their best interests.

Failure to make required distributions to our shareholders would subject us to tax.

In order to qualify as a REIT, an entity generally must distribute to its shareholders, each taxable year, at least 90% of its taxable income, other than any net capital gain and excluding the non-distributed taxable income of

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taxable REIT subsidiaries. As a result, our shareholders receive periodic distributions from us. Such distributions are taxable as ordinary income to the extent that they are made out of current or accumulated earnings and profits. To the extent that a REIT satisfies the 90% distribution requirement, but distributes less than 100% of its taxable income, it will be subject to federal corporate income tax on its undistributed income. In addition, the REIT will incur a 4% nondeductible excise tax on the amount, if any, by which its distributions in any calendar year are less than the sum of:

85% of its ordinary income for that year;
95% of its capital gain net income for that year; and
100% of its undistributed taxable income from prior years.

We have paid out, and intend to continue to pay out, our REIT taxable income to shareholders in a manner intended to satisfy the 90% distribution requirement and to avoid both Federal corporate income tax and the 4% excise tax.

Our taxable income may substantially exceed our net income as determined based on generally accepted accounting principles (GAAP) because, for example, capital losses will be deducted in determining GAAP income, but may not be deductible in computing taxable income. In addition, we may invest in assets that generate taxable income in excess of economic income or in advance of the corresponding cash flow from the assets, referred to as excess non-cash income. Although some types of non-cash income are excluded in determining the 90% distribution requirement, we will incur Federal corporate income tax and the 4% excise tax with respect to any non-cash income items if we do not distribute those items on an annual basis. As a result of the foregoing, we may generate less cash flow than taxable income in a particular year. In that event, we may be required to use cash reserves, incur debt, or liquidate non-cash assets at rates or times that we regard as unfavorable in order to satisfy the distribution requirement and to avoid federal corporate income tax and the 4% excise tax in that year.

Our ownership of and relationship with our taxable REIT subsidiaries will be limited, and a failure to comply with the limits would jeopardize our REIT status and may result in the application of a 100% excise tax.

Subject to certain restrictions, a REIT may own up to 100% of the stock of one or more taxable REIT subsidiaries. A taxable REIT subsidiary may earn income that would not be qualifying income if earned directly by the parent REIT. Both the subsidiary and the REIT must jointly elect to treat the subsidiary as a taxable REIT subsidiary. A corporation of which a taxable REIT subsidiary directly or indirectly owns more than 35% of the voting power or value of the stock will automatically be treated as a taxable REIT subsidiary. Overall, no more than 20% of the value of a REIT s assets may consist of stock or securities of one or more taxable REIT subsidiaries. A taxable REIT subsidiary generally will pay income tax at regular corporate rates on any taxable income that it earns. In addition, the taxable REIT subsidiary rules limit the deductibility of interest paid or accrued by a taxable REIT subsidiary to its parent REIT to assure that the taxable REIT subsidiary is subject to an appropriate level of corporate taxation. The rules also impose a 100% excise tax on certain transactions between a taxable REIT subsidiary and its parent REIT that are not conducted on an arm s-length basis.

Our taxable REIT subsidiaries are PMCIC, First Western, PMC Funding Corp. and PMC Properties, Inc. (PMC Properties). PMC Funding Corp. holds assets on our behalf. PMC Properties is the operator, through third party management companies, of certain of our Hotel Properties.

Our taxable REIT subsidiaries are subject to normal corporate income taxes. We will monitor at all times the value of our investments in taxable REIT subsidiaries for the purpose of ensuring compliance with the rule that no more than 20% of the value of our assets may consist of taxable REIT subsidiary stock and securities (which is applied at the end of each calendar quarter). The aggregate value of our taxable REIT subsidiary stock and securities is less than 20% of the value of our total assets (including our taxable REIT subsidiary stock and securities). In addition, we will scrutinize all of our transactions with our taxable REIT subsidiaries for the purpose of ensuring that they are entered into on arm s-length terms in order to avoid incurring the 100% excise tax described above. There are no distribution requirements applicable to the taxable REIT subsidiaries and after-tax earnings may be retained. There can be no assurance, however, that we will be able to comply with the 20% limitation on ownership of taxable REIT subsidiary stock and securities on an ongoing basis so as to maintain REIT status or to avoid application of the 100% excise tax imposed on certain non-arm s-length transactions.

Hotel Property Ownership Risks

We are dependent on third party management for the operation and management of our Hotel Properties and we are subject to operating risks of Hotel Properties.

We are currently dependent upon third party managers to operate and manage our Hotel Properties. As a REIT, PMC Commercial cannot directly operate the Hotel Properties. The operating results of our Hotel Properties are subject to a variety of risks which could negatively impact their cash flows.

Arlington rejected the remaining 12 individual property leases on January 13, 2006. As a result, we are incurring costs including holding costs and operating costs until the properties are sold. While we are unable to currently quantify these costs, we anticipate, based on the properties past operating results, that working capital shortfalls may occur during the winter months. In addition, our properties are typically located in tertiary markets and as a result are generally dependent on the local economy and businesses to generate revenue. We expect to sell properties in an orderly and timely manner. In addition, we may seek to locate new tenants for some or all of our Hotel Properties. There can be no assurance that we will be able to find new tenants for our Hotel Properties or negotiate to receive the same amount of historical lease income.

Our ability to sell the Hotel Properties at favorable prices could be adversely affected by market conditions or other factors.

The expected sales proceeds from our Hotel Properties could be impacted by numerous factors including supply and demand of hotel properties and negotiations with buyers regarding acceptable down payments and eligibility of financing. We generally require a down payment of 20% on any Hotel Property sale. There can be no assurance that we will receive our expected net proceeds from the Hotel Property sales.

We could encounter risks that adversely affect real estate ownership.

Our real estate investments are subject to a variety of risks including, but not limited to:

- adverse changes in general or local economic or real estate market conditions;
- changes in zoning laws;
- changes in traffic patterns and neighborhood characteristics;
- increases in assessed valuation and real estate tax rates;
- increases in the cost of property insurance;
- governmental regulations and fiscal policies;
- the potential for uninsured or underinsured property losses; and
- the impact of environmental laws and regulations.

Materialization of any of these risks could cause us to incur losses, and our results of operations and financial condition could be adversely impacted.

Uninsured and underinsured losses could result in a loss of value of our Hotel Properties.

Our insurance coverage may not be sufficient to fully insure our businesses and assets from claims and/or liabilities, including environmental liabilities. In the event that losses or claims are beyond the scope of our coverage, we could incur losses which could be substantial and our results of operations and financial position could be materially adversely affected.

We may be required to make significant capital improvements to maintain our Hotel Properties and their flags.

We may be required to replace furniture, fixtures and equipment or to make other capital improvements or renovations to the Hotel Properties which could affect our liquidity. We could also need periodic capital improvements to comply with standards associated with any flag under franchise agreements. These capital improvements may cause a disruption of operations and potential lost room revenue to the extent not covered by insurance and/or a reduction of return on our investment in these Hotel Properties including not being able to recoup these costs from the buyers of our Hotel Properties and impairment losses could result.

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We may be adversely affected by the requirements of our franchise and licensing agreements for our Hotel Properties.

Subsequent to December 31, 2005, we executed franchise agreements on our Hotel Properties. These agreements contain standards required for the operation and maintenance of our Hotel Properties.

To the extent we sell our Hotel Properties as Amerihost Inns, the buyer will be subject to the approval of the franchisor. At times, it may be more difficult to receive their approval to sell a Hotel Property. However, we may sell our Hotel Properties as independents (without a flag) or as other franchises. If this occurs, the buyer would be subjected to costs of re-flagging the property which could reduce the price at which we could sell the property and impairment losses could result.

We may not be able to compete effectively with other hotels for guests.

The limited service hospitality segment of the hotel business is highly competitive. As such, our Hotel Properties compete on the basis of price, quality, reputation, services and reservation systems, among other things. Other hotel brands may have greater resources than us and may be able to provide other services that we cannot. There is no assurance that we will be able to compete effectively and losses could result which could adversely affect our results of operations or financial condition.

We are subject to increasing operating costs at our hotels.

We are subject to a variety of risks associated with operating our Hotel Properties, including, but not limited to increases in the following costs:

- repair and maintenance;
- utilities
- insurance;
- property taxes;
- third party management; and
- other operating costs.

These operating costs are relatively fixed in nature and generally cannot be curtailed if our revenues decrease. As such, we may incur operating losses.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

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Item 2. PROPERTIES

We lease office space for our corporate headquarters in Dallas, Texas under an operating lease which expires in October 2011.

At December 31, 2005, we owned 13 Hotel Properties of which four Hotel Properties were sold prior to March 14, 2006. Except for one property, at December 31, 2005, the Hotel Properties were leased to AII pursuant to individual property leases, as amended, which were subject to the terms of a Master Lease Agreement. On January 13, 2006, we received rejection notices on the remaining 12 individual property leases. As a result of the rejection of the leases, we have now taken possession of the properties and hired third party management companies to operate the properties. See Item 1. Business Property Ownership.

The following table describes the location, number of rooms and year built relating to our Hotel Properties:

City	State	Number of Rooms	Year Built
Rochelle (1) (3)	Illinois	61	1997
Macomb	Illinois	60	1995
Sycamore (2)	Illinois	60	1996
Plainfield	Indiana	60	1992
Mt. Pleasant (1)	Iowa	63	1997
Coopersville (1)	Michigan	60	1996
Grand Rapids North (1) (3)	Michigan	60	1995
Grand Rapids South (1)	Michigan	61	1997
Tupelo (1) (3)	Mississippi	61	1997
Marysville	Ohio	79	1990
Wooster East (1)	Ohio	58	1994
Wooster North (1)	Ohio	60	1995
Mosinee (1) (3)	Wisconsin	53	1993
		796	

(1) Represents a real estate investment held for sale at December 31, 2005.

(2) Operated by PMC Properties through a third party management company at December 31, 2005.

(3) Property was sold subsequent to December 31, 2005.

Item 3. LEGAL PROCEEDINGS

In the normal course of business, including the ownership and operations of our assets acquired in liquidation, we are periodically party to certain legal actions and proceedings involving matters that are generally incidental to our business (*i.e.,* collection of loans receivable). In management s opinion, the resolution of these legal actions and proceedings will not have a material adverse effect on our consolidated financial statements.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of security holders during the fourth quarter of 2005.

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PART II

Item 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Common Shares are traded on the American Stock Exchange (the AMEX) under the symbol PCC. The following table sets forth, for the periods indicated, the high and low sales prices as reported on the AMEX and the regular dividends per share declared by us for each such period.

Quarter Ended	High	Low	Regular Dividends Per Share
December 31, 2005	$ 13.48	$ 11.26	$ 0.300
September 30, 2005	$ 13.67	$ 11.30	$ 0.300
June 30, 2005	$ 15.44	$ 12.80	$ 0.300
March 31, 2005	$ 15.65	$ 14.64	$ 0.350
December 31, 2004	$ 15.98	$ 14.40	$ 0.340
September 30, 2004	$ 15.44	$ 14.00	$ 0.340
June 30, 2004	$ 15.55	$ 13.03	$ 0.340
March 31, 2004	$ 17.20	$ 14.77	$ 0.380
December 31, 2003	$ 15.94	$ 13.53	$ 0.380
September 30, 2003	$ 14.09	$ 13.00	$ 0.380
June 30, 2003	$ 14.45	$ 11.25	$ 0.380
March 31, 2003	$ 13.59	$ 12.44	$ 0.400

On March 7, 2006, there were approximately 1,200 holders of record of Common Shares and the last reported sales price of the Common Shares was $13.15.

Our shareholders are entitled to receive dividends when and as declared by our Board of Trust Managers (the Board). Our Board considers many factors in determining dividend policy including, but not limited to, expectations for future earnings, REIT taxable income, the interest rate environment, competition, our ability to obtain leverage and our loan portfolio activity. The Board also uses REIT taxable income plus tax depreciation in determining the amount of dividends declared. In addition, as a REIT we are required to pay out 90% of taxable income. Consequently, the dividend rate on a quarterly basis will not necessarily correlate directly to any single factor such as REIT taxable income or earnings expectations. The Board anticipates that the minimum quarterly dividend per common share during 2006 will be $0.30.

We have certain covenants within our debt facilities that limit our ability to pay out returns of capital as part of our dividends. These restrictions have not historically limited the amount of dividends we have paid and management does not believe that they will restrict future dividend payments. See Selected Consolidated Financial Data in Item 6, Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources in Item 7 and Consolidated Financial Statements and Supplementary Data in Item 8 for additional information concerning dividends.

We have not had any sales of unregistered securities during the last three years.

See Item 12 in this Form 10-K for information regarding our equity compensation plans.

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Item 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following is a summary of our Selected Consolidated Financial Data as of and for the five years in the period ended December 31, 2005. The following data should be read in conjunction with our consolidated financial statements and the notes thereto and Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations appearing elsewhere in this Form 10-K. The selected financial data presented below has been derived from our consolidated financial statements.

	Years Ended December 31,				
	2005	2004 (1)	2003	2002	2001
	(In thousands, except per share information)				
Total revenues	$ 25,584	$ 21,231	$ 10,272	$ 11,497	$ 15,628
Income from continuing operations	$ 8,980	$ 10,013	$ 4,809	$ 6,899	$ 7,685
Discontinued operations (2)	$ 2,317	$ 3,175	$ 2,654	$ 2,475	$ 967
Gain on sale of loans receivable	$	$	$ 711	$ 562	$ 1,433
Gain on sale of real estate investments (2)	$	$	$	$	$ 1,350
Extraordinary item: negative goodwill	$	$ 11,593	$	$	$
Net income	$ 11,297	$ 24,781	$ 8,174	$ 9,936	$ 11,435
Basic weighted average common shares outstanding	10,874	10,134	6,448	6,444	6,431
Basic and diluted earnings per common share:					
Income from continuing operations and gain on sale of loans receivable and real estate investments (2)	$ 0.83	$ 0.99	$ 1.12	$ 1.16	$ 1.63
Extraordinary item: negative goodwill	$	$ 1.14	$	$	$
Net income	$ 1.04	$ 2.44	$ 1.27	$ 1.54	$ 1.78
Dividends declared, common	$ 13,569	$ 14,140	$ 9,932	$ 10,440	$ 9,789
Dividends per common share	$ 1.25	$ 1.40	$ 1.54	$ 1.62	$ 1.52

	At December 31,				
	2005	2004 (1)	2003	2002	2001
	(In thousands)				
Loans receivable, net	$ 157,574	$ 128,234	$ 50,534	$ 71,992	$ 78,486
Retained Interests	$ 62,991	$ 70,523	$ 30,798	$ 23,532	$ 17,766
Real estate investments, net	$ 8,080	$ 36,223	$ 41,205	$ 44,928	$ 52,718
Real estate investments, held for sale, net	$ 15,470	$ 1,859	$ 2,134	$ 1,877	$
Total assets	$ 259,192	$ 253,840	$ 131,736	$ 149,698	$ 156,347
Debt	$ 84,040	$ 75,349	$ 33,380	$ 48,491	$ 57,070
Redeemable preferred stock of subsidiary	$ 3,575	$ 3,488	$	$	$

(1) *On February 29, 2004, we merged with PMC Capital. Primarily as a result of the merger, total beneficiaries equity and total assets increased. The merger also resulted in a substantial increase in revenues and expenses. Revenues increased as a result of the income generated by the assets acquired from PMC Capital. Prior to the merger, we had no employees and most of our overhead was paid through an advisory relationship with PMC Capital. Subsequent to the merger, we are internally managed.*

(2) *Effective January 1, 2002, we adopted SFAS No. 144, Accounting for the Impairment of or Disposal of Long-Lived Assets (SFAS No. 144). In accordance with SFAS No. 144, gains and losses on property sales are classified within discontinued operations subsequent to the adoption. In addition, the operations of our Hotel Properties either sold subsequent to January 1, 2002 or held for sale at December 31, 2005 have been reflected as discontinued operations in our accompanying statements of income and the prior period financial*

statements have been reclassified to reflect the operations of these properties as discontinued operations during all periods presented above.

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Item 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our Consolidated Financial Statements and the related notes that appear elsewhere in this document.

BUSINESS

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

We are primarily a commercial lender that originates loans to small businesses that are principally collateralized by first liens on the real estate of the related business. We then sell certain of our loans receivable through privately-placed structured loan transactions. Historically, we have retained residual interests in all loans receivable sold through our subordinate financial interest in the related qualifying special purpose entities (QSPEs).

Our revenues have historically included the following:

- Interest earned on our loans receivable;
- Lease income on our Hotel Properties;
- Income on our Retained Interests; and
- Other related loan fees, including late fees, prepayment fees and construction monitoring fees.

Our ability to generate interest income, as well as other revenue sources, is dependent on economic, regulatory and competitive factors that influence interest rates and loan originations, and our ability to secure financing for our investment activities. The amount of income earned will vary based on the volume of loans funded, the timing and amount of structured loan financings, the volume of loans receivable which prepay, the mix of loans (construction versus non-construction), the interest rate and type of loans originated (whether fixed or variable) as well as the general level of interest rates. For a more detailed description of the risks affecting our financial condition and results of operations, see Risk Factors in Item 1A of this Form 10-K.

EXECUTIVE SUMMARY

We have gone through a period of transition, with 2005 being the first full year of combined operations following the merger of our affiliate, PMC Capital, into PMC Commercial. During 2005, we were faced with several challenges including (1) the loan products which we offer to our borrowers do not include a viable fixed-rate loan product, (2) the margins we currently receive between the interest rate we charge our borrowers and the interest rate we are charged by our lenders has been diminishing, (3) the tenant for our owned Hotel Properties filed for bankruptcy and (4) we needed to provide liquidity to build a portfolio of variable-rate loans to securitize.

As a result of the flattening of the yield curve (*i.e.,* compression of long-term and short-term interest rates) combined with increased competition from fixed-rate lenders, our margins for fixed-rate loans have contracted to the point where they are not economically viable. Our volume and commitments have therefore been primarily variable-rate. Until the yield curve combined with fixed-rate competition changes, we expect this trend to continue. We believe that the market has changed so that a greater percentage of borrowers are looking for fixed-rate loans; however, we are constrained by our cost of funds. The local banks offer a five-year maturity, 20-year amortization loan (mini-perm loan) at a more attractive rate than we can offer based on our current cost of funds. For the first two months of 2006, our loan originations were approximately $10.8 million of which approximately $8.2 million were originated in connection with sales of Amerihost Inn hotels and $1.0 million represents a loan repurchased from a securitization.

Even if we were to originate fixed-rate loans, the securitization market cost of funds may cause us to have a lower spread than we have historically achieved on our fixed-rate securitizations. In addition, during the interim period between when we make loans with fixed interest rates and when we complete a fixed-rate structured loan transaction, if rates were to rise, our spreads would narrow. Therefore, until interest rate markets and competition revert back to conditions in 2002 and prior or we find an alternative source of funds, we expect continued strong competition and therefore, limited originations of fixed-rate loans. We continue to actively pursue alternative sources of funds, including interest rate hedges, to reduce our cost of funds which will allow us to originate fixed-rate loans at competitive rates.

For our liquidity needs, in February 2005, we completed a $100 million conduit warehouse facility which operates as a revolving credit line and is collateralized by loans we originated. The advantages of this facility are to lower our cost of funds and increase our capacity to originate variable-rate loans. Then, in March 2005, we received net proceeds of approximately $26 million through the issuance of junior subordinated notes. While the floating interest rate on these notes is relatively high at LIBOR plus 3.25%, they provide a long-term source of capital with a maturity of 30 years which can be prepaid at our option any time after the initial five years. These notes are subordinate to our other debt and have few corporate restrictions. We believe that the issuance of these junior subordinated notes is a favorable alternative to an equity issuance.

In June 2005, after we did not receive our May and June rent payments, the lessee of our Hotel Properties, Arlington Inns, Inc. (AII) filed for bankruptcy protection. This was followed in August 2005 with the bankruptcy filing of Arlington Hospitality, Inc. (AHI and together with AII, Arlington), the parent of AII and the guarantor of all lease obligations. AII operated the properties under its bankruptcy plan and paid us an aggregate of approximately $1.5 million in rent from July 2005 through January 2006.

On January 13, 2006, AII rejected the leases and turned over property operations on those properties as well as two additional properties that were owned by Arlington and served as collateral on two of our loans receivable. Due to the lease rejection, no additional rent payments will be received from Arlington. We originally purchased a total of 30 properties, operated as Amerihost Inns, during 1998 and 1999. We commenced selling properties during 2000, and we began 2005 with 19 owned Hotel Properties and four securitized loans on Amerihost properties owned by Arlington for a total of 23 properties. We have reduced our ownership through the sale of twelve properties (six during 2005 and six during 2006 through March 14, 2006) and the repayment in full on two loans, so that our ownership has been reduced to nine Hotel Properties with two of those properties under contract for sale with significant deposits. The six properties sold during 2005 resulted in gains of approximately $1.3 million. During 2005, as a result of the Arlington bankruptcies and anticipated lease rejection, we recorded impairment losses on our Hotel Properties of approximately $2.2 million and a reserve on our rent and related receivables relating to Arlington of approximately $1.3 million.

Arlington has completed the sale of substantially all of its assets. We have significant outstanding claims against Arlington s bankruptcy estate. Based on information provided through the bankruptcy proceedings, an estimate of net cash proceeds available to the unsecured creditors we recorded an impairment on these claims and valued those claims at approximately $1.5 million at December 31, 2005. There can be no assurance that we will collect our claims from Arlington.

We anticipate selling certain of our Amerihost hotels before the end of the summer season (August) and to lease the other properties which have mortgages with significant prepayment penalties. As a REIT, we cannot directly operate hotel properties. As a result, we hired third party management companies to operate the properties. While the annualized leases payments we were receiving from AII were approximately $2.4 million for the 12 hotel properties operated by Arlington at December 31, 2005, based on operating data provided by Arlington, the properties cash flow from operations commonly referred to as EBITDAR (earnings before interest, taxes, depreciation, amortization and rent) was approximately $1.0 million. In addition, the first quarter of the year is typically the slowest period for hotel operations and the projected data provided by Arlington shows negligible EBITDAR generated during the first quarter.

CURRENT OPERATING OVERVIEW AND ECONOMIC FACTORS

The following provides a summary of our current operating overview and significant economic factors that may have an impact on our financial condition and results of operations. The factors described below could impact the volume of loan originations, the income we earn on our assets, our ability to complete a securitization, the performance of our loans, the operations of our properties and/or the performance of the QSPEs.

Lending Division

Loans originated during 2005 were $58.9 million which is greater than the $53.7 million of loans we originated during 2004. We currently anticipate loan originations to be between $60 million and $80 million during 2006. At December 31, 2005 and 2004, our outstanding commitments to fund new loans were approximately $50.5 million and $30.3 million, respectively. All of our current commitments are for variable-rate loans which provide an interest rate match with our present sources of funds. Our outstanding commitments to fund new loans have been increasing and are expected to continue at these levels. The majority of these commitments are for construction loans and loans committed to refinance construction loans upon project completion which should provide a stronger funding base for 2006. The funding of construction and construction takeout loans generally takes place over a longer period of time compared to non-construction loans.

Several key concerns affect our estimates of future loan originations as detailed below:

- our inability to originate fixed-rate loans with an adequate spread;
- borrowers looking to fix their cost of capital (borrow at fixed rates) in anticipation of continuation of rising interest rates;
- uncertainty as to the cost of funds of future securitizations; and
- local banks, with a substantially lower cost of capital than us, lending to operators in the limited service hospitality industry.

In order to effectively compete for variable-rate loans, we are currently reducing the interest rate spreads that we charged during 2005 by approximately 25 to 50 basis points related to our LIBOR based loans. We believe that the spread reduction will still provide us with appropriate rewards for the risk related to the types of loans that we are originating but such loans will not be as profitable as in prior years.

We believe that the market has changed so that a greater percentage of borrowers are looking for fixed-rate loans; however, we are constrained by our cost of funds and potential exposure to interest rate risk. Local bank competition offers, among other things, five-year fixed-rate loans whose rates are well below the long-term interest rates that we can presently offer. Historically, the rate charged to our borrowers for our fixed-rate product needed to be around 3.75% to 4% over the 10-year treasury in order to provide us with what management believed was a reasonable spread. With the 10-year treasury at approximately 4.75%, the rate we needed to obtain is approximately 8.5% to 8.75% for a quality loan with a 20-year amortization and maturity. The local banks offer a five-year maturity, 20-year amortization loan at approximately 7.0% to 7.5%. Management believes that the difference between the bank s rate and ours is causing a greater percentage of borrowers to take on the refinancing risk that rates will not rise by more than 1.75% in the next five years and they are therefore taking the mini-perm bank loan.

Our net interest margin is dependent upon the difference between the cost of our borrowed funds and the rate at which we invest these funds (the net interest spread). A significant reduction in net interest spread may have a material adverse effect on our results of operations and may cause us to re-evaluate our lending focus. Over the past few years the spread has been reduced causing decreased income from continuing operations (excluding the increase from loans acquired in the merger) and there can be no assurance that it will not continue to decrease. We believe that our LIBOR-based loan program allows us to compete more effectively with variable-rate products of our competitors, provides us with a more attractive securitization product and provides us with a net interest spread that is less susceptible to interest rate fluctuations than any fixed-rate loan programs.

Property Division

We owned 13 Hotel Properties at December 31, 2005 of which four Hotel Properties were sold prior to March 14, 2006. As a REIT, PMC Commercial cannot directly operate these properties. As a result, we are dependent upon third party management companies to operate and manage our Hotel Properties. We entered into a Master Lease Agreement with AHI and AII covering all the properties and entered into a guaranty agreement with AHI whereby AHI guaranteed all obligations of AII under the individual property lease agreements. The Master Lease Agreement, as amended, with the individual property lease agreements being known as the Lease Agreement. AII filed for bankruptcy protection under Chapter 11 on June 22, 2005. Since Arlington defaulted on the amended master lease agreement (Master Lease Agreement), there is no assurance that we will be able to sell the Hotel Properties, find a new operator for our Hotel Properties, negotiate to receive the same amount of lease income or collect on the guarantee of Arlington. In addition, we are incurring costs, including additional holding costs and legal fees and may incur costs to re-franchise the properties.

It is our intention to sell the Hotel Properties in an orderly and efficient manner. While there can be no assurance of the net proceeds that we will receive from selling our properties, we believe that the net proceeds on an aggregate basis for our nine remaining Hotel Properties held for sale with a net book value of approximately $15.4 million will be approximately $18.2 million. As of March 14, 2006, we have sold four Hotel Properties with an aggregate net book value of approximately $7.2 million for approximately $8.9 million. While management believes these values are appropriate based on current market conditions, these values may change based on the numerous factors that impact the (1) local and national economy, (2) prospects for the hospitality industry, (3) timing of particular sales, (4) franchise affiliation and (5) particular operating results of the property.

Our Hotel Properties are reviewed for impairment whenever events or circumstances indicate that the carrying amount of the property may not be recoverable, but in no event less than on a quarterly basis. To the extent Hotel Properties are sold, we will receive the net proceeds, after payment of any mortgage debt related to individual properties (as of December 31, 2005 we have mortgage debt of approximately $11.5 million on nine of the properties, including approximately $5.9 million on the properties deemed held for sale). Mortgage debt of approximately $4.7 million was repaid during 2006.

Lodging Industry

The prevailing lodging industry perception for 2006 and 2007 is more optimistic than 2005. Lodging demand in the United States appears to correlate to changes in U.S. GDP growth, with typically a two to three quarter lag. Therefore, given the relatively strong U.S. GDP growth in the past year, an improvement in 2006 and 2007 lodging demand is predicted by industry analysts. Such improvement will be dependent upon several factors including: the strength of the economy, the correlation of hotel demand to new hotel supply and the impact of global or domestic events on travel and the hotel industry. Leading industry analysts, PricewaterhouseCoopers LLP, have published reports that predict the industry s results will continue to improve in 2006 and 2007. However, the economic recovery in the Midwestern United States, which is primarily where our Hotel Properties are located, has lagged behind the general United States economic recovery. In fact, the lodging industry in certain Midwestern states has not shown any significant signs of recovery. See Property Ownership Data.

PORTFOLIO INFORMATION

Lending Activities

General

Our lending activities consist primarily of originating loans to borrowers who operate properties in the hospitality industry. Our net loans receivable were $157.6 million and $128.2 million at December 31, 2005 and 2004, respectively.

Loans originated and principal repayments on loans were as follows:

	Years Ended December 31,	
	2005	2004
	(In millions)	
Loan Originations:		
Commercial mortgage loans	$ 35.9	$ 41.8
SBA 7(a) Loan Program loans	10.7	9.4
Loans originated in connection with sale of assets acquired in liquidation and Hotel Properties	8.5	1.8
SBA 504 program loans (1)	3.8	0.7
Total loans originated	$ 58.9	$ 53.7

Principal Repayments:		
Prepayments	$ 9.4	$ 13.7
Proceeds from the sale of SBA 7(a) guaranteed loans	7.8	6.2
Scheduled principal payments	3.8	5.8
Balloon maturities or SBA 504 program loans	2.8	5.3
Total principal repayments	$ 23.8	$ 31.0

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(1) Represents second mortgages obtained through the SBA 504 Program which are repaid by certified development companies.

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At December 31, 2005, approximately $138.9 million of our loans receivable had a variable interest rate (reset on a quarterly basis) based primarily on the 90-day LIBOR, or the prime rate (primarily related to our SBA 7(a) Loan Program) with a weighted average interest rate of approximately 8.3%. The spread that we charge over LIBOR generally ranges from 3.25% to 4.50% and the spread we charge over the prime rate generally ranges from 1.75% to 2.75%. The LIBOR and prime rate used in determining interest rates during the first quarter of 2006 (set on January 1, 2006) was 4.53% and 7.25%, respectively. To the extent LIBOR or the prime rate changes, we will have changes in interest income from our variable-rate loans receivable. In addition, at December 31, 2005, approximately $18.7 million of our loans receivable had a fixed interest rate with a weighted average interest rate of approximately 9.4%. See Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Prepayment Activity

Prepayment activity on our aggregate loans receivable has remained at high levels during 2005. Prepayment activity for our aggregate fixed-rate loans receivable has remained at high levels as a result of the continued low interest rate environment while prepayment activity for our aggregate variable-rate loans receivable has recently increased since borrowers with variable-rate loans are generally seeking fixed-rate loans due to anticipated rising interest rates. Accordingly, we believe that we will continue to see prepayment activity at these higher levels during 2006.

The timing and volume of our prepayment activity for both our variable and fixed-rate loans receivable fluctuate and are impacted by numerous factors including the following:

- The competitive lending environment (*i.e.,* availability of alternative financing);
- The current and anticipated interest rate environment;
- The market for limited service hospitality property sales; and
- The amount of the prepayment fee and the length of prepayment prohibition, if any.

When loans receivable are repaid prior to their maturity, we generally receive prepayment fees. Prepayment fees result in one-time increases in our income. In addition, prepayments of Sold Loans will have an impact on our financial condition and results of operations. Prepayments of Sold Loans with higher interest rates negatively impact the value of our Retained Interests to a greater extent than prepayments of Sold Loans with lower interest rates. Prepayments in excess of our assumptions will cause a decline in the value of our Retained Interests primarily relating to a reduction in the excess funds (our interest-only strip receivable) expected from our structured loan sale transactions. The spread that is lost may be offset in part or in whole by the prepayment fee that we collect. Many of the prepayment fees for fixed-rate loans receivable are based upon a yield maintenance premium which provides for greater prepayment fees as interest rates decrease. In addition, certain loans receivable have prepayment prohibitions of up to five years. Prepayment fees for variable-rate loans receivable and fixed-rate loans receivable whose prepayment prohibition have expired are generally not significant. For our loans receivable, the proceeds from the prepayments we receive are either used to repay debt or invested initially in temporary investments. It is difficult for us to accurately predict the volume or timing of prepayments since the factors listed above are not all-inclusive and changes in one factor are not isolated from changes in another which might magnify or counteract the rate or volume of prepayment activity.

Our SBLC sells the guaranteed portion of most of its originated loans through private placements. These sales are especially sensitive to prepayments. Our Retained Interests in these loan sales consist only of the spread between the interest collected from the borrower and the interest paid to the purchaser of the guaranteed portion of the loan. Therefore, to the extent the prepayments of these loans exceed estimates, there is a significant impact on the value of the associated Retained Interests. In addition, loans originated under the SBA 7(a) Loan Program do not have prepayment fees which are retained by us.

Impaired Loans

Our policy with respect to loans receivable which are in arrears as to interest payments for a period in excess of 60 days is generally to discontinue the accrual of interest income. To the extent a loan becomes a Problem Loan (as defined below), we will deliver a default notice and begin foreclosure and liquidation proceedings when we determine that pursuit of these remedies is the most appropriate course of action.

Senior management closely monitors our impaired loans which are classified into two categories: Problem Loans and Special Mention Loans (together, Impaired Loans). Our Problem Loans are loans which are not complying with their contractual terms, the collection of the balance of the principal is considered impaired and on which the fair value of the collateral is less than the remaining unamortized principal balance. Our Special Mention

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Loans are those loans receivable that are either not complying or had previously not complied with their contractual terms but we expect a full recovery of the principal balance through either collection efforts or liquidation of collateral.

Historically, we have not had a significant amount of Impaired Loans or delinquent loans nor have we had a significant amount of charged-off loans. Our Impaired Loans were as follows (balances represent our investment in the loans prior to loan loss reserves and deferred commitment fees):

	At December 31, 2005	At December 31, 2004
	(Dollars in thousands)	
Problem Loans:		
Loans receivable (1)	$ 1,587	$ 3,711
Sold loans of QSPEs (2) (3)		3,150
	$ 1,587	$ 6,861
Special Mention Loans:		
Loans receivable (4)	$ 5,635	$ 1,376
Sold loans of QSPEs (2)	5,558	
	$ 11,193	$ 1,376
Percentage Problem Loans:		
Loans receivable	1.0%	2.9%
Sold loans of QSPEs (2)		1.1%
Percentage Special Mention Loans:		
Loans receivable	3.6%	1.1%
Sold loans of QSPEs (2)	2.3%	

(1) *Includes a loan collateralized by a limited service hospitality property with an estimated fair value of approximately $0.3 on which the underlying collateral was foreclosed in January 2006 and reclassified to assets acquired in liquidation.*

(2) *We do not include the remaining outstanding principal of serviced loans pertaining to the guaranteed portion of loans sold into the secondary market since the SBA has guaranteed payment of principal on these loans.*

(3) *Includes one loan on which the underlying collateral was foreclosed and the asset was subsequently sold and one loan for which payment was received for all outstanding principal and interest during 2005.*

(4) *Includes two loans collateralized by limited service hospitality properties with an estimated fair value of approximately $3.3 million related to the Arlington bankruptcy which were liquidated during January 2006 and reclassified to assets acquired in liquidation. We sold these assets acquired in liquidation during 2006 with no resulting losses.*

At December 31, 2005 and 2004, we had reserves of approximately $427,000 and $164,000, respectively, against loans receivable that we have deemed to be Impaired Loans. Our provision for loan losses as a percentage of our weighted average outstanding loans receivable was 0.24% and 0.42% during 2005 and 2004, respectively.

Retained Interests

At December 31, 2005 and 2004, the estimated fair value of our Retained Interests was $63.0 million and $70.5 million, respectively. As a result of our structured loan sale transactions, we have Retained Interests representing the subordinate interest in loans receivable that have been contributed to QSPEs and have been recorded as sold. When we securitize loans receivable, we are required to recognize Retained Interests, which represents our right to receive net future cash flows, at their estimated fair value. Our Retained Interests consist of (1) the retention of a portion of each of the Sold Loans (the required overcollateralization), (2) contractually required cash balances owned by the QSPE (the reserve fund) and (3) future excess funds to be generated by the QSPE after payment of all obligations of the QSPE (the interest-only strip receivable). Retained Interests are subject to credit, prepayment and interest rate risks.

The estimated fair value of our Retained Interests is based on estimates of the present value of future cash flows we expect to receive from the QSPEs. Estimated future cash flows are based in part upon estimates of prepayment speeds and loan losses. Prepayment speeds and loan losses are estimated based on the current and anticipated interest rate and competitive environments and our historical experience with these and similar loans receivable. The discount rates utilized are determined for each of the components of Retained Interests as estimates of market rates based on interest rate levels considering the risks inherent in the transaction. Changes in any of our assumptions, or actual results which deviate from our assumptions, may materially affect the value of our Retained Interests.

The net unrealized appreciation on our Retained Interests at December 31, 2005 and 2004 was approximately $4.5 million and $5.1 million, respectively. Any appreciation of our Retained Interests is included on our consolidated balance sheets in beneficiaries equity. Any depreciation of our Retained Interests is either included in the consolidated statements of income as a realized loss (if there is a reduction in expected future cash flows) or on our consolidated balance sheet in beneficiaries equity as an unrealized loss. Reductions in expected future cash flows generally occur as a result of decreases in expected yields, increases in anticipated loan losses or increases in prepayment speed assumptions. Our acquired Retained Interests are more susceptible to incurring realized losses. When acquired from PMC Capital, the estimated fair value at February 29, 2004 for each of the components of Retained Interests was recorded as our cost. As a result, during any period that (1) the value of any of the components of our Retained Interests is below the cost and (2) the estimated cash flow from the particular component has been reduced, realized losses would result. Once realized losses occur, we recognize subsequent appreciation of our Retained Interests as income over the estimated remaining life of the Retained Interests through a higher effective yield.

Assets Acquired in Liquidation

We have not historically had a significant amount of assets acquired in liquidation. Subsequent to December 31, 2005, we acquired assets through liquidation of the collateral underlying certain of our Impaired Loans with an estimated fair value of approximately $3.6 million, including two assets we acquired through liquidation of loans related to the Arlington Bankruptcy which were less than 30 days delinquent at the time they were liquidated. The underlying value of the assets was comparable to principal and interest due on the loans. We sold the two properties related to the Arlington Bankruptcy for net proceeds that approximated their carrying value of approximately $3.3 million. We financed the sales through originations of loans totaling approximately $2.8 million at interest rates of LIBOR plus 4% with maturity and amortization periods of 20 years.

With regard to properties acquired through foreclosure, deferred maintenance issues may have to be addressed as part of the operation of the property or it may not be economically justifiable to operate the property prior to its sale. To the extent keeping the property in operation is deemed to assist in attaining a higher value upon sale, we will take steps to do so including hiring third party management companies to operate the property.

In connection with the sale of our assets acquired in liquidation to third parties, we may finance a portion of the purchase price of the property. These loans will typically bear market rates of interest. While these loans are evaluated using the same methodology as our loans receivable, certain lending criteria may not be able to be achieved.

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Property Ownership Data

The following table summarizes statistical data regarding the underlying operations of our 13 Hotel Properties (1):

	Years Ended December 31,		
	2005	2004	2003
Occupancy	52.69%	54.35%	55.47%
ADR (2)	$ 56.99	$ 55.91	$ 56.39
RevPAR (3)	$ 30.03	$ 30.39	$ 31.28
Room revenue	$ 8,664,832	$ 8,797,163	$ 9,030,937
Rooms rented	152,037	157,354	160,147
Rooms available	288,539	289,494	288,708

(1) Arlington has provided data (only includes properties owned as of December 31, 2005) for the 12 Hotel Properties which it operated.

(2) ADR is defined as the average daily room rate.

(3) RevPAR is defined as room revenue per available room and is determined by dividing room revenue by available rooms for the applicable period.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and our results of operations is based upon our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. Our management has discussed the development and selection of these critical accounting policies and estimates with the audit committee of our Board, and the audit committee has reviewed the disclosures relating to these policies and estimates included in this annual report.

We believe the following critical accounting considerations and significant accounting policies represent our more significant judgments and estimates used in the preparation of our consolidated financial statements.

Valuation of Loans Receivable

Loan loss reserves are established based on a determination, through an evaluation of the recoverability of individual loans receivable, that significant doubt exists as to the ultimate realization of the loan receivable. We monitor the loan portfolio on an ongoing basis and evaluate the adequacy of our loan loss reserves. In our analysis, we review various factors, including the value of the collateral underlying the loan receivable and the borrower s payment history. The determination of whether significant doubt exists and whether a loan loss reserve is necessary for each loan requires judgment and consideration of the facts and circumstances existing at the evaluation date. Changes to the facts and circumstances of the borrower, the hospitality industry and the economy may require the establishment of significant additional loan loss reserves. If a determination is made that significant doubt exists as to the ultimate collection of our loans receivable, the effect on our results of operations may be material.

At December 31, 2005 and 2004, we had reserves of approximately $427,000 and $164,000, respectively, against loans receivable that we have deemed to be Impaired Loans. Our provision for loan losses (excluding reductions of loan losses) as a percentage of our weighted average outstanding loans receivable was 0.24% and 0.42% during 2005 and 2004, respectively. During 2004, we reversed $675,000 of previously recorded loan loss reserves due to the reduction in the expected loss on a loan collateralized by a limited service hospitality property due to repayment in full of all principal on the loan. To the extent one or several of our loans experience significant operating difficulties and we are forced to liquidate the loans, future losses may be substantial.

Valuation of Retained Interests

Due to the limited number of entities that conduct structured loan sale transactions with similar assets, the relatively small size of our Retained Interests and the limited number of buyers for such assets, no readily ascertainable market exists for our Retained Interests. Therefore, our estimate of fair value may vary significantly from what a willing buyer would pay for these assets.

The valuation of our Retained Interests is our most volatile critical accounting estimate because the valuation is dependent upon estimates of future cash flows that are dependent upon the performance of the underlying loans receivable and estimates of discount rates. Prepayments or losses in excess of estimates will cause unrealized depreciation and ultimately realized losses. The estimated fair value of our Retained Interests is determined based on the present value of estimated future cash flows from the QSPEs. The estimated future cash flows are calculated based on assumptions including, among other things, prepayment speeds and loan losses. We regularly measure loan loss and prepayment assumptions against the actual performance of the loans receivable sold and to the extent adjustments to our assumptions are deemed necessary, they are made on a quarterly basis. If prepayment speeds occur at a faster rate than anticipated, or future loan losses either occur quicker, or in amounts greater than expected, the fair value of the Retained Interests will decline and total income in future periods would be reduced. For example, if a $1.0 million loan with an interest rate of 10% prepays and the all-in cost of that QSPE s structured notes was 7%, we would lose the 3% spread we had expected to receive on that loan in future periods. The spread that is lost may be offset in part or in whole by any prepayment fee that we collect. If prepayments occur slower than anticipated, or future loan losses are either slower than or less than expected, cash flows would exceed estimated amounts, the estimated fair value of our Retained Interests would increase and total income in future periods would be enhanced. Although we believe that assumptions as to the future cash flows of the structured loan sale transactions are reasonable, actual rates of loss or prepayments may vary significantly from those assumed and other assumptions may be revised based upon anticipated future events. These assumptions are updated on a quarterly basis. Over the past three years, there has been no significant change in the methodology employed in valuing these assets. The discount rates utilized in computing the net present value of future cash flows are based on an estimate of the inherent risks associated with each cash flow stream. Purchasers of these types of investments may utilize different discount rates in determining the fair value of the estimated future cash flows.

As a result of the merger, we acquired PMC Capital s subordinate interests in the Joint Ventures and 100% of the subordinate interests in the 1998 Partnership and the 1999 Partnership (collectively, the Acquired Structured Loan Sale Transactions). We previously owned subordinate interests in the Joint Ventures (the Originated Structured Loan Sale Transactions).

Significant estimates related to the Originated Structured Loan Sale Transactions were as follows at December 31, 2005:

	Constant Prepayment Rate (1)	Aggregate Losses Assumed (2)	Range of Discount Rates
2000 Joint Venture	11.00%	2.74%	7.5% to 12.2%
2001 Joint Venture	12.00%	2.63%	7.5% to 12.2%
2002 Joint Venture	12.00%	3.72%	7.7% to 12.4%
2003 Joint Venture	12.00%	2.51%	8.0% to 12.3%

(1) Based on the actual performance of the loan pool, adjusted for anticipated principal prepayments considering other similar loans.

(2) Represents aggregate estimated future losses as a percentage of the principal outstanding of the underlying loans receivable as of December 31, 2005 based upon per annum losses that ranged from 0.0% to 1.3%. To the extent any loans are likely to be liquidated in the next twelve months, estimated losses were assumed to occur during that period. No losses are assumed for the year ending December 31, 2006 for those structured loan sale transactions with no current potential Impaired Loans.

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Significant estimates related to our Acquired Structured Loan Sale Transactions were as follows at December 31, 2005:

	Constant Prepayment Rate (1)	Aggregate Losses Assumed (2)	Range of Discount Rates
Secondary Market (3)	20.0%		12.20%
1998 Partnership	12.5%	3.12%	8.4% to 12.2%
1999 Partnership	14.0%	2.43%	7.5% to 12.2%
2000 Joint Venture	14.0%	3.28%	7.9% to 12.6%
2001 Joint Venture	12.0%	2.06%	7.7% to 12.4%
2002 Joint Venture	12.0%	2.68%	7.6% to 12.3%
2003 Joint Venture	12.0%	2.77%	8.0% to 12.2%

(1) *Based on the actual performance of the loan pool, adjusted for anticipated principal prepayments considering other similar loans.*

(2) *Represents aggregate estimated future losses as a percentage of the principal outstanding of the underlying loans receivable as of December 31, 2005 based upon per annum losses that ranged from 0.0% to 1.8%. To the extent any loans are likely to be liquidated in the next twelve months, estimated losses were assumed to occur during that period. No losses are assumed for the year ending December 31, 2006 for those structured loan sale transactions with no current potential Impaired Loans.*

(3) *There are no losses assumed on Secondary Market Sales as the SBA has guaranteed payment of principal on these loans.*

The following is a sensitivity analysis of our Retained Interests as of December 31, 2005 to highlight the volatility that results when prepayments, loan losses and discount rates are different than our assumptions:

Changed Assumption	Estimated Fair Value	Asset Change (1)
	(In thousands)	
Losses increase by 50 basis points per annum (2)	$ 60,260	($2,731)
Losses increase by 100 basis points per annum (2)	$ 57,590	($5,401)
Rate of prepayment increases by 5% per annum (3)	$ 62,057	($934)
Rate of prepayment increases by 10% per annum (3)	$ 61,266	($1,725)
Discount rates increase by 100 basis points	$ 60,677	($2,314)
Discount rates increase by 200 basis points	$ 58,483	($4,508)

(1) *Any depreciation of our Retained Interests is either included in the accompanying statement of income as a realized loss (if there is a reduction in expected future cash flows) or on our consolidated balance sheet in beneficiaries equity as an unrealized loss.*

(2) *If we experience significant losses (i.e., in excess of anticipated losses), the effect on our Retained Interests would first reduce the value of the interest-only strip receivables. To the extent the interest-only strip receivables could not fully absorb the losses, the effect would then be to reduce the value of our reserve funds and then the value of our required overcollateralization.*

(3)

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

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

Valuation of Rent and Related Receivables

At December 31, 2005, our rent and related receivables consisted of unpaid rent, property taxes, legal fees incurred, termination damages, notes receivable and other charges (the Arlington Claims) of approximately

$2,744,000 before reserves. As a result of the uncertainty of collection, our claim in the Arlington bankruptcy is well in excess of our recorded investment in the Arlington Claims.

We performed an analysis of our anticipated future proceeds related to the Arlington bankruptcy to determine the collectibility of our investment in the rent and related receivables based on best available information provided to us through the bankruptcy proceedings. As a result, we established an allowance of approximately $1,255,000 as of December 31, 2005. Accordingly, our net recorded investment was $1,489,000 as of December 31, 2005. To the extent there is a reduction of the anticipated future proceeds, we would record an additional allowance against these receivables.

Valuation of Real Estate Investments

In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, (SFAS No. 144) our Hotel Properties are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable.

We consider each individual Hotel Property to be an identifiable component of our business. In accordance with SFAS No. 144, we do not consider hotels as held for sale until it is probable that the sale will be completed within one year. The determination of held for sale status is assessed based on all available facts and circumstances, including management s intent and ability to eliminate the cash flows of the property from the Company s operations and management s intent and ability not to have significant continuing involvement in the operations of the property.

We discontinue depreciation on Hotel Properties if they are classified as held for sale. Upon designation of a Hotel Property as held for sale, we compare the carrying value of the Hotel Property to its estimated fair value, less costs to sell. We will reclassify the Hotel Property to real estate investment held for sale on our consolidated balance sheet at the lesser of its carrying value or its estimated fair value, less costs to sell. Any adjustment to the carrying value of a Hotel Property classified as held for sale is reflected in discontinued operations in our consolidated statements of income as impairment losses. In addition, the operating results of those properties classified as held for sale or that have been sold are included in discontinued operations. During 2005, we would have recorded approximately $120,000 in depreciation expense related to the Hotel Properties deemed held for sale at December 31, 2005 if they had remained in continuing operations.

We periodically review our real estate investments for impairment. If facts or circumstances support the possibility of impairment, we will prepare a projection of the undiscounted future cash flows without interest charges for the specific property. Impairment exists if the estimate of future cash flows expected to result from the use and ultimate disposition of the specific property is less than its carrying value. If impairment is indicated, an adjustment will be made to the carrying value of the property based on the difference between the current estimated fair value and the depreciated cost of the asset. Any impairment losses that result are included in continuing operations.

Revenue Recognition Policies

Interest Income

Interest income includes interest earned on loans and our short-term investments and the amortization of net loan origination fees and discounts. Interest income on loans is accrued as earned with the accrual of interest generally suspended when the related loan becomes a non-accrual loan. A loan receivable is generally classified as non-accrual (a Non-Accrual Loan) if (1) it is past due as to payment of principal or interest for a period of more than 60 days, (2) any portion of the loan is classified as doubtful or is charged-off or (3) if the repayment in full of the principal and/or interest is in doubt. Generally, loans are charged-off when management determines that we will be unable to collect any remaining amounts due under the loan agreement, either through liquidation of collateral or other means. Interest income on a Non-Accrual Loan is recognized on either the cash basis or the cost recovery basis.

When originating a loan receivable, we charge a commitment fee. These fees, net of costs, are deferred and recognized as an adjustment of yield over the life of the related loan receivable using a method which approximates the effective interest method.

For purchased loans, we may have discounts representing the difference between the unamortized principal balance of the loan and its estimated fair value at the date of purchase. For performing loans, these discounts are recognized as an adjustment of yield over the life of the related loan receivable using a method which approximates the effective interest method.

For loans originated under the SBA 7(a) Loan Program, when we sell the SBA guaranteed portion of the loans, a portion of the sale proceeds representing the difference in the face amount of the unguaranteed portion of the loans and the value of the loans (the Retained Loan Discount) is recorded as a reduction in basis of the retained portion of the loan rather than premium income. The Retained Loan Discount is amortized to interest income over the life of the underlying loan using the effective interest method unless the underlying loan receivable is prepaid or sold.

Income from Retained Interests

The income from our Retained Interests represents the accretion (recognized using the effective interest method) on our Retained Interests which is determined based on estimates of future cash flows and includes any fees collected (*i.e.,* late fees, prepayment fees, etc.) by the QSPEs in excess of anticipated fees. We update our cash flow assumptions on a quarterly basis and any changes to cash flow assumptions impact the yield on our Retained Interests.

Lease Income

Lease income consisted of base and percentage rent on our properties and when applicable, straight-line rental income. We record percentage rent when received and the remaining lease income is recorded on a straight-line basis (when applicable) over the estimated lease term to the extent collectibility is reasonably assured. For any properties deemed held for sale, lease income is included in discontinued operations.

RESULTS OF OPERATIONS

Year Ended December 31, 2005 Compared to the Year Ended December 31, 2004

Overview

Our income from continuing operations decreased to $8,980,000 during 2005 from $10,013,000 during 2004. Income from continuing operations during 2005 includes a provision for loss on our rent and related receivables of $1,255,000, impairment losses of $815,000 on our real estate investments held for use and realized losses on our Retained Interests of $467,000. Income from continuing operations during 2004 includes realized losses on our Retained Interests of $1,182,000. Excluding these significant non-cash items, our income from continuing operations would have remained relatively constant at $11.5 million during 2005 compared to $11.2 million during 2004. We have two operating segments: the lending division and the property division. We are in the process of selling most of our assets in the property division to focus our operations on the lending division. The lending division s income from continuing operations increased to $12.4 million during 2005 from $10.5 million during 2004 while our property division had losses from continuing operations of $3.4 million during 2005 and $0.5 million during 2004 due primarily to the losses described above.

Our total revenues increased by approximately $4.4 million compared to 2004 primarily from an increase in interest income due to an increase in our loans receivable outstanding and an increase in variable interest rates (both prime and LIBOR). Our loans receivable increased as a result of loans acquired in the merger ($55.1 million) and loan originations during 2004 ($53.7 million) and 2005 ($58.9 million). We expect our interest income to continue to increase based on current predictions of increases in future interest rates by most economists and estimated loan fundings of $60 million to $80 million during 2006. During 2005, our income from Retained Interests increased approximately $0.7 million due to the merger, increased accretion rates and unanticipated prepayment fees. Income from our Retained Interests is expected to remain relatively constant, excluding the impact of unanticipated prepayment fees collected, if any; however, our accretion income should naturally decrease over time as the Sold Loans pay down principal and/or prepay.

Our total expenses increased by approximately $4.8 million primarily as a result of (1) increased overhead (comprised of salaries and related benefits, general and administrative and advisory and servicing fees expense) of approximately $2.2 million due in large part to the increase in our serviced investment portfolio from the merger (upon merger with PMC Capital, we became a self-managed REIT whereas historically we were managed by PMC

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Capital pursuant to an advisory and servicing agreement) and increased professional fees primarily relating to Arlington s bankruptcy and increased accounting/auditing fees, (2) a provision for loss on our rent and related receivables of approximately $1.3 million, (3) increased interest expense of approximately $0.8 million due primarily to an increase in outstanding debt mainly due to borrowings necessary to fund our increased loan portfolio and an increase in LIBOR which increased interest on our variable-rate debt and (4) impairment losses of approximately $0.8 million on our real estate investments included in continuing operations. The merger substantially increased our overhead effective March 1, 2004 as a result of the significant increase in assets under management. Therefore, the impact was less in 2004 (ten months post merger) than 2005 (12 months). In general, we anticipate that our overhead will remain consistent during 2006; however, we expect our legal fees from external bankruptcy counsel relating to Arlington s bankruptcies to decrease during 2006 as less time will likely be required. Our accounting/auditing fees are expected to continue to increase based on requirements of the integrated audit including the audit of our internal controls.

We are in the process of selling most of our Hotel Properties. Consequently, the operations of those properties are now classified as discontinued operations. Our discontinued operations provided income of $3.2 million during 2004 and $2.3 million during 2005. Included in discontinued operations were gains on sales of real estate of $2,256,000 during 2005 resulting primarily from the sale of six hotel properties and two assets acquired in liquidation. In addition, we incurred impairment losses of $1,395,000 during 2005 related to our properties held for sale. At December 31, 2005, management believed it was probable that we would sell nine of the remaining Hotel Properties during 2006. As of March 14, 2006, we have sold four hotel properties for proceeds of approximately $8.9 million and recognized aggregate gains of approximately $1.8 million during 2006.

More detailed comparative information on the composition of and changes in our revenues and expenses is provided below.

Revenues

Interest income consisted of the following:

	Years Ended December 31, 2005	Years Ended December 31, 2004	Increase (Decrease)
	(In thousands)		
Interest income loans	$ 11,106	$ 7,588	$ 3,518
Accretion of loan fees and discounts	297	290	7
Interest income idle funds	175	284	(109)
	$ 11,578	$ 8,162	$ 3,416

The increase in interest income loans was primarily attributable to an increase in (1) our loan portfolio (our weighted average loans receivable outstanding increased $36.1 million (36%) to $136.9 million during 2005 from $100.8 million during 2004) primarily as a result of loans acquired in the merger and loan originations and (2) the weighted average interest rate on our loans receivable from 7.1% at December 31, 2004 to 8.5% at December 31, 2005. The increase in our weighted average interest rate is primarily due to increases in LIBOR and the prime rate. At December 31, 2005, approximately 88% of our loans receivable had variable interest rates.

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Of our Hotel Properties, four were determined to be held for use since the properties had mortgages with significant prepayment penalties that hindered our ability to sell those properties (subsequent to December 31, 2005, the significant prepayment penalty was waived on one of the Hotel Properties and the mortgage was repaid). We expect to lease these properties or operate them through third party management companies. Lease income for these Hotel Properties is included in continuing operations and consisted of the following:

	Years Ended December 31, 2005	Years Ended December 31, 2004	Increase (Decrease)
	(In thousands)		
Base rent	$ 807	$ 1,081	$ (274)
Straight-line rent	283	141	142
Percentage rent	30	104	(74)
Other	7	6	1
	$ 1,127	$ 1,332	$ (205)

We operated, through third party management companies, one of these properties beginning June 28, 2005. Those operations are included in other income and general and administrative expense in our consolidated statement of income. For the other three properties, in addition to rent paid during 2005, rent was paid for January 2006; however, during January 2006, Arlington rejected all remaining property leases. As a result of the lease rejection, we will no longer receive rent from Arlington. However, we may lease the properties to new tenants and lease income would be recorded.

Changes in, and descriptions of, lease income are as follows:

Base rent: Base rent consisted of the required monthly rental payment obligation from Arlington. Base rent declined due to the decrease in the pay rate from approximately 10.5% to 8.5% of the stated value established for the Hotel Properties based on the terms of the Lease Agreement (effective October 2004);

Straight-line rent: In accordance with the terms of the Lease Agreement, beginning in October 2004, we recorded lease income on a straight-line basis based on all remaining payments due from Arlington over the remaining fixed non-cancelable term of the Lease Agreement; however, due to the uncertainty of collection we discontinued recording straight-line rent effective July 1, 2005;

Percentage rent: We historically received percentage rent equal to 4% of the gross room revenues of the Hotel Properties which was deposited into an escrow account for future capital expenditures. Arlington did not pay the percentage rent due commencing May 2005. Due to the uncertainty of collection, we discontinued recording percentage rent effective May 1, 2005.

The primary reasons for the increase in income from Retained Interests of approximately $0.7 million were (1) increased accretion income of approximately $588,000 due to a combination of a full year of accretion during 2005 for Retained Interests acquired in the merger compared to ten months during 2004 and an increase in accretion rates and (2) an increase in the collection of unanticipated prepayment fees of approximately $80,000. The weighted average balance of our Retained Interests decreased during 2005 to $65.2 million from $65.9 million during 2004. The income from our Retained Interests consists of the accretion earned on our Retained Interests which is determined based on estimates of future cash flows and includes any fees collected by the QSPEs in excess of anticipated fees. The yield on our Retained Interests, which is comprised of the income earned less realized losses, increased to 13.8% during 2005 from 11.5% during 2004. Excluding the impact of realized losses, the yield on our Retained Interests increased to 14.5% during 2005 from 13.3% during 2004.

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Other income consisted of the following:

	Years Ended December 31, 2005	2004
	(In thousands)	
Servicing income	$ 1,222	$ 1,142
Other loan related income	646	475
Premium income	618	526
Prepayment fees	590	656
Hotel Property revenues (1)	300	
Equity in earnings of unconsolidated subsidiary	45	
Debt release income		175
Other income	$ 3,421	$ 2,974

(1) Represents the revenue of our Hotel Property held for use whose operations are included in continuing operations.

As a result of the merger, we now earn fees for servicing all loans held by the QSPEs and loans sold into the secondary market by our SBLC. As these fees are based on the principal balances of Sold Loans outstanding, they will naturally decrease over time as scheduled principal payments and prepayments occur. The increase during 2005 compared to 2004 is due primarily to the merger occurring on February 29, 2004.

Our prepayment activity has remained at relatively high levels and we believe that we will continue to see prepayment activity at these higher levels during 2006. See Current Operating Overview and Economic Factors Lending Division. Prepayment fees on our variable-rate loans receivable are generally less than on our fixed-rate loans receivable which are generally based on a yield maintenance premium. At December 31, 2005, approximately 88% of our loans receivable have variable interest rates; therefore, while our prepayment activity has continued at higher levels, the prepayment fees we received have decreased. We expect to continue to originate primarily variable-rate loans; thus, this trend of decreasing prepayment fee income is expected to continue.

Other loan related income includes late fees, assumption fees, forfeited commitment fees and other fees. These fees represent one-time increases in our other income when collected and/or earned.

Premium income results from the sale of loans into the secondary market by our SBLC. We sold 14 loans during 2005 and collected cash premiums of approximately $700,000. To the extent we were to increase our volume of loans originated by our SBLC, there should be a corresponding increase in premiums received.

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Interest Expense

Interest expense consisted of the following:

	Years Ended December 31, 2005	2004
	(In thousands)	
Junior subordinated notes	$ 1,497	$
Debentures	971	976
Conduit facility	724	
Mortgages on Hotel Properties (1)	463	483
Structured notes	451	880
Uncollateralized notes payable	223	970
Revolving credit facility	214	471
Other	262	215
	$ 4,805	$ 3,995

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(1) Represents interest expense on the four mortgages underlying the four Hotel Properties included in continuing operations.

Interest expense increased primarily as a result of an increase in our outstanding debt which corresponded to the increase in our loan portfolio including the loans acquired in the merger. Our average debt outstanding increased by 8% to $78.3 million during 2005 from $72.5 million during 2004. In addition, since we have variable-rate debt, the cost of funds on that debt has increased due to increases in LIBOR and the prime rate. The weighted average cost of our funds at December 31, 2005 was 6.5% compared to 5.9% at December 31, 2004.

During March 2005, we prepaid $20 million of uncollateralized notes with proceeds from our junior subordinated notes. The cost of funds on the junior subordinated notes is LIBOR plus 3.25%. The cost of funds for the uncollateralized notes payable was 7.44% on $10 million and LIBOR plus 1.3% on the other $10 million. In addition, the cost of funds for our conduit facility approximates LIBOR, plus 1% and our current revolving credit facility cost of funds is LIBOR plus 1.625%.

During March 2005, we rolled-over $4.0 million of debentures and repaid $3.0 million of debentures. Our debentures had a weighted average cost of funds of 6.0% at December 31, 2005.

At December 31, 2005, we had $5.6 million in mortgage notes with a weighted average interest rate of 8% related to our four Hotel Properties included in continuing operations. These mortgages mature from January 2010 to December 2017 and have restrictive provisions which provide for substantial prepayment penalties. Subsequent to December 31, 2005, the significant prepayment penalty was waived on one of the Hotel Properties and the mortgage of approximately $1.5 million was repaid.

The average structured notes outstanding decreased to $6.2 million during 2005 from $13.0 million during 2004. We expect that interest expense on the structured notes will continue to decrease naturally over time as the underlying loans pay down principal through scheduled principal payments or reach maturity and/or prepay which in turn pays down the structured notes outstanding.

Other Expenses

During the first two months of 2004, (1) our overhead expense for identifying, originating and servicing our investment portfolio and costs of corporate overhead was covered by an investment advisory agreement with PMC Capital and (2) other general and administrative costs were limited primarily to professional fees, directors and officers insurance, trust manager fees and shareholder expenses. As a result of the merger, on March 1, 2004, we became a self-managed REIT and our assets under management substantially increased from approximately $244.4 million to approximately $563.9 million. Beginning March 1, 2004, our operating expenses consisted of salaries and related benefits, rent and other general and administrative expenses necessary to service our investment portfolio, identify and originate new investments and provide for our corporate administrative needs. Since our

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assets under management increased, the increase in our general and administrative expenses is greater than our historical advisory fee expense.

Our combined general and administrative expenses, advisory fee expense and salaries and related benefits during 2005 increased from $5.7 million during 2004 to $7.9 million during 2005 primarily as a result of the increased costs related to our larger investment portfolio and corporate structure. In addition, our professional fees, including accounting, legal and consulting services, increased to $1,755,000 during 2005 from $880,000 during 2004. The increase relates primarily to accounting and auditing fees and legal fees, including those associated with Arlington s bankruptcies. Direct costs associated with the Sarbanes-Oxley Act of 2002 were approximately $390,000 during both 2005 and 2004. Our salaries and related benefits were $3,557,000 for the ten months of 2004 or $4,268,000 on an annualized basis compared to $4,553,000 during 2005. The 6.7% increase was primarily due to cost of living salary increases and increased costs associated with share-based compensation awards.

Realized losses on Retained Interests were $467,000 during 2005 compared to $1,182,000 during 2004. The realized losses during 2005 resulted primarily from reductions in expected future cash flows due to increased anticipated and actual prepayments primarily on our acquired Retained Interests while the realized losses during 2004 resulted primarily from reductions in expected future cash flows due to increased anticipated and actual prepayments and anticipated losses primarily on our acquired Retained Interests. Our acquired Retained Interests are more susceptible to incurring realized losses, since upon acquisition the estimated fair value at February 29, 2004 for each of the components of Retained Interests was recorded as our cost. As a result, during any period that (1) the value of any of the components of our Retained Interests is below the cost and (2) the estimated cash flow from the particular component has been reduced, realized losses f; MARGIN-LEFT: 0pt; FONT-SIZE: 10pt; VERTICAL-ALIGN: bottom" id=TBL1430.finRow.8.trail.4 noWrap>

Effect of Dilutive Securities

Options

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Diluted EPS

Net Earnings available to common stockholders plus assumed conversions

$12,660 18,886 $0.67

Six Months Ended March 30, 2013		
Income	Shares	Per Share
(Numerator)	(Denominator)	Amount

	(in thousands, except per share amounts)		
Basic EPS			
Net Earnings available to common stockholders	$22,886	18,803	$ 1.22
Effect of Dilutive Securities			
Options	-	75	(0.01)
Diluted EPS			
Net Earnings available to common stockholders plus assumed conversions	$22,886	18,878	$ 1.21

Note 5 At March 29, 2014, the Company has three stock-based employee compensation plans. Share-based compensation was recognized as follows:

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	Three months ended		Six months ended	
	March 29, 2014	March 30, 2013	March 29, 2014	March 30, 2013
	(in thousands, except per share amounts)			
Stock Options	$388	$215	$700	$390
Stock purchase plan	48	45	177	137
Stock issued to outside directors	-	12	-	24
Restricted stock issued to an employee	4	5	8	9
	$440	$277	$885	$560
Per diluted share	$0.02	$0.01	$0.05	$0.03
The above compensation is net of tax benefits	$85	$132	$164	$356

The Company anticipates that share-based compensation will not exceed $1.7 million net of tax benefits, or approximately $.09 per share for the fiscal year ending September 27, 2014.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes options-pricing model with the following weighted average assumptions used for grants in fiscal 2014 first six months: expected volatility of 20.6%; risk-free interest rate of 1.4%; dividend rate of .8% and expected lives of 5 years.

During the 2014 six month period, the Company granted 98,975 stock options. The weighted-average grant date fair value of these options was $15.21. During the 2013 six month period, the Company granted 1,100 stock options. The weighted-average grant date fair value of these options was $12.24.

Expected volatility is based on the historical volatility of the price of our common shares over the past 55 months for 5 year options and 10 years for 10 year options. We use historical information to estimate expected life and forfeitures within the valuation model. The expected term of awards represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Compensation cost is recognized using a straight-line method over the vesting or service period and is net of estimated forfeitures.

Note 6	We account for our income taxes under the liability method. Under the liability method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates that will be in effect when these differences reverse. Deferred tax expense is the result of changes in deferred tax assets and liabilities.

Additionally, we recognize a liability for income taxes and associated penalties and interest for tax positions taken or expected to be taken in a tax return which are more likely than not to be overturned by taxing authorities ("uncertain tax positions"). We have not recognized a tax benefit in our financial statements for these uncertain tax positions.

The total amount of gross unrecognized tax benefits is $420,000 and $438,000 on March 29, 2014 and September 28, 2013, respectively, all of which would impact our effective tax rate over time, if recognized. We recognize interest and penalties related to income tax matters as a part of the provision for income taxes. As of March 29, 2014 and September 28, 2013, respectively, the Company has $222,000 and $224,000 of accrued interest and penalties.

In addition to our federal tax return and tax returns for Mexico and Canada, we file tax returns in all states that have a corporate income tax with virtually all open for examination for three to four years.

Note 7 In February 2013, the FASB issued guidance which requires us to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, we are required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts not required under U.S. GAAP to be reclassified in their entirety to net income, we are required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. This guidance was effective for our fiscal year 2014 first quarter and its adoption did not have a material impact on our financial statements.

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Note 8 Inventories consist of the following:

	March 29, 2014 (unaudited)	September 28, 2013
	(in thousands)	
Finished goods	$36,296	$ 33,013
Raw Materials	14,530	14,489
Packaging materials	6,428	5,937
Equipment parts & other	19,498	18,346
	$76,752	$ 71,785
The above inventories are net of reserves	$4,544	$ 4,449

Note 9 We principally sell our products to the food service and retail supermarket industries. Sales and results of our frozen beverages business are monitored separately from the balance of our food service business because of different distribution and capital requirements. We maintain separate and discrete financial information for the three operating segments mentioned above which is available to our Chief Operating Decision Makers.

We have applied no aggregation criteria to any of these operating segments in order to determine reportable segments. Our three reportable segments are Food Service, Retail Supermarkets and Frozen Beverages. All inter-segment net sales and expenses have been eliminated in computing net sales and operating income (loss). These segments are described below.

Food Service

The primary products sold by the food service group are soft pretzels, frozen juice treats and desserts, churros, dough enrobed handheld products and baked goods. Our customers in the food service industry include snack bars and food stands in chain, department and discount stores; malls and shopping centers; fast food outlets; stadiums and sports arenas; leisure and theme parks; convenience stores; movie theatres; warehouse club stores; schools, colleges and other institutions. Within the food service industry, our products are purchased by the consumer primarily for consumption at the point-of-sale.

Retail Supermarkets

The primary products sold by the retail supermarket segment are soft pretzel products – including SUPERPRETZEL, frozen juice treats and desserts including LUIGI'S Real Italian Ice, MINUTE MAID Juice Bars and Soft Frozen Lemonade, WHOLE FRUIT frozen fruit bars, WHOLE FRUIT Sorbet, ICEE Squeeze-Up Tubes, dough enrobed handheld products and TIO PEPE'S Churros. Within the retail supermarket channel, our frozen and prepackaged products are purchased by the consumer for consumption at home.

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Frozen Beverages

We sell frozen beverages and related products to the food service industry primarily under the names ICEE, ARCTIC BLAST,

SLUSH PUPPIE and PARROT ICE in the United States, Mexico and Canada. We also provide repair and maintenance service to customers for customers' owned equipment.

The Chief Operating Decision Maker for Food Service and Retail Supermarkets and the Chief Operating Decision Maker for Frozen Beverages monthly review detailed operating income statements and sales reports in order to assess performance and allocate resources to each individual segment. In addition, the Chief Operating Decision Makers review and evaluate depreciation, capital spending and assets of each segment on a quarterly basis to monitor cash flow and asset needs of each segment. Information regarding the operations in these three reportable segments is as follows:

	Three months ended		Six months ended	
	March 29, 2014	March 30, 2013	March 29, 2014	March 30, 2013
	(unaudited) (in thousands)			
Sales to External Customers:				
Food Service				
Soft pretzels	$38,815	$35,337	$78,123	$67,931
Frozen juices and ices	11,857	10,122	20,086	17,649
Churros	13,430	14,067	27,381	27,874
Handhelds	5,712	6,938	12,116	13,252
Bakery	66,169	67,084	135,245	135,389
Other	2,346	1,845	4,158	3,485
	$138,329	$135,393	$277,109	$265,580
Retail Supermarket				
Soft pretzels	$10,309	$10,046	$19,224	$18,624
Frozen juices and ices	8,402	8,998	14,825	15,468
Handhelds	4,815	5,117	10,102	11,430
Coupon redemption	(689)	(754)	(1,369)	(1,543)
Other	213	146	432	277
	$23,050	$23,553	$43,214	$44,256

Frozen Beverages				
Beverages	$26,713	$25,183	$51,902	$50,480
Repair and maintenance service	13,135	12,710	26,744	24,552
Machines sales	3,759	3,945	9,282	6,993
Other	335	542	593	873
	$43,942	$42,380	$88,521	$82,898
Consolidated Sales	$205,321	$201,326	$408,844	$392,734
Depreciation and Amortization:				
Food Service	$5,233	$4,717	$10,372	$9,226
Retail Supermarket	8	7	16	15
Frozen Beverages	3,921	3,541	7,714	7,011
	$9,162	$8,265	$18,102	$16,252
Operating Income:				
Food Service	$17,562	$15,363	$32,713	$27,960
Retail Supermarket	2,602	2,404	4,566	3,974
Frozen Beverages	168	1,392	1,024	2,286
	$20,332	$19,159	$38,303	$34,220
Capital Expenditures:				
Food Service	$4,991	$4,682	$10,839	$9,942
Retail Supermarket	-	-	-	-
Frozen Beverages	6,517	3,394	9,986	5,615
	$11,508	$8,076	$20,825	$15,557
Assets:				
Food Service	$505,745	$471,807	$505,745	$471,807
Retail Supermarket	6,051	6,082	6,051	6,082
Frozen Beverages	154,198	141,944	154,198	141,944
	$665,994	$619,833	$665,994	$619,833

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Note 10 Our three reporting units, which are also reportable segments, are Food Service, Retail Supermarkets and Frozen Beverages.

The carrying amounts of acquired intangible assets for the Food Service, Retail Supermarkets and Frozen Beverage segments as of March 29, 2014 and September 29, 2013 are as follows:

	March 29, 2014		**September 28, 2013**	
	Gross Carrying Amount	**Accumulated Amortization**	**Gross Carrying Amount**	**Accumulated Amortization**
	(in thousands)			
FOOD SERVICE				
Indefinite lived intangible assets				
Trade Names	$13,072	$ -	$12,880	$ -
Amortized intangible assets				
Non compete agreements	592	493	545	478
Customer relationships	40,797	28,051	40,187	26,187
License and rights	3,606	2,661	3,606	2,614
	$58,067	$ 31,205	$57,218	$ 29,279
RETAIL SUPERMARKETS				
Indefinite lived intangible assets				
Trade Names	$4,006	$ -	$4,006	$ -
Amortized Intangible Assets				
Customer relationships	279	78	279	62
	$4,285	$ 78	$4,285	$ 62
FROZEN BEVERAGES				
Indefinite lived intangible assets				
Trade Names	$9,315	$ -	$9,315	$ -
Amortized intangible assets				
Non compete agreements	198	198	198	198
Customer relationships	6,478	5,139	6,478	4,830
Licenses and rights	1,601	749	1,601	714
	$17,592	$ 6,086	$17,592	$ 5,742

CONSOLIDATED	$79,944	$ 37,369	$79,095	$ 35,083

Amortized intangible assets are being amortized by the straight-line method over periods ranging from 3 to 20 years and amortization expense is reflected throughout operating expenses. Intangible assets of $849,000 were acquired in the food service segment in the New York Pretzel acquisition in the three months ended December 28, 2013. Aggregate amortization expense of intangible assets for the three months ended March 29, 2014 and March 30, 2013 was $1,143,000 and $1,113,000, respectively and for the six months ended March 29,2014 and March 30, 2013 was $2,286,000 and $2,232,000, respectively.

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Estimated amortization expense for the next five fiscal years is approximately $4,600,000 in 2014, $4,500,000 in 2015 and $4,300,000 in 2016, $1,800,000 in 2017 and $1,000,000 in 2018. The weighted average amortization period of the intangible assets is 10.1 years.

Goodwill

The carrying amounts of goodwill for the Food Service, Retail Supermarket and Frozen Beverage segments are as follows:

	Food Service	Retail Supermarket	Frozen Beverages	Total
	(in thousands)			
Balance at March 29, 2014	$46,831	$ 1,844	$ 35,940	$84,615

Goodwill of $7,716,000 was acquired in the New York Pretzel acquisition in the three months ended December 28, 2013, all of which was allocated to the food service segment.

Note 11 We have classified our investment securities as marketable securities held to maturity and available for sale. The FASB defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, the FASB has established three levels of inputs that may be used to measure fair value:

Level 1 Observable input such as quoted prices in active markets for identical assets or liabilities;

Level 2 Observable inputs, other than Level 1 inputs in active markets, that are observable either directly or indirectly; and

Level 3 Unobservable inputs for which there is little or no market data, which require the reporting entity to develop its own assumptions.

Marketable securities held to maturity and available for sale values are derived solely from level 1 inputs.

The amortized cost, unrealized gains and losses, and fair market values of our investment securities held to maturity at March 29, 2014 are summarized as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Market Value
	(in thousands)			
US Government Agency Debt	$2,000	-	$ 32	$1,968
	$2,000	$ -	$ 32	$1,968

The amortized cost, unrealized gains and losses, and fair market values of our investment securities available for sale at March 29, 2014 are summarized as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Market Value
	(in thousands)			
Mutual Funds	$129,538	$ 779	$ 1,577	$128,740
	$129,538	$ 779	$ 1,577	$128,740

The mutual funds seek current income with an emphasis on maintaining low volatility and overall moderate duration. The funds do not have contractual maturities; however, we classify them as long term assets as it is our intent to hold them for a period of over one year, although we may sell some or all of them depending on presently unanticipated needs for liquidity or market conditions. The unrealized losses of $1,577,000 are spread over 22 funds with total fair market value of $82.2 million.

The amortized cost, unrealized gains and losses, and fair market values of our investment securities held to maturity at September 28, 2013 are summarized as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Market Value
	(in thousands)			
US Government Agency Debt	$2,000	$ -	$ 50	$ 1,950
Certificates of Deposit	256	-	-	256
	$2,256	$ -	$ 50	$ 2,206

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The amortized cost, unrealized gains and losses, and fair market values of our investment securities available for sale at September 28, 2013 are summarized as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Market Value
	(in thousands)			
Mutual Funds	$109,891	$ 254	$ 2,481	$107,664
	$109,891	$ 254	$ 2,481	$107,664

The amortized cost and fair value of the Company's held to maturity securities by contractual maturity at March 29, 2014 and September 28, 2013 are summarized as follows:

	March 29, 2014		**September 28, 2013**	
	Amortized Cost	**Fair Market Value**	**Amortized Cost**	**Fair Market Value**
	(in thousands)			
Due in one year or less	$-	$ -	$256	$ 256
Due after one year through five years	-	-	-	-
Due after five years through ten years	2,000	1,968	2,000	1,950
Total held to maturity securities	$2,000	$ 1,968	$2,256	$ 2,206
Less current portion	-	-	256	256
Long term held to maturity securities	$2,000	$ 1,968	$2,000	$ 1,950

Proceeds from the redemption and sale of marketable securities were $565,000 and $6,060,000 in the three and six months ended March 29, 2014 respectively, and $23,238,000 and $23,478,000 in the three and six months ended March 30, 2013, respectively. Losses of $36,000 and $296,000 were recorded in the three and six months ended March 29, 2014, respectively, and none were recorded last year. We use the specific identification method to determine the cost of securities sold.

Note 12 In June 2012, we acquired the assets of Kim & Scott's Gourmet Pretzels, Inc., a manufacturer and seller of a premium brand soft pretzel. This business had sales of approximately $8 million over the prior twelve months to food service and retail supermarket customers and had sales of approximately $1.8 million in our 2012 fiscal year from the acquisition date.

In October 2013, we acquired the assets of New York Pretzel, a manufacturer and distributor of soft pretzels selling primarily in the northeast to foodservice and retail locations. Of the purchase price of $11.8 million, $849,000 was allocated to intangible assets, $7,716,000 was allocated to goodwill and $3,049,000 was allocated to property, plant and equipment.

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These acquisitions were and will be accounted for under the purchase method of accounting, and their operations are and will be included in the consolidated financial statements from their respective acquisition dates.

The goodwill and intangible assets acquired in the business combinations are recorded at fair value. To measure fair value for such assets, we use techniques including discounted expected future cash flows (Level 3 input).

Note 13 Changes to the components of accumulated other comprehensive loss are as follows:

	Three Months Ended March 29, 2014 (unaudited) (in thousands)			Six Months Ended March 29, 2014 (unaudited) (in thousands)		
	Foreign Currency Translation Adjustments	Unrealized Holding Loss on Marketable Securities	Total	Foreign Currency Translation Adjustments	Unrealized Holding Loss on Marketable Securities	Total
Beginning Balance	$(3,807)	$ (1,754)	$(5,561)	$(3,703)	$ (2,227)	$(5,930)
Other comprehensive income (loss) before reclassifications	(172)	914	742	(276)	1,126	850
Amounts reclassified from accumulated other comprehensive income	-	42	42	-	303	303
Ending Balance	$(3,979)	$ (798)	$(4,777)	$(3,979)	$ (798)	$(4,777)

All amounts are net of tax.

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	Three Months Ended March 30, 2013 (unaudited) (in thousands)			Six Months Ended March 30, 2013 (unaudited) (in thousands)		
	Foreign Currency Translation Adjustments	Unrealized Holding Loss on Marketable Securities	Total	Foreign Currency Translation Adjustments	Unrealized Holding Loss on Marketable Securities	Total
Beginning Balance	$(3,255)	$ 18	$(3,237)	$(3,132)	$ -	$(3,132)
Other comprehensive income (loss) before reclassifications	570	166	736	447	184	631
Amounts reclassified from accumulated other comprehensive income	-	-	-	-	-	-
Ending Balance	$(2,685)	$ 184	$(2,501)	$(2,685)	$ 184	$(2,501)

All amounts are net of tax.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Liquidity and Capital Resources

Our current cash and cash equivalents balances and cash expected to be provided by future operations are our primary sources of liquidity. We believe that these sources, along with our borrowing capacity, are sufficient to fund future growth and expansion. See Note 11 to these financial statements for a discussion of our investment securities.

The Company's Board of Directors declared a regular quarterly cash dividend of $.32 per share of its common stock payable on April 3, 2014, to shareholders of record as of the close of business on March 14, 2014.

In our fiscal year ended September 28, 2013, we purchased and retired 204,397 shares of our common stock at a cost of $14,500,215. We did not purchase any shares in the six months ended March 29, 2014. On November 8, 2012 the Company’s Board of Directors authorized the purchase and retirement of an additional 500,000 shares of the Company’s common stock; 343,858 shares remain to be purchased under this authorization.

In the three months ended March 29, 2014 and March 30, 2013 fluctuations in the valuation of the Mexican and Canadian currencies and the resulting translation of the net assets of our Mexican and Canadian subsidiaries caused an increase of $172,000 in accumulated other comprehensive loss in the 2014 second quarter and an decrease of $570,000 in accumulated other comprehensive loss in the 2013 second quarter. In the six month period, fluctuations in the valuation of the Mexican and Canadian currencies and the resulting translation of the net assets of our Mexican and Canadian subsidiaries caused an increase of $276,000 in accumulated other comprehensive loss in the 2014 six month period and a decrease of $447,000 in accumulated other comprehensive loss in the 2013 six month period.

Our general-purpose bank credit line which expires in December 2016 provides for up to a $50,000,000 revolving credit facility. The agreement contains restrictive covenants and requires commitment fees in accordance with standard banking practice. There were no outstanding balances under this facility at March 29, 2014.

Results of Operations

Net sales increased $3,995,000 or 2% to $205,321,000 for the three months and $16,110,000 or 4% to $408,844,000 for the six months ended March 29, 2014 compared to the three and six months ended March 30, 2013.

We believe our sales, and to a lesser extent, our costs, were impacted by the severe weather which occurred in many parts of the country during the current three month period; although we are unable to quantify the impact on our operating income. Most of our product sales are to consumers at snack bar and food stand locations, restaurants and schools so to the extent that traffic was reduced at these locations because of weather, our sales were affected.

FOOD SERVICE

Sales to food service customers increased $2,936,000 or 2% in the second quarter to $138,329,000 and increased $11,529,000 or 4% for the six months. Excluding sales resulting from the acquisition of New York Pretzel in October 2013, food service sales increased approximately 1.5% for the second quarter and increased 4% for the six months. Soft pretzel sales to the food service market increased 10% to $38,815,000 in the second quarter and increased 15% to $78,123,000 in the six months due to increased sales to restaurant chains, warehouse club stores, school food service and throughout our customer base. Increased sales to one customer accounted for approximately 1/2 of the increase in pretzel sales in the quarter and 40% in the six months. Without New York Pretzel, pretzel sales increased about 7% for the second quarter and 13% for the six months. Frozen juices and ices sales increased 17% to $11,857,000 in the three months and 14% to $20,086,000 in the six months resulting from sales increases primarily to warehouse club stores. Churro sales to food service customers decreased 5% to $13,430,000 in the second quarter and were down 2%

to $27,381,000 for the six months which was net of a decline in sales of $465,000 in the quarter and $1,229,000 in the six months to one restaurant chain which rolled out a churros product in the year ago period.

Sales of bakery products decreased $915,000 or 1% in the second quarter to $66,169,000 and were essentially unchanged at $135,245,000 for the six months as sales increases and decreases were spread throughout our customer base.

Sales of new products in the first twelve months since their introduction were approximately $2.1 million in this quarter and $4.6 million in the six months. Price increases accounted for approximately $1.3 million of sales in the quarter and $2.2 million in the six months and net volume increases, including new product sales as defined above and sales resulting from the acquisition of New York Pretzel, accounted for approximately $1.6 million of sales in the quarter and $9.3 million in the six months.

Operating income in our Food Service segment increased from $15,363,000 to $17,562,000 in the quarter and increased from $27,960,000 to $32,713,000 in the six months. Operating income for the quarter and six months benefited from increased sales volume, price increases and lower ingredient costs.

RETAIL SUPERMARKETS

Sales of products to retail supermarkets decreased $503,000 or 2% to $23,050,000 in the second quarter and decreased $1,042,000 or 2% to $43,214,000 in the six months. Soft pretzel sales for the second quarter were up 3% to $10,309,000 and were up 3% to $19,224,000 for the six months on a unit volume increase of 2% for the quarter and 2% for the six months. Sales of frozen juices and ices decreased $596,000 or 7% to $8,402,000 in the second quarter and were down 4% to $14,825,000 for the six months on a unit volume decrease of 8% in the quarter and 7% in the six months. Lower sales to one customer accounted for all of the sales decrease in both periods. Coupon redemption costs, a reduction of sales, decreased 9% or about $65,000 for the quarter and decreased 11% to $1,369,000 for the six months. Handheld sales to retail supermarket customers decreased 6% to $4,815,000 in the quarter and decreased 12% to $10,102,000 for the six months with sales increases and decreases throughout our customer base; however, sales to one customer were down over $700,000 for the second quarter and sales to two customers were down about $1.7 million for the six months as products introduced in the year ago period have not been successful.

Price increases accounted for approximately $300,000 of sales in the quarter and $1.0 million in the six months and net volume decreases, net of decreased coupon costs, accounted for approximately $800,000 of the sales decrease in this quarter and $2.0 million in the six months. Operating income in our Retail Supermarkets segment increased from $2,404,000 to $2,602,000 in the quarter and from $3,974,000 to $4,566,000 in the six months primarily because of higher gross margins because of product mix and lower coupon expense.

FROZEN BEVERAGES

Frozen beverage and related product sales increased 4% to $43,942,000 in the second quarter and increased 7% to $88,521,000 in the six month period. Beverage related sales alone were up 6% to $26,713,000 in the second quarter and were up 3% to $51,902,000 in the six month period. Gallon sales were up 5% for the three months and were up 2% for the six month period. Service revenue increased 3% to $13,135,000 in the second quarter and increased 9% to $26,744,000 for the six month period with sales increases and decreases spread throughout our customer base.

Sales of beverage machines, which tend to fluctuate from year to year while following no specific trend, were $186,000 or 5% lower in the second quarter and were $2,289,000 or 33% higher in the six month period. The approximate number of company owned frozen beverage dispensers was 46,500 and 44,700 at March 29, 2014 and September 28, 2013, respectively. Operating income in our Frozen Beverage segment was $168,000 in this quarter and $1,024,000 for the six months compared to $1,392,000 and $2,286,000; respectively, last year as higher operating expenses in these seasonally low periods offset the benefits of increased sales. Group health insurance and liability insurance costs were higher by about $900,000 in the quarter and $800,000 in the six months compared to last year due primarily to an unusually high level of medical claims under our self-insured group health insurance program.

CONSOLIDATED

Gross profit as a percentage of sales increased to 29.76% in the three month period from 28.88% last year and increased to 29.60% in the six month period from 28.59% a year ago. Higher volume in our food service segment was the primary reason for the improved gross profit margin in the six month period while lower ingredients costs benefitted both the three and six month periods.

Total operating expenses increased $1,789,000 in the second quarter and as a percentage of sales increased from 19.37% percent to 19.86%. About 1/3 of the increase in total operating expenses were higher group health insurance costs due primarily to an unusually high level of medical claims under our self-insured group health insurance program. For the first half, operating expenses increased $4,650,000, and as a percentage of sales increased from 19.88% to 20.23%. Operating expenses in the six months this year include $800,000 of other general expenses for shutdown costs of our Norwalk, CA manufacturing facility as well as about $500,000 of higher group health insurance costs. Marketing expenses increased from 8.3% to 8.5% of sales in the quarter and increased from 8.6% to 8.7% of sales in the six months. Distribution expenses were 8.0% of sales in this year’s quarter and were 7.8% of sales in last year’s quarter, and were 7.9% of sales in both years’ six month period. Administrative expenses were 3.3% of sales this quarter and 3.4% for the six month period as compared to 3.2% of sales last year in the second quarter and 3.3% for the six months.

Operating income increased $1,173,000 or 6% to $20,332,000 in the second quarter and increased $4,083,000 or 12% to $38,303,000 in the first half as a result of the aforementioned items.

Investment income increased by $80,000 and $442,000 in the second quarter and six months, respectively, due primarily to increased investments of marketable securities. We have investments of $128.7 million in mutual funds that seek current income with an emphasis on maintaining low volatility and overall moderate duration. We estimate the annual yield from these funds to approximate 3.5 – 3.75%.

The effective income tax rate has been estimated at 36.5% and 36.8% for the quarter this year and last year, respectively and 35.7% and 36.1% for the six months this year and last year, respectively. We are estimating an effective income tax rate of approximately 36% for the year.

Net earnings increased $861,000 or 7% in the current three month period to $13,521,000 and increased 13% to $25,947,000 for the six months this year from $22,886,000 as a result of the aforementioned items.

There are many factors which can impact our net earnings from year to year and in the long run, among which are the supply and cost of raw materials and labor, insurance costs, factors impacting sales as noted above, the continuing consolidation of our customers, our ability to manage our manufacturing, marketing and distribution activities, our ability to make and integrate acquisitions and changes in tax laws and interest rates.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There has been no material change in the Company’s assessment of its sensitivity to market risk since its presentation set forth, in item 7a. “Quantitative and Qualitative Disclosures About Market Risk,” in its 2013 annual report on Form 10-K filed with the SEC.

Item 4. Controls and Procedures

The Chief Executive Officer and the Chief Financial

Officer of the Company (its principal executive officer and principal financial officer, respectively) have concluded, based on their evaluation as of March 29, 2014, that the Company’s disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports filed or submitted by it under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and include controls and procedures designed to ensure that information required to be disclosed by the Company in such reports is accumulated and communicated to the Company’s management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There has been no change in the Company’s internal control over financial reporting during the quarter ended March 29, 2014, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Exhibits

Item 6.

Exhibit No.

31.1 & 31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
99.5 & 99.6	Certification Pursuant to the 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.1	The following financial information from J&J Snack Foods Corp.'s Quarterly Report on Form 10-Q for the quarter ended March 29, 2014, formatted in XBRL (extensible Business Reporting Language):

(i) Consolidated Balance Sheets,
(ii) Consolidated Statements of Earnings,
(iii) Consolidated Statements of Comprehensive Income,
(iv) Consolidated Statements of Cash Flows and
(v) the Notes to the Consolidated Financial Statements

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	J & J SNACK FOODS CORP.
Dated: April 28, 2014	/s/ Gerald B. Shreiber Gerald B. Shreiber Chairman of the Board, President, Chief Executive Officer and Director (Principal Executive Officer)
Dated: April 28, 2014	/s/ Dennis G. Moore Dennis G. Moore, Senior Vice President, Chief Financial Officer and Director (Principal Financial Officer) (Principal Accounting Officer)

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