

PMC CAPITAL INC
Form 10-Q
August 14, 2001
Table of Contents

FORM 10 Q
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

(Mark One)

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

For the quarterly period ended **June 30, 2001**

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 811-3780

PMC CAPITAL, INC

(Exact name of registrant as specified in its charter)

FLORIDA

(State or other jurisdiction of incorporation or organization)

59-2338439

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

18111 Preston Road, Suite 600, Dallas, TX 75252

(Address of principal executive offices)

(972) 349-3200

(Registrant's telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES NO

As of August 13, 2001, Registrant had outstanding 11,853,516 shares of Common Stock, par value \$.01 per share.

TABLE OF CONTENTS

PART I

Financial Information

ITEM 1.

Financial Statements

CONSOLIDATED BALANCE SHEETS

CONSOLIDATED STATEMENTS OF INCOME

CONSOLIDATED STATEMENTS OF CASH FLOWS

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Item 3.

Quantitative and qualitative disclosures about market risk

PART II Other Information

ITEM 4. Submission of Matters to a Vote of Security Holders

ITEM 6. Exhibits and Reports on Form 8-K

EX-10.1 Servicing Agreement

EX-10.2 Trust Indenture

Table of Contents

PMC CAPITAL, INC. AND SUBSIDIARIES

INDEX

**PAGE
NO.**

PART I. Financial Information

Item 1.

Financial

StatementsConsolidated

Balance

Sheets

-June 30, 2001

(Unaudited)

and

December 31,

20002Consolidated

Statements of

Income

(Unaudited)

-Three and Six

Months Ended

June 30, 2001

and

20003Consolidated

Statements of

Cash Flows

(Unaudited)

-Six Months
Ended
June 30, 2001
and
2000
Notes to
Consolidated
Financial
Statements
(Unaudited)
Item 2.
Management's
Discussion
and Analysis
of Financial
Condition and
Results of
Operations
Item 3.
Quantitative
and
Qualitative
Disclosures
about Market
Risk
PART
II. Other
Information
Item 4.
Submission of
Matters to a
Vote of
Security
Holders
Item 6.
Exhibits and
Reports on
Form 8-K

Table of Contents

PART I

Financial Information

ITEM 1.

Financial Statements

1

Table of Contents

PMC CAPITAL, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)

	June 30, 2001	December 31, 2000
	<i>(Unaudited)</i>	
ASSETS		
Investments at value:		
Loans receivable, net \$89,655	\$100,353	Retained interests in transferred assets 41,430
Cash equivalents 26,321	21,655	Mortgage-backed security of affiliate 1,726
Restricted investments in unconsolidated subsidiaries 336	148	Assets acquired in liquidation 217
Total investments at value 159,958	156,515	
Other assets:		
Due from unconsolidated subsidiaries 496	2,278	Deferred charges, deposits and other assets 792
Receivable for loans sold 1,071	750	Accrued interest receivable 513
Cash 238	254	Property and equipment, net 164
Total other assets 3,274	963	
Total assets \$163,232	\$161,478	
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes and debentures		

payable\$72,977\$72,977Dividends
 payable2,4333,026Borrower
 advances1,8501,549Accrued
 interest
 payable1,2521,284Accounts
 payable2,2591,088Due to
 unconsolidated
 subsidiaries255667Other
 liabilities1,0111,220

Total
 liabilities82,03781,811

**Commitments and
 contingenciesCumulative
 preferred stock of
 subsidiary7,0007,000**

Shareholders

equity:Common stock,
 authorized 30,000,000
 shares of \$.01 par value,
 11,853,516 shares issued
 and outstanding at
 June 30, 2001 and
 December 31,
 2000119119Additional
 paid-in
 capital71,50871,508Undistributed
 net operating
 income1,281238Net
 unrealized appreciation on
 investments1,287802

74,19572,667

**Total liabilities and
 shareholders
 equity\$163,232\$161,478**

Net asset value per
 common share\$6.26\$6.13

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

Table of Contents

**PMC CAPITAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)**

	<u>Six Months Ended June 30,</u>		<u>Three Months Ended June 30,</u>	
	<u>2001</u>	<u>2000</u>	<u>2001</u>	<u>2000</u>
	<i>(Unaudited)</i>			
Investment income:				
Interest from retained interests in transferred assets	\$6,499	\$6,338	\$3,345	\$3,106
Premium income	2,452	2,201	1,941	1,166
Other investment income, net	342	274	179	147

Total investment income	9,649	9,187	5,345	5,655
Other income, net	1,003	1,042	532	543
Equity in income of unconsolidated subsidiaries, net	187	235	97	105

Total income	10,835	10,464	5,825	6,303

Expenses:				
Interest and related benefits	2,797	2,529	1,417	1,265
Salaries and administrative	2,221	1,995	1,154	1,008
General and administrative	471	389	257	195
Rent	163	155	82	80
Profit sharing plan	122	79	14	11
Legal and accounting	179	129	34	40
Small Business Administration fees	61	47	29	21
Directors and shareholders expense	32	39	24	29

Total expenses	6,047	5,362	3,127	3,679

Net operating
income 4,788,102,455,624

**Realized and unrealized gain (loss) on
investments:** Investments
written-off (1,019)(16)(729)(11) Sale of
assets 2,732 2,732 Change in unrealized
appreciation (depreciation) on
investments 485,234,689

Total realized and unrealized gain
(loss) on investments 2,198,218,071

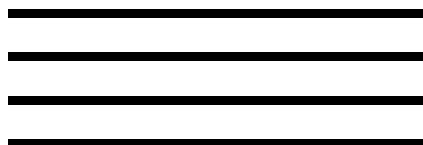
**Net operating income and realized and
unrealized gain (loss) on
investments** \$6,986,532,452,704

Preferred dividends \$124,125,62,63

*Basic weighted average common shares
outstanding* 11,854,11,830,11,854,11,830

*Diluted weighted average common shares
outstanding* 11,855,11,833,11,854,11,836

*Basic and diluted earnings per common
share* \$0.58 \$0.44 \$0.38 \$0.22



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

Table of Contents

**PMC CAPITAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)**

**Six Months
Ended
June 30,**

2001	2000
------	------

(Unaudited)

Cash flows from operating activities:

Net operating income and realized and unrealized gain (loss) on investments \$6,986 \$5,320 Adjustments to reconcile net operating income and realized and unrealized gain (loss) on investments to net cash provided by operating activities: Loans funded, held for sale (5,329) (4,394) Proceeds from sale of guaranteed loans 5,785 4,733 Change in unrealized depreciation on investments and investments written-off 682 (218) Gain on sale of asset (2,732) Unrealized premium income, net (15) (130) Depreciation and amortization 828 1 Accretion of loan discount and deferred fees (48) (102) Deferred fees collected 20 Equity in income of unconsolidated subsidiaries,

net(187)(235)Net change in
operating assets and
liabilities: Accrued interest
receivable66(167) Other
assets32(23) Accrued
interest
payable(32)(117) Borrower
advances301(1,191) Other
liabilities977(695)

**Net cash provided by
operating
activities**6,5682,882

**Cash flows from investing
activities:**Loans
funded(43,149)(19,739)Principal
collected3,2916,089Proceeds
from retained interests in
transferred
assets1,3182,096Proceeds
from sale of
assets 65Proceeds from
mortgage-backed security
of
affiliate108192Investment
in retained interests in
transferred
assets(1,771) Purchase of
property and equipment and
other assets(33)(10)Release
of (investment in) restricted
cash(96)61Advances
(to) from unconsolidated
affiliates, net(46)438

**Net cash used in investing
activities**(40,378)(10,808)

**Cash flows from financing
activities:**Proceeds from
debt issued by limited
partnerships44,511 Proceeds
from issuance of notes
payable 2,700Proceeds from
issuance of common
stock 137Payment of
dividends on common
stock(5,927)(6,092)Payment
of dividends on preferred
stock(124)(125)Payment of
SBA debentures (7,330)

Net cash provided by
(used in) financing
activities 38,460(10,710)

Net increase (decrease) in
cash and cash
equivalents 4,650(18,636) Cash
and cash equivalents,
beginning of
year 21,909 23,193

Cash and cash
equivalents, end of
period \$26,559 \$4,557

Supplemental
disclosure: Interest
paid \$2,832 \$2,646

Reclassification from loans
receivable to real property
owned \$217

Loans and interest
receivable transferred to
limited partnership,
net \$4,215

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

Table of Contents

**PMC CAPITAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

Note 1. Interim Financial Statements:

The accompanying consolidated balance sheet of PMC Capital, Inc. (PMC Capital) and its wholly-owned regulated investment company subsidiaries (collectively, we , us or our) as of June 30, 2001 and the consolidated statements of income for the three and six months ended June 30, 2001 and 2000 and cash flows for the six months ended June 30, 2001 and 2000 have not been audited by independent accountants. In the opinion of our management, the financial

statements reflect all adjustments necessary to present fairly the financial position at June 30, 2001 and the results of operations for the three and six months ended June 30, 2001 and 2000. These adjustments are of a normal recurring nature.

Certain notes and other information have been omitted from the interim financial statements presented in this Quarterly Report on Form 10-Q. Therefore, these financial statements should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended December 31, 2000.

The preparation of financial statements in conformity with generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The results for the three and six months ended June 30, 2001 are not necessarily indicative of future financial results.

Note 2. Reclassifications:

Certain prior period amounts have been reclassified to conform to the current year presentation.

Note 3. Business and consolidation:

Business

PMC Capital is a diversified closed-end management investment company that operates as a business development company (BDC) under the Investment Company Act of 1940, as amended (the 1940 Act). Our common stock (the Common Stock) is traded on the American Stock Exchange under the symbol PMC.

We are engaged in the business of originating loans to small businesses either directly or through our three principal subsidiaries: First Western SBLC, Inc. (First Western), PMC Investment Corporation (PMCIC) and Western Financial Capital Corporation (Western Financial).

First Western, PMCIC and Western Financial are registered under the 1940 Act as diversified closed-end management investment companies. In addition, PMC Capital is either directly or

Table of Contents

**PMC CAPITAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

indirectly the sole shareholder or partner of several non-investment company act subsidiaries. These are: PMC Advisers, Ltd. and its subsidiary (PMC Advisers); PMC Funding Corp. and its subsidiary (PMC Funding); PMC Capital Limited Partnership (the 1996 Partnership); PMC Capital, L.P. 1998-1 (the 1998 Partnership) and PMC Capital, L.P. 1999-1 (the 1999 Partnership).

Additionally, PMC Capital owns approximately 33% of PMC Joint Venture, L.P. 2000 (the 2000 Joint Venture) and 60% of PMC Joint Venture, L.P. 2001 (the 2001 Joint Venture), and together with the 1996 Partnership, the 1998 Partnership, the 1999 Partnership and the 2000 Joint Venture, the Limited Partnerships).

Principles of Consolidation

The consolidated financial statements include the accounts of PMC Capital and its wholly-owned regulated investment company subsidiaries, First Western, PMCIC and Western Financial. Intercompany transactions have been eliminated in consolidation.

The accounts of our wholly-owned non-investment company act subsidiaries (other than the Limited Partnerships), PMC Advisers and PMC Funding are accounted for by the equity method of accounting in conformity with Federal securities laws. Our interests in the Limited Partnerships are accounted for as retained interests in transferred assets.

Note 4. Retained Interests in Transferred Assets:

Upon securitization and sale of our loan pools, we value our retained interests in transferred assets (the Retained Interests) in accordance with SFAS No. 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities since our securitizations meet the definition of a transfer under SFAS No. 140. Our Retained Interests are comprised of three separate assets: (1) the Reserve Fund, and the interest earned thereon, which consists of the cash required to be kept in a liquid cash account pursuant to the securitization documents, (2) the subordinated portion of the sold loans (commonly referred to as the B piece or the over-collateralized or OC portions of the loans), and (3) the excess cash flow that is to be received by us in the future after (a) payment of all interest and principal amount due to the purchaser of the loans or the Noteholders, (b) payment of all principal and interest on the B piece, (c) the repayment of the corpus of the Reserve Fund and (d) ongoing costs of the transaction. This excess cash flow is the interest-only strip receivable or the IO Receivable.

Table of Contents

**PMC CAPITAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

Our Retained Interests are comprised of the following as of June 30, 2001 and December 31, 2000, respectively:

	June 30, 2001			
	Total	OC Piece	Reserve Fund	IO Receivable
	<i>(In thousands)</i>			
First Western	\$4,046	\$	\$ 1,080	\$ 2,966
1996 Partnership	6,494			
1998 Partnership	5,203			
1999 Partnership	11,311			
2000 Joint Venture	5,294			
2001 Joint Venture	9,082			
	\$41,430		\$8,687	\$13,325

December 31, 2000

	Total	OC Piece	Reserve Fund	IO Receivable
		<i>(In thousands)</i>		
First Western	\$4,004	\$	\$ 1,142	\$ 2,862
1996 Partnership	6,568	5,749	819	1998
Partnership	5,249	1,999	2,086	1,164
Partnership	10,832	4,346	2,465	4,021
Joint Venture	5,688	3,256	1,314	1,118
	\$32,341	\$15,350	\$7,826	\$9,165

Retained Interest Details:

First Western. First Western sells the unguaranteed portion of some of its originated loans through private placements (SBA Unguaranteed Sales). First Western retains the right to service all such loans. In addition, the SBA guaranteed portions of First Western s loans are sold to either dealers in government guaranteed loans or institutional investors.

PMC Capital Limited Partnership. On November 13, 1996, the 1996 Partnership (a special purpose affiliate of PMC Capital) completed a private placement of approximately \$40.7 million of its Loan-Backed Fixed Rate Notes, Series 1996-A.

PMC Capital L.P. 1998-1. On November 24, 1998, the 1998 Partnership (a special purpose affiliate of PMC Capital) completed a private placement of approximately \$39.6 million of its Loan-Backed Variable Rate Notes, Series 1998-1.

PMC Capital L.P. 1999-1. On June 3, 1999, the 1999 Partnership (a special purpose affiliate of PMC Capital) completed a private placement of approximately \$55.6 million of its Loan-Backed Fixed Rate Notes, Series 1999-1.

Table of Contents

PMC CAPITAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

PMC Joint Venture, L.P. 2000. On December 18, 2000, the 2000 Joint Venture (a special purpose affiliate of PMC Capital and our affiliate, PMC Commercial Trust) completed a private placement of approximately \$74.5 million of its Loan-Backed Fixed Rate Notes, Series 2000 (the 2000 Notes). PMC Capital owns approximately 33% of the 2000 Joint Venture as of June 30, 2001 and December 31, 2000. Accordingly, at inception PMC Capital's share of the 2000 Notes amounted to approximately \$24.9 million (the 2000 PMC Notes). At June 30, 2001, the aggregate remaining principal balance of PMC Capital's loans sold to the 2000 Joint Venture was \$27.0 million and the outstanding balance on the 2000 PMC Notes was \$24.1 million. During the six months ended June 30, 2001, our limited partnership share of the net income of the 2000 Joint Venture was approximately \$356,000.

PMC Joint Venture, L.P. 2001. On June 27, 2001, the 2001 Joint Venture (a special purpose affiliate of PMC Capital and our affiliate, PMC Commercial Trust) completed a private placement of approximately \$75.4 million of its Loan-Backed Fixed Rate Notes, Series 2001 (the 2001 Notes). PMC Capital owned approximately 60% of the 2001 Joint Venture at inception and as of June 30, 2001. Accordingly, at inception PMC Capital's share of the 2001 Notes amounted to approximately \$45.3 million (the 2001 PMC Notes). The 2001 PMC Notes, issued at par, which have a state maturity in 2021 and bear interest at 6.36% are collateralized by loans contributed by PMC Capital and PMC Commercial to the 2001 Joint Venture. In connection with this private placement, the 2001 Notes were given a rating of Aaa by Moody's Investors Service. We recognized a gain of \$2,732,000 in connection with the loan sale. During the period from inception (June 27, 2001) to June 30, 2001, our limited partnership share of the net income of the 2000 Joint Venture was approximately \$16,000. At June 30, 2001, the aggregate remaining principal balance of PMC Capital's loans sold to the 2001 Joint Venture was \$49.2 million and the outstanding balance on the 2001 PMC Notes was \$45.3 million.

Valuation of Retained Interests. As there is no quoted market value for the Retained Interests, the fair value is based on management's estimate of the fair market value. This value may or may not vary significantly from what a willing buyer would pay for these assets. In determining the fair value of the Retained Interests related to our securitization and sale transactions, we utilize certain assumptions which include:

	SBA 7(a) Transactions	Non-SBA 7(a) Transactions
Prepayment rate(a)	Minimum 20% CPR	Minimum 7% CPR
Loss rate(b) Range from 0.4% to 0.8% per annum Range from 0.3% to 0.8% per annum Discount rate(c) Range from 10.5% to 13.5% Range from 6.7% to 13.5%		

- (a) The prepayment rate is based on current performance of the respective loan pools, adjusted for anticipated principal payments considering the current loan pools and similar loans. The minimum rates are for the twelve-month period ending June 30, 2002.

Table of Contents

PMC CAPITAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

- (b) Credit exposure exists to the extent of possible default on the underlying collateral requiring payment from anticipated future residual interests. We believe that a range of 0.3% to 0.8% loss rate covers this inherent risk. For SBA 7(a) guaranteed loan sales, there are no assumed losses since all principal losses are the responsibility of the SBA.
- (c) The discount rates are as of June 30, 2001 and are based upon our estimate of comparable rates which would be used by potential purchasers of similar assets. The discount rates (1) range from 6.7% to 8.8% for our B Pieces, (2) are 10.5% for our Reserve Funds and (3) are 13.5% for our IO Receivables.

The following information summarizes the financial position at June 30, 2001 and December 31, 2000 and the results of operations for the six month periods ended June 30, 2001 and 2000 of the Limited Partnerships created in connection with our securitization transactions:

Summary of Financial Position (as of June 30):

	PMC Capital Limited Partnership		PMC Capital, L. P. 1998-1		PMC Capital, L. P. 1999-1	
	2001	2000	2001	2000	2001	2000
	<i>(In millions)</i>					
Loans Receivable, Net	\$ 9.9	\$ 12.0	\$ 32.8	\$ 34.9	\$ 52.4	\$ 55.3
Total Assets	\$ 11.5	\$ 12.9	\$ 36.1	\$ 38.5	\$ 58.9	\$ 59.8
Notes Payable	\$ 4.4	\$ 6.4	\$ 31.2	\$ 33.3	\$ 50.2	\$ 51.1
Total Liabilities	\$ 5.3	\$ 6.5	\$ 31.4	\$ 34.0	\$ 50.5	\$ 52.2
Partners' Capital	\$ 6.2	\$ 6.4	\$ 4.7	\$ 4.5	\$ 8.4	\$ 7.6

	PMC Joint Venture, L.P. 2000(1)		PMC Joint Venture, L.P. 2001(1)
	2001	2000	2001
	<i>(In millions)</i>		
Loans Receivable, Net	\$ 80.7	\$ 83.6	\$ 80.3
Total Assets	\$ 87.4	\$ 87.4	\$ 85.5
Notes Payable	\$ 72.0	\$ 74.5	\$ 75.4

	█	█	█
Total Liabilities	\$72.4	\$74.7	\$ 75.4
	█	█	█
Partners' Capital	\$15.0	\$12.7	\$ 10.1
	█	█	█

- (1) Balances represent 100% of the limited partnership interests in PMC Joint Venture, L.P. 2000 and PMC Joint Venture, L.P. 2001.

9

Table of Contents

PMC CAPITAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Summary of Operations (for the six months ended June 30):

	PMC Capital Limited Partnership		PMC Capital, L. P. 1998-1		PMC Capital, L. P. 1999-1		PMC Joint Venture, L.P. 2000	PMC Joint Venture, L.P. 2001
	2001	2000	2001	2000	2001	2000	2001(1)	2001(1)
<i>(In thousands)</i>								
Interest Income	\$ 662	\$ 836	\$ 1,774	\$ 1,984	\$ 2,694	\$ 2,859	\$ 4,007	\$ 64
Total Revenues	\$ 680	\$ 837	\$ 1,837	\$ 2,074	\$ 2,878	\$ 2,873	\$ 4,223	\$ 211
Interest Expense	\$ 205	\$ 282	\$ 1,257	\$ 1,399	\$ 1,669	\$ 1,738	\$ 2,661	\$ 40
Total Expenses	\$ 229	\$ 332	\$ 1,316	\$ 1,465	\$ 1,760	\$ 1,831	\$ 2,781	\$ 40
Net Income	\$ 451	\$ 505	\$ 521	\$ 609	\$ 1,118	\$ 1,042	\$ 1,442	\$ 171

- (1) The balances represent PMC Capital's and PMC Commercial's limited partnership interests in PMC Joint Venture L.P. 2000 and PMC Joint Venture L.P. 2001, there were no operations prior to June 30, 2000. In accordance with SFAS No. 140, management has performed a sensitivity analysis of our Retained Interests to highlight the volatility that results when prepayments, losses and discount rates are different than management's original assumptions.

The following summarizes the results of the sensitivity analysis as of June 30, 2001:

Changed Assumption	Pro-Forma Value	Amount of Asset Reduction
Losses increase by 50 basis points per annum	\$38,555,000	\$2,875,000
Losses increase by 100 basis points per annum	\$35,951,000	\$5,479,000
Prepayments increase by 5% per annum	\$40,326,000	\$1,104,000
Prepayments increase by 10% per annum	\$39,307,000	\$2,123,000
Discount rates increase by 1%	\$39,458,000	\$1,972,000
Discount rates increase by 2%	\$37,475,000	\$3,955,000

Table of Contents

**PMC CAPITAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

Note 5. Dividends Paid and Declared:

In both January and April 2001, we paid quarterly dividends of \$0.25 per share of common stock to shareholders of record on December 31, 2000 and March 30, 2001, respectively. On June 14, 2001, the Board declared a dividend of \$0.20 per share to shareholders of record on June 29, 2001, which was paid in July 2001.

Note 6. Net Unrealized Appreciation on Investments and Realized and Unrealized Gain (Loss) on Investments:

Net unrealized appreciation on investments is comprised of the following at June 30, 2001 and December 31, 2000:

	June 30, 2001	December 31, 2000
	<i>(In thousands)</i>	
Loans receivable	\$(661)	\$ (659)
Retained interests in transferred assets	1,873	1,379
Other investments	758	2
	<u>\$1,287</u>	<u>\$802</u>

Total realized and unrealized gain (loss) on investments \$330,000 \$(112,000) \$218,000 \$220,000 \$(140,000) \$80,000

Note 7. Earnings Per Common Share Computations:

For purposes of calculating diluted earnings per share, the weighted average shares outstanding were increased by 1,000 shares and 3,000 shares during the six months ended June 30, 2001 and 2000, respectively, and by 6,000 shares during the three months ended June 30, 2000. There was no change in the weighted average shares outstanding for the effect of stock options during the three months ended June 30, 2001 since the stock options were anti-dilutive.

Earnings are defined as the net operating income and realized and unrealized gain (loss) on investments reduced by the preferred stock dividend requirements of PMCIC.

Table of Contents

**PMC CAPITAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

Note 8. Commitments and Contingencies:

Loan commitments outstanding at June 30, 2001 to various small business companies, including the unfunded portion of projects in the construction phase, amounted to approximately \$28.0 million. Of these commitments, \$6.2 million are for loans to be originated by First Western, a portion of which will be sold into the secondary market. These commitments are made in the ordinary course of our business and, in our opinion, are generally on the same terms as those to existing borrowers. Commitments to extend credit are agreements to lend to a customer provided that the terms established in the contract are met. Commitments generally have fixed expiration dates and require payment of a fee. Since some commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Note 9. Subsequent Event:

On July 19, 2001 we refinanced \$6.7 million in senior notes upon their maturity and simultaneously borrowed an additional \$3.3 million in senior notes. The aggregate \$10 million in senior notes matures in July 2006 and has an interest rate of LIBOR plus 1.3%, reset on a quarterly basis.

Table of Contents

PART I
Financial Information

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

Results of Operations

General

Our operations include originating, servicing and selling commercial loans. We sell the government guaranteed portion of our loans originated under the SBA 7(a) program and sell commercial mortgage loans through securitizations and structured financings. Historically, we have retained servicing rights and residual interests in all loans sold. Servicing rights include the right to collect payments on behalf of the loan purchaser, monitor the loan for any defaults and address any problems in collecting the required principal and interest payments. We retain a residual interest in sold loans by owning a percentage of the related loan and by establishing cash reserves to cover future losses relating to the sold loans through our ownership in our Limited Partnerships (also referred to as special purpose entities or SPEs). In addition, we operate as an investment manager to evaluate properties and loans and to service loans and lease contracts pursuant to fee arrangements with our affiliate, PMC Commercial Trust. Our revenue sources include the following:

Interest earned on commercial loans originated and retained including the effect of commitment fees collected at the inception of the loan.

Earnings on the retained interests in transferred assets.

Fee income from the management of PMC Commercial's property and loan portfolios.

Equity interests in the income of our non-investment company unconsolidated subsidiaries.

Premiums recognized from the sale of the government guaranteed portion of SBA 7(a) program loans into the secondary market.

Interest earned on temporary (short-term) investments.

Gains relating to securitizations.

Other fees, including: late fees, prepayment fees, construction monitoring and site visit fees.

Interest income includes the stated interest rate earned on a loan and the collection of loan origination fees. Our ability to generate interest income 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. For a more detailed description of the risk factors affecting our financial condition and results of operations, see Risk Factors in Item 1 of our Annual Report on Form 10-K for the year ended December 31, 2000.

Table of Contents

Our serviced loan portfolio increased by \$25.6 million (8%) to \$333.3 million at June 30, 2001 from \$307.7 million at December 31, 2000. The value of our retained loan portfolio decreased by \$10.7 million (11%) to \$89.7 million at June 30, 2001 from \$100.4 million at December 31, 2000. The reason for the reduction in retained loans was the sale of \$49.2 million of our loans in a securitization completed in June 2001.

During the three months ended June 30, 2001 and 2000, we originated investments in loans totaling \$32.9 million and \$10.9 million, respectively, and received repayments and sold loans totaling, in the aggregate, \$54.8 million (including the \$49.2 million described above) and \$7.0 million, respectively. During the six months ended June 30, 2001 and 2000, we originated investments in loans totaling \$48.5 million and \$24.1 million, respectively, and received repayments and sold loans totaling, in the aggregate, \$58.4 million (including the \$49.2 million described above) and \$10.8 million, respectively.

The loan volume for the three months ended June 30, 2001 was the highest level of quarterly fundings in our history. The increase in the fundings is attributable to the sharp cut-back by banks in lending to our primary market. See Economy and Competition.

As a result of several factors, the number and dollar volume of loans originated under the SBA 7(a) program have decreased. The primary factors that contributed to this decrease were an increase in competition from alternative loan products and an increase in competition to originate SBA 7(a) program loans from other SBA 7(a) program lenders. These other products often provide prospective borrowers with fixed interest rates at less than the floating interest rates available through the SBA 7(a) program. In addition, due to the high rate of prepayments experienced by lenders in the limited service hospitality industry, purchasers of the guaranteed portion of our SBA 7(a) loans have significantly decreased the premium paid for these assets. Accordingly, SBA 7(a) program funding and the premiums earned on the sales of the government guaranteed portions of these loans remained at significantly lower levels than prior to 1998. During the six months ended June 30, 2001, funding of SBA 7(a) program loans was \$7.6 million, an increase of 21% from the \$6.3 million funded during the six months ended June 30, 2000.

During the six months ended June 30, 2001 and 2000 and the years ended December 31, 2000 and 1999, we received \$3.4 million, \$6.1 million, \$11.2 million and \$15.4 million, respectively, in collections of principal on retained loans including prepayments. As a percentage of our total retained loan portfolio, these collections on an annualized basis were 7% and 11% during the six months ended June 30, 2001 and 2000, respectively, and were 11% and 15% during the years ended December 31, 2000 and 1999, respectively. Prepayments generally increase during times of declining interest rates. While prepayment speeds were low during the second half of 2000 and the first quarter of 2001, they have increased during the three months ended June 30, 2001. When fixed interest rate loans are paid-off prior to their maturity, we receive the immediate benefit of prepayment charges. Prepayment charges result in one-time increases in our other investment income. The proceeds from the prepayments we have received were invested initially in temporary investments and have generally been re-loaned or committed to be re-loaned at lower interest rates than the prepaid loans. The lower interest rates we receive on these new loans have had

Table of Contents

an adverse effect on our results of operations and depending upon the rate of future prepayments may further impact our results of operations.

We believe that as a result of the current interest rate environment (the prime rate has decreased by 2.75% during 2001), we may continue to see prepayment activity at levels greater than the levels of prepayment activity experienced during 2000 and the first half of 2001.

Substantially all of the First Western loans are variable-rate which reset quarterly based on a spread above the prime rate of interest as stated in *The Wall Street Journal* on the first day of the applicable period (the Prime Rate). The spread over the Prime Rate charged by First Western ranges from 0.5% to 2.75%.

The Prime Rates for variable-rate loans are as follows:

	<u>2001</u>	<u>2000</u>	<u>1999</u>
First Quarter	9.50%	8.50%	7.75%
Second Quarter	8.00%	9.00%	7.75%
Third Quarter	6.75%	9.50%	8.00%
Fourth Quarter	9.50%	8.25%	

At June 30, 2001, approximately \$32.4 million of our retained loan portfolio had a variable interest rate. Effective July 1, 2001 the Prime Rate on our loans was reduced to 6.75%. Assuming there are no other changes to the Prime Rate and our variable rate portfolio pays in accordance with the contractual terms, this 2.75% drop in interest rates will reduce our interest income by approximately \$900,000 on an annual basis.

The reduction in interest rates will also reduce our LIBOR based interest expense on \$25 million of our outstanding variable interest rate debt (including \$10 million issued in July 2001, see Liquidity and Capital Resources Debt) by approximately \$687,000 on an annual basis assuming the same 2.75% reduction in the LIBOR.

We receive other investment income from various sources including prepayment fees, late fees, construction monitoring fees and site visit fees. The amount of other investment income earned will vary based on volume of loans funded, the timing and amount of financings, volume of loans which prepay, the mix of loans (construction versus non-construction), the rate and type of loans originated (whether fixed or variable) as well as the general level of interest rates.

Expenses primarily consist of interest expense, salaries and related benefits and overhead. General and administrative expenditures consist primarily of insurance, advertising and promotional expense, telephone services, corporate printing costs, and general office expenses. In addition, we have other administrative costs which consist of profit sharing plan, rent, legal and accounting, SBA fees and directors and shareholders expense. Our operations are centralized in Dallas, Texas where our headquarters are located. We presently have additional business development offices located in Kansas City, Missouri; Atlanta, Georgia; Hillsdale, New Jersey; and, Phoenix, Arizona.

Table of Contents***Economy and Competition:***

Our primary competition has come from banks, financial institutions and other lending companies. Some of these competitors have greater financial and larger managerial resources than us and are able to provide services we are not able to provide (*i.e.* depository services). During 2001, as the interest rate environment changed and the prime rate was reduced from 9.5% to 6.75%, the increased competition that we had previously faced had moderated. We believe we compete effectively with such entities on the basis of the variety of lending programs offered, interest rates, our long-term maturities and payment schedules, the quality of our service, our reputation as a lender, and the timely credit analysis and decision-making processes.

Since the beginning of 2001, we have experienced an increase in loan origination opportunities due to the reductions in prime rate and competition lessening from banks. Based on this increased activity, our volume of new loans funded during the first six months of 2001 (\$48.5 million) exceeded our fiscal year ended 2000 fundings of \$44.1 million. As a result of several factors, the number and dollar volume of our loans funded peaked in the second quarter with reduced levels expected throughout the remainder of the year. The average non-construction deal takes approximately 90 to 120 days to fund from the time of the initial commitment. Therefore, the volume in any quarter is usually determined in the prior two to three months. The major factors for this increased lending activity leading into 2001 included: a drop in rates with 10 year treasuries dropping from just under 6% at the end of September 2000 to just over 5% at the beginning of 2001; the curtailment/reduction in lending by banks and other lenders during the first quarter of 2001 as their credit quality was impacted by downturns in other sectors; the forming of a strategic alliance with a major franchiser at the beginning of the year; and, expanding our incentive programs effective for the first half of the year. This surge in commitment activity in the first quarter of 2001 led to the increased volume levels in the second quarter.

As we look to the third and fourth quarter, we are already aware of the economic downturn settling in with reductions in business travel, and consumers rethinking vacations causing a moderation in demand and a resulting slowdown in construction. Although the limited service area continues to outperform the luxury and upscale sectors, with the high-end resorts taking the hardest hit, the outlook for the balance of 2001 and into next year is for reduced activity. As indicated in published sources, experts have reduced their outlook for the limited service hospitality industry with revenue per available room (REVPAR) decreasing during the second quarter of 2001. In addition REVPAR is expected to fall for the year ending December 31, 2001 and for 2002, the rise in REVPAR is expected to be significantly below recent double digit rises.

Table of Contents**Six Months Ended June 30, 2001 Compared to the Six Months Ended June 30, 2000**

Net income increased by \$1,666,000 (31%), to \$6,986,000 during the six months ended June 30, 2001 from \$5,320,000 during the six months ended June 30, 2000. The most significant reason for the increase in net income was the \$2.7 million gain recognized as a result of our securitization and sale of loans during June 2001. There was no comparable transaction during the six months ended June 30, 2000. The increase in net income resulting from the securitization transaction was partially offset by losses from our Retained Interests.

Interest income: Interest income increased by \$161,000 (3%), to \$6,499,000 for the six months ended June 30, 2001 from \$6,338,000 for the six months ended June 30, 2000. Interest income includes the interest earned on loans, the interest earned on short-term (temporary) investments and up-front fees collected. This overall increase was

primarily attributable to interest income and up-front fees collected on the high volume of loans funded during the six months ended June 30, 2001.

Interest income and commitment fees received on loans increased by \$156,000 (3%), to \$6,274,000 during the six months ended June 30, 2001 from \$6,118,000 during the six months ended June 30, 2000. Interest income on loans increased by \$25,000 (-%), to \$5,860,000 during the six months ended June 30, 2001 from \$5,835,000 during the six months ended June 30, 2000 primarily as a result of an increase in the weighted average retained loan portfolio outstanding of \$4.2 million (4%) to \$117.3 million during the six months ended June 30, 2001 from \$113.1 million during the six months ended June 30, 2000. Partially offsetting the effects of the increased portfolio was a reduction of 1.5% in variable interest rates. In addition, interest income increased due to an increase in the collection of up-front fees. During the six months ended June 30, 2001, we recognized approximately \$414,000 of up-front fees compared to \$283,000 in up-front fees during the six months ended June 30, 2000. The increase of \$131,000 in commitment fees is attributable to our increased loan originations.

Interest on other investments (which consists of interest on temporary investments) for the six months ended June 30, 2001 was \$225,000 which was \$5,000 (2%) greater than the \$220,000 in interest income on other investments earned during the six months ended June 30, 2000.

Income from retained interests in transferred assets: Income from retained interests in transferred assets increased by \$239,000 (11%), to \$2,459,000 for the six months ended June 30, 2001 from \$2,220,000 for the six months ended June 30, 2000. The income from retained interests in transferred assets is comprised of the yield received on our investment in our Retained Interests. This increase was primarily a result of the income from the Retained Interests from our securitization completed in December 2000.

Premium income: Premium income decreased by \$10,000 (3%), to \$345,000 for the six months ended June 30, 2001 from \$355,000 for the six months ended June 30, 2000. While the proceeds from the sale of the government guaranteed portion of loans (under the

Table of Contents

SBA 7(a) program) were \$5,785,000 during the six months ended June 30, 2001 compared to \$4,733,000 during the six months ended June 30, 2000, the premium paid for these assets was lower in 2001 than 2000 resulting in income being comparable for the two periods.

Other investment income, net: Other investment income, net, increased by \$68,000 (25%), to \$342,000 for the six months ended June 30, 2001 from \$274,000 for the six months ended June 30, 2000. This increase was primarily attributable to an increase in servicing fees received during the six months ended June 30, 2001 relating to our securitization completed in December 2000.

Other income, net: Other income, net, decreased by \$39,000 (4%), to \$1,003,000 during the six months ended June 30, 2001 from \$1,042,000 during the six months ended June 30, 2000. Other income was reduced during the six months ended June 30, 2001 primarily as a result of a reduction in fees earned on loans.

Equity in income (loss) of unconsolidated subsidiaries: As a BDC, we do not consolidate the operations of our non-investment company subsidiaries. Instead we are required to recognize the income of our non-investment company subsidiaries under the equity method of accounting. Earnings of our unconsolidated subsidiaries are reflected as a single line item (Equity in income (loss) of unconsolidated subsidiaries) on our consolidated statements of income.

Equity in income (loss) of unconsolidated subsidiaries decreased by \$48,000 (20%), to \$187,000 during the six months ended June 30, 2001 from \$235,000 during the six months ended June 30, 2000.

The decrease was a result of the following:

The net income of PMC Advisers was \$230,000 during the six months ended June 30, 2001 compared to \$246,000 during the six months ended June 30, 2000. The decrease was primarily a result of the sale by PMC Commercial of three properties during the six months ended June 30, 2001. As a result of the property sales, our future income from PMC Advisers should be reduced.

PMC Funding had a net loss of \$43,000 during the six months ended June 30, 2001 as compared to a net loss of \$11,000 during the six months ended June 30, 2000.

Operating expenses, not including interest expense: Operating expenses, not including interest, increased by \$417,000 (15%), to \$3,250,000 during the six months ended June 30, 2001 from \$2,833,000 during the six months ended June 30, 2000. Operating expenses are comprised of salaries and related benefits, general and administrative, profit sharing plan, rent, legal and accounting, SBA fees and directors and shareholders expense. The largest operating expense is salaries and related benefits which consist of salaries for our officers and employees who provide all of our management, advisory and portfolio functions, including marketing, servicing, accounting and portfolio analysis. We had an increase in

Table of Contents

salaries and related benefits of \$227,000 (11%), to \$2,222,000 during the six months ended June 30, 2001 from \$1,995,000 during the six months ended June 30, 2000. The increase in salaries and related benefits was primarily attributable to marketing staff commissions, a special incentive program for employees during the first half of 2001 and general cost of living increases in salaries and benefits.

Interest expense: Interest expense increased by \$268,000 (11%), to \$2,797,000 during the six months ended June 30, 2001 from \$2,529,000 during the six months ended June 30, 2000. Interest expense results primarily from interest on (i) our unsecured notes (as of June 30, 2001 and 2000 the outstanding balances were \$41.7 million and \$41.0 million, respectively) with a weighted average interest rate of 7.3% and weighted average remaining maturity of 2.4 years as of June 30, 2001, and (ii) debentures due to the SBA (as of June 30, 2001 and 2000 the outstanding balances were \$31.3 million and \$28.3 million respectively), with a weighted average interest rate of approximately 7.6% and weighted average remaining maturity of 5.1 years as of June 30, 2001. The increase in interest expense primarily resulted from an additional \$3.3 million in unsecured notes issued during July 2000 and an increase of 3% in the interest rate on \$12 million of SBA debentures as a result of the SBA subsidy period expiring in September 2000.

Realized and unrealized gain (loss) on investments: The net realized and unrealized gain on investments was \$2,198,000 and \$218,000 during the six months ended June 30, 2001 and 2000, respectively.

The increase in net realized and unrealized gain on investments was due primarily to the securitization and sale of \$49.2 million of loan portfolio completed during June 2001. We recognized a gain of \$2,732,000 as a result of this securitization. There were no securitization transactions completed during the six months ended June 30, 2000.

During the six months ended June 30, 2001, we recognized net realized and unrealized losses on our Retained Interests of \$218,000 compared to net unrealized gains of \$330,000 during the six months ended June 30, 2000. During the six months ended June 30, 2001, included in the net realized and unrealized loss on our Retained Interest are realized losses of \$705,000. The primary reason for the net valuation losses during the six months ended June 30,

2001 was a reduction in expected future cash flows resulting from higher than anticipated prepayment activity and lower than anticipated income on our reserve funds and underlying loan portfolio. The primary reason for the net gains during the six months ended June 30, 2000 was the low rate of prepayment and loss activity related to the structured loan sale completed in June 1999.

We also recognized \$316,000 of net loan losses during the six months ended June 30, 2001 compared to \$112,000 in net loan losses during the six months ended June 30, 2000. The increase was primarily related to an increase in valuation reserve on a limited service hospitality property.

Loan losses (including the change in unrealized appreciation (depreciation) on loans) were \$690,000 and \$175,000 during the twelve month periods ended June 30, 2001 and 2000,

Table of Contents

respectively, or 0.57% and 0.17% of our weighted average outstanding portfolio during the twelve month periods ended June 30, 2001 and 2000, respectively.

Three Months Ended June 30, 2001 Compared to the Three Months Ended June 30, 2000

Net income increased by \$1,822,000 (67%), to \$4,526,000 during the three months ended June 30, 2001 from \$2,704,000 during the three months ended June 30, 2000. The most significant reason for the increase in net income was the \$2.7 million gain recognized as a result of our securitization and sale of loans during June 2001. There was no comparable transaction during the three months ended June 30, 2000. The increase in net income resulting from the securitization transaction was partially offset by losses from our retained interests in transferred assets.

Interest income: Interest income increased by \$239,000 (8%), to \$3,345,000 for the three months ended June 30, 2001 from \$3,106,000 for the three months ended June 30, 2000. Interest income includes the interest earned on loans, the interest earned on short-term (temporary) investments and up-front fees collected. This overall increase was primarily attributable to interest income and up-front fees collected on the high volume of loans funded during the three months ended June 30, 2001.

Interest income and commitment fees received on loans increased by \$243,000 (8%), to \$3,298,000 during the three months ended June 30, 2001 from \$3,055,000 during the three months ended June 30, 2000. Interest income on loans increased by \$120,000 (4%), to \$3,039,000 during the three months ended June 30, 2001 from \$2,919,000 during the three months ended June 30, 2000 as a result of an increase in the weighted average retained loan portfolio outstanding of \$9.3 million (8%) to \$125.9 million during the three months ended June 30, 2001 from \$116.6 million during the three months ended June 30, 2000. Partially offsetting the effects of the increased portfolio was a reduction in weighted average interest rates as a result of the decrease in rates charged on our variable rate loan portfolio of 1.5% during the second quarter of 2001. In addition, during the three months ended June 30, 2001, we recognized approximately \$259,000 of up-front fees compared to \$136,000 in up-front fees during the three months ended June 30, 2000. The increase of \$123,000 in commitment fees is attributable to the increased level of loan originations during the three months ended June 30, 2001.

Interest on other investments (which consists of interest on temporary investments) for the three months ended June 30, 2001 was \$47,000 which was \$4,000 (8%) less than the \$51,000 in interest income on other investments earned during the three months ended June 30, 2000.

Income from retained interests in transferred assets: Income from retained interests in transferred assets increased by \$28,000 (2%), to \$1,194,000 for the three months ended June 30, 2001 from \$1,166,000 for the three months ended June 30, 2000. The income from retained interests in transferred assets is comprised of the yield received on our investment in our Retained Interests. This increase was primarily a result of the income from the Retained Interests from our securitization completed in December 2000.

Table of Contents

Premium income: Premium income decreased by \$1,000 (%), to \$235,000 for the three months ended June 30, 2001 from \$236,000 for the three months ended June 30, 2000. Proceeds from the sale of the government guaranteed portion of loans (under the SBA 7(a) program) were approximately \$4 million during each of the three months ended June 30, 2001 and June 30, 2000.

Other investment income, net: Other investment income, net, increased by \$32,000 (22%), to \$179,000 for the three months ended June 30, 2001 from \$147,000 for the three months ended June 30, 2000. This increase was primarily attributable to an increase in servicing fees received during the three months ended June 30, 2001 relating to our securitization completed in December 2000.

Other income, net: Other income, net, decreased by \$11,000 (2%), to \$532,000 during the three months ended June 30, 2001 from \$543,000 during the three months ended June 30, 2000. Other income was reduced during the three months ended June 30, 2001 primarily as a result of a reduction in fees earned on loans.

Equity in income (loss) of unconsolidated subsidiaries: Equity in income (loss) of unconsolidated subsidiaries decreased by \$8,000 (8%), to \$97,000 during the three months ended June 30, 2001 from \$105,000 during the three months ended June 30, 2000.

The decrease was a result of the following:

The net income of PMC Advisers was \$110,000 during the three months ended June 30, 2001 compared to \$118,000 during the three months ended June 30, 2000. The decrease was primarily a result of the sale by PMC Commercial of hotel properties. As a result of the property sales, our future income from PMC Advisers should be reduced.

PMC Funding had a net loss of \$13,000 during both the three months ended June 30, 2001 and 2000.

Operating expenses, not including interest expense: Operating expenses, not including interest, increased by \$296,000 (21%), to \$1,710,000 during the three months ended June 30, 2001 from \$1,414,000 during the three months ended June 30, 2000. Operating expenses are comprised of salaries and related benefits, general and administrative, profit sharing plan, rent, legal and accounting, SBA fees and directors and shareholders expense. The largest operating expense is salaries and related benefits which consist of salaries for our officers and employees who provide all of our management, advisory and portfolio functions, including marketing, servicing, accounting and portfolio analysis. We had an increase in salaries and related benefits of \$146,000 (14%), to \$1,154,000 during the three months ended June 30, 2001 from \$1,008,000 during the three months ended June 30, 2000. The increase in salaries and related benefits was primarily attributable to marketing staff commissions, staff increases, a special incentive program for employees during the first half of 2001 and general cost of living increases in salaries and benefits including the cost of health benefits.

Table of Contents

Interest expense: Interest expense increased by \$152,000 (12%), to \$1,417,000 during the three months ended June 30, 2001 from \$1,265,000 during the three months ended June 30, 2000. Interest expense results primarily from interest on (i) our unsecured notes (as of June 30, 2001 and 2000 the outstanding balances were \$41.7 million and \$41.0 million, respectively) with a weighted average interest rate of 7.3% and weighted average remaining maturity of 2.4 years as of June 30, 2001, and (ii) debentures due to the SBA (as of June 30, 2001 and 2000 the outstanding balances were \$31.3 million and \$28.3 million respectively), with a weighted average interest rate of approximately 7.6% and weighted average remaining maturity of 5.1 years as of June 30, 2001. The increase in interest expense primarily resulted from an additional \$3.3 million in unsecured notes issued during July 2000 and an increase of 3% in the interest rate on \$12 million of SBA debentures as a result of the SBA subsidy period expiring in September 2000.

Realized and unrealized gain (loss) on investments: The net realized and unrealized gain on investments was \$2,071,000 and \$80,000 during the three months ended June 30, 2001 and 2000, respectively.

The increase in net realized and unrealized gain on investments was primarily due to the securitization and sale of \$49.2 million of loan portfolio completed during June 2001. We recognized a gain of \$2,732,000 as a result of this securitization. There were no securitization transactions during the three months ended June 30, 2000.

During the three months ended June 30, 2001, we recognized net realized and unrealized losses on our Retained Interests of \$393,000 compared to net unrealized gains of \$220,000 during the three months ended June 30, 2000. During the three months ended June 30, 2001, included in the net realized and unrealized loss on our Retained Interest are realized losses of \$705,000. The primary reason for the net valuation losses during the three months ended June 30, 2001 was a reduction in expected future cash flows resulting from higher than anticipated prepayment activity and lower than anticipated income on our reserve funds and underlying loan portfolio. The primary reason for the net gains during the three months ended June 30, 2000 was the low rate of prepayment and loss activity related to the structured loan sale completed in June 1999.

We also recognized \$268,000 of net loan losses during the three months ended June 30, 2001 compared to \$140,000 in net loan valuation losses during the three months ended June 30, 2000. The increase was primarily related to an increase in valuation reserve on a limited service hospitality property.

Table of Contents**Cash Flow Analysis**

Cash Flow From Operating Activities: We generated cash flow from operating activities of \$6,568,000 and \$2,882,000 during the six months ended June 30, 2001 and 2000, respectively. This increase in source of funds of \$3,686,000 primarily relates to the net change in our operating assets and liabilities. During the six months ended June 30, 2001, we had a positive change of \$1,344,000 from our net assets compared to a negative change of \$2,193,000 during the six months ended June 30, 2000.

Cash Flow From Investing Activities: We used cash of \$40,378,000 and \$10,808,000 from investing activities during the six months ended June 30, 2001 and 2000, respectively. This \$29,570,000 increase in cash flows used in investing activities relates primarily to a net increase in loans funded less principal collected of \$26,208,000 and our cash investment of \$1,771,000 in the securitization transaction completed in June 2001.

Cash Flow From Financing Activities: We generated cash of \$38,460,000 from financing activities during the six months ended June 30, 2001 and used cash of \$10,710,000 during the six months ended June 30, 2000. This \$49,170,000 increase in cash flows from financing activities relates primarily to the \$45,253,000 proceeds from the debt issued by PMC Joint Venture, L.P. 2001 during June 2001 and the repayment at maturity of \$7,330,000 in SBA debentures during the six months ended June 30, 2000.

Liquidity and Capital Resources

Sources and uses of funds:

As a regulated investment company, under the Internal Revenue Code, we are required to pay out substantially all of our net investment company taxable income to our common shareholders (see Dividends below). Consequently, we must procure funds from sources other than earnings in order to meet our capital requirements. In addition, as a BDC, we are generally required to maintain a ratio of at least 200% of total assets to total borrowings, which may restrict our ability to borrow in certain circumstances.

Our primary use of funds is to originate loans. We also expend funds primarily for payment of:

dividends to shareholders,

principal payments on borrowings,

interest and related financing costs, and

salaries and other general and administrative expenses.

Our primary source of capital has most recently been through the structured sale of loans. In order to generate growth in the size of our investment portfolio and meet our outstanding loan commitments, we will need to obtain additional funds from:

the structured sale or securitization of a portion of our loan portfolio,

24

Table of Contents

borrowings under our short-term, unsecured revolving credit facility.

the issuance of senior unsecured medium-term notes, and/or

issuance of SBA debentures, or

to the extent available, the issuance of equity .

At June 30 2001, we had approximately \$26.6 million of cash and cash equivalents, availability of \$15 million under our revolving credit facility and approximately \$28.0 million of total loan commitments and approvals outstanding (see Commitments below). Accordingly, we have enough working capital available to fund all of our outstanding commitments. In order to fund our anticipated volume of loan originations during the next twelve months, to the extent we fully utilize of our cash and cash equivalents on hand and our \$15 million revolving credit facility, we anticipate that we would complete another securitization and sale of loan portfolio. Having received the required exemptive relief from the Securities and Exchange Commission to permit us to co-securitize our loan portfolio with PMC Commercial, we anticipate that the transaction would be a co-securitization with PMC Commercial. Co-securitizing allows us to achieve a more cost-efficient cost of funds, a lower retained interest in loans securitized

and more timely access to the securitization market.

Additional sources of capital include principal collections on our existing loan portfolio and proceeds from the sale of SBA 7(a) program loans in the secondary market. To the extent commitments pertain to PMCIC or Western Financial, we should be able to issue SBA debentures to fund those commitments. Management believes that these financing sources will enable us to generate funds sufficient to meet both our short-term and long-term capital needs.

There can be no assurances that we will be able to complete the above transactions at acceptable advance rates and/or interest rates. If not, we may have to refer future commitments to PMC Commercial, issue debt having decreased advance rates or increased interests rates and/or sell assets to meet our committed obligations when and if they come due.

Commitments:

Loan commitments and approvals outstanding at June 30, 2001 to various prospective small business companies, including the unfunded portion of projects in the construction phase, amounted to approximately \$28.0 million. Of these commitments, \$6.2 million were for loans partially guaranteed by the SBA of which \$4.6 million is expected to be sold (when fully funded) into the secondary market. Such commitments are made in the ordinary course of our business. Commitments to extend credit are agreements to lend to a customer provided that the terms established in the contract are met. Commitments generally have fixed expiration dates and require payment of a fee. Since some commitments expire without the proposed loan closing, the total commitment amounts do not necessarily represent future cash requirements.

Debt:

At June 30, 2001, we did not have any borrowings outstanding under our revolving credit facility, and had credit availability of \$15.0 million. Advances under the credit facility bear interest at our option at either the lender's prime rate less 50 basis points or

Table of Contents

LIBOR plus 175 basis points. The credit facility requires we meet certain covenants, the most restrictive of which provides that the ratio of net charge-offs to net loans receivable may not exceed 2%, and liquidity covenants which require that the ratio of assets to senior debt (as defined in the credit facility) may not fall below 110%, as amended, with respect to PMC Capital and 135% including our consolidated subsidiaries. At June 30, 2001 we were in compliance with the covenants of this facility.

We refinanced (rolled-over) \$6.7 million in senior notes when they matured in July 2001 and simultaneously borrowed an additional \$3.3 million in senior notes. The aggregate \$10 million in senior notes matures in July 2006 and has an interest rate of LIBOR plus 1.3% reset on a quarterly basis.

Investment Company Act Requirements:

PMC Capital is in compliance with the requirement to maintain a minimum of 200% asset coverage of debt as defined in sections 18 and 61 of the 1940 Act as modified by exemptive orders obtained by us from the Securities and Exchange Commission.

Dividends:

PMC Capital has historically paid at least 100% of its investment company taxable income as dividends to shareholders. There are certain timing differences between book and tax income, most notably the recognition of income relating to our securitizations. As a result of these timing differences and the anticipation of cash flows from our Limited Partnerships, the payment and amount of dividends does not necessarily coincide with our earnings and we may have a distribution of dividends in excess of our net operating income. In addition, our dividends paid since we became an investment company exceeded our earnings and profits for tax purposes. During 2000, we recognized a 22.5% return of capital for dividend reporting purposes. The computation of return of capital provides for several timing differences, most notably relating to the recognition of gain treatment on securitization transactions.

In June 2001, the Board declared a dividend of \$0.20 per share to shareholders of record on June 29, 2001, which was paid in July 2001. Our Board may amend our dividend policy as warranted by actual and/or anticipated earnings.

Table of Contents

Item 3. Quantitative and qualitative disclosures about market risk

Since our balance sheet consists of items subject to interest rate risk, we are subject to market risk associated with changes in interest rates.

A majority of our investment portfolio (approximately 64%) consists of fixed interest rate loans and, as a result, changes in interest rates should not have a direct impact on interest income. Changes in market interest rates are considered by our Board of Directors in its determination of fair value of our loans. To date, changes in market interest rates have not had a significant effect on the Board of Directors' determination. However, future interest rate changes could have an impact. Significant reductions in interest rates, however, can prompt increased prepayments of our loans, resulting in possible decreases in long-term revenues due to the re-lending of prepayment proceeds at lower interest rates.

The sensitivity of our variable-rate portfolio and debt to changes in interest rates is regularly monitored and analyzed by measuring the characteristics of our assets and liabilities. We assess interest rate risk in terms of the potential effect on interest income net of interest expense, the value of net assets and the value at risk in an effort to ensure that we are insulated from any significant adverse effects from changes in interest rates. Based on our analysis of the sensitivity of interest income, net of interest expense, if the balance sheet were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 100 basis point change in interest rates would affect net income by less than 1% over a one year period.

We have an investment in Retained Interests which is valued by our Board of Directors based on various factors including estimates of appropriate market discount rates. Significant reductions (or increases) in the discount rates used by the Board of Directors in determining the valuation of the Retained Interests will have an impact on the value. If market rates, and consequently the discount rates used by the Board, were to increase by 1% or 2% from current rates, the value of our Retained Interests would diminish by \$2.0 million and \$4.0 million, respectively.

Our liabilities include debt payable to the SBA and our senior unsecured debt. The SBA debentures and the senior unsecured debt are primarily payable at fixed rates of interest. A portion of our senior unsecured debt (\$15 million at June 30, 2001) has a variable interest rate ranging from LIBOR plus 1.3% to 1.4%.

Although management believes that the above described measures are indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of our balance sheet and other business developments that could affect our net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by these estimates.

Table of Contents

**PART II
Other Information**

ITEM 4. Submission of Matters to a Vote of Security Holders

At our Annual Meeting or Shareholders held on May 16, 2001, the following members were re-elected to the Board of Directors:

Irvin Borish
Thomas HamillBarry A. Imber

Other members of the Board of Directors are as follows:

Fredric M. Rosemore
Lance B. RosemoreMartha GreenbergBarry A. Chafitz

The proposal to ratify the appointment of PricewaterhouseCoopers LLP as our independent public accountants was approved at our Annual Meeting was approved. There were 9,706,598 votes for, 22,159 votes against and 130,580 abstentions.

ITEM 6. Exhibits and Reports on Form 8-K

- | | |
|----|---|
| A. | Exhibits |
| | 10.1 Servicing Agreement by and among BNY Midwest Trust Company as Trustee and Supervisory Servicer, PMC Joint Venture, L.P. 2001, as Issuer, and PMC Capital, Inc. and PMC Commercial Trust, as Servicers. |
| | 10.2Trust Indenture by and among BNY Midwest Trust Company as Trustee and PMC Joint Venture, L.P. 2001, as Issuer.B. Reports on Form 8-KNone |

Table of Contents**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.

		PMC Capital, Inc.
Date:	<u>8/14/2001</u>	<u>/s/ Lance B. Rosemore</u> Lance B. Rosemore President
Date:	<u>8/14/2001</u>	<u>/s/ Barry N. Berlin</u> Barry N. Berlin Chief Financial Officer (Principal Accounting Officer)

Table of Contents**EXHIBIT INDEX**

EXHIBIT NUMBER	DESCRIPTION
10.1	Servicing Agreement by and among BNY Midwest Trust Company as Trustee and Supervisory Servicer, PMC Joint Venture, L.P. 2001, as Issuer, and PMC Capital, Inc. and PMC Commercial Trust, as Servicers.
10.2	Trust Indenture by and among BNY Midwest Trust Company as Trustee and PMC Joint Venture, L.P. 2001, as Issuer.