REDWOOD TRUST INC
Form 10-Q
May 09, 2007

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

FORM 10-Q

x	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the quarterly period ended: March 31, 2007**
	OR
¨	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the transition period from _______________ to _______________**

Commission file number: 1-13759

REDWOOD TRUST, INC.
(Exact Name of Registrant as Specified in Its Charter)

Maryland	**68-0329422**
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)

One Belvedere Place, Suite 300
Mill Valley, California 94941
(Address of Principal Executive Offices)(Zip Code)
Registrant's Telephone Number, Including Area Code: **(415) 389-7373**

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

Title of Each Class:	**Name of Exchange on Which Registered:**
Common Stock, par value $0.01 per share	New York Stock Exchange

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

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 x No ¨

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 x   Accelerated Filer ¨   Non-Accelerated Filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer's classes of stock, as of the last practicable date.

Common Stock, $0.01 par value per share	27,359,006 as of May 8, 2007

REDWOOD TRUST, INC.
2007 FORM 10-Q REPORT

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PART I. FINANCIAL INFORMATION

Item 1. ***FINANCIAL STATEMENTS***

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data) **(Unaudited)**		**March 31, 2007**		**December 31, 2006**
ASSETS				
Real estate loans	$	8,706,370	$	9,352,107
Real estate securities		3,600,462		3,232,767
Other real estate investments		50,057		—
Cash and cash equivalents		91,656		168,016
Total earning assets		12,448,545		12,752,890
Restricted cash		340,114		112,167
Accrued interest receivable		64,814		70,769
Derivative assets		18,424		26,827
Deferred tax asset		5,542		5,146
Deferred asset-backed securities issuance costs		41,115		42,468
Other assets		28,185		20,206
Total Assets	$	12,946,739	$	13,030,473
LIABILITIES AND STOCKHOLDERS' EQUITY				
LIABILITIES				
Redwood debt	$	1,879,783	$	1,856,208
Asset-backed securities issued		9,946,508		9,979,224
Accrued interest payable		51,709		50,590
Derivative liabilities		7,401		6,214
Accrued expenses and other liabilities		16,951		16,832
Dividends payable		20,347		18,715
Junior subordinated notes		100,000		100,000
Total liabilities		12,022,699		12,027,783
Commitments and contingencies (Note 16)				
STOCKHOLDERS' EQUITY				
Common stock, par value $0.01 per share, 50,000,000 shares authorized; 27,129,446 and 26,733,460 issued and outstanding		271		267
Additional paid-in capital		927,648		903,808
Accumulated other comprehensive income (loss)		(6,183)		93,158
Cumulative earnings		827,320		809,011
Cumulative distributions to stockholders		(825,016)		(803,554)
Total stockholders' equity		924,040		1,002,690
Total Liabilities and Stockholders' Equity	$	12,946,739	$	13,030,473

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except share data)	**Three Months Ended March 31,**	
(Unaudited)	**2007**	**2006**
Interest Income		
Real estate loans	$ 126,850	$ 166,902
Real estate securities	83,458	56,503
Other real estate investments	2,465	—
Cash and cash equivalents	2,332	2,477
Total interest income	215,105	225,882
Interest Expense		
Redwood debt	(31,094)	(2,072)
Asset-backed securities issued	(134,945)	(178,583)
Junior subordinated notes	(2,057)	—
Total interest expense	(168,096)	(180,655)
Net Interest Income	47,009	45,227
Operating expenses	(17,782)	(12,582)
Realized gains on sales and calls, net	1,146	1,062
Market valuation adjustments, net	(10,264)	(2,932)
Net income before provision for income taxes	20,109	30,775
Provision for income taxes	(1,800)	(2,760)
Net Income	$ 18,309	$ 28,015
Basic earnings per share:	$ 0.68	$ 1.11
Diluted earnings per share:	$ 0.66	$ 1.09
Regular dividends declared per common share	$ 0.75	$ 0.70
Special dividends declared per common share	$ —	$ —
Total dividends declared per common share	$ 0.75	$ 0.70
Basic weighted average shares outstanding	26,855,681	25,201,525
Diluted weighted average shares outstanding	27,684,029	25,702,730

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands) **(Unaudited)**		Three Months Ended March 31, **2007**		**2006**
Net Income	$	18,309	$	28,015
Other Comprehensive (Loss) Income:				
Net unrealized loss on available-for-sale securities		(92,685)		(8,058)
Reclassification adjustment for net (gains) losses included in net income		(113)		1,997
Unrealized (losses) gains on cash flow hedges, net		(6,138)		14,187
Reclassification of net realized cash flow hedge (gains) to interest expense on asset-backed securities issued and realized gains on sales and calls		(405)		(266)
Total Other Comprehensive (Loss) Income		(99,341)		7,860
Comprehensive (Loss) Income	$	(81,032)	$	35,875

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

For the Three Months Ended March 31, 2007

(In thousands, except share data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
December 31, 2006	26,733,460	$ 267	$ 903,808	$ 93,158	$ 809,011	$ (803,554)	$ 1,002,690
Net income	—	—	—	—	18,309	—	18,309
Net unrealized loss/reclassification on assets AFS	—	—	—	(92,798)	—	—	(92,798)
Net unrealized loss/reclassification on interest rate agreements	—	—	—	(6,543)	—	—	(6,543)
Issuance of common stock:							
Secondary offerings	—	—	—	—	—	—	—
Dividend reinvestment & stock purchase plans	330,315	3	18,659	—	—	—	18,662
Employee option & stock purchase plan	65,671	1	64	—	—	—	65
Non-cash equity award compensation	—	—	5,117	—	—	—	5,117
Common dividends declared	—	—	—	—	—	(21,462)	(21,462)
March 31, 2007	27,129,446	$ 271	$ 927,648	$ (6,183)	$ 827,320	$ (825,016)	$ 924,040

For the Three Months Ended March 31, 2006

(In thousands, except share data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
December 31, 2005	25,132,625	$ 251	$ 824,365	$ 73,731	$ 681,479	$ (644,866)	$ 934,960
Net income	—	—	—	—	28,015	—	28,015
Net unrealized loss/reclassification on assets AFS	—	—	—	(6,061)	—	—	(6,061)
Net unrealized gain/reclassification	—	—	—	13,921	—	—	13,921

on interest rate agreements							
Issuance of common stock:							
Secondary offerings	—	—	—	—	—	—	—
Dividend reinvestment & stock purchase plans	209,653	2	8,697	—	—	—	8,699
Employee option & stock purchase plan	39,580	1	471	—	—	—	472
Non-cash equity award compensation	—	—	5,634	—	—	—	5,634
Common dividends declared	—	—	—	—	—	(18,307)	(18,307)
March 31, 2006	25,381,858	$ 254	$ 839,167	$ 81,591	$ 709,494	$ (663,173)	$ 967,333

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)	**Three Months Ended March 31,**	
(Unaudited)	**2007**	**2006**
Cash Flows From Operating Activities:		
Net income	$ 18,309	$ 28,015
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of premiums, discounts, and debt issuance costs	(14,189)	(16,104)
Depreciation and amortization of non-financial assets	342	269
Provision for credit losses	3,829	176
Non-cash equity award compensation	5,117	5,634
Net recognized losses and valuation adjustments	9,118	1,870
Purchases of other real estate investments - trading	(40,818)	
Principal payments on other real estate investments - trading	2,284	
Net change in:		
Accrued interest receivable	5,955	3,051
Deferred income taxes	(315)	518
Other assets	(4,807)	(1,699)
Accrued interest payable	1,119	2,375
Accrued expenses and other liabilities	119	(7,893)
Net cash (used in) provided by operating activities	(13,937)	16,212
Cash Flows From Investing Activities:		
Purchases of real estate loans held-for-investment	(414,422)	(52,689)
Principal payments on real estate loans held-for-investment	1,042,027	1,928,003
Purchases of real estate securities available-for-sale	(650,124)	(163,599)
Proceeds from sales of real estate securities available-for-sale	120,049	13,634
Principal payments on real estate securities available-for-sale	70,043	45,083
Net increase in restricted cash	(227,947)	(58,750)
Net cash (used in) provided by investing activities	(60,374)	1,711,682
Cash Flows From Financing Activities:		
Net borrowings (repayments) on Redwood debt	23,575	(169,707)
Proceeds from issuance of asset-backed securities	1,359,833	277,800
Deferred asset-backed security issuance costs	(5,869)	(3,365)
Repayments on asset-backed securities	(1,377,883)	(1,911,617)
Net purchases of interest rate agreements	(601)	(2,463)
Net proceeds from issuance of common stock	18,727	9,171
Dividends paid	(19,831)	(18,132)
Net cash used in financing activities	(2,049)	(1,818,313)
Net decrease in cash and cash equivalents	(76,360)	(90,419)
Cash and cash equivalents at beginning of period	168,016	175,885
Cash and cash equivalents at end of period	$ 91,656	$ 85,466
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	$ 166,977	$ 178,327
Cash paid for taxes	$ 450	$ 2,660
Non-Cash Financing Activity:		
Dividends declared but not paid	$ 20,347	$ 17,767

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
March 31, 2007
(Unaudited)

Note 1. Redwood Trust

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), invests in, finances, and manages real estate assets. We invest in residential and commercial real estate loans and in asset-backed securities backed by real estate loans. Our primary focus is credit-enhancing residential and commercial real estate loans. We credit-enhance loans by acquiring and managing the first-loss and other credit-sensitive securities that bear the bulk of the credit risk of securitized loans.

We seek to invest in assets that have the potential to generate high long-term cash flow returns to help support our goal of distributing an attractive level of dividends per share to shareholders over time. For tax purposes, we are structured as a real estate investment trust (REIT).

Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. Our executive offices are located at One Belvedere Place, Suite 300, Mill Valley, California 94941.

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements presented herein are at March 31, 2007 and December 31, 2006 and for the three months ended March 31, 2007 and 2006. The accompanying consolidated financial statements are unaudited. The unaudited interim consolidated financial statements have been prepared on the same basis as the annual consolidated financial statements and, in our opinion, reflect all adjustments necessary for a fair statement of our financial position, results of operations, and cash flows. These consolidated financial statements and notes thereto should be read in conjunction with our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2006. The results for the three months ended March 31, 2007 are not necessarily indicative of the expected results for the year ended December 31, 2007. Certain amounts for prior years have been reclassified to conform to the March 31, 2007 presentation.

These consolidated financial statements include the accounts of Redwood Trust, Inc. (Redwood Trust) and its direct and indirect wholly-owned subsidiaries (collectively, Redwood). All inter-company balances and transactions have been eliminated in consolidation. A number of Redwood Trust’s subsidiaries are qualifying REIT subsidiaries and the remainder are taxable subsidiaries. References to the Redwood REIT mean Redwood Trust and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

We currently operate two securitization programs. Our Sequoia program is used for the securitization of residential mortgage loans. References to Sequoia refer collectively to all the Sequoia securitization entities. Our Acacia program involves the resecuritization of mortgage-backed securities and other types of financial assets through the issuance of collateralized debt obligations (CDOs). References to Acacia refer collectively to all of the Acacia CDO issuing entities.

Under the provisions of Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), we treat the securitizations we sponsor as financings, as under these provisions we have retained effective control over these loans and securities. Control is maintained through our active management of the assets in the securitization entities, our retained asset transfer discretion, our ability to direct certain servicing decisions, or a combination of the foregoing. Accordingly, the underlying loans and securities owned by these securitization entities are shown on our consolidated balance sheets under real estate loans, real estate securities, and the asset-back securities (ABS) issued to third parties are shown on our consolidated balance sheets under ABS issued. In our consolidated statements of income, we record interest income on the loans and securities and interest expense on the ABS issued. Any Sequoia ABS acquired by Redwood or Acacia from Sequoia entities and any Acacia ABS acquired by Redwood for its own portfolio are eliminated in consolidation and thus are not shown separately on our consolidated balance sheets and the associated income and expense are not shown separately on our consolidated statements of income.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

Use of Estimates

The preparation of financial statements in conformity with Generally Accepted Accounting Principles in the United States of America (GAAP) requires us to make a significant number of estimates. These include fair market value of certain assets, amount and timing of credit losses, prepayment assumptions, and other items that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. It is likely that changes in these estimates (e.g., market values due to changes in supply and demand, credit performance, prepayments, interest rates, or other reasons; yields due to changes in credit outlook and loan prepayments) will occur in the near term. Our estimates are inherently subjective in nature and actual results could differ from our estimates and the differences may be material.

Real Estate Loans

Residential and Commercial Real Estate Loans: Held-for-Investment

Real estate loans include residential and commercial real estate loans. Currently, all our real estate loans are held-for-investment as we have the ability and intent to hold these loans to maturity. Real estate loans held-for-investment are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and net of any allowance for credit losses.

Coupon interest is recognized as revenue when earned and deemed collectible. We accrue interest on loans until they are more than 90 days past due at which point they are placed on nonaccrual status. Purchase discounts and premiums related to real estate loans are amortized into interest income over their estimated lives to generate an effective yield, considering the actual and future estimated prepayments of the loans pursuant to the provisions discussed below. Gains or losses on the sale of real estate loans are based on the specific identification method.

Pursuant to Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases* (FAS 91), we use the interest method to determine an effective yield and amortize the premium or discount on loans. For loans acquired prior to July 1, 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine an effective yield to amortize the premium or discount. For loans acquired after July 1, 2004, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments to calculate an effective yield to amortize the premium or discount.

We may exercise our right to call ABS issued by entities sponsored by us and may subsequently sell the underlying loans to third parties. For balance sheet purposes, we reclassify held-for-investment loans to held-for-sale loans once we determine which loans will be sold to third parties. In our consolidated statements of cash flows, sales of loans are reported as sales of loans held-for-investment as the acquisition of loans were reported as purchases of loans held-for-investment.

Residential and Commercial Real Estate Loans: Held-for-Sale

Residential and commercial real estate loans that we are marketing for sale are classified as real estate loans held-for-sale. These are carried at the lower of cost or fair market value on a loan-by-loan basis. Any market valuation adjustments on these loans are recognized in valuation adjustments net, in our consolidated statements of income.

Real Estate Loans - Reserve for Credit Losses

For consolidated real estate loans held-for-investment, we establish and maintain credit reserves based on estimates of credit losses inherent in these loan portfolios as of the reporting date. To calculate the credit reserve, we assess inherent losses by determining loss factors (defaults, the timing of defaults, and loss severities upon defaults) that can be specifically applied to each of the consolidated loans, loan pools, or individual loans. See *Note 7* for a discussion of the levels of reserves for credit losses.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

We follow the guidelines of Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation* (SAB 102), Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), and Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114), and Statement of Financial Accounting Standards No. 118, *Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures* (FAS 118) in setting credit reserves for our real estate loans.

The following factors are considered and applied in such determinations:

- Ongoing analyses of loans — including, but not limited to, the age of loans, underwriting standards, business climate, economic conditions, geographical considerations, and other observable data;
- Historical loss rates and past performance of similar loans;
- Relevant environmental factors;
- Relevant market research and publicly available third-party reference loss rates;
- Trends in delinquencies and charge-offs;
- Effects and changes in credit concentrations;
- Information supporting the borrowers' ability to meet obligations;
- Ongoing evaluations of fair market values of collateral using current appraisals and other valuations; and
- Discounted cash flow analyses.

Once we determine applicable default amounts, the timing of the defaults, and severity of losses upon the defaults, we estimate expected losses for each pool of loans over its expected life. We then estimate the timing of these losses and the losses probable to occur over an effective loss confirmation period. This period is defined as the range of time between the probable occurrence of a credit loss (such as the initial deterioration of the borrower's financial condition) and the confirmation of that loss (the actual impairment or charge-off of the loan). The losses expected to occur within the estimated loss confirmation period are the basis of our credit reserves because we believe those losses exist as of the reported date of the financial statements. We re-evaluate the level of our credit reserves on at least a quarterly basis, and we record provision, charge-offs, and recoveries monthly.

We do not maintain a loan repurchase reserve, as any risk of loss due to loan repurchases (i.e., due to breach of representations) would normally be covered by recourse to the companies from whom we acquired the loans.

Real Estate Securities

Real estate securities include residential, commercial, and CDO securities. Real estate securities are classified as available-for-sale (AFS) and are carried at their estimated fair market values. Cumulative unrealized gains and losses are reported as a component of accumulated other comprehensive income (loss) in our consolidated statements of stockholders' equity. Upon sale this accumulated other comprehensive income (loss) is reclassified into earnings on the specific identification method.

Coupon interest is recognized as revenue when earned and deemed collectible. Purchase discounts and premiums related to the securities are amortized into interest income over their estimated lives to generate an effective yield, considering the actual and future estimated prepayments of the securities pursuant to the provisions discussed below. Gains or losses on the sale of securities are based on the specific identification method.

When recognizing revenue on AFS securities, we employ the interest method to account for purchase premiums, discounts, and fees associated with these securities. For securities rated AAA or AA, we use the interest method as prescribed under FAS 91, while for securities rated A or lower we use the interest method as prescribed under the Emerging Issues Task Force of the Financial Accounting Standards Board 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* (EITF 99-20). The use of these methods requires us to project cash flows over the remaining life of each asset. These projections include assumptions about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. We review and make adjustments to our cash flow projections on an ongoing basis and monitor these projections based on input and analyses received from external sources, internal models, and our own judgment and experience. Actual maturities of AFS securities are generally shorter than stated contractual maturities. All of our stated maturities are greater than ten years. Actual maturities of the AFS securities are affected by the contractual lives of the underlying mortgages, periodic payments of principal, and prepayments of principal. There can be no assurance that our assumptions used to estimate future cash flows or the current period's yield for each asset would not change in the near term, and the change could be material.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

For determining other-than-temporary impairment on our real estate securities, we use the guidelines prescribed under EITF 99-20, Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), and Staff Accounting Bulletin No. 5(m), *Other-Than-Temporary Impairment for Certain Investments in Debt and Equity Securities* (SAB 5(m)). Any other-than-temporary impairments are reported under market valuation adjustments, net in our consolidated statements of income. For real estate securities subject to Emerging Issues Task Force of the Financial Accounting Standards Board 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (*EITF 03-1), we assess whether a drop in fair market value below the cost of the real estate security should be deemed as other-than-temporary impairment. If we have the ability and intent to hold a real estate security for a reasonable period of time sufficient for a forecasted recovery of fair market value up to (or beyond) the cost of the investment, we do not deem that unrealized loss an other-than-temporary impairment.

In the footnotes to the consolidated financial statements, we disclose information on our real estate securities portfolio based on the underlying residential, commercial, and CDO assets. We also provide a further breakdown of these securities by investment-grade securities (IGS, those rated BBB to AAA) and credit-enhancement securities (CES, those rated non-rated to BB, also referred to as first-loss, second-loss, and third-loss securities) based on their current credit rating.

Other Real Estate Investments

Other real estate investments include interest-only certificates (IOs), net interest margin securities (NIMs), and residual securities (residuals). At the conclusion of the first quarter of 2007, we classified these investments as trading securities. With the adoption of *Statement of Financial Accounting Standards* No. 155, *Accounting for Certain Hybrid Financial Investments*, (FAS 155) IOs, NIMs and residuals may contain embedded derivatives which would require bifurcation and separate valuation through the income statement. We have elected to treat these investments as trading securities under FAS 115 rather than bifurcate the embedded derivative component. Trading securities are reported on our consolidated balance sheet at their estimated fair market values with changes in fair market values reported through our consolidated statements of income through market valuation adjustments.

Total income recognized in current period earnings on these investments equals coupon interest earned plus the change in fair market value. Interest income is equal to the instruments' yield based on market expectations.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less.

Derivative Financial Instruments

All derivative financial instruments are reported at fair market value on our consolidated balance sheets. Those with a positive value to us are reported as an asset and those with a negative value to us are reported as a liability. Whether changes in the fair market value of these instruments are reported through our income statement depends on the type of derivative it is and the accounting treatment chosen. See *Note 6* for a discussion on the value of our derivative financial instruments.

We currently enter into interest rate agreements to help manage some of our interest rate risks. We report our interest rate agreements at fair market value. We may elect hedge accounting treatment under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), or we may account for these as trading instruments. Net purchases and proceeds from interest rate agreements are classified within cash flows from financing activities within the consolidated statement of cash flows together with the items the interest rate agreements hedge.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

We designate an interest rate agreement as (1) a hedge of the fair market value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), (2) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge), or (3) held for trading (trading instrument).

In a cash flow hedge, the effective portion of the change in the fair market value of the hedging derivative is recorded in accumulated other comprehensive income (loss) and is subsequently reclassified into earnings when the hedging relationship is terminated. The ineffective portion of the cash flow hedge is recognized immediately in earnings. We use the dollar-offset method to determine the amount of ineffectiveness, and we anticipate having some ineffectiveness in our hedging program, as not all terms of our hedges and not all terms of our hedged items match perfectly.

We will discontinue hedge accounting when (1) we determine that the derivative is no longer expected to be effective in offsetting changes in the fair market value or cash flows of the designated hedged item; (2) the derivative expires or is sold, terminated, or exercised; (3) the derivative is de-designated as a fair value or cash flow hedge; or (4) it is probable that the forecasted transaction will not occur by the end of the originally specified time period.

As of each period end, we may also have outstanding commitments to purchase real estate loans. These commitments are accounted for as derivatives under Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149), when applicable. These are classified as trading instruments and changes in fair market value of the purchase commitments are recorded through valuation adjustments in the consolidated statements of income.

Beginning in the first quarter of 2007, we entered into credit default swap agreements. A credit default swap is an agreement to provide (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed rate fee or premium over the term of the contract. Under FAS 133, credit default swaps are accounted for as trading instruments.

Restricted Cash

Restricted cash includes principal and interest payments from real estate loans and securities owned by consolidated securitization entities that are collateral for, or payable to, owners of ABS issued by those entities and cash pledged as collateral on interest rate agreements. Restricted cash may also include cash retained in Acacia or Sequoia securitization trusts prior to purchase of real estate loans and securities or the redemption of outstanding ABS issued.

Accrued Interest Receivable

Accrued interest receivable represents interest that is due and payable to us. This is generally received within the next month.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

Deferred Tax Assets

Income recognition for GAAP and tax differ in material respects. As a result, we may recognize taxable income in periods prior to recognizing the income for GAAP. When this occurs, we pay the tax liability and establish a deferred tax asset for GAAP. When the income is then realized under GAAP in future periods, the deferred tax asset is recognized as an expense. Our deferred tax assets are generated by differences in GAAP and tax income at our taxable subsidiaries.

Deferred Asset-Backed Securities Issuance Costs

ABS issuance costs are costs associated with the issuance of ABS from securitization entities we sponsor. These costs typically include underwriting, rating agency, legal, accounting, and other fees. Deferred ABS issuance costs are reported on our consolidated balance sheets as deferred charges and are amortized as an adjustment to consolidated interest expense using the interest method based on the actual and estimated repayment schedules of the related ABS issued under the principles prescribed in Accounting Practice Bulletin 21, *Interest on Receivables and Payables* (APB 21).

Other Assets

Other assets on our consolidated balance sheets include real estate owned (REO), fixed assets, purchased interest, principal receivable, and other prepaid expenses. REO is reported at the lower of cost or fair market value.

Redwood Debt

Redwood debt is currently all short-term debt collateralized by loans and securities. We report this debt at its unpaid principal balance.

Asset-Backed Securities Issued

The majority of the liabilities reported on our consolidated balance sheets represent ABS issued by bankruptcy-remote securitization entities sponsored by Redwood. These ABS issued are carried at their unpaid principal balances net of any unamortized discount or premium. Our exposure to loss from consolidated securitization entities (such as Sequoia and Acacia) is limited (except, in some circumstances, for limited loan repurchase obligations) to our net investment in securities we have acquired from these entities. Sequoia and Acacia assets are held in the custody of trustees. Trustees collect principal and interest payments (less servicing and related fees) from the assets and make corresponding principal and interest payments to the issued ABS. ABS obligations are payable solely from the assets of these entities and are non-recourse to Redwood.

Junior Subordinated Notes

Junior subordinated notes (trust preferred securities) are unsecured debt, requiring quarterly interest payments at a floating rate equal to LIBOR plus a spread until they are redeemed in whole, or mature at a future date. These notes contain an earlier optional redemption date without penalty.

Earnings per Share

Basic earnings per share are computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per share are computed by dividing net income by the weighted average number of common shares and potential common shares outstanding during the period. Potential common shares outstanding are calculated using the treasury stock method, which assumes that all dilutive common stock equivalents are exercised and the funds generated by the exercises are used to buy back outstanding common stock at the average market price of the common stock during the reporting period.

The following table provides reconciliation of denominators of the basic and diluted earnings per share computations.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

Basic and Diluted Earnings per Share

(In thousands, except share data)	Three Months Ended March 31, 2007		Three Months Ended March 31, 2006	
Denominators:				
Denominator for basic earnings per share is equal to the weighted average number of common shares outstanding during the period		26,855,681		25,201,525
Adjustments for diluted earnings per share are:				
Net effect of dilutive stock options		828,348		501,205
Denominator for diluted earnings per share		27,684,029		25,702,730
Basic Earnings Per Share	$	0.68	$	1.11
Diluted Earnings Per Share	$	0.66	$	1.09

Pursuant to EITF 03-6, *Participating Securities and the Two — Class Method* under *FASB No. 128* (EITF 03-6), we determined that there was no allocation of income for our outstanding stock options as they were antidilutive for the three months ended March 31, 2007 and 2006. There were no other participating securities, as defined by EITF 03-6, during for the three months ended March 31, 2007 and 2006. For the three months ended March 31, 2007 and 2006, the number of outstanding stock options that were antidilutive totaled 61,042, and 466,755, respectively.

Other Comprehensive Income (Loss)

Current period net unrealized gains and losses on real estate securities available-for-sale, and interest rate agreements classified as cash flow hedges are reported as components of other comprehensive income (loss) on our consolidated statements of comprehensive income (loss). Net unrealized gains and losses on securities and interest rate agreements held by our taxable subsidiaries that are reported in other comprehensive income (loss) are adjusted for the effects of tax and may create deferred tax assets or liabilities.

Stock-Based Compensation

As of March 31, 2007 and December 31, 2006, we had one stock-based employee compensation plan and one employee stock purchase plan. These plans, and associated stock options and other equity awards, are described more fully in *Note 15*.

We adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (FAS 123R), on January 1, 2006. With the adoption of FAS 123R, the grant date fair market value of all remaining unvested stock compensation awards (stock options, deferred stock units, and restricted stock) are expensed on the consolidated statements of income over the remaining vesting period. At January 1, 2006, upon adoption of FAS 123R, we had $19.3 million of unamortized costs related to unvested equity awards (stock options, restricted stock, and deferred stock units). At March 31, 2007, the unamortized costs totaled $17.7 million and will be expensed over the next six years, over half of which will be recognized over the next twelve months.

The Black-Scholes option-pricing model was used in determining fair market values of option grants accounted for under FAS 123R. The model requires the use of inputs such as strike price, and assumptions such as expected life, risk free rate of return, and stock price volatility. Options are generally granted over the course of the calendar year. The stock price volatility assumption is based on the historical volatility of our common stock. Certain options have dividend equivalent rights (DERs) and, accordingly, the assumed dividend yield was zero for these options. Other options granted have no DERs and the assumed dividend yield was 10%. The following table describes the weighted average of assumptions used for calculating the value of options granted for the three months ended March 31, 2007 and 2006.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

Weighted Average Assumptions used for Valuation of Options under FAS 123R Granted during period

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
Stock price volatility	25.5%	25.7%
Risk free rate of return (5 yr Treasury Rate)	4.58%	4.75%
Average life	6 years	5 years
Dividend yield	10.00%	10.00%

Recent Accounting Pronouncements

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115*, ("SFAS 159"). SFAS 159 permits fair value accounting to be irrevocably elected for certain financial assets and liabilities at the time of acquisition on an individual contract basis or at a remeasurement event date. Upon adoption of SFAS 159, fair value accounting may also be elected for existing financial assets and liabilities. For those instruments for which fair value accounting is elected, changes in fair value will be recognized in earnings and fees and costs associated with origination or acquisition will be recognized as incurred rather than deferred. SFAS 159 is effective January 1, 2008, with early adoption permitted as of January 1, 2007. We have determined that we will adopt SFAS 159 concurrent with the adoption of FASB issued Statement 157, Fair Value Measurements ("SFAS 157"), on January 1, 2008, but we have not yet determined the financial impact, if any, upon adoption.

Note 3. Real Estate Loans

We acquire residential real estate loans from third party originators. A portion of these loans are sold to securitization entities sponsored by us under our Sequoia program which, in turn, issue ABS. The remainder of the loans we invest in are held and financed with Redwood debt and equity. The following tables summarize the carrying value of the residential and commercial real estate loans, as reported on our consolidated balance sheets at March 31, 2007 and December 31, 2006.

Real Estate Loans Composition

(In thousands)	March 31, 2007	December 31, 2006
Residential real estate loans	$ 8,680,487	$ 9,323,935
Commercial real estate loans	25,883	28,172
Total real estate loans	$ 8,706,370	$ 9,352,107

Real Estate Loans Carrying Value

March 31, 2007 (In thousands)	Residential Real Estate Loans	Commercial Real Estate Loans	Total
Current face	$ 8,582,964	$ 38,394	$ 8,621,358
Unamortized premium (discount)	117,477	(2,022)	115,455

Discount designated as credit reserve	—	(8,141)	(8,141)
Amortized cost	8,700,441	28,231	8,728,672
Reserve for credit losses	(19,954)	(2,348)	(22,302)
Carrying value	$ 8,680,487	$ 25,883	$ 8,706,370

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

Real Estate Loans Carrying Value

December 31, 2006 (In thousands)	Residential Real Estate Loans	Commercial Real Estate Loans	Total
Current face	$ 9,212,002	$ 38,360	$ 9,250,362
Unamortized premium (discount)	132,052	(2,047)	130,005
Discount designated as credit reserve	—	(8,141)	(8,141)
Amortized cost	9,344,054	28,172	9,372,226
Reserve for credit losses	(20,119)	—	(20,119)
Carrying value	$ 9,323,935	$ 28,172	$ 9,352,107

Of the $8.6 billion of face and $117 million of unamortized premium on our residential real estate loans at March 31, 2007, $4.5 billion of face and $95 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. At December 31, 2006, the residential loans acquired prior to July 1, 2004 had face and unamortized premium balances of $5.2 billion and $104 million, respectively. For these residential loans, we use coupon interest rates as they change over time and anticipated principal payments to determine an effective yield to amortize the premium or discount. During the first quarter of 2007, 13% of these residential loans prepaid and we amortized 9% of the premium. For residential loans acquired after July 1, 2004, the face and unamortized premium was $4.1 billion and $22 million at March 31, 2007 and $4.0 billion and $28 million at December 31, 2006, respectively. For these residential loans, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments to calculate an effective yield to amortize the premium or discount.

Residential real estate loans are either sold to securitization entities sponsored by us under our Sequoia program which, in turn, issue ABS or are held and financed with Redwood debt. The table below presents information regarding real estate loans pledged under our borrowing agreements.

Real Estate Loans Pledged and Unpledged

(In thousands)	March 31, 2007		December 31, 2006	
	Face Value	Carrying Value	Face Value	Carrying Value
Unpledged	$ 106,987	$ 94,119	$ 120,578	$ 111,231
Pledged for Redwood debt:				
Repurchase (repo) agreements	900,142	909,230	978,713	982,629
Commercial paper	252,897	253,430	301,827	302,615
Owned by securitization entities, financed through the issuance of ABS	7,361,332	7,449,591	7,849,244	7,955,632
Carrying value	$ 8,621,358	$ 8,706,370	$ 9,250,362	$ 9,352,107

Note 4. Real Estate Securities

The real estate securities shown on our consolidated balance sheets include residential, commercial, and CDO securities acquired from securitizations sponsored by others. The table below presents the carrying value (which equals fair market value as these are available-for-sale securities (AFS)) of our securities that are included in our consolidated balance sheets as of March 31, 2007 and December 31, 2006, by type of securities, and by credit rating of investment-grade (IGS) and below investment-grade (CES).

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

Securities (AFS) — Underlying Collateral Characteristics

March 31, 2007 (In thousands)	**CES**	**IGS**	**Total AFS Securities**
Residential securities:			
Prime	$ 571,149	$ 789,492	$ 1,360,641
Alt-a	171,987	765,840	937,827
Subprime	9,141	470,518	479,659
Total residential securities	752,277	2,025,850	2,778,127
Commercial securities	435,382	116,494	551,876
CDO securities	16,152	254,307	270,459
Total securities	$ 1,203,811	$ 2,396,651	$ 3,600,462

December 31, 2006 (In thousands)	**CES**	**IGS**	**Total AFS Securities**
Residential securities:			
Prime	$ 555,369	$ 723,247	$ 1,278,616
Alt-a	156,859	455,550	612,409
Subprime	9,303	518,453	527,756
Total residential securities	721,531	1,697,250	2,418,781
Commercial securities	448,060	119,613	567,673
CDO securities	21,964	224,349	246,313
Total securities	$ 1,191,555	$ 2,041,212	$ 3,232,767

The table below presents the components comprising the carrying value of available-for-sale IGS reported on our consolidated balance sheets at March 31, 2007 and December 31, 2006.

Investment-Grade Securities (AFS)

March 31, 2007 (In thousands)	**Residential**	**Commercial**	**CDO**	**Total IGS**
Current face	$ 2,094,494	$ 121,737	$ 263,237	