LUMINENT MORTGAGE CAPITAL INC
Form 424B5
October 13, 2006

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Filed pursuant to Rule 424(b)(5)
Registration No. 333-121816

PROSPECTUS SUPPLEMENT

(To Prospectus dated January 19, 2005)

6,000,000 Shares
Common Stock

We are offering 6,000,000 shares of common stock to be sold in this offering. We will receive all of the net proceeds from the sale of such common stock.

Our common stock is listed on the New York Stock Exchange, or NYSE, under the symbol LUM. The last reported sale price of our common stock on October 12, 2006 was $10.30 per share.

Our common stock is subject to certain restrictions on ownership. See Description of Capital Stock on page 24 of the accompanying prospectus.

Investing in our common stock involves a high degree of risk. Before buying any shares, you should read the discussion of material risks of investing in our common stock under the caption Risk Factors in our Form 10-K Annual Report for the year ended December 31, 2005 and our Form 10-Q Quarterly Report for the six months ended June 30, 2006 which are incorporated by reference in the accompanying prospectus.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved these securities or determined if this prospectus supplement and the accompanying prospectus are truthful or complete. Any representation to the contrary is a criminal offense.

	Per share	Total
Public offering price	$ 10.25	$ 61,500,000
Underwriting discounts and commissions	$ 0.45	$ 2,700,000
Proceeds, before expenses, to us	$ 9.80	$ 58,800,000

The underwriters may also purchase up to an additional 900,000 shares from us at the public offering price, less underwriting discounts and commissions payable by us to cover over-allotments, if any, within 30 days from the date of this prospectus supplement. If the underwriters exercise the option in full, the total underwriting discounts and commissions will be $3,105,000, and the total proceeds, before expenses, to us will be $67,620,000.

The underwriters are offering the shares of our common stock as set forth under Underwriting. Delivery of the shares of common stock will be made on or about October 18, 2006.

Sole Book-Running Manager

UBS Investment Bank

JMP Securities

The date of this Prospectus Supplement is October 12, 2006

You should rely only on the information contained in or incorporated by reference into this prospectus supplement and the accompanying prospectus. We have not, and the underwriters have not, authorized any one to provide you with additional information or information that is different from that contained in this prospectus supplement or the accompanying prospectus. We are offering to sell, and seeking offers to buy, shares of our common stock only in jurisdictions where offers or sales are permitted. The information appearing in this prospectus supplement, the accompanying prospectus and the documents incorporated therein by reference is accurate only as of its respective date or dates or on the date or dates that are specified in these documents, regardless of the time of delivery of this prospectus supplement or any sale of shares of our common stock.

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Special note regarding forward-looking statements

This preliminary prospectus supplement, and the accompanying prospectus, contain forward-looking statements. Forward-looking statements convey our current expectations or forecasts of future events. All statements contained in this preliminary prospectus supplement, and the accompanying prospectus, other than statements of historical fact are forward-looking statements. Forward-looking statements include statements regarding our future financial position, business strategy, budgets, projected costs, plans and objectives of management for future operations. The words may continue, estimate, intend, project, believe, expect, plan, anticipate and similar terms may identify forwa statements, but the absence of such words does not necessarily mean that a statement is not forward-looking. These forward-looking statements include, among other things, statements about:

- the flattening of, or other changes in the yield curve, on our investment strategies;
- changes in interest rates and mortgage prepayment rates;
- our ability to obtain or renew sufficient funding to maintain our leverage strategies;
- continued creditworthiness of the holders of mortgages underlying our mortgage-related assets;
- the possible effect of negative amortization of mortgages on our financial condition and REIT qualification;
- potential impacts of our leveraging policies on our net income and cash available for distribution;
- the power of our board of directors to change our operating policies and strategies without stockholder approval;
- effects of interest rate caps on our adjustable-rate and hybrid adjustable-rate loans and mortgage-backed securities;
- the degree to which our hedging strategies may or may not protect us from interest rate volatility;
- our ability to invest up to 10% of our investment portfolio in residuals, leveraged mortgage derivative securities and shares of other REITs as well as other investments; and
- volatility in the timing and amount of our cash distributions.

Any or all of our forward-looking statements in this preliminary prospectus supplement, or the accompanying prospectus, may turn out to be inaccurate. We have based these forward-looking statements largely on our current expectations and projections about future events and future trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. They may be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties, including the risks, uncertainties and assumptions described under the caption Risk Factors in the accompanying prospectus and in the documents incorporated by reference therein. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this preliminary prospectus supplement, in the accompanying prospectus and in the documents incorporated therein by reference may not occur as contemplated, and actual results could differ materially from those anticipated or implied by our forward-looking statements.

You should not rely unduly on those forward-looking statements, which speak only as of the date of this preliminary prospectus supplement. Unless required by the federal securities laws, we undertake no obligation to update publicly or revise any forward-looking statements to reflect new information or future events or otherwise. You should, however, review the factors and risks we describe in the reports we file from time to time with the Securities and Exchange Commission, or SEC, after the date of this preliminary prospectus supplement.

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Prospectus supplement summary

This summary highlights selected information contained elsewhere in this prospectus supplement and the accompanying prospectus or incorporated in the accompanying prospectus by reference. While this summary highlights what we consider to be the most important information about us, you should read carefully this entire prospectus supplement and the accompanying prospectus, especially the risks of investing in our common stock, which we reference under the caption Risk Factors in our annual report on Form 10-K for the fiscal year ended December 31, 2005 and under the caption Risk Factors in our quarterly reports on Form 10-Q for subsequent fiscal quarters, all of which are incorporated by reference in the accompanying prospectus, and the information set forth under the caption Where You Can Find More Information on page 61 of the accompanying prospectus. Unless the context otherwise requires, all references to we, our and us in this prospectus supplement mean Luminent Mortgage Capital, Inc. and all entities owned or controlled by us except where it is made clear that the term means only the parent company.

THE COMPANY

We are a real estate investment trust, or REIT, which invests in two core mortgage investment strategies. Our Residential Mortgage Credit strategy invests in mortgage loans originated in cooperation with selected high-quality providers within certain established criteria as well as subordinated mortgage-backed securities that have credit ratings below AAA. Our Spread strategy invests primarily in US agency and other highly-rated single-family, adjustable-rate and hybrid adjustable-rate mortgage-backed securities and leverages these investments through repurchase agreements and commercial paper.

Our primary objective is to provide a secure stream of income for our stockholders based on the steady and reliable payment of residential mortgages made to borrowers of prime credit quality. When we began investing in 2003, we followed a Spread strategy exclusively. While this strategy has a nominal level of credit risk, it has considerable interest rate exposure. The persistently flat yield curve and the ongoing Federal Reserve rate increases since June 2004 pressured our ability to provide steady income to our stockholders. As a result, we adopted our Residential Mortgage Credit strategy in 2005.

During the first six months of 2006, we repositioned our portfolios in order to reduce our exposure to interest rate volatility. At June 30, 2006, our Residential Mortgage Credit portfolio represented approximately 73% of our overall investment portfolio. Our Residential Mortgage Credit portfolio holds investments that are less sensitive to interest rate risk and therefore provide a basis for dividend stability and growth. As a further result of this repositioning, approximately 85% of the securities in our Spread portfolio consist of mortgage-backed securities with interest rates that reset within one month or less.

Through our Residential Mortgage Credit strategy, we seek long-term reliable income for our stockholders primarily through the purchase of mortgage assets that we design and originate in cooperation with selected high quality providers with whom we have long and well-established relationships. We then securitize those loans and retain the most valuable tranches of the securitizations. These securitizations reduce our sensitivity to interest rate risk and help match the income we earn on our mortgage assets with the cost of our related liabilities. The debt that we incur in these securitizations is non-recourse to us; however, our mortgage loans are pledged as collateral for the securities we issue. As a secondary strategy, we invest in subordinated mortgage-backed securities that have credit ratings below AAA. We make these investments on an opportunistic basis, as we discover value and credit arbitrage opportunities in the market.

We have acquired and will seek to acquire additional assets that will produce competitive returns, taking into consideration the amount and nature of the anticipated returns from the investments, our ability to pledge the investments for secured, collateralized borrowings and the costs associated with financing, managing, securitizing and reserving for these investments.

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During July 2006, we established a relationship with Central Mortgage Co. that services our residential mortgage loans for a fee. This relationship enables us to purchase residential mortgage loans with servicing released while maintaining our operational efficiency. As a result, we are able to expand the network of originators from whom we can purchase residential mortgage loans without generating a servicing asset that we would need to own and hedge. We manage our Residential Mortgage Credit strategy assets and our Spread strategy assets.

ASSETS

We invest in mortgage-related assets within two core mortgage investment strategies. Our Residential Mortgage Credit strategy investments are in residential mortgage loans as well as mortgage-backed securities that have credit ratings below AAA. Our Spread strategy investments are primarily in US agency and other AAA-rated single-family, adjustable-rate and hybrid adjustable-rate mortgage-backed securities. We review the credit risk associated with each potential investment and may diversify our portfolio to avoid undue geographic, product, originator, servicer and other types of concentrations. By maintaining a large percentage of our assets in a highly diversified pool of high quality, highly-rated assets, we believe we can mitigate our exposure to losses from credit risk. We have significant credit enhancement that protects our investment in the assets we own that are not rated AAA or better. We employ rigorous due diligence and underwriting criteria to qualify whole loan assets for our portfolio in order to mitigate risk. This due diligence includes performing compliance sampling in states with predatory lending statutes, valuation analysis and layered credit risk analysis using a suite of software screening tools.

COMPLIANCE WITH REIT AND INVESTMENT COMPANY REQUIREMENTS

We monitor our investment securities and the income from those securities on a regular basis. To the extent we enter into hedging transactions, we monitor income from our hedging transactions as well, so as to ensure that we maintain our qualification as a REIT and our exempt status under the Investment Company Act of 1940, as amended, or the 1940 Act.

OUR BUSINESS STRATEGY

Investment Strategy

In our Residential Mortgage Credit portfolio, we invest in residential mortgage loans underwritten to our specifications in cooperation with selected high-quality originators with whom we have long-term relationships. The loans we acquire are first lien, single-family residential adjustable-rate and hybrid adjustable-rate loans with original terms to maturity of not more than 40 years. All residential mortgage loans we acquire for our portfolio bear an interest rate tied to an interest rate index. Most loans have periodic and lifetime constraints on how much the loan interest rate can change on any predetermined interest rate reset date. The interest rate on each adjustable-rate mortgage loan resets monthly, semi-annually or annually and generally adjusts to a margin over a US Treasury index, moving Treasury average or LIBOR index. Hybrid adjustable-rate loans have a fixed rate for an initial period, generally three to 10 years, and then convert to adjustable-rate loans for their remaining term to maturity. The originator performs the credit review of the borrower, the appraisal of the property and quality control procedures we specify. Generally, our whole loan target market includes prime borrowers with average FICO scores greater than 700, Alt-A documentation, geographic diversification, owner-occupied property, moderate loan size and moderate loan-to-value ratio. We or a third party then perform an independent underwriting review of the underwriting and loan closing methodologies that the originators used in qualifying a borrower for a loan. Depending on the size of the purchase commitment, we may not review all of the loans in a pool, but rather select loans for underwriting review based upon specific risk-based criteria such as property location, loan size, effective loan-to-value ratio, borrowers credit score and other criteria we believe to be important indicators of credit risk. We also obtain representations and warranties from each originator to the

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effect that each loan has been underwritten to our requirements or underwriting exceptions have been made known to us as part of our evaluation. An originator who breaches its representations and warranties may be obligated to repurchase the loan from us. As added security, we retain a third-party document custodian to insure the quality and accuracy of all individual mortgage loan closing documents and to hold the documents in safekeeping. As a result, all of the original loan collateral documents that are signed by the borrower, other than the original credit verification documents, are examined, verified and held by the custodian.

In general, the servicers servicing our loans are highly-rated by the rating agencies. We also conduct a due diligence review of each servicer before executing a servicing agreement. Servicing procedures typically follow Fannie Mae guidelines but are specified in each servicing agreement. All of our servicing agreements meet standards for inclusion in highly-rated mortgage-backed or asset-backed securitizations.

We acquire residential mortgage loans for our portfolio with the intention of securitizing them and retaining interests in the securitized mortgage loans in our portfolio. In order to facilitate the securitization or financing of our loans, we generally create subordinate certificates, which provide a specified amount of credit enhancement. We issue securities through securities underwriters and either retain these securities or finance them through repurchase agreements.

An additional channel of our Residential Mortgage Credit strategy is investment in credit-sensitive residential mortgage securities from securitizations where we did not contribute collateral. These mortgage-backed securities have credit ratings below AAA, and are sometimes referred to as subordinated residential mortgage-backed securities, or SRMBS. We analyze the basic parameters of a SRMBS (i.e., sector, rating and cash flow) and the available financing on the SRMBS and then perform a yield analysis to ascertain if the SRMBS meets our hurdle rates for return. If a security meets the applicable hurdle rate, the loan credit characteristics are evaluated and compared to specific guidelines. Credit characteristics include, but are not limited to, loan balance distribution, geographic concentration, property type, occupancy, periodic and lifetime cap, weighted-average loan-to-value and weighted-average FICO score. Qualifying securities are then analyzed using base line expectations of expected prepayments and losses from given sectors, issuers and the current state of the fixed income market. Losses and prepayments are stressed simultaneously based on a credit risk-based model. Securities in this portfolio are monitored for variance from expected prepayments, frequencies, severities, losses and cash flow.

Our Spread portfolio invests in US agency and other AAA-rated single-family adjustable-rate and hybrid adjustable-rate mortgage-backed securities. We acquire these investments in the secondary market. We seek to acquire assets that will produce competitive returns after considering the amount and nature of the anticipated returns from the investment, our ability to pledge the investment for secured, collateralized borrowings and the costs associated with financing, managing, securitizing and reserving for these investments.

Future interest rates and mortgage prepayment rates are difficult to predict and, as a result, we seek to build an investment portfolio that we believe provides acceptable returns over a broad range of interest rate and prepayment scenarios. When evaluating new acquisitions for our portfolio, we analyze whether the purchase will permit us to continue to satisfy the SEC requirement that we maintain at least 55% of our assets in qualifying real estate assets so that we are not deemed to be an investment company under the 1940 Act. We also assess the relative value. Many aspects of a mortgage-backed security or loan pool, and the dynamic interaction of these characteristics with those of our portfolio, can influence our valuation analysis. The characteristics of each potential investment that we generally analyze include, but are not limited to, origination year, originator, coupon, margin, periodic cap, lifetime cap, time-to-reset, loan-to-value, geographic dispersion and expectations as to price and prepayment. We do not assign a particular weight to any factor because the relative importance of these factors varies depending upon the characteristics we seek for our portfolio and our borrowing cost structure.

Typically, we engage in various hedging activities designed to match the terms of our assets and liabilities more closely. Hedging involves risk and typically involves costs, including transaction costs. The costs of hedging can increase as the periods covered by the hedging increase. During periods of rising and volatile interest rates, we may increase our hedging and, thus, increase our hedging costs during such periods. We generally hedge as much of the interest rate risk as we determine is in the best interest of our stockholders, after considering the cost of such hedging transactions and our desire to maintain our qualification as a REIT. Our policies do not contain specific requirements as to the percentage or amount of interest rate risk that we hedge. Our hedging activities may not have the desired beneficial impact on our results of operations or financial condition. Moreover, no hedging activity can completely insulate us from the risks associated with changes in interest rates and prepayment rates.

At June 30, 2006, we had entered into various derivative instruments to mitigate our interest rate risk. Prior to January 1, 2006, we entered into derivative contracts that were accounted for under hedge accounting as prescribed by Statement of Financial Accounting Standards, or SFAS, No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended and interpreted. Effective January 1, 2006, we discontinued the use of hedge accounting and, as a result, all changes in the value of derivative instruments that had previously been accounted for under hedge accounting are now reflected in our consolidated statement of operations rather than primarily through accumulated other comprehensive income and loss on our consolidated balance sheet. In general, rising interest rates will increase, while declining interest rates will decrease, the value of our derivative instruments. We expect this change to introduce some volatility into our results of operations, as the market value of our hedge positions changes. This volatility does not affect our taxable net income for federal income tax purposes.

Financing Strategy

We employ a leverage strategy to increase our mortgage-related assets by borrowing against our mortgage-related assets and using the proceeds to acquire additional mortgage-related assets. We actively manage the adjustment periods and the selection of the interest rate indices of our borrowings against the interest rate adjustment periods and the selection of interest rate indices on our mortgage-backed securities and our residential mortgage loans in order to manage our liquidity and interest rate-related risks.

We finance the acquisition of our mortgage-backed securities using repurchase agreements and loans with a term of less than one year and, to a lesser extent, equity capital. After analyzing the then-applicable interest rate yield curves, we may finance with long-term borrowings from time to time depending upon the amount of our equity capital, among other factors. We generally seek to diversify our exposure by entering into repurchase agreements with multiple lenders. In addition, we only enter into repurchase agreements with institutions that we believe are financially sound and that meet credit standards approved by our board of directors. We intend to finance our future purchases of mortgage-backed securities in this manner as well as through a single-seller commercial paper program we established in August 2006.

At June 30, 2006, we had borrowing arrangements in the form of repurchase agreements with 20 different investment banking firms and other lenders, 13 of which were in use as of that date. The repurchase agreements are secured by our mortgage-backed securities. We renew repurchase agreement liabilities as they mature under the then-applicable borrowing terms of the counterparties to our repurchase agreements.

The residential mortgage loans we acquire are financed initially through our warehouse lending facilities. Our intent is to securitize the loans and finance them permanently through the issuance of non-recourse mortgage-backed notes. In order to facilitate the securitization of these loans, we generally create subordinate certificates that provide a specified amount of credit enhancement, which we intend to retain in our portfolio. We use proceeds from our securitizations to pay down the

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outstanding balance of our warehouse lending facilities. Our objective is to match the income that we earn on our mortgage loans, plus the benefit of any hedging activities, with the cost of the liabilities related to our mortgage loans, a process known as match-funding our balance sheet.

At June 30, 2006, non-recourse mortgage-backed notes we issued were the primary source of funding for our loan origination and securitization portfolio. In addition, we have a $500 million warehouse lending facility with Bear Stearns Mortgage Capital Corporation that we established in October 2005 and a $1 billion warehouse lending facility with Greenwich Financial Products, Inc. that we established in January 2006. All of these warehouse lending facilities are structured as repurchase agreements. In July 2006, we established a $1 billion warehouse lending facility with Barclays Bank plc that is also structured as a repurchase agreement. In August 2006, we closed a $1 billion single-seller commercial paper program to finance our purchases of Agency and AAA-rated mortgage assets. In October 2006, we entered into an agreement with RBS Greenwich Capital whereby RBS will finance our purchase of up to $500 million in asset-backed securities. In October 2006, we also entered into a $435 million term repurchase agreement with Barclays Capital.

Growth Strategy

In addition to the strategies described above, we use other strategies to seek to generate earnings and distributions to our stockholders, including:

- increasing the size of our balance sheet at a rate faster than the rate of increase in our operating expenses; and

- lowering our effective borrowing costs over time by seeking direct funding with collateralized lenders.

RECENT DEVELOPMENTS

We completed the securitization of approximately $773 million of residential mortgage loans at the end of September 2006. We plan to continue to purchase high-quality adjustable-rate residential mortgage loans for our Residential Mortgage Credit portfolio.

We plan to further finance our Residential Mortgage Credit portfolio utilizing collateralized debt obligations which will allow us long-term, non-recourse financing for our credit-sensitive bond portfolio.

In July 2006, we established a $1 billion warehouse lending facility, in the form of a repurchase agreement, with Barclays Bank plc.

In July 2006, our $2.5 billion securitization shelf registration statement was declared effective by the SEC. Under this shelf registration statement, we may administer our own securitizations by offering securities collateralized by loans we acquire.

During July 2006, we established a relationship with Central Mortgage Co. to service selected residential mortgage loans. This relationship allows us to purchase residential mortgage loans with servicing released while maintaining our objective of operational efficiency. As a result, we are expanding the network of originators from whom we can purchase residential mortgage loans without generating a servicing asset that we would need to own and hedge.

In August 2006, we closed a $1 billion single-seller commercial paper program to finance our purchases of Agency and AAA-rated mortgage-backed securities.

At August 31, 2006, our book value per share was $10.13.

On September 28, 2006, our board of directors declared a regular quarterly dividend of $0.30 per share payable on November 6, 2006 to stockholders of record as of the close of business on October 9, 2006. On October 10, 2006, our board of directors declared a special dividend of

$0.075 per share payable on November 10, 2006 to stockholders of record as of the close of business on October 20, 2006.

CORPORATE INFORMATION

Our principal executive offices are located at 101 California Street, Suite 1350, San Francisco, California. Our telephone number is (415) 217-4500. Our website is http://www.luminentcapital.com. The contents of our website are not a part of this preliminary prospectus supplement or the accompanying prospectus.

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The offering

Common stock we are offering	6,000,000 shares
Common stock to be outstanding after this offering	45,065,245 shares
Use of proceeds after expenses	We intend to use the net proceeds of this offering to purchase mortgage assets as part of our Residential Mortgage Credit and Spread strategies. We also intend to use a portion of the net proceeds from this offering for other general corporate purposes, which may include additional investments.
NYSE symbol	LUM

The number of shares of our common stock outstanding immediately after the closing of this offering is based on 39,065,245 shares of our common stock outstanding as of June 30, 2006.

The number of shares of our common stock outstanding immediately after this offering excludes 55,000 shares of our common stock issuable upon the exercise of stock options outstanding as of June 30, 2006 under our equity incentive plan at a weighted-average exercise price of $14.82 per share.

Unless otherwise indicated, all information in this preliminary prospectus supplement assumes that the underwriters do not exercise their option to purchase up to 900,000 additional shares of our common stock to cover over-allotments, if any.

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Risk factors

Investing in our common stock involves a high degree of risk. You should carefully consider all of the risks described under Risk Factors beginning on page 6 of the accompanying prospectus, as well as the other information contained in, or incorporated by reference into, the accompanying prospectus, including the information under Risk Factors in our Form 10-K annual report for the year ended December 31, 2005 and our Form 10-Q quarterly report for the six months ended June 30, 2006. If any of these risks actually occurs, it could materially harm our business and our financial condition and results of operations. In this event, the market price of our common stock could decline and you may lose part or all of your investment.

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Use of proceeds

We estimate that the net proceeds to us from the sale of the 6,000,000 shares of common stock we are offering will be approximately $58.5 million after deducting underwriting discounts and commissions and the estimated offering expenses payable by us. If the underwriters exercise their overallotment option in full, we estimate the net proceeds to us from this offering will be approximately $67.3 million.

We intend to use the net proceeds of this offering to fund the growth of our business, principally our Residential Mortgage Credit and Spread strategies, through the purchase of additional mortgage assets.

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Dividends and dividend policy

To maintain our qualification as a REIT, we must distribute at least 90% of our net taxable income to our stockholders each year. We have done so in the past and intend to continue to do so in the future through the declaration and payment of regular quarterly dividends. We have a dividend reinvestment plan that enables stockholders to reinvest dividends automatically in additional shares of our common stock.

The following table sets forth the per share cash distributions we have declared through October 12, 2006 of our current fiscal year and our two prior fiscal years.

		Cash dividends declared per share	Declaration date
2006:			
First Quarter	$	0.05	March 31, 2006
Second Quarter		0.20	June 12, 2006
Third Quarter		0.30	September 28, 2006
Special Dividend		0.075*	October 10, 2006
Fourth Quarter			
2005:			
First Quarter	$	0.36	March 31, 2005
Second Quarter		0.27	June 29, 2005
Third Quarter		0.11	September 30, 2005
Fourth Quarter		0.03	December 20, 2005
2004:			
First Quarter	$	0.42	March 9, 2004
Second Quarter		0.43	June 28, 2004
Third Quarter		0.43	September 28, 2004
Fourth Quarter		0.43	December 21, 2004

* *This amount represents a special dividend of $0.075 per share payable on November 10, 2006 to stockholders of record as of the close of business on October 20, 2006.*

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Capitalization

The following table sets forth our equity capitalization as of June 30, 2006:

on an actual basis;

on a pro forma basis to give effect to our cash dividend of $0.30 per share (approximately $12 million) declared on September 28, 2006, which is payable on November 6, 2006 to stockholders of record on October 9, 2006 and our cash dividend of $0.075 per share (approximately $3 million) declared on October 10, 2006, which is payable on November 10, 2006 to stockholders of record on October 20, 2006; and

on an as adjusted basis to reflect the issuance and sale of 6,000,000 shares of our common stock we are offering at a public offering price of $10.25 per share, after deducting underwriting discounts and commissions and estimated offering expenses payable by us and the incremental special dividend paid on the newly issued shares.

	As of June 30, 2006		
	Actual	**Pro forma**	**Pro forma as adjusted**
	(in thousands, except share and per share amounts) (unaudited)		
Stockholders equity:			
Preferred stock, par value $0.001 per share; 10,000,000 shares authorized; no shares issued and outstanding at June 30, 2006 actual, pro forma or pro forma as adjusted			
Common stock, par value $0.001 per share, 100,000,000 shares authorized; 39,065,245 shares issued and outstanding at June 30, 2006 actual and pro forma, and 45,065,245 issued and outstanding as of June 30, 2006 pro forma as adjusted	$ 39	$ 39	$ 45
Additional paid-in capital	498,084	498,084	556,578
Accumulated other comprehensive loss	(8,431)	(8,431)	(8,431)
Accumulated distributions in excess of accumulated earnings	(97,191)	(111,840)	(112,290)
Total stockholders equity	$ 392,501	$ 377,852	$ 435,902

The table above should be read in conjunction with our financial statements and related notes included in our annual report on Form 10-K for the fiscal year ended December 31, 2005 and our quarterly reports on Form 10-Q for subsequent fiscal quarters, all of which are incorporated by reference into the accompanying prospectus. The table is based on 39,065,245 shares of our common stock outstanding as of June 30, 2006 and excludes 55,000 shares of our common stock issuable upon the exercise of stock options outstanding as of June 30, 2006 under our long-term incentive plan at a weighted average exercise price of $14.82 per share, and of which options to purchase 53,334 shares are currently exercisable at a weighted average exercise price of $14.87 per share.

Additional federal income tax considerations

The following is a summary of certain additional federal income tax considerations. For additional information, see Certain United States Federal Income Tax Considerations beginning on page 47 of the accompanying prospectus.

TAXATION OF OUR COMPANY

We elected to be taxed as a REIT under the federal income tax laws commencing with our short taxable year ended December 31, 2003. We believe that we have operated in a manner qualifying us as a REIT since our election and intend to continue to so operate. In connection with this offering, Hunton & Williams LLP is issuing an opinion that we qualified to be taxed as a REIT for our taxable years ended December 31, 2003 through December 31, 2005, and our organization and current and proposed method of operation will enable us to continue to qualify as a REIT for our taxable year ending December 31, 2006 and in the future. You should be aware that Hunton & Williams LLP s opinion is based upon customary assumptions (including an assumption that prior opinions regarding our REIT qualification issued by other law firms are correct), is conditioned upon certain representations made by us as to factual matters, including representations regarding the nature of our properties and the future conduct of our business, and is not binding upon the Internal Revenue Service or any court. In addition, Hunton & Williams LLP s opinion is based on existing federal income tax law governing qualification as a REIT, which is subject to change, possibly on a retroactive basis. Moreover, our continued qualification and taxation as a REIT depend upon our ability to meet on a continuing basis, through actual annual operating results, certain qualification tests set forth in the federal tax laws. Those qualification tests involve the percentage of income that we earn from specified sources, the percentage of our assets that falls within specified categories, the diversity of our share ownership and the percentage of our earnings that we distribute. While Hunton & Williams LLP has reviewed those matters in connection with the foregoing opinion, Hunton & Williams LLP will not review our compliance with those tests on a continuing basis. Accordingly, no assurance can be given that the actual results of our operations for 2006 or any future taxable year will satisfy such requirements. For a discussion of the tax consequences of our failure to qualify as a REIT, see Certain United States Federal Income Tax Considerations Failure to Qualify as a REIT in the accompanying prospectus.

TAXABLE MORTGAGE POOLS AND EXCESS INCLUSION INCOME

An entity, or a portion of an entity, may be classified as a taxable mortgage pool under the Internal Revenue Code if:

- substantially all of its assets consist of debt obligations or interests in debt obligations;
- more than 50% of those debt obligations are real estate mortgage loans or interests in real estate mortgage loans as of specified testing dates;
- the entity has issued debt obligations that have two or more maturities; and
- the payments required to be made by the entity on its debt obligations bear a relationship to the payments to be received by the entity on the debt obligations that it holds as assets.

Under US Treasury regulations, if less than 80% of the assets of an entity (or a portion of an entity) consist of debt obligations, these debt obligations are considered not to comprise substantially all of its assets and therefore the entity would not be treated as a taxable mortgage pool.

We expect that certain of our current and future securitizations will result in the treatment of certain portions of our assets as taxable mortgage pools for federal income tax purposes. When an entity, or a

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Additional federal income tax considerations

portion of an entity, is classified as a taxable mortgage pool, it is generally treated as a taxable corporation for federal income tax purposes. However, special rules apply to a REIT, a portion of a REIT or a qualified REIT subsidiary that is a taxable mortgage pool. The portion of the REIT s assets held directly or through a qualified REIT subsidiary that qualifies as a taxable mortgage pool is treated as a qualified REIT subsidiary that is not subject to corporate income tax, and the taxable mortgage pool classification does not affect the tax qualification of the REIT. Rather, the consequences of the taxable mortgage pool classification would generally, except as described below, be limited to the REIT s stockholders. The Treasury Department has yet to issue regulations governing the tax treatment of the stockholders of a REIT that owns an interest in one or more taxable mortgage pools.

A portion of our income from a taxable mortgage pool, which might be non-cash accrued income, or phantom taxable income, could be treated as excess inclusion income. Excess inclusion income is an amount, with respect to any calendar quarter, equal to the excess, if any, of (i) income allocable to the holder of a real estate mortgage investment conduit, or REMIC, residual interest or taxable mortgage pool interest over (ii) the sum of an amount for each day in the calendar quarter equal to the product of (a) the adjusted issue price at the beginning of the quarter multiplied by (b) 120% of the long-term federal rate (determined on the basis of compounding at the close of each calendar quarter and properly adjusted for the length of such quarter). This non-cash or phantom income would be subject to the distribution requirements that apply to us and could therefore adversely affect our liquidity.

Although the law is unclear, we might be taxable at the highest corporate rate on the portion of any excess inclusion income that we derive from a taxable mortgage pool equal to the percentage of our stock that is held in record name by disqualified organizations. Similar rules may apply if we own a residual interest in a REMIC. To the extent that we own a taxable mortgage pool or a REMIC residual interest through a taxable REIT subsidiary, we will not be subject to this tax. In addition, to the extent that stock owned by disqualified organizations is held in record name by a broker/dealer or other nominee, the broker/dealer or other nominee would be liable for the corporate level tax on the portion of our excess inclusion income allocable to the stock held by the broker/dealer or other nominee on behalf of the disqualified organizations. A disqualified organization includes:

- the United States;
- any state or political subdivision of the United States;
- any foreign government;
- any international organization;
- any agency or instrumentality of any of the foregoing;
- any other tax-exempt organization, other than a farmer s cooperative described in section 521 of the Internal Revenue Code, that is exempt both from income taxation and from taxation under the unrelated business taxable income provisions of the Internal Revenue Code; and
- any rural electrical or telephone cooperative.

We expect that our current and future securitizations will result in the treatment of certain portions of our assets as one or more taxable mortgage pools. In addition, it is possible that one or more disqualified organizations will own our stock in record name. In that event, we may become subject to the tax described above. Because this tax would be imposed on us, all of our stockholders, including stockholders that are not disqualified organizations, would bear a portion of the tax cost associated with the classification of certain portions of our assets as one or more taxable mortgage pools.

Additional federal income tax considerations

We will allocate any excess inclusion income we realize to our stockholders. A stockholder s share of excess inclusion income (i) would not be allowed to be offset by any net operating losses otherwise available to the stockholder, (ii) would be subject to tax as unrelated business taxable income in the hands of most types of stockholders that are otherwise generally exempt from federal income tax and (iii) would result in the application of US federal income tax withholding at the maximum rate (30%), without reduction for any otherwise applicable income tax treaty, to the extent allocable to most types of foreign stockholders. See Certain United States Federal Income Tax Considerations Passive Activity Losses, Investment Interest Limitations and Other Considerations of Holding Our Stock and Taxation of Tax-Exempt Stockholders and Taxation of Non-United States Stockholders in the accompanying prospectus. The manner in which excess inclusion income would be allocated among shares of different classes of our stock or how such income is to be reported to stockholders is not clear under current law. Tax-exempt investors, foreign investors and taxpayers with net operating losses should carefully consider the tax consequences described above and are urged to consult their tax advisors in connection with their decision to invest in our common stock.

If we own less than 100% of the ownership interests in a subsidiary that is a taxable mortgage pool, the foregoing rules would not apply. Rather, the subsidiary would be treated as a corporation for federal income tax purposes, and would potentially be subject to corporate income tax. In addition, this characterization would alter our REIT income and asset test calculations and could adversely affect our compliance with those requirements. We currently do not have, and currently do not intend to form, any subsidiary in which we own some, but less than all, of the ownership interests that are or will become taxable mortgage pools, and we intend to monitor the structure of any taxable mortgage pools in which we have an interest to ensure that they will not adversely affect our qualification as a REIT.

DISTRIBUTION TEST AND EXCISE TAX

Each taxable year, we must distribute dividends, other than capital gain dividends and deemed distributions of retained capital gain, to our stockholders in an aggregate amount at least equal to:

the sum of:

- 90% of our REIT taxable income, computed without regard to the dividends paid deduction and our net capital gain or loss, and

- 90% of our after-tax net income, if any, from foreclosure property,

minus the sum of certain items of non-cash income.

We must pay such distributions in the taxable year to which they relate, or in the following taxable year if we declare the distribution before we timely file our federal income tax return for the year and pay the distribution on or before the first regular dividend payment date after such declaration.

Furthermore, if we fail to distribute during a calendar year, or by the end of January following the calendar year in the case of distributions with declaration and record dates falling in the last three months of the calendar year, at least the sum of:

85% of our ordinary income for such year,

95% of our capital gain income for such year, and

any undistributed taxable income from prior periods,

we will incur a 4% nondeductible excise tax on the excess of such required distribution over the amounts we actually distribute. We may elect to retain and pay income tax on the net long-term

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Additional federal income tax considerations

capital gain we receive in a taxable year. If we so elect, we will be treated as having distributed any such retained amount for purposes of the 4% nondeductible excise tax described above.

From time to time, we experience timing differences between the actual receipt of cash and actual payment of expenses and the inclusion of income and deduction of expenses in arriving at our net taxable income. Examples of those timing differences include the following:

Certain mortgages that we purchase directly and certain mortgages collateralizing mortgage-backed securities that we purchase permit negative amortization. A negative amortization provision in a mortgage allows the borrower to defer payment of a portion or all of the monthly interest accrued on the mortgage and to add the deferred interest amount to the principal balance of the mortgage. When a mortgage or a mortgage collateralizing a mortgage-backed security experiences negative amortization, we continue to recognize interest income attributable to the negative amortization on the mortgage or mortgage-backed security even though we do not receive cash in an amount equal to the deferred portion of the interest income.

Because we may deduct capital losses only to the extent of our capital gains, we may have taxable income that exceeds our economic income.

We will recognize taxable income in advance of the related cash flow if any of our mortgage loans or mortgage-backed securities have original issue discount. We generally must accrue original issue discount based on a constant yield method that takes into account projected prepayments but that defers taking into account credit losses until they are actually incurred.

We may recognize taxable market discount income when we receive the proceeds from the disposition of, or principal payments on, loans that have a stated redemption price at maturity that is greater than our tax basis in those loans. In addition, in such a case, we may be required to make a non-deductible principal payment on our borrowings with the proceeds from the disposition or principal payment.

We may recognize taxable income without receiving a corresponding cash payment if we foreclose on or make a significant modification to a loan, to the extent that the fair market value of the underlying property or the principal amount of the modified loan, as applicable, exceeds our basis in the original loan.

We may recognize phantom taxable income from any residual interests in REMICs or retained ownership interests in mortgage loans subject to collateralized mortgage obligation debt.

Although several types of non-cash income are excluded in determining the annual distribution requirement, we will incur corporate income tax and the 4% nondeductible excise tax with respect to those non-cash income items if we do not distribute those items on a current basis. As a result of the foregoing, we may have less cash than is necessary to distribute all of our net taxable income and thereby avoid corporate income tax and the excise tax imposed on certain undistributed income. In such a situation, we may need to borrow funds or issue additional common or preferred stock. Moreover, because we often do not receive timely information with respect to the income from our mortgage-backed securities, it may be difficult for us to estimate our net taxable income and make sufficient distributions to avoid the 4% nondeductible excise tax. Although we intend to continue to make timely distributions sufficient to satisfy the annual distribution requirements and to avoid corporate income tax and the 4% nondeductible excise tax, our non-cash income and the lack of timely information regarding our mortgage-backed securities may cause us to incur the 4% nondeductible excise tax in the future.

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Additional federal income tax considerations

TAXABLE REIT SUBSIDIARIES

We may own up to 100% of the stock of one or more taxable REIT subsidiaries. A taxable REIT subsidiary is a fully taxable corporation that may earn income that would not be qualifying income for purposes of the REIT requirements if earned directly by us. A corporation will not qualify as a taxable REIT subsidiary if it directly or indirectly operates or manages any hotels or health care facilities or provides rights to any brand name under which any hotel or health care facility is operated.

We and any corporate subsidiary must elect for the subsidiary to be treated as a taxable REIT subsidiary on a form signed by us and the subsidiary. A corporation of which a qualifying taxable REIT subsidiary directly or indirectly owns more than 35% of the voting power or value of the stock will automatically be treated as a taxable REIT subsidiary. Overall, no more than 20% of the value of our assets may consist of securities of one or more taxable REIT subsidiaries, and no more than 25% of the value of our assets may consist of the securities of taxable REIT subsidiaries and other non-taxable REIT subsidiaries and other assets that are not qualifying assets for purposes of the 75% asset test.

The taxable REIT subsidiary rules limit the deductibility of interest paid or accrued by a taxable REIT subsidiary to us to ensure that the taxable REIT subsidiary is subject to an appropriate level of corporate taxation. Further, the rules impose a 100% excise tax on transactions between our taxable REIT subsidiaries and us that are not conducted on an arm s-length basis.

We currently have four taxable REIT subsidiaries. Three subsidiaries, Maia Mortgage Finance Statutory Trust (Maia), Lares Asset Securitization, Inc. and Juno CDO Finance, Inc., were formed to purchase mortgage loans and mortgage-backed securities and conduct securitizations. The fourth taxable REIT subsidiary, Proserpine LLC, was formed to provide management services with respect to certain of our subsidiaries that acquire and securitize mortgage loans. We believe that all transactions between us and our taxable REIT subsidiaries have been, and will be, conducted on an arm s-length basis.

WE HAVE A POTENTIAL TAX LIABILITY AS A RESULT OF A DEFECTIVE TAXABLE REIT SUBSIDIARY ELECTION

As described above, we and our subsidiaries must timely elect for our subsidiaries to be treated as taxable REIT subsidiaries on elections signed by us and our subsidiaries. We timely filed an election to treat Maia, one of our subsidiaries, as a taxable REIT subsidiary. That election contained certain technical defects. Maia has executed several REMIC securitizations, which are treated as sales for federal income tax purposes. If Maia were not treated as a taxable REIT subsidiary, the gain from those sales would likely be subject to the 100% tax on prohibited transactions. If we incur that tax liability, it would reduce the amount we have available to distribute to our stockholders by approximately $3 million. See Certain United States Federal Income Tax Considerations General in the accompanying prospectus for a discussion of the 100% tax on prohibited transactions.

Applicable Treasury regulations provide a procedure under which a late or defective filing of an election, such as a taxable REIT subsidiary election, will be excused, provided that the taxpayer has established to the Internal Revenue Service s satisfaction that the taxpayer has acted reasonably and in good faith and that the interests of the government will not be prejudiced. We have submitted a request for a private letter ruling to the Internal Revenue Service seeking such relief. Our counsel advises us that the Internal Revenue Service has granted relief to other REITs in similar situations. If we do not receive such a ruling, our qualification as a REIT would not be jeopardized.

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Additional federal income tax considerations

RECENT LEGISLATION

The Gulf Opportunity Zone Act of 2005 and the Tax Increase Prevention and Reconciliation Act of 2005 amended certain rules relating to REITs and the taxation of stockholders of a REIT. The changes made by the Gulf Opportunity Zone Act of 2005 and the Tax Increase Prevention and Reconciliation Act of 2005 most relevant to us include:

In the event of a failure of any of the asset tests, other than a de minimis failure of the 5% Asset Test or the 10% Asset Test (as described in Certain United State Federal Income Tax Considerations Asset Tests in the accompanying prospectus), as long as the failure is due to reasonable cause and not due to willful neglect, we will not lose our REIT qualification if we (1) dispose of assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify such failure, (2) file a schedule with the Internal Revenue Service that identifies each asset that caused us to fail such test and (3) pay a tax equal to the greater of $50,000 or 35% of the net income from the nonqualifying assets during the period in which we failed to satisfy the asset tests.

The preferential tax rates for qualified dividend income and capital gains (currently at a maximum rate of 15%), which were scheduled to expire in 2008, have been extended to apply to the 2009 and 2010 tax years. Without further congressional action, the maximum tax rate on qualified dividend income will increase to 39.6% in 2011 and the maximum tax rate on capital gains will increase to 20% in 2011. Qualified dividend income generally includes dividends paid to stockholders taxed at individual rates by domestic C corporations and certain qualified foreign corporations. Because we are not generally subject to federal income tax on the portion of our net taxable income distributed to our stockholders, see Certain United States Federal Income Tax Considerations General in the accompanying prospectus, our dividends generally will not be eligible for the 15% rate on qualified dividend income. As a result, our ordinary dividends will continue to be taxed at the higher tax rate applicable to ordinary income, which currently is a maximum rate of 35%.

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Underwriting

We are offering the shares of our common stock described in this prospectus supplement and the accompanying prospectus through the underwriters named below. UBS Securities LLC is the representative of the underwriters. We have entered into an underwriting agreement with the underwriters. Subject to the terms and conditions of the underwriting agreement, each of the underwriters has severally agreed to purchase the number of shares of common stock listed next to its name in the following table:

Underwriters	**Number of shares**
UBS Securities LLC	4,800,000
JMP Securities LLC	1,200,000
Total	6,000,000

The underwriting agreement provides that the underwriters must buy all of the shares if they buy any of them. However, the underwriters are not required to take or pay for the shares covered by the underwriters over-allotment option described below.

Our common stock is offered subject to a number of conditions, including:

- receipt and acceptance of our common stock by the underwriters, and
- the underwriters right to reject orders in whole or in part.

In connection with this offering, certain of the underwriters or securities dealers may distribute prospectus supplements and prospectuses electronically.

Sales of shares made outside of the United States may be made by affiliates of the underwriters. Upon the execution of the underwriting agreement, the underwriters will be obligated to purchase the shares at the prices and upon the terms stated therein, and, as a result, will thereafter bear any risk associated with changing the offering price to the public or other selling terms.

OVER-ALLOTMENT OPTION

We have granted the underwriters an option to buy up to 900,000 additional shares of our common stock. The underwriters may exercise this option solely for the purpose of covering over-allotments, if any, made in connection with this offering. The underwriters have 30 days from the date of this prospectus supplement to exercise this option. If the underwriters exercise this option, they will purchase additional shares approximately in proportion to the amounts specified in the table above.

COMMISSIONS AND DISCOUNTS

Shares sold by the underwriters to the public will initially be offered at the offering price set forth on the cover of this prospectus supplement. Any shares sold by the underwriters to securities dealers may be sold at a discount of up to $0.27 per share from the public offering price. Any of these securities dealers may resell any shares purchased from the underwriters to other brokers or dealers at a discount of up to $0.10 per share from the public offering price. If all the shares are not sold at the public offering price, the representative may change the offering price and the other selling terms. Sales of shares made outside of the United States may be made by affiliates of the underwriters.

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Underwriting

The following table shows the per share and total underwriting discounts and commissions we will pay to the underwriters, assuming both no exercise and full exercise of the underwriters option to purchase up to an additional 900,000 shares:

	No exercise	Full exercise
Per share	$ 0.45	$ 0.45
Total	$ 2,700,000	$ 3,105,000

In compliance with NASD guidelines, the maximum compensation received by NASD Members in connection with this offering will not exceed 10% of the gross proceeds of the offering, plus 0.5% for bona fide due diligence expenses.

We estimate that the total expenses of this offering payable by us, not including the underwriting discounts and commissions, will be approximately $300,000.

NO SALES OF SIMILAR SECURITIES

We, our executive officers and directors have entered into lock-up agreements with the underwriters. Under these agreements, we and each of these persons may not, without the prior written approval of UBS Securities LLC, subject to limited exceptions, offer, sell, contract to sell or otherwise dispose of or hedge our common stock or securities convertible into or exercisable or exchangeable for our common stock. These restrictions will be in effect for a period of 90 days after the date of this prospectus supplement. At any time and without public notice, UBS Securities LLC may in its sole discretion release all or some of the securities from these lock-up agreements.

INDEMNIFICATION AND CONTRIBUTION

We have agreed to indemnify the underwriters and their controlling persons against certain liabilities, including liabilities under the Securities Act. If we are unable to provide this indemnification, we will contribute to payments the underwriters and their controlling persons may be required to make in respect of those liabilities.

NEW YORK STOCK EXCHANGE LISTING

Our common stock is quoted on The New York Stock Exchange under the symbol LUM.

PRICE STABILIZATION, SHORT POSITIONS, PASSIVE MARKET MAKING

In connection with this offering, the underwriters may engage in activities that stabilize, maintain or otherwise affect the price of our common stock, including:

- stabilizing transactions;
- short sales;
- purchases to cover positions created by short sales;
- imposition of penalty bids; and
- syndicate covering transactions.

Stabilizing transactions consist of bids or purchases made for the purpose of preventing or retarding a decline in the market price of our common stock while this offering is in progress. These transactions may also include making short sales of our common stock, which involve the sale by the underwriters of a greater number of shares of common stock than they are required to purchase in this offering. Short sales may be covered short sales, which are short positions in an amount not greater than the

Underwriting

underwriters over-allotment option referred to above, or may be naked short sales, which are short positions in excess of that amount.

The underwriters may close out any covered short position either by exercising their over-allotment option, in whole or in part, or by purchasing shares in the open market. In making this determination, the underwriters will consider, among other things, the price of shares available for purchase in the open market compared to the price at which they may purchase shares through the over-allotment option. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of the common stock in the open market that could adversely affect investors who purchased in this offering.

The underwriters also may impose a penalty bid. This occurs when a particular underwriter repays to the underwriters a portion of the underwriting discount received by it because the representative has repurchased shares sold by or for the account of that underwriter in stabilizing or short covering transactions.

As a result of these activities, the price of our common stock may be higher than the price that otherwise might exist in the open market. If these activities are commenced, they may be discontinued by the underwriters at any time. The underwriters may carry out these transactions on The New York Stock Exchange, in the over-the-counter market or otherwise.

In addition, in connection with this offering the underwriters (and selling group members) may engage in passive market making transactions in our common stock on The New York Stock Exchange prior to the pricing and completion of this offering. Passive market making consists of displaying bids on The New York Stock Exchange no higher than the bid prices of independent market makers and making purchases at prices no higher than these independent bids and effected in response to order flow. Net purchases by a passive market maker on each day are generally limited to a specified percentage of the passive market maker s average daily trading volume in the common stock during a specified period and must be discontinued when such limit is reached. Passive market making may cause the price of our common stock to be higher than the price that otherwise would exist in the open market in the absence of these transactions. If passive market making is commenced, it may be discontinued at any time.

AFFILIATIONS

The underwriters and their affiliates have provided and may provide certain commercial banking, financial advisory and investment banking services for us for which they receive fees. The underwriters and their affiliates may from time to time in the future engage in transactions with us and perform services for us in the ordinary course of their business.

NOTICE TO INVESTORS

European Economic Area

With respect to each Member State of the European Economic Area which has implemented Prospectus Directive 2003/71/ EC, including any applicable implementing measures, from and including the date on which the Prospectus Directive is implemented in that Member State, the offering of our common stock in this offering is only being made:

(a) to legal entities which are authorized or regulated to operate in the financial markets or, if not so authorized or regulated, whose corporate purpose is solely to invest in securities;

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Underwriting

(b) to any legal entity which has two or more of (1) an average of at least 250 employees during the last financial year; (2) a total balance sheet of more than 43,000,000 and (3) an annual net turnover of more than 50,000,000, as shown in its last annual or consolidated accounts; or

(c) in any other circumstances which do not require the publication by the Issuer of a prospectus pursuant to Article 3 of the Prospectus Directive.

United Kingdom

Shares of our common stock may not be offered or sold and will not be offered or sold to any persons in the United Kingdom other than to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or as agent) for the purposes of their businesses and in compliance with all applicable provisions of the FSMA with respect to anything done in relation to shares of our common stock in, from or otherwise involving the United Kingdom. In addition, any invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) in connection with the issue or sale of shares of our common stock may only be communicated in circumstances in which Section 21(1) of the FSMA does not apply to us. Without limitation to the other restrictions referred to herein, this offering circular is directed only at (1) persons outside the United Kingdom, (2) persons having professional experience in matters relating to investments who fall within the definition of investment professionals in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 or (3) high net worth bodies corporate, unincorporated associations and partnerships and trustees of high value trusts as described in Article 49(2) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005. Without limitation to the other restrictions referred to herein, any investment or investment activity to which this offering circular relates is available only to, and will be engaged in only with, such persons, and persons within the United Kingdom who receive this communication (other than persons who fall within (2) or (3) above) should not rely or act upon this communication.

Switzerland

Shares of our common stock may be offered in Switzerland only on the basis of a non-public offering. This prospectus does not constitute an issuance prospectus according to articles 652a or 1156 of the Swiss Federal Code of Obligations or a listing prospectus according to article 32 of the Listing Rules of the Swiss exchange. The shares of our common stock may not be offered or distributed on a professional basis in or from Switzerland and neither this prospectus nor any other offering material relating to shares of our common stock may be publicly issued in connection with any such offer or distribution. The shares have not been and will not be approved by any Swiss regulatory authority. In particular, the shares are not and will not be registered with or supervised by the Swiss Federal Banking Commission, and investors may not claim protection under the Swiss Investment Fund Act.

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Legal matters

Certain legal matters in connection with this offering will be passed upon for us by Duane Morris LLP, Philadelphia, Pennsylvania and for the underwriters by Clifford Chance US LLP, New York, New York. Duane Morris LLP and Clifford Chance US LLP will rely as to certain matters of Maryland law upon Venable LLP, Baltimore, Maryland. Certain federal income tax matters will be passed upon for us by Hunton & Williams LLP, Richmond, Virginia.

Experts

The consolidated financial statements of Luminent Mortgage Capital, Inc. and subsidiaries and management s report on the effectiveness of internal control over financial reporting incorporated in the accompanying prospectus by reference from the Annual Report of Luminent Mortgage Capital, Inc. on Form 10-K for the year ended December 31, 2005 have been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their reports, which are incorporated by reference, and have been so incorporated in reliance upon the reports of such firm given upon their authority as experts in accounting and auditing.

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PROSPECTUS

$500,000,000
Common Stock
Preferred Stock
Warrants to Purchase Common Stock or Preferred Stock
Debt Securities

By this prospectus, we may offer, from time to time:

- shares of our common stock;
- shares of our preferred stock;
- warrants to purchase shares of our common stock or preferred stock;
- debt securities; or
- any combination of the foregoing

in one or more series with an aggregate initial public offering price of up to $500,000,000. We will provide specific terms of each issuance of these securities in supplements to this prospectus. You should read this prospectus and any prospectus supplement carefully before you decide to invest.

This prospectus may not be used to consummate sales of these securities unless it is accompanied by a prospectus supplement.

Our common stock is listed on the New York Stock Exchange under the symbol LUM.

To ensure we qualify as a real estate investment trust, no person may own more than 9.8% of the outstanding shares of any class of our common stock or our preferred stock, unless our board of directors waives this limitation.

See Risk Factors beginning on page 6 of this prospectus for a description of risks that should be considered by purchasers of these securities.

We may offer these securities in amounts, at prices and on terms to be set forth in one or more prospectus supplements. We may sell these securities to or through underwriters, dealers or agents or we may sell these securities directly to investors on our own behalf.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus is January 19, 2005

You should rely only on the information contained in or incorporated by reference into this prospectus and any related prospectus supplement. We have not authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus, the related prospectus supplement and the documents incorporated by reference herein is accurate only as of its respective date or dates or on the date or dates specified in these documents. Our business, financial condition, results of operations and prospects may have changed since those dates.

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus, including any prospectus supplement, and the documents incorporated by reference herein contain certain forward-looking statements. Forward-looking statements are those that are not historical in nature. They can often be identified by the inclusion of words such as will, anticipate, estimate, should, expect, believe intend and similar expressions. Any projection of revenues, earnings or losses, distributions, capital structure or other financial terms is a forward-looking statement.

Our forward-looking statements are based upon our management s beliefs, assumptions and expectations of our future operations and economic performance, taking into account the information currently available to us. Forward-looking statements involve risks and uncertainties, some of which are not currently known to us, that might cause our actual results, performance or financial condition to be materially different from the expectations of future results, performance or financial condition we express or imply in any forward-looking statement. Some of the important factors that could cause our actual results, performance or financial condition to differ materially from our expectations are:

- interest rate mismatches between our mortgage-backed securities and the borrowings we use to fund our purchases of such securities;

- changes in interest rates and mortgage prepayment rates;

- our ability to obtain or renew sufficient funding to maintain our leverage strategies;

- potential impacts of our leveraging policies on our net income and cash available for distribution;

- our limited operating history and the limited experience of Seneca Capital Management LLC, our management company, in managing a real estate investment trust, or REIT;

- the ability of our board of directors to change our operating policies and strategies without stockholder approval or notice to you;

- effects of interest rate caps on our adjustable-rate and hybrid adjustable-rate mortgage-backed securities;

- the degree to which our hedging strategies may or may not protect us from interest rate volatility;

- the fact that Seneca could be motivated to recommend riskier investments in an effort to maximize its incentive compensation under its management agreement with us;

- potential conflicts of interest arising out of our relationship with Seneca, on the one hand, and Seneca s relationships with other third parties, on the other hand; and

- our ability to invest up to 10% of our investment portfolio in lower-credit quality mortgage-backed securities that carry an increased likelihood of default or rating downgrade relative to investment-grade securities;

- your inability to review the assets that we will acquire with the net proceeds of any securities we offer;

- the other important factors described in this prospectus, including under the caption Risk Factors, in any prospectus supplement and in the documents incorporated herein by reference.

We undertake no obligation to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the events described in our forward-looking statements might not occur. We qualify all of our forward-looking statements by these cautionary factors. Please keep this cautionary note in mind as you read this prospectus, any prospectus supplement and the documents incorporated herein by reference.

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we filed with the Securities and Exchange Commission, or SEC, using a shelf registration process. Under this process, we may offer and sell any combination of common stock, preferred stock, warrants to purchase common stock or preferred stock and debt securities in one or more offerings for total proceeds of up to $500,000,000. This prospectus provides you with a general description of the securities we may offer. Each time we offer to sell securities, we will provide a supplement to this prospectus that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. We encourage you to read, in their entirety, this prospectus and any related prospectus supplement, as well as the information that is incorporated by reference herein. You should read this entire prospectus carefully, including the section titled Risk Factors before making an investment in our securities. As used in this prospectus, Luminent, company, we, our and us refer to Luminent Mortgage Capital, Inc. and Seneca, our M and the Manager refer to Seneca Capital Management LLC, except where the context otherwise requires.

LUMINENT MORTGAGE CAPITAL, INC.

General

We were incorporated in April 2003 to invest primarily in U.S. agency and other highly-rated, single-family, adjustable-rate, hybrid adjustable-rate and fixed-rate mortgage-backed securities, which we acquire in the secondary market. Our strategy is to acquire mortgage-related assets, finance these purchases in the capital markets and use leverage in order to provide an attractive return on stockholders equity. Through this strategy, we seek to earn income, which is generated from the spread between the yield on our earning assets and our costs, including the interest cost of the funds we borrow. We operate as a REIT, and generally do not pay federal corporate income taxes on our income that is distributed to our stockholders.

We commenced operations in June 2003, following the completion of a private placement of our common stock, in which we raised net proceeds of approximately $159.7 million. On December 18, 2003, we completed an initial public offering of our common stock in which we raised net proceeds of approximately $157.0 million. On December 19, 2003, our common stock began trading on the New York Stock Exchange, or NYSE, under the trading symbol LUM. On March 29, 2004, we completed a follow-on public offering of our common stock in which we raised net proceeds of approximately $157.5 million.

We invest primarily in adjustable-rate and hybrid adjustable-rate mortgage-backed securities. Adjustable-rate mortgage-backed securities have interest rates that reset periodically, typically every six months or on an annual basis. Hybrid adjustable-rate mortgage-backed securities have interest rates that are fixed for the first few years of the loan typically three, five, seven or 10 years and thereafter reset periodically in a manner similar to adjustable-rate mortgage-backed securities.

Unless otherwise indicated in an accompanying prospectus supplement, we intend to use the net proceeds from the sale of the securities offered by this prospectus and the related accompanying prospectus supplement and other borrowed funds to invest in mortgage-backed securities similar to those currently in our portfolio. We will seek to acquire mortgage-backed securities that will produce competitive returns, taking into consideration the amount and nature of the anticipated returns from the investment, our ability to pledge the investment for secured, collateralized borrowings and the costs associated with financing, managing, securitizing and reserving for these investments. As of the date of this prospectus, we have not identified any specific mortgage-backed securities that we intend to acquire with the net proceeds of this offering. All of the mortgage-backed securities that we acquired with the net proceeds of our initial public offering and our follow-on offering are agency-backed or have AAA credit ratings from at least one nationally-recognized statistical rating agency, and all of the securities are either adjustable-rate or hybrid adjustable-rate mortgage-backed securities. We expect that the substantial majority, or perhaps all of the mortgage-backed securities that we acquire with the net proceeds of this offering will be agency-backed or have AAA credit ratings. Such securities are readily available in the market. As of June 30, 2004, the market for residential mortgage debt that had been securitized into mortgage-backed securities was approximately $4.2 trillion, approximately $3.4 trillion of which was agency-backed and, therefore, generally consistent with our investment guidelines. As of June 30, 2004, approximately $69.8 billion of all available mortgage-backed securities were held by REITs.

We have financed our acquisition of mortgage-related assets by investing our equity and by borrowing at short-term rates under repurchase agreements. We intend to continue to finance our acquisitions in this manner. We generally seek to borrow between eight and 12 times the amount of our equity. We actively manage the adjustment periods and the selection of the interest rate indices of our borrowings against the adjustment periods and the selection of indices on our mortgage-related assets in order to manage our liquidity and interest rate-related risks. We may also choose to engage in various hedging activities designed to match more closely the terms of our assets and liabilities.

As a long-term holder of mortgage-backed securities, we focus on acquiring, financing and managing a diverse portfolio of mortgage-backed securities with a variety of characteristics that we believe will provide attractive returns in a multitude of interest rate and prepayment environments. We do not construct our overall investment portfolio in order to express a directional expectation for interest rates or mortgage prepayment rates.

We review the credit risk associated with each potential investment and may diversify our portfolio to avoid undue geographic, guarantor, industry and other types of concentrations. By maintaining a large percentage of our assets in high-quality and highly-rated assets, many of which are guaranteed under limited circumstances as to payment of a limited amount of principal and interest by federal agencies or federally-chartered entities such as Fannie Mae, Freddie Mac or Ginnie Mae, we believe we can mitigate our exposure to losses from credit risk.

In addition to the strategies described above, we intend to use other strategies to seek to generate earnings and distributions to our stockholders, which may include the following:

- increasing the size of our balance sheet at a rate faster than the rate of increase in our operating expenses;
- using leverage to increase the size of our balance sheet; and
- lowering our effective borrowing costs over time by seeking direct funding with collateralized lenders.

We are externally managed and advised by Seneca pursuant to a management agreement between Seneca and us. We have a full-time chief financial officer who is not employed by Seneca, and who provides us with dedicated financial management, analysis and investor relations capability.

We have elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended. As such, we will routinely distribute substantially all of the income generated from our operations to our stockholders. As long as we retain our REIT status, we generally will not be subject to U.S. federal or state corporate taxes on our income to the extent that we distribute our net income to our stockholders.

Our principal offices are located at 909 Montgomery Street, Suite 500, San Francisco, California 94133. Our telephone number is (415) 486-2110 and our website is www.luminentcapital.com. Information contained on our website does not constitute a part of this prospectus.

Seneca and Executive Officers

Our day-to-day operations are externally managed and advised by Seneca, subject to the direction and oversight of our board of directors. Seneca was established in 1989, and is an investment adviser registered under the Investment Advisers Act of 1940, as amended. Seneca, whose sole business is investment management, manages fixed-income and equity assets for pension and profit-sharing plans, financial institutions, such as banking and insurance companies, and mutual funds for retail and institutional investors. Seneca had over 100 full-time employees and approximately $13 billion of institutional and private investment accounts on September 30, 2004.

From time to time, we will assess whether we should be internally managed. In May 2004, our board of directors formed a committee of independent directors to assess the advisability of internalization. We believe this on-going assessment will consider a number of factors, including, without limitation, our ability to attract and retain full-time employees, and the costs, expenses and potential efficiencies related to becoming internally managed.

A majority of Seneca s outstanding equity interests are owned by Phoenix Investment Partners, Ltd., or Phoenix. Phoenix is a wholly owned subsidiary of The Phoenix Companies, Inc. (NYSE: PNX). Our board of directors consists of seven members, five of whom are not affiliated with Seneca or Phoenix. Neither this prospectus nor any offering or sale of securities made through this prospectus and a related prospectus supplement are endorsed or guaranteed in any way by Seneca or Phoenix.

Our executive officers have significant experience in providing investment advisory services, with an average of 17 years of experience. Prior to founding Seneca in 1989, Gail P. Seneca, our chief executive officer, spent two years as senior vice president of the Asset Management Division of Wells Fargo Bank, where she managed fixed-income assets in excess of $10 billion. Before joining Seneca as its fixed income chief investment officer, Albert J. Gutierrez, our president, spent two years as head of portfolio management, trading and investment systems at American General Investment Management, where he was responsible for approximately $75 billion in client assets, and 12 years with Conseco Capital Management as a senior vice president in charge of fixed income research and trading as well as insurance asset portfolio management. Other than our full-time chief financial officer, all of our executive officers are also employees and/or officers of Seneca, as described in the following table:

Name	Position with Seneca	Position with Us
Gail P. Seneca, Ph.D.	President/Chief Executive Officer and Chief Investment Officer	Chairman of the Board of Directors and Chief Executive Officer
Albert J. Gutierrez, CFA	Fixed Income Chief Investment Officer and Principal	President and Director
Christopher J. Zyda	None	Senior Vice President and Chief Financial Officer
Andrew S. Chow, CFA	Fixed Income Portfolio Manager	Senior Vice President

The Management Agreement

Pursuant to our management agreement, Seneca, as our sole manager, generally implements our business strategy, is responsible for our day-to-day operations and performs services and activities relating to our assets and operations in accordance with the terms of the management agreement. The management agreement will remain in effect until terminated. Seneca s services for us can be divided into the following three principal activities:

Asset Management Seneca advises us with respect to, arranges for and manages the acquisition, financing, management and disposition of, our investments.

Liability Management Seneca evaluates the credit risk and prepayment risk of our investments and arranges borrowing and hedging strategies.

Capital Management Seneca coordinates our capital raising activities.

In conducting these activities, Seneca advises us on the formulation of, and implements, our operating strategies and policies, arranges for our acquisition of assets, monitors the performance of our assets, arranges for various types of financing and hedging strategies and provides administrative and managerial services in connection with our operations. At all times in the performance of these activities, Seneca is subject to the direction and oversight of our board of directors.

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Pursuant to the management agreement and a cost-sharing agreement between Seneca and us, Seneca may earn or be entitled to receive the following compensation, fees and other benefits:

Base management fee 1% per annum of the first $300 million of our average net worth, plus 0.8% per annum of our average net worth in excess of $300 million during such fiscal year, calculated on a quarterly basis.

Incentive compensation a specified percentage of our REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) in excess of a threshold amount of taxable income, calculated on a quarterly basis and subject to annual reconciliation.

*Out-of-*pocket expense reimbursements reimbursement of actual out-of-pocket expenses incurred in connection with our administration on an ongoing basis.

Reimbursement of overhead expenses reimbursement of actual costs attributable to our use of services rendered by Seneca pursuant to the cost-sharing agreement. Our portion of such costs is allocated to us as determined by Seneca, subject to reasonable approval by a majority of our independent directors.

Termination fee payable only upon termination by us without cause or by Seneca upon our change of control. Actual amount of fee depends on the circumstances of the termination.

For a more detailed discussion of the compensation and other fees payable to Seneca, as well as our and Seneca s right to terminate the management agreement, see the management agreement and cost-sharing agreement incorporated by reference as exhibits to the registration statement of which this prospectus is a part.

Conflicts of Interest

We are subject to potential conflicts of interest involving Seneca because, among other reasons:

the incentive compensation, which is based on our net income, may create an incentive for Seneca to recommend investments with greater income potential, which may be relatively more risky than would be the case if its compensation from us did not include an incentive-based component;

Seneca is permitted to purchase mortgage-backed securities for its own account and to advise accounts of other clients, and certain investment opportunities appropriate for us also will be appropriate for these accounts; and

two of our directors, and all but one of our executive officers, are managers or employees of, or otherwise affiliated with, Seneca.

The management agreement does not limit or restrict the right of Seneca from engaging in any business or rendering services to any other person, including, without limitation, the purchase of, or rendering advice to others purchasing, mortgage-backed securities that meet our investment guidelines. However, Seneca has agreed that for as long as Seneca is our exclusive manager pursuant to the management agreement, it will not sponsor any other mortgage REIT that invests primarily in high-quality, residential mortgage-backed securities, without first obtaining the approval of a majority of our independent directors.

SUMMARY OF THE SECURITIES OFFERED BY THIS PROSPECTUS

We may offer any of the following securities from time to time:

- common stock;
- preferred stock;
- warrants to purchase common stock or preferred stock; and
- debt securities.

When we use the term securities in this prospectus, we mean any of the securities we may offer with this prospectus, unless we indicate otherwise. The total dollar amount of all securities that we may issue will not exceed $500,000,000. This prospectus, including the following summary of the securities we may issue, describes the general terms of such securities. The specific terms of any particular securities we may offer will be described in a separate prospectus supplement.

Common Stock

We may offer shares of our common stock, which is currently traded on the New York Stock Exchange under the symbol LUM . See Description of Capital Stock beginning on page 21 of this prospectus.

Preferred Stock

We may offer our preferred stock in one or more series. For any particular series we offer, the applicable prospectus supplement will describe the specific designation; the aggregate number of shares offered; the rate and periods, or the method of calculating the rate and periods for dividends, if any; the stated value and liquidation preference, if any; the voting rights, if any; the terms on which the series will be convertible into or exchangeable for other securities or property, if any; the redemption terms, if any and any other specific terms of the particular series of preferred stock. See Description of Capital Stock beginning on page 21 of this prospectus.

Warrants

We may offer warrants to purchase our common stock or preferred stock. For any warrants we offer, the applicable prospectus supplement will describe the security underlying the warrant; the expiration date of the warrant; the exercise price or other method of determining the exercise price; the amount and kind, or the method of determining the amount and kind, of the security to be issued upon the exercise of the warrant and any other specific terms. See Description of Capital Stock Warrants beginning on page 27 of this prospectus.

Debt Securities

We may offer debt securities in one or more series. The debt securities will be our direct unsecured general obligations and may include debentures, notes, bonds or other evidences of indebtedness. The applicable prospectus supplement will describe the terms of any debt securities. See Description of Debt Securities beginning on page 30 of this prospectus.

RISK FACTORS

An investment in our securities involves various risks. Before you decide to invest in our securities, you should consider carefully the following risk factors in connection with the other information in this prospectus, the prospectus supplement accompanying this prospectus and the documents incorporated herein by reference. Our business, financial condition or results of operations could be harmed if any of these risks or uncertainties actually occurs. In that event, the price of our securities could decline and you might lose all or part of your investment. Our actual results could differ materially from those anticipated by our forward-looking statements as a result of the risk factors described below, in any prospectus supplement and the documents incorporated herein by reference. These risks are not the only ones that may affect us. Additional risks not presently known to us or that we currently deem immaterial might also impair our business operations.

Risks Related to Our Business

Interest rate mismatches between our mortgage-backed securities and the borrowings used to fund our purchases of mortgage-backed securities might reduce our net income or result in losses during periods of changing interest rates.

We invest primarily in adjustable-rate and hybrid adjustable-rate mortgage-backed securities. The mortgages underlying these adjustable-rate mortgage-backed securities have interest rates that reset periodically, typically every six months or on an annual basis, based upon market-based indices of interest rates such as U.S. Treasury bonds or LIBOR, the interest rate that banks in London offer for deposits in London of U.S. dollars. The mortgages underlying hybrid adjustable-rate mortgage-backed securities have interest rates that are fixed for the first few years of the loan typically three, five, seven or 10 years and thereafter their interest rates reset periodically similar to the mortgages underlying adjustable-rate mortgage-backed securities. We have funded our acquisitions, and expect to fund our future acquisitions, of adjustable-rate and hybrid adjustable-rate mortgage-backed securities in part with borrowings that have interest rates based on indices and repricing terms similar to, but with shorter maturities than, the interest rate indices and repricing terms of our adjustable-rate and hybrid adjustable-rate mortgage-backed securities. During periods of changing interest rates, this interest rate mismatch between our assets and liabilities could reduce or eliminate our net income and distributions to our stockholders and could cause us to suffer a loss.

Accordingly, in a period of rising interest rates, we could experience a decrease in, or elimination of, our net income or a net loss because the interest rates on our borrowings could increase faster than the interest rates on our adjustable-rate mortgage-backed securities. Conversely, in a period of declining interest rates, we could experience a decrease in, or elimination of, our net income or a net loss because our amortization of premiums could increase.

Increased levels of prepayments on the mortgages underlying our mortgage-backed securities might decrease our net interest income or result in a net loss.

The mortgage-backed securities that we acquire generally represent interests in pools of mortgage loans. The principal and interest payments we receive from our mortgage-backed securities are generally funded by the payments that mortgage borrowers make on those underlying mortgage loans. When borrowers prepay their mortgage loans sooner than expected, corresponding prepayments on the mortgage-backed securities occur sooner than expected by the marketplace. Sooner-than-expected prepayments could harm our results of operations in the following ways, among others:

We seek to purchase mortgage-backed securities that we believe to have favorable risk-adjusted expected returns relative to market interest rates at the time of purchase. If the coupon interest rate for a mortgage-backed security is higher than the market interest rate at the time it is purchased, then that mortgage-backed security will be acquired at a premium to its par value.

In accordance with applicable accounting rules, we are required to amortize any premiums or accrete discounts related to our mortgage-backed securities over their expected terms. The amortization of a premium reduces interest income, while the accretion of a discount increases interest income. The expected terms for mortgage-backed securities are a function of the prepayment rates for the mortgages underlying the mortgage-backed securities. Mortgage-backed securities that are at a premium to their par value are more likely to experience prepayment of some or all of their principal through refinancings. If the mortgages underlying our mortgage-backed securities purchased at a premium are prepaid in whole or in part more quickly than their respective maturity dates, then we must also amortize their respective premiums more quickly, which would decrease our net interest income and harm our profitability.

A substantial portion of our adjustable-rate mortgage-backed securities may bear interest at rates that are lower than their fully-indexed rates, which refers to their applicable index rates plus a margin. If an adjustable-rate mortgage-backed security is prepaid prior to or soon after the time of adjustment to a fully-indexed rate, we will have held that mortgage-backed security while it was less profitable and lost the opportunity to receive interest at the fully-indexed rate over the remainder of its expected life.

If we are unable to acquire new mortgage-backed securities to replace the prepaid mortgage-backed securities, our financial condition, results of operations and cash flow may suffer and we could incur losses.

Prepayment rates generally increase when interest rates decline and decrease when interest rates rise; however, changes in prepayment rates may lag behind changes in interest rates and are difficult to predict. Prepayment rates also may be affected by other factors, including, without limitation, conditions in the housing and financial markets, general economic conditions and the relative interest rates on adjustable-rate and fixed-rate mortgage loans. While we seek to minimize prepayment risk, we must balance prepayment risk against other risks and the potential returns of each investment when selecting investments. No strategy can completely insulate us from prepayment or other such risks.

We depend on short-term borrowings to purchase mortgage-related assets and reach our desired amount of leverage. If we fail to obtain or renew sufficient funding on favorable terms or at all, we will be limited in our ability to acquire mortgage-related assets, which will harm our results of operations.

We depend on short-term borrowings to fund acquisitions of mortgage-related assets and reach our desired amount of leverage. Accordingly, our ability to achieve our investment and leverage objectives depends on our ability to borrow money in sufficient amounts and on favorable terms. In addition, we must be able to renew or replace our maturing short-term borrowings on a continuous basis. We depend on a few lenders to provide the primary credit facilities for our purchases of mortgage-related assets. In addition, our existing indebtedness may limit our ability to make additional borrowings. If our lenders do not allow us to renew our borrowings or we cannot replace maturing borrowings on favorable terms or at all, we might have to sell our mortgage-related assets under adverse market conditions, which would harm our results of operations and may result in losses.

Our leverage strategy increases the risks of our operations, which could reduce our net income and the amount available for distributions or cause us to suffer a loss.

We generally seek to borrow between eight and 12 times the amount of our equity, although at times our borrowings may be above or below this amount. We incur this indebtedness by borrowing against a substantial portion of the market value of our mortgage-backed securities. Our total indebtedness, however, is not expressly limited by our policies and depends on our and our prospective lender s estimate of the stability of our portfolio s cash flow. We face the risk that we might not be able to meet our debt service obligations or a lender s margin requirements from our income and, to the extent we cannot, we might be forced to liquidate some of our assets at disadvantageous prices. Our use of leverage amplifies the risks associated with other risk factors, which could reduce our net income and the amount available for distributions or cause us to suffer a loss. For example:

A majority of our borrowings are secured by our mortgage-backed securities, generally under repurchase agreements. A decline in the market value of our mortgage-backed securities used to secure these debt obligations could limit our ability to borrow or result in lenders requiring us to pledge

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additional collateral to secure our borrowings. In that situation, we could be required to sell mortgage-backed securities under adverse market conditions in order to obtain the additional collateral required by the lender. If these sales are made at prices lower than the carrying value of our mortgage-backed securities, we would experience losses.

A default under a mortgage-related asset that constitutes collateral for a loan could also result in an involuntary liquidation of the mortgage-related asset, including any cross-collateralized mortgage-backed securities. This circumstance would result in a loss to us to the extent that the value of our mortgage-related asset upon liquidation is less than the amount we borrowed against the mortgage-related asset.

To the extent we are compelled to liquidate qualified REIT assets to repay our debts or further collateralize them, our compliance with the REIT rules regarding our assets and our sources of income could be negatively affected, which could jeopardize our status as a REIT. Losing our REIT status would cause us to lose tax advantages applicable to REITs and would decrease our overall profitability and our distributions to our stockholders.

If we experience losses as a result of our leverage policy, such losses would reduce the amounts available for distribution to our stockholders.

We may incur increased borrowing costs related to repurchase agreements that would harm our results of operations.

Our borrowing costs under repurchase agreements are generally adjustable and correspond to short-term interest rates, such as LIBOR or a short-term Treasury index, plus or minus a margin. The margins on these borrowings over or under short-term interest rates may vary depending upon a number of factors, including, without limitation, the following:

- the movement of interest rates;
- the availability of financing in the market; and
- the value and liquidity of our mortgage-backed securities.

Most of our borrowings are collateralized borrowings in the form of repurchase agreements. If the interest rates on these repurchase agreements increases, our results of operations will be harmed and we may have losses.

We have only been in business since June 2003 and our implementation of our operating policies and strategies may not continue to be successful.

We began operations in June 2003, and therefore have a limited operating history. Our results of operations depend on many factors, including the availability of opportunities to acquire mortgage-related assets, the level and volatility of interest rates, readily accessible short- and long-term funding alternatives in the financial markets and economic conditions. Moreover, delays in fully leveraging and investing the net proceeds of our public offerings may cause our performance to be weaker than other fully leveraged and invested mortgage REITs pursuing comparable investment strategies. Furthermore, we face the risk that our implementation of our operating policies and strategies may not continue to be successful.

Our board of directors may change our operating policies and strategies without stockholder approval or prior notice and such changes could harm our business and results of operations and the value of our stock.

Our board of directors has the authority to modify or waive our current operating policies and our strategies, including our election to operate as a REIT, without prior notice and without stockholder approval. We cannot predict the effect any changes to our current operating policies and strategies would have on our business, operating results and value of our stock. However, the effects might be adverse.

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

We depend on the diligence, experience and skill of our officers and the Seneca personnel who provide management services to us for the selection, acquisition, structuring, monitoring and sale of our mortgage-related assets and the borrowings used to acquire these assets. Our key officers include Gail P. Seneca, Albert J. Gutierrez, Christopher J. Zyda and Andrew S. Chow. We have not entered into employment agreements with our key officers other than Mr. Zyda, who is our Senior Vice President and Chief Financial Officer. With the exception of Mr. Zyda, none of our senior officers, including Ms. Seneca and Messrs. Gutierrez and Chow, devote all of their business time to our business and are free to engage in competitive activities in our industry. In addition, our management agreement with Seneca pursuant to which Ms. Seneca and Messrs. Gutierrez and Chow provide management services to us is terminable by Seneca at any time upon 60 days notice. The loss of our key officers or the termination of our management agreement with Seneca could harm our business, financial condition, cash flow and results of operations.

Competition might prevent us from acquiring mortgage-backed securities at favorable yields, which would harm our results of operations.

Our net income depends on our ability to acquire mortgage-backed securities at favorable spreads over our borrowing costs. In acquiring mortgage-backed securities, we compete with other REITs, investment banking firms, savings and loan associations, banks, insurance companies, mutual funds, other lenders and other entities that purchase mortgage-backed securities, many of which have greater financial resources than we do. As a result, we may not be able to acquire sufficient mortgage-backed securities at favorable spreads over our borrowing costs, which would harm our results of operations.

Interest rate caps related to our mortgage-backed securities may reduce our net income or cause us to suffer a loss during periods of rising interest rates.

The mortgages underlying our mortgage-backed securities are typically subject to periodic and lifetime interest rate caps. Periodic interest rate caps limit the amount that the interest rate of a mortgage can increase during any given period. Lifetime interest rate caps limit the amount an interest rate can increase through the maturity of a mortgage.

Our borrowings are not subject to similar restrictions. The periodic adjustments to the interest rates of the mortgages underlying our mortgage-backed securities are based on changes in an objective index. Substantially all of the mortgages underlying our mortgage-backed securities adjust their interest rates based on one of two main indices, the U.S. Treasury index, which is a monthly or weekly average yield of benchmark U.S. Treasury securities published by the Federal Reserve Board, or LIBOR.

Accordingly, in a period of rapidly increasing interest rates, the interest rates paid on our borrowings could increase without limitation while interest rate caps could limit the increases in the yields on our mortgage-backed securities. This problem is magnified for mortgage-backed securities that are not fully indexed. Further, some of the mortgages underlying our mortgage-backed securities may be subject to periodic payment caps that result in a portion of the interest being deferred and added to the principal outstanding. As a result, we may receive less cash income on our mortgage-backed securities than we need to pay interest on our related borrowings. These factors could reduce our net interest income or cause us to suffer a net loss.

We might experience reduced net interest income or a loss from holding fixed-rate investments during periods of rising interest rates.

A significant portion of our investment portfolio consists of hybrid adjustable-rate mortgage-backed securities. We may also invest in fixed-rate mortgage-backed securities from time to time. We fund our acquisition of fixed-rate mortgage-backed securities, including those based on balloon maturity and hybrid adjustable-rate mortgages, in part with short-term repurchase agreements and term loans. During periods of rising interest rates, our costs associated with borrowings used to fund the acquisition of fixed-rate mortgage-backed securities are subject to increases, while the income we earn from these assets remains substantially fixed. The reduction or elimination of the net interest spread between the fixed-rate mortgage-backed securities that we purchase and our borrowings used to purchase them would reduce our net interest income and could cause us to suffer a loss.

We might not be able to use derivatives to mitigate our interest rate and prepayment risks.

Our policies permit us to enter into interest rate swaps, caps and floors and other derivative transactions in an effort to reduce our interest rate and prepayment risks. These transactions might mitigate our interest rate and prepayment risks, but cannot eliminate these risks. Moreover, the use of derivative transactions could have a negative impact on our net income and our status as a REIT and, therefore, our use of such derivatives could be limited.

We may enter into ineffective derivative transactions or other hedging activities that may reduce our net interest rate spread or cause us to suffer losses.

Our policies permit us, but we are not required, to enter into derivative transactions such as interest rate swaps, caps and floors and other derivative transactions to help us seek to reduce our interest rate and prepayment risks. The effectiveness of any derivative transaction will depend significantly upon whether we correctly quantify the interest rate or prepayment risks being hedged, our execution of and ongoing monitoring of our hedging activities and the treatment of such hedging activities under generally accepted accounting principles in the United States, or GAAP.

In the case of these hedges, and any other efforts to mitigate the effects of interest rate changes on our liability costs, if we enter into hedging instruments that have higher interest rates embedded in them as a result of the forward yield curve, and at the end of the term of these hedging instruments the spot market interest rates for the liabilities that we hedged are actually lower, then we will have locked in higher interest rates for our liabilities than would be available in the spot market at the time which could result in a narrowing of our net interest rate spread or result in losses. In some situations, we may sell assets or hedging instruments at a loss in order to maintain adequate liquidity.

In addition, we apply Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted, and record derivatives at fair value. If the derivatives meet the criteria to be accounted for as hedging transactions, the effects of the transactions could be materially different as to timing than if they do not qualify as hedges, which may cause a narrowing of our net interest rate spread or result in losses.

An increase in interest rates might adversely affect our book value.

We use changes in 10-year U.S. Treasury yields as a reference indicator for changes in interest rates because it is a common market benchmark. Increases in the general level of interest rates can cause the fair market value of our assets to decline, particularly those mortgage-backed securities whose underlying mortgages have fixed-rate components. Our fixed-rate mortgage-backed securities and our hybrid adjustable-rate mortgage-backed securities (during the fixed-rate component of the mortgages underlying such securities) will generally be more negatively affected by such increases than our adjustable-rate mortgage-backed securities. In accordance with GAAP, we will be required to reduce the carrying value of our mortgage-backed securities by the amount of any decrease in the fair value of our mortgage-backed securities compared to their respective amortized costs. If unrealized losses in fair value occur, we will have to either reduce current earnings or reduce stockholders equity without immediately affecting current earnings, depending on how we classify such mortgage-backed securities under GAAP. In either case, our net book value will decrease to the extent of any realized or unrealized losses in fair value.

We may invest in leveraged mortgage derivative securities that generally experience greater volatility in market prices, and thus expose us to greater risk with respect to their rate of return.

We may acquire leveraged mortgage derivative securities that expose us to a high level of interest rate risk. The characteristics of leveraged mortgage derivative securities cause those securities to experience greater volatility in their market prices. Thus, acquisition of leveraged mortgage derivative securities will expose us to the risk of greater volatility in our portfolio, which could reduce our net income and harm our overall results of operations.

Possible market developments could cause our lenders to require us to pledge additional assets as collateral. If our assets are insufficient to meet the collateral requirements, we might be compelled to liquidate particular assets at inopportune times and at disadvantageous prices.

Possible market developments, including a sharp or prolonged rise in interest rates, an increase in prepayment rates or increasing market concern about the value or liquidity of one or more types of mortgage-backed securities in which our portfolio is concentrated, might reduce the market value of our portfolio, which might cause our lenders to require additional collateral. Any requirement for additional collateral might compel us to liquidate our assets at inopportune times and at disadvantageous prices, thereby harming our operating results. If we sell our mortgage-backed securities at prices lower than their carrying value, we would experience losses.

Because the assets that we acquire might experience periods of illiquidity, we might be prevented from selling our mortgage-related assets at opportune times and prices.

We bear the risk of being unable to dispose of our mortgage-related assets at advantageous times and prices or in a timely manner because mortgage-related assets generally experience periods of illiquidity. The lack of liquidity might result from the absence of a willing buyer or an established market for these assets, as well as legal or contractual restrictions on resale. If we are unable to sell our mortgage-related assets at opportune times, we might suffer a loss and/or reduce our distributions.

We remain subject to losses despite our strategy of investing in highly-rated mortgage-backed securities.

Our investment guidelines provide that at least 90% of our assets must be invested in mortgage-backed securities that are either agency-backed or are rated at least investment grade by at least one nationally recognized statistical rating agency. While highly-rated mortgage-backed securities are generally subject to a lower risk of default than lower credit quality mortgage-backed securities and may benefit from third-party credit enhancements such as insurance or corporate guarantees, there is no assurance that such mortgage-backed securities will not be subject to credit losses. Furthermore, ratings are subject to change over time as a result of a number of factors, including greater than expected delinquencies, defaults or credit losses or a deterioration in the financial strength of corporate guarantors, any of which may reduce the market value of such securities. Furthermore, ratings do not take into account the reasonableness of the issue price, interest risks, prepayment risks, extension risks or other risks associated with such mortgage-backed securities. As a result, while we attempt to mitigate our exposure to credit risk on a relative basis by focusing on highly-rated mortgage-backed securities, we cannot eliminate such credit risks and remain subject to other risks to our investment portfolio and may suffer losses, which may harm the market price of our common stock.

Our investment guidelines permit us to invest up to 10% of our assets in unrated mortgage-related assets and mortgage-backed securities rated below investment-grade, which carry a greater likelihood of default or rating downgrade than investments in investment-grade mortgage-backed securities and may cause us to suffer losses.

Our investment guidelines allow us to invest up to 10% of our assets in lower credit quality mortgage-related assets, including mortgage-backed securities that are not rated at least investment grade by at least one nationally-recognized statistical rating organization, and other investments such as leveraged mortgage derivative securities, shares of other REITs, mortgage loans or other mortgage-related investments. If we

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acquire non-investment-grade mortgage-backed securities, which may include residual mortgage-backed securities, we are more likely to incur losses because the mortgages underlying those securities are made to borrowers possessing lower-quality credit. While all mortgage-backed securities are subject to a risk of default, that risk is greater with non-investment grade mortgage-backed securities. In addition, the rating agencies are more likely to downgrade the credit quality of those securities, which would reduce the value of those securities.

Our use of repurchase agreements to borrow funds may give our lenders greater rights in the event that either we or any of our lenders file for bankruptcy.

Our borrowings under repurchase agreements may qualify for special treatment under the bankruptcy code, giving our lenders the ability to avoid the automatic stay provisions of the bankruptcy code and to take possession of and liquidate our collateral under the repurchase agreements without delay if we file for bankruptcy. Furthermore, the special treatment of repurchase agreements under the bankruptcy code may make it difficult for us to recover our pledged assets in the event that any of our lenders files for bankruptcy. Thus, the use of repurchase agreements exposes our pledged assets to risk in the event of a bankruptcy filing by any of our lenders or us.

Defaults on the mortgage loans underlying our mortgage-backed securities may reduce the value of our investment portfolio and may harm our results of operations.

We bear the risk of any losses resulting from any defaults on the mortgage loans underlying the mortgage-backed securities in our investment portfolio. Many of the mortgage-backed securities that we acquire have one or more forms of credit enhancement provided by third parties, such as insurance against risk of loss due to default on the underlying mortgage loans or bankruptcy, fraud and special hazard losses. To the extent that third parties have agreed to insure against these types of losses, the value of such insurance will depend in part on the creditworthiness and claims-paying ability of the insurer and the timeliness of reimbursement in the event of a default on the underlying obligations. Further, the insurance coverage for various types of losses is limited in amount, and we would bear losses in excess of these limitations.

Other mortgage-backed securities that we purchase are subject to limited guarantees of the payment of limited amounts of principal and interest on mortgage loans underlying such mortgage-backed securities, either by federal government agencies, including Ginnie Mae, by federally-chartered corporations, including Fannie Mae and Freddie Mac, or by other corporate guarantors. While Ginnie Mae s obligations are backed by the full faith and credit of the United States, the obligations of Fannie Mae and Freddie Mac and other corporate guarantors are solely their own. As a result, a substantial deterioration in the financial strength of Fannie Mae, Freddie Mac or other corporate guarantors could increase our exposure to future delinquencies, defaults or credit losses on our holdings of Fannie Mae or Freddie Mac-backed mortgage-backed securities or other corporate-backed mortgage-backed securities, and could harm our results of operations. In addition, while Freddie Mac guarantees the eventual payment of principal, it does not guarantee the timely payment thereof, and our results of operations may be harmed if borrowers are late or delinquent in their payments on mortgages underlying Freddie Mac-backed mortgage-backed securities. Moreover, Fannie Mae, Freddie Mac, Ginnie Mae and other corporate guarantees relate only to payments of limited amounts of principal and interest on the mortgages underlying such agency-backed or corporate-backed securities, and do not guarantee the market value of such mortgage-backed securities or the yields on such mortgage-backed securities. As a result, we remain subject to interest rate risks, prepayment risks, extension risks and other risks associated with our investment in such mortgage-backed securities and may experience losses in our investment portfolio.

Decreases in the value of the property underlying our mortgage-backed securities might decrease the value of our assets.

The mortgage-backed securities in which we invest are secured by underlying real property interests. To the extent that the value of the property underlying our mortgage-backed securities decreases, our security might be impaired, which might decrease the value of our assets.

Insurance will not cover all potential losses on the underlying real property and the absence thereof may harm the value of our assets.

Under our asset acquisition policy, we are permitted to invest up to a maximum of 10% of our total assets in assets other than agency-backed securities, or rated as at least investment grade by a nationally recognized statistical rating agency. Mortgage loans that fall outside of this category of investments under our investment guidelines are subject to the 10% limitation. If we elect to purchase mortgage loans, we may require that each of the mortgage loans that we purchase include comprehensive insurance covering the underlying real property, including liability, fire and extended coverage. Certain types of losses, however, generally of a catastrophic nature, such as earthquakes, floods and hurricanes, may be uninsurable or not economically insurable. Inflation, changes in building codes and ordinances, environmental considerations and other factors might also make it infeasible to use insurance proceeds to replace a property if it is damaged or destroyed. Under such circumstances, the insurance proceeds, if any, might not be adequate to restore the economic value of the underlying real property, which might impair our security and decrease the value of our assets.

Distressed mortgage loans have a higher risk of future default.

If we elect to purchase mortgage loans, we may purchase distressed mortgage loans as well as mortgage loans that have had a history of delinquencies. These distressed mortgage loans may be in default or may have a greater than normal risk of future defaults and delinquencies, compared to a pool of newly-originated, high quality loans of comparable type, size and geographic concentration. Returns on an investment of this type depend on accurate pricing of such investment, the borrower s ability to make required payments or, in the event of default, the ability of the loan s servicer to foreclose and liquidate the mortgage loan. We cannot assure you that the servicer will be able to liquidate a defaulted mortgage loan in a cost-effective manner, at an advantageous price or in a timely manner.

Subordinated loans on real estate are subject to higher risks.

If we elect to purchase mortgage loans, we may acquire loans secured by commercial properties, including loans that are subordinated to first liens on the underlying commercial real estate. Subordinated mortgage loans are subject to greater risks of loss than first lien mortgage loans. An overall decline in the real estate market could reduce the value of the real property securing such loans such that the aggregate outstanding balance of the second-lien loan and the outstanding balance of the more senior loan on the real property exceed the value of the real property.

Risks Related to Seneca

We pay Seneca incentive compensation based on our portfolio s performance. This arrangement may lead Seneca to recommend riskier or more speculative investments in an effort to maximize its incentive compensation.

In addition to its base management fee, Seneca earns incentive compensation for each fiscal quarter equal to a specified percentage of the amount by which our taxable income, before deducting incentive compensation, exceeds a return on equity based on the 10-year U.S. Treasury rate plus 2%. The percentage for this calculation is the weighted-average of the following percentages based on our average net invested assets for the fiscal quarter:

20% for the first $400 million of our average net invested assets; and

10% of our average net invested assets in excess of $400 million.

Pursuant to the formula for calculating Seneca s incentive compensation, Seneca shares in our profits but not in our losses. Consequently, as Seneca evaluates different mortgage-backed securities and other investments for our account, there is a risk that Seneca will cause us to assume more risk than is prudent in an attempt to increase its incentive compensation. Other key criteria related to determining appropriate investments and investment strategies, including the preservation of capital, might be under-weighted if Seneca focuses exclusively or disproportionately on maximizing its incentive income from us.

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We may be obligated to pay Seneca incentive compensation even if we incur a loss.

Pursuant to the management agreement, Seneca is entitled to receive incentive compensation for each fiscal quarter in an amount equal to a tiered percentage of the excess of our taxable income for that quarter (before deducting incentive compensation, net operating losses and certain other items) above a threshold return for that quarter. In addition, the management agreement further provides that our taxable income for incentive compensation purposes excludes net capital losses that we may incur in the fiscal quarter, even if such capital losses result in us incurring net loss for that quarter. Thus, we may be required to pay Seneca incentive compensation for a fiscal quarter even if there is a decline in the value of our portfolio or we incur a net loss for that quarter.

Because Seneca is entitled to a significant fee if we terminate the management agreement, economic considerations might preclude us from terminating the management agreement in the event that Seneca fails to meet our expectations.

From time to time, we will assess whether we should be internally managed. In May 2004, our board of directors formed a committee of independent directors to assess the advisability of internalization and this assessment is currently ongoing. If we terminate the management agreement without cause or because we decide to manage our company internally or if Seneca terminates the management in the event of a change of control, then we will have to pay a significant fee to Seneca. The amount of the fee depends on whether:

- we terminate the management agreement without cause in connection with a decision to manage our portfolio internally, in which case we will be obligated to pay to Seneca a fee equal to the highest amount of management fee incurred in a particular year during the then three most recent years; or

- our decision to terminate the management agreement without cause is for a reason other than our decision to manage our portfolio internally, in which case we will be obligated to pay Seneca an amount equal to two times the highest amount of management fee incurred in a particular year during the then three most recent years.

In each of the above cases, Seneca will also receive accelerated vesting of the stock component of its incentive compensation. The actual amount of such fee cannot be known at this time because it is based in part on the performance of our portfolio of mortgage-backed securities. Paying this fee would reduce significantly the cash available for distribution to our stockholders and might cause us to suffer a net operating loss. Consequently, terminating the management agreement might not be advisable even if we determine that it would be more efficient to operate with an internal management structure or if we are otherwise dissatisfied with Seneca s performance.

Seneca s liability is limited under the management agreement, and we have agreed to indemnify Seneca against certain liabilities.

Seneca has not assumed any responsibility to us other than to render the services described in the management agreement, and is not responsible for any action of our board of directors in declining to follow Seneca s advice or recommendations. Seneca and its directors, officers and employees will not be liable to us for acts performed by its officers, directors or employees in accordance with and pursuant to the management agreement, except for acts constituting gross negligence, recklessness, willful misconduct or active fraud in connection with their duties under the management agreement. We have agreed to indemnify Seneca and its directors, officers and employees with respect to all expenses, losses, damages, liabilities, demands, charges and claims arising from acts of Seneca not constituting gross negligence, recklessness, willful misconduct or active fraud.

Seneca might allocate mortgage-related opportunities to other entities, and thus might divert attractive investment opportunities away from us.

Our operations and assets are managed by specified individuals at Seneca. Seneca and those individuals, including some of our officers, manage mortgage and other portfolios for parties unrelated to us. These multiple responsibilities might create conflicts of interest for Seneca and these individuals if they are presented with opportunities that might benefit us and Seneca s other clients. Seneca and these individuals must allocate investments among our portfolio and their other clients by determining the entity or account for which the investment is most suitable. In making this determination, Seneca and these individuals consider the investment strategy and guidelines of each entity or account with respect to the acquisition of assets, leverage, liquidity and other factors that Seneca and these individuals determine to be appropriate. However, Seneca and those working on its behalf have no obligation to make any specific investment opportunities available to us and the above-mentioned conflicts of interest might result in decisions or allocations of investments that are not in our or our stockholders best interests.

Seneca may render services to other mortgage investors, which could reduce the amount of time and effort that Seneca devotes to us.

Our management agreement with Seneca does not restrict the right of Seneca or any persons working on its behalf to carry on their respective businesses, including the rendering of advice to others regarding the purchase of mortgage-backed securities that would meet our investment criteria. In addition, the management agreement does not specify a minimum time period that Seneca and its personnel must devote to managing our investments. The ability of Seneca to engage in these other business activities, and specifically to manage mortgage-related assets for third parties, could reduce the time and effort it spends managing our portfolio to the detriment of our investment returns.

Seneca has significant influence over our affairs, and might cause us to engage in transactions that are not in our or our stockholders best interests.

In addition to managing us and having two of its officers as members of our board, Seneca provides advice on our operating policies and strategies. Seneca may also cause us to engage in future transactions with Seneca and its affiliates, subject to the approval of, or guidelines approved by, the independent members of our board of directors. Our directors, however, rely primarily on information supplied by Seneca in reaching their determinations. Accordingly, Seneca has significant influence over our affairs, and may cause us to engage in transactions that are not in our or our stockholders best interests.

Seneca has limited experience managing a REIT and we cannot assure you that Seneca s past experience will be sufficient to manage our business as a REIT successfully.

Seneca has limited experience managing a REIT, and limited experience in complying with the income, asset and other limitations imposed by the REIT provisions of the Internal Revenue Code. Those provisions are complex and the failure to comply with those provisions in a timely manner could cause us to lose our qualification as a REIT or could force us to pay unexpected taxes and penalties. In such event, our net income would be reduced and we could incur a loss.

During periods of declining market prices for our common stock, we may be required to issue greater numbers of shares to Seneca for the same amount of incentive compensation arising under the management agreement, which will have a dilutive effect on our stockholders that may harm the market price of our common stock.

Pursuant to the terms of the management agreement, the incentive compensation payable to Seneca for each fiscal quarter is paid one-half in cash and one-half in restricted shares of our common stock. The number of shares to be issued to Seneca is based on (a) one-half of the total incentive compensation for the period, divided by (b) the average of the closing prices of our common stock over the 30-day period ending three calendar days prior to the grant date, less a fair market value discount determined by our board of directors on a quarterly basis. During periods of declining market prices of our common stock, we may be required to issue more shares to Seneca for the same amount of incentive compensation. Although these shares are subject to restrictions on transfer that lapse ratably over a three-year period, the issuance of these shares will have a dilutive effect on our stockholders that may harm the market price of our common stock.

Investors may not be able to estimate with certainty the aggregate fees and expense reimbursements that will be paid to Seneca under the management agreement and the cost-sharing agreement due to the time and manner in which Seneca s incentive compensation and expense reimbursements are determined.

Seneca may be entitled to substantial fees pursuant to the management agreement. Seneca s base management fee is calculated as a percentage of our average net worth. Seneca s incentive compensation is calculated as a tiered percentage of our taxable income, before deducting certain items, in excess of a threshold amount of taxable income and is indeterminable in advance of a particular period. Since future payments of base management fees, incentive compensation and expense reimbursements are determined at future dates based upon our then-applicable average net worth, results of operations and actual expenses incurred by Seneca, such fees and expense reimbursements cannot be estimated with mathematical certainty. Any base management fees, incentive compensation or expense reimbursements payable to Seneca may be materially greater or less than the historical amounts and we can provide no assurance at this time as to the amount of any such base management fee, incentive compensation or expense reimbursements that may be payable to Seneca in the future.

Legal and Tax Risks

If we are disqualified as a REIT, we will be subject to tax as a regular corporation and face substantial tax liability.

Qualification as a REIT involves the application of highly technical and complex U.S. federal income tax code provisions for which only a limited number of judicial or administrative interpretations exist. Accordingly, it is not certain we will be able to remain qualified as a REIT for U.S. federal income tax purposes. Even a technical or inadvertent mistake could jeopardize our REIT status. Furthermore, Congress or the Internal Revenue Service (the IRS), might change tax laws or regulations and the courts might issue new rulings, in each case potentially having retroactive effect, that could make it more difficult or impossible for us to qualify as a REIT in a particular tax year. If we fail to qualify as a REIT in any tax year, then:

- we would be taxed as a regular domestic corporation, which, among other things, means that we would be unable to deduct distributions to our stockholders in computing taxable income and we would be subject to U.S. federal income tax on our taxable income at regular corporate rates;

- any resulting tax liability could be substantial, would reduce the amount of cash available for distribution to our stockholders and could force us to liquidate assets at inopportune times, causing lower income or higher losses than would result if these assets were not liquidated; and

- unless we were entitled to relief under applicable statutory provisions, we would be disqualified from treatment as a REIT for the subsequent four taxable years following the year during which we lost our qualification and, thus, our cash available for distribution to our stockholders would be reduced for each of the years during which we did not qualify as a REIT.

Even if we remain qualified as a REIT, we might face other tax liabilities that reduce our cash flow. Further, we might be subject to federal, state and local taxes on our income and property. Any of these taxes would decrease cash available for distribution to our stockholders.

Complying with the REIT requirements might cause us to forego otherwise attractive opportunities.

In order to qualify as a REIT for U.S. federal income tax purposes, we must satisfy tests concerning, among other things, our sources of income, the nature and diversification of our mortgage-backed securities, the amounts we distribute to our stockholders and the ownership of our stock. We may also be required to make distributions to our stockholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with REIT requirements may cause us to forego opportunities we would otherwise pursue.

In addition, the REIT provisions of the Internal Revenue Code impose a 100% tax on income from prohibited transactions. Prohibited transactions generally include sales of assets that constitute inventory or other property held for sale in the ordinary course of a business, other than foreclosure property. This 100% tax could impact our desire to sell mortgage-backed securities at otherwise opportune times if we believe such sales could be considered a prohibited transaction.

Complying with the REIT requirements may limit our ability to hedge effectively.

The existing REIT provisions of the Internal Revenue Code substantially limit our ability to hedge mortgage-backed securities and related borrowings. Under these provisions, our annual income from qualified hedges, together with any other income not generated from qualified REIT real estate assets, is limited to less than 25% of our gross income. In addition, we must limit our aggregate income from hedging and services from all sources, other than from qualified REIT real estate assets or qualified hedges, to less than 5% of our annual gross income. As a result, we might in the future have to limit our use of advantageous hedging techniques, which could leave us exposed to greater risks associated with changes in interest rates than we would otherwise want to bear. If we fail to satisfy the 25% or 5% limitations, unless our failure was due to reasonable cause and we meet certain other technical requirements, we could lose our REIT status for federal income tax purposes. Even if our failure were due to reasonable cause, we might have to pay a penalty tax equal to the amount of our income in excess of certain thresholds, multiplied by a fraction intended to reflect our profitability.

Complying with the REIT requirements may force us to borrow to make distributions to our stockholders.

As a REIT, we must distribute 90% of our annual taxable income (subject to certain adjustments) to our stockholders. From time to time, we might generate taxable income greater than our net income for financial reporting purposes from, among other things, amortization of capitalized purchase premiums, or our taxable income might be greater than our cash flow available for distribution to our stockholders. If we do not have other funds available in these situations, we might be unable to distribute 90% of our taxable income as required by the REIT rules. In that case, we would need to borrow funds, sell a portion of our mortgage-backed securities potentially at disadvantageous prices or find another alternative source of funds. These alternatives could increase our costs or reduce our equity and reduce amounts available to invest in mortgage-backed securities.

Complying with the REIT requirements may force us to liquidate otherwise attractive investments.

In order to qualify as a REIT, we must ensure that at the end of each calendar quarter at least 75% of the value of our assets consists of cash, cash items, government securities and qualified REIT real estate assets. The remainder of our investment in securities generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, generally, no more than 5% of the value of our assets can consist of the securities of any one issuer. If we fail to comply with these requirements, we could lose our REIT status unless we are able to avail ourselves of certain relief provisions. Under certain relief provisions, we would be subject to penalty taxes.

Failure to maintain an exemption from the Investment Company Act would harm our results of operations.

We intend to conduct our business so as not to become regulated as an investment company under the Investment Company Act of 1940, as amended. If we fail to qualify for this exemption, our ability to use leverage would be substantially reduced and we would be unable to conduct our business as described in this prospectus.

The Investment Company Act exempts entities that are primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. Under the current interpretation of the SEC, in order to qualify for this exemption, we must maintain at least 55% of our assets directly in these qualifying real estate interests. Mortgage-backed securities that do not represent all of the certificates issued with respect to an underlying pool of mortgages may be treated as separate from the underlying mortgage loans and, thus, may not qualify for purposes of the 55% requirement. Therefore, our ownership of these mortgage-backed securities is limited by the provisions of the Investment Company Act.

In satisfying the 55% requirement under the Investment Company Act, we treat as qualifying interests mortgage-backed securities issued with respect to an underlying pool as to which we hold all issued certificates. If the SEC adopts a contrary interpretation of such treatment, we could be required to sell a substantial amount of our mortgage-backed securities under potentially adverse market conditions. Further, in our attempts to ensure that we at all times qualify for the exemption under the Investment Company Act, we might be precluded from acquiring mortgage-backed securities if their yield is higher than the yield on mortgage-backed securities that could be purchased in a manner consistent with the exemption. These factors may lower or eliminate our net income.

Misplaced reliance on legal opinions or statements by issuers of mortgage-backed securities could result in a failure to comply with the REIT income or assets tests.

When purchasing mortgage-backed securities, we may rely on opinions of counsel for the issuer or sponsor of such securities, or statements made in related offering documents, for purposes of determining whether and to what extent those securities constitute REIT real estate assets for purposes of the REIT asset tests and produce income that qualifies under the REIT gross income tests. The inaccuracy of any such opinions or statements may adversely affect our REIT qualification and result in significant corporate-level tax.

One-action rules may harm the value of the underlying property.

Several states have laws that prohibit more than one action to enforce a mortgage obligation, and some courts have construed the term action broadly. In such jurisdictions, if the judicial action is not conducted according to law, there may be no other recourse in enforcing a mortgage obligation, thereby decreasing the value of the underlying property.

We may be harmed by changes in various laws and regulations.

Changes in the laws or regulations governing Seneca may impair Seneca s ability to perform services in accordance with the management agreement. Our business may be harmed by changes to the laws and regulations affecting Seneca or us, including changes to securities laws and changes to the Internal Revenue Code applicable to the taxation of REITs. New legislation may be enacted into law or new interpretations, rulings or regulations could be adopted, any of which could harm us, Seneca and our stockholders, potentially with retroactive effect.

Legislation was recently enacted that reduces the maximum tax rate of non-corporate taxpayers for capital gains (for taxable years ending on or after May 6, 2003 and before January 1, 2009) and for dividends (for taxable years beginning after December 31, 2002 and before January 1, 2009) to 15%. Generally, dividends paid by REITs are not eligible for the new 15% federal income tax rate, with certain exceptions discussed under United States Federal Income Tax Considerations Taxation of Taxable United States Stockholders and Distributions Generally. Although this legislation does not adversely affect the taxation of REITs or dividends paid by REITs, the more favorable treatment of regular corporate dividends could cause investors who are individuals to consider stocks of other corporations that pay dividends as more attractive relative to stocks of REITs.

We may incur excess inclusion income that would increase the tax liability of our stockholders.

In general, dividend income that a tax-exempt entity receives from us should not constitute unrelated business taxable income as defined in Section 512 of the Internal Revenue Code. If we realize excess inclusion income and allocate it to our stockholders, this income cannot be offset by net operating losses. If the stockholder is a tax-exempt entity, then this income would be fully taxable as unrelated business taxable income under Section 512 of the Internal Revenue Code. If the stockholder is foreign, it would be subject to

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U.S. federal income tax withholding on this income without reduction pursuant to any otherwise applicable income-tax treaty.

Excess inclusion income could result if we held a residual interest in a real estate mortgage investment conduit, or REMIC. Excess inclusion income also would be generated if we were to issue debt obligations with two or more maturities and the terms of the payments on these obligations bore a relationship to the payments that we received on our mortgage-backed securities securing those debt obligations. We generally structure our borrowing arrangements in a manner designed to avoid generating significant amounts of excess inclusion income. We do, however, enter into various repurchase agreements that have differing maturity dates and afford the lender the right to sell any pledged mortgage securities if we default on our obligations. The IRS may determine that these borrowings give rise to excess inclusion income that should be allocated among our stockholders. Furthermore, some types of tax-exempt entities, including voluntary employee benefit associations and entities that have borrowed funds to acquire our common stock, may be required to treat a portion of or all of the distributions they may receive from us as unrelated business taxable income. Finally, we may invest in equity securities of other REITs and it is possible that we might receive excess inclusion income from those investments.

Risks Related to Investing in Our Securities

We have not established a minimum distribution payment level, and we cannot assure you of our ability to make distributions to our stockholders in the future.

Our policy is to make quarterly distributions to our stockholders in amounts such that we distribute all or substantially all of our taxable income in each year, subject to certain adjustments, which, along with other factors, should enable us to qualify for the tax benefits accorded to a REIT under the Internal Revenue Code. We have not established a minimum distribution payment level and our ability to make distributions might be harmed by the risk factors described in this prospectus. All distributions will be made at the discretion of our board of directors and will depend on our earnings, our financial condition, maintenance of our REIT status and such other factors as our board of directors may deem relevant from time to time. We cannot assure you that we will have the ability to make distributions to our stockholders in the future.

Our declared cash distributions may force us to liquidate mortgage-backed securities or borrow additional funds.

From time to time, our board of directors will declare cash distributions. These distribution declarations are irrevocable. If we do not have sufficient cash to fund distributions, we will need to liquidate mortgage-backed securities or borrow funds by entering into repurchase agreements or otherwise borrowing funds under our margin lending facility to pay the distribution. If required, the sale of mortgage-backed securities at prices lower than the carrying value of such assets would result in losses. Additionally, if we were to borrow funds on a regular basis to make distributions, it is likely that our results of operations and our stock price would be harmed.

Future offerings of debt securities by us, which would be senior to our common stock upon liquidation, or equity securities, which would dilute our existing stockholders and may be senior to our common stock for the purposes of distributions, may harm the value of our common stock.

In the future, we may attempt to increase our capital resources by making additional offerings of debt or equity securities, including commercial paper, medium-term notes, senior or subordinated notes and classes of preferred stock or common stock. Upon our liquidation, holders of our debt securities and shares of preferred stock and lenders with respect to other borrowings will receive a distribution of our available assets prior to the holders of our common stock. Additional equity offerings by us may dilute the holdings of our existing stockholders or reduce the value of our common stock, or both. Our preferred stock, if issued, would have a preference on distributions that could limit our ability to make distributions to the holders of our common stock. Because our decision to issue securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Thus, our stockholders bear the risk of our future offerings reducing the market price of our common stock and diluting their stock holdings in us.

Changes in yields may harm the market price of our common stock.

Our earnings are derived primarily from the expected positive spread between the yield on our assets and the cost of our borrowings. This spread will not necessarily be larger in high interest rate environments than in low interest rate environments and may also be negative. In addition, during periods of high interest rates, our net income and, therefore, the amount of any distributions on our common stock, might be less attractive compared to alternative investments of equal or lower risk. Each of these factors could harm the market price of our common stock.

The market price and trading volume of our common stock may be volatile.

The market price of our common stock may be volatile and be subject to wide fluctuations. In addition, the trading volume in our common stock may fluctuate and cause significant price variations to occur. If the market price of our common stock declines significantly, you may be unable to resell your shares at or above your purchase price. We cannot assure you that the market price of our common stock will not fluctuate or decline significantly in the future. Some of the factors that could negatively affect our stock price or result in fluctuations in the price or trading volume of our common stock include:

- actual or anticipated variations in our quarterly operating results or distributions;
- changes in our funds from operations or earnings estimates or publication of research reports about us or the real estate industry;
- increases in market interest rates that lead purchasers of our shares to demand a higher yield;
- changes in market valuations of similar companies;
- adverse market reaction to any indebtedness we incur in the future;
- additions or departures of key management personnel;
- the termination of or resignation by Seneca as our manager;
- actions by institutional stockholders;
- speculation in the press or investment community; and
- general market and economic conditions.

Issuance of large amounts of our stock could cause our price to decline.

This prospectus may be used for the issuance of additional shares of common stock or shares of preferred stock that are convertible into common stock. If we were to issue a significant number of shares of our common stock or convertible preferred stock in a short period of time, our outstanding shares of common stock could be diluted and the market price of our common stock could decrease.

Restrictions on ownership of a controlling percentage of our capital stock might limit your opportunity to receive a premium on our stock.

For the purpose of preserving our REIT qualification and for other reasons, our charter prohibits direct or constructive ownership by any person of more than 9.8% of the lesser of the total number or value of the outstanding shares of our common stock or more than 9.8% of the outstanding shares of our preferred stock. The constructive ownership rules in our charter are complex and may cause our outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of less than 9.8% of our outstanding stock by an individual or entity could cause that individual or entity to own constructively in excess of 9.8% of our outstanding stock, and thus be subject to the ownership limit in our charter. Any attempt to own or transfer shares of our common or preferred stock in

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excess of the ownership limit without the consent of our board of directors is void, and will result in the shares being transferred by operation of law to a charitable trust. These provisions might inhibit market activity and the resulting opportunity for our stockholders to receive a premium for their shares that might otherwise exist if any person were to attempt to assemble a block of our stock in excess of the number of shares permitted under our charter and that may be in the best interests of our stockholders.

Broad market fluctuations could harm the market price of our common stock.

The stock market has experienced price and volume fluctuations that have affected the market price of many companies in industries similar or related to ours and that have been unrelated to these companies operating performances. These broad market fluctuations could reduce the market price of our common stock. Furthermore, our operating results and prospects may be below the expectations of public market analysts and investors or may be lower than those of companies with comparable market capitalizations, which could harm the market price of our common stock.

Certain provisions of Maryland law and our charter and bylaws could hinder, delay or prevent a change in control of our company.

Certain provisions of Maryland law, our charter and our bylaws have the effect of discouraging, delaying or preventing transactions that involve an actual or threatened change in control of our company. These provisions include the following:

Classified Board of Directors. Our board of directors is divided into three classes with staggered terms of office of three years each. The classification and staggered terms of office of our directors make it more difficult for a third party to gain control of our board of directors. At least two annual meetings of stockholders, instead of one, generally would be required to effect a change in a majority of our board of directors.

Removal of Directors. Under our charter, subject to the rights of one or more classes or series of preferred stock to elect one or more directors, a director may be removed only for cause and only by the affirmative vote of at least two-thirds of all votes entitled to be cast by our stockholders generally in the election of directors.

Number of Directors, Board Vacancies, Term of Office. We have elected to be subject to certain provisions of Maryland law that vest in our board of directors the exclusive right to determine the number of directors and the exclusive right, by the affirmative vote of a majority of the remaining directors, to fill vacancies on the board even if the remaining directors do not constitute a quorum. These provisions of Maryland law, which are applicable even if other provisions of Maryland law or our charter or bylaws provide to the contrary, also provide that any director elected to fill a vacancy shall hold office for the remainder of the full term of the class of directors in which the vacancy occurred, rather than the next annual meeting of stockholders as would otherwise be the case, and until his or her successor is elected and qualifies.

Limitation on Stockholder-Requested Special Meetings. Our bylaws provide that our stockholders have the right to call a special meeting only upon the written request of stockholders entitled to cast not less than a majority of all the votes entitled to be cast by our stockholders at such meeting.

Advance Notice Provisions for Stockholder Nominations and Proposals. Our bylaws require advance written notice for stockholders to nominate persons for election as directors at, or to bring other business before, any meeting of our stockholders. This bylaw provision limits the ability of our stockholders to make nominations of persons for election as directors or to introduce other proposals unless we are notified in a timely manner prior to the meeting.

Exclusive Authority of our Board to Amend our Bylaws. Our bylaws provide that our board of directors has the exclusive power to adopt, alter or repeal any provision of our bylaws or to make new bylaws. Thus, our stockholders may not effect any changes to our bylaws.

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Preferred Stock. Under our charter, our board of directors has authority to issue preferred stock from time to time in one or more series and to establish the terms, preferences and rights of any such series of preferred stock, all without approval of our stockholders.

Duties of Directors with Respect to Unsolicited Takeovers. Maryland law provides protection for Maryland corporations against unsolicited takeovers by limiting, among other things, the duties of the directors in unsolicited takeover situations. The duties of directors of Maryland corporations do not require them to (1) accept, recommend or respond to any proposal by a person seeking to acquire control of the corporation, (2) authorize the corporation to redeem any rights under, or modify or render inapplicable, any stockholder rights plan, (3) make a determination under the Maryland Business Combination Act or the Maryland Control Share Acquisition Act, or (4) act or fail to act solely because of the effect the act or failure to act may have on an acquisition or potential acquisition of control of the corporation or the amount or type of consideration that may be offered or paid to the stockholders in an acquisition. Moreover, under Maryland law, the act of the directors of a Maryland corporation relating to or affecting an acquisition or potential acquisition of control is not subject to any higher duty or greater scrutiny than is applied to any other act of a director. Maryland law also contains a statutory presumption that an act of a director of a Maryland corporation satisfies the applicable standards of conduct for directors under Maryland law.

Ownership Limit. In order to preserve our status as a REIT under the Internal Revenue Code, our charter generally prohibits any single stockholder, or any group of affiliated stockholders, from beneficially owning more than 9.8% of our outstanding common and preferred stock unless our board of directors waives or modifies this ownership limit.

Maryland Business Combination Act. The Maryland Business Combination Act provides that, unless exempted, a Maryland corporation may not engage in business combinations, including mergers, dispositions of 10% or more of its assets, certain issuances of shares of stock and other specified transactions, with an interested stockholder or an affiliate of an interested stockholder for five years after the most recent date on which the interested stockholder became an interested stockholder, and thereafter unless specified criteria are met. An interested stockholder is generally a person owning or controlling, directly or indirectly, 10% or more of the voting power of the outstanding stock of a Maryland corporation. Our board of directors has adopted a resolution exempting our company from this statute. However, our board of directors may repeal or modify this resolution in the future, in which case the provisions of the Maryland Business Combination Act would be applicable to business combinations between our company and interested stockholders.

Maryland Control Share Acquisition Act. Maryland law provides that control shares of a corporation acquired in a control share acquisition shall have no voting rights except to the extent approved by a vote of two-thirds of the votes eligible to be cast on the matter under the Maryland Control Share Acquisition Act. Control shares means shares of stock that, if aggregated with all other shares of stock previously acquired by the acquiror, would entitle the acquiror to exercise voting power in electing directors within one of the following ranges of the voting power: one-tenth or more but less than one-third, one-third or more but less than a majority or a majority or more of all voting power. A control share acquisition means the acquisition of control shares, subject to certain exceptions. If voting rights of control shares acquired in a control share acquisition are not approved at a stockholders meeting, then, subject to certain conditions and limitations, the corporation may redeem any or all of the control shares for fair value. If voting rights of such control shares are approved at a stockholders meeting and the acquiror becomes entitled to vote a majority of the shares of stock entitled to vote, all other stockholders may exercise appraisal rights. Our bylaws contain a provision exempting acquisitions of our shares from the Maryland Control Share Acquisition Act. However, our board of directors may amend our bylaws in the future to repeal or modify this exemption, in which case any control shares of our company acquired in a control share acquisition will be subject to the Maryland Control Share Acquisition Act.

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The market price of our common stock may be adversely affected by future sales of a substantial number of shares of our common stock by our existing stockholders in the public market or the availability of such shares for sale.

We cannot predict the effect, if any, of future sales of our common stock, or the availability of shares for future sales, on the market price of our common stock. Sales of substantial amounts of shares of our common stock, or the perception that these sales could occur, may harm prevailing market prices for our common stock.

Subject to Rule 144 volume limitations applicable to our affiliates, substantially all of our 37,113,011 shares of common stock outstanding as of the date of this prospectus are eligible for immediate resale by their holders. If any of our stockholders were to sell a large number of shares in the public market, the sale could reduce the market price of our common stock and could impede our ability to raise future capital through a sale of additional equity securities.

Terrorist attacks and other acts of violence or war may affect the market for our common stock, the industry in which we operate and our operations and profitability.

Terrorist attacks may harm our results of operations and your investment. We cannot assure you that there will not be further terrorist attacks against the United States, U.S. businesses or elsewhere in the world. These attacks or armed conflicts may impact the property underlying our mortgage-backed securities, directly or indirectly, by undermining economic conditions in the United States. Losses resulting from terrorist events are generally uninsurable.

USE OF PROCEEDS

Unless otherwise indicated in an accompanying prospectus supplement, we intend to use the net proceeds from the sale of the securities offered by this prospectus and the related accompanying prospectus supplement to expand our portfolio of mortgage-related assets, primarily U.S. agency and other highly-rated, single-family, adjustable-rate, hybrid adjustable-rate and fixed-rate mortgage-backed securities and for general corporate purposes. We then intend to further increase our portfolio of mortgage-related assets by borrowing against the mortgage-backed securities we purchase with the offering proceeds and use the funds we borrow to purchase additional mortgage-backed securities. We expect to pay market rates for brokerage fees and commissions when purchasing the securities. Until such assets can be identified and obtained, we intend to temporarily invest the balance of the proceeds of this offering in readily marketable interest-bearing assets consistent with our qualification as a REIT.

RATIO OF EARNINGS TO FIXED CHARGES

The following table sets forth our ratio of earnings to fixed charges for the periods shown:

	For the Nine Months Ended September 30, 2004	For the Period from April 26, 2003 through December 31, 2003(1)
Ratio of earnings to fixed charges	2.23x	1.31x

(1) We commenced operations on April 26, 2003. Our operating expenses for the period April 26, 2003 through December 31, 2003 were high in proportion to our gross interest income and expense and to our net interest income compared to expectations for future periods of operations because of the costs of our start-up operations.

The ratios of earnings to fixed charges were computed by dividing earnings as adjusted by fixed charges. For this purpose, earnings consist of net income from continuing operations and fixed charges. Fixed charges consist of interest expense. To date, we have not issued any preferred stock.

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DESCRIPTION OF CAPITAL STOCK

The following summary highlights the material information about our capital stock. You should refer to our charter and our bylaws for a full description. Copies of our charter and our bylaws are incorporated herein by reference. You can also obtain copies of our charter and our bylaws and every other exhibit to our registration statement. Please see Where You Can Find More Information/ Incorporation by Reference on page 55 of this prospectus.

We may offer under this prospectus one or more of the following categories of securities: (i) shares of our common stock; (ii) shares of our preferred stock, in one or more series; (iii) warrants to purchase shares of our common stock or preferred stock; (iv) debt securities and (v) any combination of the foregoing, either individually or consisting of one or more of the types of securities described in clauses (i) through (iv). The terms of any specific offering of such securities will be set forth in a prospectus supplement relating to such offering.

General

Our charter provides that we may issue up to 100,000,000 shares of our common stock, $0.001 par value per share, and 10,000,000 shares of our preferred stock, $0.001 par value per share. As of December 31, 2004, we had 37,113,011 shares of our common stock issued and outstanding and no shares of our preferred stock issued and outstanding. As of December 31, 2004, the number of record holders of our common stock was 56. The 56 holders of record include Cede & Co., which holds shares as nominee for The Depository Trust Company, which itself holds shares on behalf of beneficial owners of our common stock. Under Maryland law, our stockholders generally are not liable for our debts or obligations.

Common Stock

All outstanding shares of our common stock have been duly authorized, validly issued and are fully paid and non-assessable, and any shares of our common stock offered hereby will be duly authorized and, upon issuance in exchange for the consideration thereof, will be validly issued, fully paid and non-assessable. Subject to the preferential rights of any other class or series of stock and to the provisions of our charter regarding the restrictions on transfers of stock, holders of shares of our common stock are entitled to receive dividends on such stock if, as and when authorized and declared by our board of directors out of assets legally available therefor and to share ratably in our assets legally available for distribution to our stockholders in the event of our liquidation, dissolution or winding up after payment of or adequate provision for all our known debts and liabilities.

Subject to the provisions of our charter regarding the restrictions on ownership and transfer of stock and the terms of any other class or series of our stock, each outstanding share of our common stock entitles the holder to one vote on all matters submitted to a vote of stockholders, including the election of directors and, except as provided with respect to any other class or series of our stock, the holders of such shares of our common stock possess the exclusive voting power. There is no cumulative voting in the election of our directors, which means that the holders of a plurality of the outstanding shares of our common stock voting at that meeting elect all of the directors then standing for election and the holders of the remaining shares are not able to elect any of our directors.

Holders of shares of our common stock have no preference, conversion, exchange, sinking fund or redemption rights and have no preemptive rights to subscribe for any of our securities. Subject to the provisions of our charter regarding the restrictions on ownership and transfer of stock, shares of our common stock have equal dividend, liquidation and other rights.

Under the Maryland General Corporation Law, which we sometimes refer to as the MGCL, a Maryland corporation generally cannot dissolve, amend its charter, merge, sell all or substantially all of its assets, engage in a share exchange or engage in similar transactions outside the ordinary course of business unless approved by the affirmative vote of stockholders holding at least two-thirds of the shares entitled to vote on the matter, unless a lesser percentage (but not fewer than a majority of all of the votes entitled to be cast by the stockholders on the matter) is set forth in the corporation s charter. Our charter provides that any such action shall be effective and valid if taken or authorized by our stockholders by the affirmative vote of a majority of all the votes entitled to be cast on the matter, except that amendments to the provisions of our charter relating to the removal of directors must be approved by our stockholders by the affirmative vote of at least two-thirds of the votes entitled to be cast on the matter.

Our charter authorizes our board of directors to reclassify any unissued shares of our common stock into other classes or series of classes of our stock, to establish the number of shares in each class or series and to set the preferences, conversion and other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications or terms or conditions of redemption for each such class or series.

Preferred Stock

Our charter authorizes our board of directors to classify any unissued shares of preferred stock and to reclassify any previously classified but unissued shares of any series of preferred stock previously classified by our board of directors. Prior to the issuance of shares of each class or series of preferred stock, our board is required by the MGCL and our charter to fix the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications and terms or conditions of redemption for each such class or series. Thus, our board, without stockholder approval, could authorize the issuance of shares of preferred stock with terms and conditions that could have the effect of delaying, deterring or preventing a transaction or a change of control that might involve a premium price for holders of our common stock or otherwise be in their best interest.

The following description of our preferred stock sets forth certain general terms and provisions of our preferred stock to which any prospectus supplement may relate. The statements below describing the preferred stock are in all respects subject to and qualified in their entirety by reference to the applicable provisions of our charter (including the applicable articles supplementary) and bylaws.

Subject to limitations prescribed by Maryland law and our charter, our board of directors is authorized to fix the number of shares constituting each class or series of preferred stock and the designations and powers, preferences and relative, participating, optional or other special rights and qualifications, limitations or restrictions thereof, including those provisions regarding voting, redemption, dividends, dissolution or the distribution of assets, conversion or exchange and such other subjects or matters as may be fixed by resolution of our board of directors or a duly authorized committee thereof. Our preferred stock will, when issued in exchange for the consideration therefor, be fully paid and non-assessable and will not have, or be subject to, any preemptive or similar rights, unless otherwise provided in the prospectus supplement relating to such preferred stock.

You should refer to the prospectus supplement relating to the class or series of preferred stock offered thereby for specific terms, including:

- the class or series, title and stated value of that preferred stock;
- the number of shares of that preferred stock offered, the liquidation preference per share and the offering price of that preferred stock;
- the dividend rate(s), period(s) and/or payment date(s) or method(s) of calculation thereof applicable to that preferred stock;
- whether dividends on that preferred stock are cumulative or not and, if cumulative, the date from which dividends on that preferred stock shall accumulate;
- the procedures for any auction and remarketing, if any, for that preferred stock;
- provisions for a sinking fund, if any, for that preferred stock;
- provisions for redemption, if applicable, of that preferred stock;

any listing of that preferred stock on any securities exchange;

- the terms and conditions, if applicable, upon which that preferred stock will be convertible into our common stock, including the conversion price or manner of calculation thereof;
- any voting rights;
- the relative ranking and preference of the preferred stock as to distribution rights and rights upon our liquidation, dissolution or winding up if other than as described in the prospectus supplement;
- any limitations on issuance of any other series of preferred stock ranking senior to or on a parity with the preferred stock as to distribution rights and rights upon our liquidation, dissolution or winding up;
- a discussion of certain federal income tax considerations applicable to that preferred stock;
- any limitations on actual, beneficial or constructive ownership and restrictions on transfer of that preferred stock and, if convertible, the related common stock, in each case as may be appropriate to preserve our status as a REIT; and
- any other material terms, preferences, rights, limitations or restrictions of that preferred stock.

Rank

Unless otherwise specified in the applicable prospectus supplement, the preferred stock will, with respect to rights to the payment of dividends and distribution of our assets and rights upon our liquidation, dissolution or winding up, rank:

- senior to all classes or series of our common stock and to all of our equity securities the terms of which provide that those equity securities are junior to the preferred stock;
- on a parity with all of our equity securities as to which they are not expressly senior or junior; and
- junior to all of our equity securities the terms of which provide that those equity securities will rank senior to it.

For these purposes, the term equity securities does not include convertible debt securities.

Dividends

Holders of shares of our preferred stock of each class or series are entitled to receive, when, as and if authorized by our board of directors and declared by us, out of our assets legally available for payment, cash dividends at rates and on dates as will be set forth in the applicable prospectus supplement. Each dividend will be payable to holders of record as they appear on our stock transfer books on the record dates as are fixed by our board of directors.

Dividends on any class or series of our preferred stock may be cumulative or non-cumulative, as provided in the applicable prospectus supplement. Dividends, if cumulative, will accumulate from and after the date set forth in the applicable prospectus supplement. If our board of directors fails to authorize a dividend payable on a dividend payment date on any class or series of our preferred stock for which dividends are non-cumulative, then the holders of that class or series of our preferred stock will have no right to receive a dividend in respect of the dividend period ending on that dividend payment date, and we will have no obligation to pay the dividend accrued for that period, whether or not dividends on that class or series are declared payable on any future dividend payment date.

Unless otherwise specified in the applicable prospectus supplement, if any shares of our preferred stock of any class or series are outstanding, no full dividends shall be authorized or paid or set apart for payment on our preferred stock of any other class or series ranking, as to dividends, on a parity with or junior to the preferred stock of that class or series for any period unless:

- if that class or series of preferred stock has a cumulative dividend, full cumulative dividends have been or contemporaneously are authorized and paid or authorized and a sum sufficient for the payment thereof set apart for that payment on the preferred stock of that class or series for all past dividend periods and the then current dividend period, or

if that class or series of preferred stock does not have a cumulative dividend, full dividends for the then current dividend period have been or contemporaneously are authorized and paid or authorized and a sum sufficient for the payment thereof set apart for that payment on the preferred stock of that class or series.

Unless otherwise specified in the applicable prospectus supplement, when dividends are not paid in full or a sum sufficient for their full payment is not so set apart upon the shares of preferred stock of any class or series and the shares of any other class or series of preferred stock ranking on a parity as to dividends with the preferred stock of that class or series, all dividends declared upon shares of preferred stock of that class or series and any other class or series of preferred stock ranking on a parity as to dividends with that preferred stock shall be authorized pro rata so that the amount of dividends authorized per share on the preferred stock of that class or series and that other class or series of preferred stock shall in all cases bear to each other the same ratio that accrued and unpaid dividends per share on the shares of preferred stock of that class or series, which shall not include any accumulation in respect of unpaid dividends for prior dividend periods if that preferred stock does not have a cumulative dividend, and that other class or series of preferred stock bear to each other. No interest, or sum of money in lieu of interest, shall be payable in respect of any dividend payment or payments on preferred stock of that series that may be in arrears.

Except as provided in the immediately preceding paragraph or as otherwise provided in the applicable prospectus supplement, unless:

if that class or series of preferred stock has a cumulative dividend, full cumulative dividends on the preferred stock of that class or series have been or contemporaneously are authorized and paid or authorized and a sum sufficient for the payment thereof set apart for payment for all past dividend periods and the then current dividend period; and

if that class or series of preferred stock does not have a cumulative dividend, full dividends on the preferred stock of that class or series have been or contemporaneously are authorized and paid or authorized and a sum sufficient for the payment thereof set apart for payment for the then current dividend period,

then no dividends, other than in our common stock or other stock ranking junior to the preferred stock of that class or series as to dividends and upon our liquidation, dissolution or winding up, shall be authorized or paid or set aside for payment or other distribution shall be authorized or made upon our common stock or any of our other stock ranking junior to or on a parity with the preferred stock of that class or series as to dividends or upon liquidation, nor shall any common stock, excess stock or any of our other stock ranking junior to or on a parity with the preferred stock of such class or series as to dividends or upon our liquidation, dissolution or winding up be redeemed, purchased or otherwise acquired for any consideration, or any moneys be paid to or made available for a sinking fund for the redemption of any shares of that stock, by us, except by conversion into or exchange for other of our stock ranking junior to the preferred stock of that class or series as to dividends and upon our liquidation, dissolution or winding up.

Any dividend payment made on shares of a class or series of preferred stock will be first credited against the earliest accrued but unpaid dividend due with respect to shares of that class or series that remains payable.

Redemption

If the applicable prospectus supplements so states, the shares of preferred stock will be subject to mandatory redemption or redemption at our option, in whole or in part, in each case on the terms, at the times and at the redemption prices set forth in that prospectus supplement.

The prospectus supplement relating to a class or series of preferred stock that is subject to mandatory redemption will specify the number of shares of that preferred stock that shall be redeemed by us in each year commencing after a date to be specified, at a redemption price per share to be specified, together with an amount equal to all accrued and unpaid dividends thereon, which shall not, if that preferred stock does not have a cumulative dividend, include any accumulation in respect of unpaid dividends for prior dividend periods, to the date of redemption. The redemption price may be payable in cash or other property, as specified in the applicable prospectus supplement. If the redemption price for preferred stock of any series is payable only from the net proceeds of the issuance of our stock, the terms of that preferred stock may provide that, if no such stock shall have been issued or to the extent the net proceeds from any issuance are insufficient to pay in full the aggregate redemption price then due, that preferred stock shall automatically and mandatorily be converted into shares of our applicable stock pursuant to conversion provisions specified in the applicable prospectus supplement.

Notwithstanding the foregoing and except as otherwise specified in the applicable prospectus supplement, unless:

- if that class or series of preferred stock has a cumulative dividend, full cumulative dividends on all shares of any class or series of preferred stock shall have been or contemporaneously are authorized and paid or authorized and a sum sufficient for the payment thereof set apart for payment for all past dividend periods and the then current dividend period; and

- if that class or series of preferred stock does not have a cumulative dividend, full dividends on the preferred stock of any class or series have been or contemporaneously are authorized and paid or authorized and a sum sufficient for the payment thereof set apart for payment for the then current dividend period;

no shares of any class or series of preferred stock shall be redeemed unless all outstanding shares of preferred stock of that class or series are simultaneously redeemed; provided, however, that the foregoing shall not prevent the purchase or acquisition of shares of preferred stock of that class or series pursuant to a purchase or exchange offer made on the same terms to holders of all outstanding shares of preferred stock of that class or series.

If fewer than all of the outstanding shares of preferred stock of any class or series are to be redeemed, the number of shares to be redeemed will be determined by us and those shares may be redeemed pro rata from the holders of record of those shares in proportion to the number of those shares held by those holders, with adjustments to avoid redemption of fractional shares, or any other equitable method determined by us that will not result in the issuance of any excess preferred stock.

Notice of redemption will be mailed at least 30 days but not more than 60 days before the redemption date to each holder of record of a share of preferred stock of any class or series to be redeemed at the address shown on our stock transfer books. Each notice shall state:

- the redemption date;

- the number of shares and class or series of the preferred stock to be redeemed;

- the redemption price;

- the place or places where certificates for that preferred stock are to be surrendered for payment of the redemption price;

- that dividends on the shares to be redeemed will cease to accrue on that redemption date; and

- the date upon which the holder s conversion rights, if any, as to those shares will terminate.

If fewer than all the shares of preferred stock of any class or series are to be redeemed, the notice mailed to each holder thereof shall also specify the number of shares of preferred stock to be redeemed from each holder. If notice of redemption of any shares of preferred stock has been given and if the funds necessary for that redemption have been set apart by us in trust for the benefit of the holders of any shares of preferred stock so called for redemption, then from and after the redemption date dividends will cease to accrue on those shares of preferred stock, those shares of preferred stock shall no longer be deemed outstanding and all rights of the holders of those shares will terminate, except the right to receive the redemption price.

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Liquidation Preference

Upon our voluntary or involuntary liquidation, dissolution or winding up, then, before any distribution or payment shall be made to the holders of any common stock or any other class or series of our stock ranking junior to that class or series of preferred stock in the distribution of assets upon our liquidation, dissolution or winding up, the holders of each class or series of preferred stock shall be entitled to receive out of our assets legally available for distribution to stockholders liquidating distributions in the amount of the liquidation preference per share, set forth in the applicable prospectus supplement, plus an amount equal to all dividends accrued and unpaid thereon, which shall not include any accumulation in respect of unpaid dividends for prior dividend periods if that class or series of preferred stock does not have a cumulative dividend. After payment of the full amount of the liquidating distributions to which they are entitled, the holders of that class or series of preferred stock will have no right or claim to any of our remaining assets. If, upon our voluntary or involuntary liquidation, dissolution or winding up, our legally available assets are insufficient to pay the amount of the liquidating distributions on all outstanding shares of that class or series of preferred stock and the corresponding amounts payable on all shares of other classes or series of our stock ranking on a parity with that class or series of preferred stock in the distribution of assets upon our liquidation, dissolution or winding up, then the holders of that class or series of preferred stock and all other classes or series of stock shall share ratably in that distribution of assets in proportion to the full liquidating distributions to which each class or series would otherwise be respectively entitled.

If liquidating distributions shall have been made in full to all holders of shares of that class or series of preferred stock, our remaining assets shall be distributed among the holders of any other classes or series of stock ranking junior to that class or series of preferred stock upon our liquidation, dissolution or winding up, according to their respective rights and preferences and in each case according to their respective number of shares. For those purposes, neither our consolidation nor merger with or into any other corporation, trust or other entity nor the sale, lease, transfer or conveyance of all or substantially all of our property or business shall be deemed to constitute our liquidation, dissolution or winding up.

Voting Rights

Except as set forth below or as otherwise indicated in the applicable prospectus supplement, holders of preferred stock will not have a

Debt securities

Municipal bonds

19,010

-

(28

)

18,982

20,548

74

-

20,622

Mutual funds

220

-

(7
)

213

4,344

155

(76
)

4,423

Fixed maturity funds

22,367

73

(61
)

22,379

2,799

-

(41
)

2,758

Corporate bonds

9,773

-

(152
)

9,621

14,897

12

(435

)

14,474

Total debt securities

51,370

73

(248

)

51,195

42,588

241

(552

)

42,277

Marketable securities

available for sale

$

51,589

$

73

$

(252

)

$

51,410

$

67,463

$

4,234

$

(873
)
$
70,824

The aggregate fair value of investments in debt instruments with a cost basis of $51,150 (net of mutual funds of $220) as of May 31, 2006 by contractual maturity date, consisted of the following:
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	Fair Value
Due within 1 year	$ 26,996
Due between 1 and 2 years	6,743
Due between 2 and 3 years	144
Due between 3 and 4 years	261
Due between 4 and 5 years	199
Due beyond five years	16,639
Total	$ 50,982

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other than temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at May 31, 2006.

May 31, 2006 (unaudited)

	Less than 12 months		**12 months or greater**		**Total**	
	Fair Value $	Unrealized Losses $	Fair Value $	Unrealized Losses $	Fair Value $	Unrealized Losses $
Common stocks	65	4	-	-	65	4
Municipal bonds	2,882	28	-	-	2,882	28
Debt mutual funds	213	7	-	-	213	7
Fixed maturity funds	12,656	61	-	-	12,656	61
Corporate bonds	2,638	41	6,983	111	9,621	152
Total	$ 18,454	$ 141	$ 6,983	$ 111	$ 25,437	$ 252

Net realized gains on the sale of securities for the nine months ended May 31, 2006 and 2005 were $3.7 million and $0.6 million, respectively.

Equity securities and funds. During the first quarter of fiscal 2006, Management sold equity investments and reinvested in liquid debt securities. As of May 31, 2006, total equity investments had been reduced to a fair value of $215 thousand.

Debt instruments and funds. The unrealized losses on municipal bonds and corporate bonds were primarily due to changes in interest rates. At May 31, 2006 the Company held loss positions in 149 debt instruments. Because the decline in market values of these securities is attributable to changes in interest rates and not credit quality and because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not believe any of the unrealized losses represent other than temporary impairment based on the evaluation of available evidence as of May 31, 2006.

4. Mortgages and notes receivable:

Mortgage and notes receivable arose from real estate sales. The balances are as follows:

	May 31, 2006 (unaudited)	August 31, 2005
	$	$
Mortgage notes receivable on retail land sales	459	580
Mortgage notes receivable on bulk land sales	56,610	56,976
Other notes receivable	3	10
Total mortgage and notes receivable	57,072	57,566
Less: Deferred revenue	(43,656)	(46,207)
Discount on note to impute market interest	(2,594)	(2,594)
Current portion	(51)	(2,370)
Non-current portion	$ 10,771	$ 6,395

Real estate sales are recorded under the accrual method of accounting. Gains from commercial or bulk land sales are not recognized until payments received for property to be developed within two years after the sale equal 20% or property to be developed after two years equal 25%, of the contract sales price according to the installment sales method. At May 31, 2006 and August 31, 2005, the Company had deferred revenue of $43.7 million and $46.2 million related to commercial real estate, which was sold subject to a mortgage note receivable.

Profits from commercial real estate sales are discounted to reflect the market rate of interest where the stated rate of the mortgage note is less than the market rate. The recorded imputed interest discounts are realized as the balances due are collected. In the event of early liquidation, interest is recognized on the simple interest method. At May 31, 2006 and August 31, 2005, the Company had an imputed interest discount of $2.6 million recorded in mortgages and notes receivable.

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5. Inventories:

A summary of the Company's inventories is shown below:

	May 31, 2006 (unaudited)	August 31, 2005
	$	$
Unharvested fruit crop on trees	8,201	8,176
Unharvested sugarcane	3,234	5,691
Beef cattle	7,247	5,024
Unharvested sod	865	831
Plants and vegetables	56	1,180
Total inventories	$ 19,603	$ 20,902

The Company's unharvested sugarcane and cattle are partially uninsured.

Hurricane Wilma, a category three hurricane swept through southwest Florida in October 2005. The hurricane caused extensive damage to the Company's crops and infrastructure in Collier and Hendry Counties. During August and September of 2004 a series of three hurricanes struck a portion of the Company's citrus groves in Polk County Florida.

Crop damages estimated during the first quarter as a result of hurricane Wilma were replaced by actual results as harvests were completed. The Company recognized casualty losses resulting from damages to inventory from the hurricanes as follows: (see also note 15)

Inventory damages

	Three months ended		Nine months ended	
	May 31, 2006 (unaudited)	May 31, 2005 (unaudited)	May 31, 2006 (unaudited)	May 31, 2005 (unaudited)
	$	$	$	$
Unharvested citrus	40	-	3,629	408
Unharvested sugarcane	-	-	313	-
Unharvested vegetables	-	-	147	-
Total inventories	$ 40	$ -	$ 4,089	$ 408

The Company records its inventory at the lower of cost or net realizable value. At May 31, 2006 and May 31, 2005 the cost bases for all inventories were below estimated net realizable value.
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6. Income taxes:

The provision for income taxes for the three and nine months ended May 31, 2006 and 2005 is summarized as follows:

	Three months ended		Nine months ended	
	May 31, 2006 (unaudited)	May 31, 2005 (unaudited)	May 31, 2006 (unaudited)	May 31, 2005 (unaudited)
Current:				
Federal income tax	$ 529	$ 595	$ 1,417	$ 1,009
State income tax	57	64	151	108
	586	659	1,568	1,117
Deferred:				
Federal income tax	457	858	1,647	841
State income tax	49	92	176	90
	506	950	1,823	931
Total provision for income taxes	$ 1,092	$ 1,609	$ 3,391	$ 2,048

The Internal Revenue Service is examining the Company's tax returns for the years ended August 31, 2004, 2003, 2002, 2001 and 2000, and Agri tax returns for calendar years 2003, 2002, 2001 and 2000. The examinations began in October 2003. Any assessments resulting from the examinations will be currently due and payable. A revenue agent issued a report in May 2004, challenging Agri's tax exempt status for the years examined; however, the report did not quantify an adjustment or assessment proposed. Agri responded with a written report that disputed the facts, interpretation of law, and conclusions cited in the Agent's report. Upon receipt of Agri's response in July 2004, the Agent proposed requesting a Technical Advice Memorandum (TAM) from the national office to assist in settling the differences. After reviewing the proposed TAM request from the IRS, Agri responded with a written report that disputed the facts the IRS cited in its request. Due to the breadth and substantial nature of the dispute, the IRS has chosen not to pursue the TAM.

In June 2006 the IRS issued notices of proposed adjustments that take the position that the determination letter issued to Agri should be retroactively revoked, and the value of the assets contributed from Alico to Agri should be taxed at their fair market value at the date of transfer. Additionally, the notices allege that Alico expensed certain fees and expenses that should have been capitalized. Although the proposed adjustments do not quantify the tax, penalty or interest proposed, the total proposed adjustments would result in additional taxable income to the Company of $0.3 million, $76.6 million and $42.8 million for the fiscal years ended August 31, 2002, 2001 and 2000, respectively. The notices of proposed adjustments also contain an alternative IRS position alleging that even if the determination letter was valid, that under the Code Section 482, Alico, Inc. remains liable for tax on the sale of the real estate transferred. This alternative proposed adjustment does not quantify the tax, penalty or interest proposed, but the proposed adjustment would result in additional taxable income to the Company of $19.4 million, $13.4 million, $11.1 million, $1.4 million and $10.3 million for the fiscal years ended August 31, 2004, 2003, 2002, 2001 and 2000, respectively. A third and fourth alternative position taken by the IRS alleges that Alico acted as Agri's agent or that two real estate sales be taxable to Alico under the assignment of income doctrine. These alternative positions do not quantify the adjustment to income, tax, penalty or interest proposed, but the Company estimates that the adjustment under either of these alternative positions would result in additional taxable income to the Company of approximately $0.3 million, $1.2 million, and $10.3 million for the fiscal years ended August 31, 2002, 2001, and 2000, respectively. The

Company does not agree with the proposed adjustments and plans to defend against the challenges vigorously. See also footnote 8 to the condensed consolidated financial statements.

Since January 1, 2004 Agri has been filing as a taxable entity as a result of changes in the Internal Revenue Code.
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7. Indebtedness:

In October 2005, Alico, Inc. entered into a Credit Facility with a commercial lender. The Credit Facility provided the Company with a $175 million revolving line of credit until August 1, 2010 to be used for general corporate purposes including: (i) the normal operating needs of the Company and its operating divisions, (ii) to refinance existing lines of credit and (iii) to finance the Ginn Receivable (as defined in the Loan Agreement). The terms also allowed an annual extension at the lender's option.

In May 2006 the above Credit Facility was amended "Amended Credit Facility" and restated to modify certain terms. Per the amended Credit Facility the $175 million revolving line of credit, which matures on August 1, 2010, may be used for general corporate purposes including: (i) the normal operating needs of the Company and its operating divisions, (ii) the purchase of capital assets and (iii) the payment of dividends. The Amended Credit Facility also allows for an annual extension at the lender's option.

Under the Amended Credit Facility, revolving borrowings require quarterly interest payments at LIBOR plus a variable rate between 0.8% and 1.5% depending on the Company's debt ratio. The Amended Credit Facility is partially collateralized by mortgages on two parcels of agricultural property located in Hendry County, Florida consisting of 7,672 acres and 33,700 acres.

Under the Amended Credit Facility an event of default occurs if the Company fails to make the payments required of it or otherwise fails to fulfill the provisions and covenants applicable to it. In the event of default, the Amended Credit Facility shall bear an increased interest rate of 2% in addition to the then-current rate specified in the Amended Credit Facility. In the event of default, the lender may alternatively at its option, terminate its revolving credit commitment and require immediate payment of the entire unpaid principal amount of the Amended Credit Facility, accrued interest and declare all other obligations immediately due and payable. The Company is currently in compliance with all of the covenants and provisions of the Amended Credit Facility.

The Amended Credit Facility also contains numerous restrictive covenants including those requiring the Company to maintain minimum levels of net worth, retain certain debt, current and fixed charge coverage ratios, and sets limitations on the extension of loans or additional borrowings by the Company or any subsidiary.

Outstanding debts under the Company's various loan agreements were as follows at May 31, 2006 and August 31, 2005:

May 31, 2006

	Principal Balance	Additional Credit Available	Interest Rate (h)	Collateral
a) Revolving credit facility	$ 51,089	$ 123,911	Libor +1%	Real estate
b) Term loan	2,000	-	5.80%	Unsecured
c) Mortgage note payable	9,922	-	6.68%	Real estate
d) Other	146	-	7.00%	Real estate
Total	$ 63,157	$ 123,911		

August 31, 2005

	Principal Balance	Additional Credit Available	Interest Rate (h)	Collateral
b) Term loan	$ 4,000	-	5.80%	Unsecured
c) Mortgage note payable	10,872	-	6.68%	Real estate
d) Other	146	-	7.00%	Real estate
e) Revolving credit line	21,330	4,670	Libor +1%	Unsecured
f) Demand note	-	3,000	Libor +1%	Unsecured
g) Revolving credit line	15,000	-	Libor +1%	Unsecured
Total	$ 51,348	$ 7,670		

a) Terms described above.
b) 5-year fixed rate term loan with commercial lender. $2 million principal due annually. Interest due quarterly.
c) First mortgage on 7,680 acres of cane, citrus, pasture and improvements in Hendry County, Florida with commercial lender. Monthly principal payments of $106 thousand plus accrued interest.
d) First mortgage on a parcel of land in Polk County, Florida with private seller. Annual equal payments of $55 thousand.
e) Line of credit with commerical bank, refinanced in October, 2005
f) Working capital loan with commerical bank, due on demand, refinanced in October, 2005
g) Line of credit with commerical lender, refinanced in October, 2005
h) The Libor rate was 5.11% at May 31, 2006 and 3.69% at August 31, 2005.

Maturities of the Company's debt at May 31, 2006 is as follows:

Due within 1 year	$ 3,312
Due between 1 and 2 years	1,315
Due between 2 and 3 years	1,318
Due between 3 and 4 years	1,267
Due between 4 and 5 years	52,356
Due beyond five years	3,589
Total	$ 63,157

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Interest costs expensed and capitalized to property, buildings and equipment were as follows:

	Three months ended		Nine months ended	
	May 31, 2006 (unaudited)	May 31, 2005 (unaudited)	May 31, 2006 (unaudited)	May 31, 2005 (unaudited)
Interest expense	$ 1,055	$ 694	$ 2,839	$ 1,762
Interest capitalized	9	53	57	157
Total interest cost	$ 1,064	$ 747	$ 2,896	$ 1,919

8. Other non-current liability:

Alico formed a wholly owned insurance subsidiary, Agri Insurance Company, Ltd. (Bermuda) in June of 2000. Agri was formed in response to the lack of insurance availability, both in the traditional commercial insurance markets and governmental sponsored insurance programs, suitable to provide coverage for the increasing number and potential severity of agricultural events. Such events include citrus canker, crop diseases, livestock related maladies and weather. Alico's goal included not only pre-funding its potential exposures related to the aforementioned events, but also to attempt to attract new underwriting capital if it was successful in profitably underwriting its own potential risks as well as similar risks of its historic business partners.

Alico capitalized Agri by contributing real estate located in Lee County Florida. The real estate was transferred at its historical cost basis. Agri received a determination letter from the Internal Revenue Service (IRS) stating that Agri was exempt from taxation provided that net premium levels, consisting only of premiums with third parties, were below an annual stated level ($350 thousand). Third party premiums remained below the stated annual level. As the Lee County real estate was sold, substantial gains were generated in Agri, creating permanent book/tax differences.

Since receiving the favorable IRS determination letter, certain transactions, entered into by other taxpayers under the same IRS Code Section came under scrutiny and criticism by the news media. In response, Management has recorded a contingent liability of $17.0 million at May 31, 2006 and August 31, 2005 for income taxes in the event of an IRS challenge. Management's decision has been influenced by perceived changes in the regulatory environment. Because Management believes it is probable that a challenge will be made and that it may be successful as to some of the possible assertions, Management has provided for the contingency.

The Internal Revenue Service is examining the Company's tax returns for the years ended August 31, 2004, 2003, 2002, 2001 and 2000, and Agri tax returns for calendar years 2003, 2002, 2001 and 2000. The examinations began in October 2003. Any assessments resulting from the examinations will be currently due and payable. A revenue agent issued a report in May 2004, challenging Agri's tax exempt status for the years examined; however, the report did not quantify the adjustment or assessment proposed. Agri responded with a written report that disputed the facts, interpretation of law, and conclusions cited in the Agent's report. Upon receipt of Agri's response in July 2004, the Agent proposed requesting a Technical Advice Memorandum (TAM) from the national office to assist in settling the differences. After reviewing the proposed TAM request from the IRS, Agri responded with a written report that disputed the facts the IRS cited in its request. Due to the breadth and substantial nature of the dispute, the IRS has chosen not to pursue the TAM.

In June 2006 the IRS issued notices of proposed adjustments that take the position that the determination letter issued to Agri should be retroactively revoked, and the value of the assets contributed from Alico to Agri should be taxed at their fair market value at the date of transfer. Additionally, the notices allege that Alico expensed certain fees and expenses that should have been capitalized. Although the proposed adjustments do not quantify the tax, penalty or interest proposed, the total proposed adjustments would result in additional taxable income to the Company of $0.3 million, $76.6 million and $42.8 million for the fiscal years ended August 31, 2002, 2001 and 2000, respectively. The notices of proposed adjustments also contain an alternative IRS position alleging that even if the determination letter was valid, that under the Code Section 482, Alico, Inc. remains liable for tax on the sale of the real estate transferred. This alternative proposed adjustment does not quantify the tax, penalty or interest proposed, but the proposed adjustment would result in additional taxable income to the Company of $19.4 million, $13.4 million, $11.1 million, $1.4 million and $10.3 million for the fiscal years ended August 31, 2004, 2003, 2002, 2001 and 2000, respectively. A third and fourth alternative position taken by the IRS alleges that Alico acted as Agri's agent or that two real estate sales be taxable to Alico under the assignment of income doctrine. These alternative positions do not quantify the adjustment to income, tax, penalty or interest proposed, but the Company estimates that the adjustment under either of these alternative positions would result in additional taxable income to the Company of approximately $0.3 million, $1.2 million, and $10.3 million for the fiscal years ended August 31, 2002, 2001, and 2000, respectively. The Company does not agree with the proposed adjustments and plans to defend against the challenges vigorously.

Since January 1, 2004 Agri has been filing as a taxable entity as a result of changes in the Internal Revenue Code.

9. Dividends:

Quarterly dividends of $0.25 per share were paid on October 15, 2005, January 15, 2006 and April 15, 2006 to stockholders of record as of September 30, 2005, December 31, 2005 and March 31, 2006, respectively. At its meeting on March 31, 2006 the Board of Directors declared a quarterly dividend of $0.25 per share payable to stockholders of record as of June 30, 2006, with payment expected on or around July 15, 2006. At its meeting on June 30, 2006 the Board of Directors declared a quarterly dividend of $0.275 per share payable to stockholders of record as of September 30, 2006 with payment expected on or around October 15, 2006.

10. Disclosures about reportable segments:

Alico has four reportable segments: Citrus groves, Citrus purchasing, harvesting and marketing (Bowen Brothers Fruit, LLC), Sugarcane and Sod and Cattle. Citrus groves and Citrus purchasing, harvesting and marketing are consolidated under the caption "citrus" on the Company's Statement of Operations. The goods and services produced by these segments are sold to wholesalers and processors who prepare the products for consumption. The Company's operations are located in Florida.

Alico, through its newly formed subsidiary Bowen Brothers Fruit, LLC (Bowen), purchased the assets of Bowen Brothers Fruit Co., Inc. for $1.9 million in February 2006. The purchase was made in order to provide Alico with additional marketing expertise and with the ability to harvest its own fruit crop. Bowen is a citrus company that is a purchaser, harvester and marketer of citrus fruit. The revenue and expenses for Bowen are consolidated with the Company's citrus groves on the Statement of Operations.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies in the Company's annual report on Form 10K filed for the fiscal year ended August 31, 2005. Alico, Inc. evaluates performance based on profit or loss from operations before income taxes. Alico, Inc.'s reportable segments are strategic business units that offer different products and services. They are managed separately because each segment requires different management techniques, knowledge and skills.

The following table presents information (unaudited) for each of the Company's operating segments:

	Three months ended May 31, 2006	Three months ended May 31, 2005	Nine months ended May 31, 2006	Nine months ended May 31, 2005
Citrus				
Alico				
Revenue	$ 11,986	$ 10,246	$ 20,238	$ 20,711
Costs and expenses	7,549	6,622	13,378	15,431
Segment profit	4,437	3,624	6,860	5,280
Depreciation	$ 632	$ 611	$ 1,906	$ 1,826
Segment assets			$ 49,860	$ 55,212
Bowen Brothers Fruit				
Revenue	$ 19,751	$ -	25,473	$ -
Costs and expenses	19,806	-	25,526	-
Segment	(55)	-	(53)	-
Depr & Amortization	$ 340	$ -	$ 638	$ -
Segment assets			$ 5,251	$ -
Total Citrus				
Revenue	$ 31,737	$ 10,246	$ 45,711	$ 20,711
Less intersegment revenue	(3,461)	-	(3,461)	-
Consolidated revenue	28,276	10,246	42,250	20,711
Total costs and expenses	27,355	6,622	38,904	15,431
Less intersegment costs	(3,469)	-	(3,469)	-
Consolidated costs	23,886	6,622	35,435	15,431
Segment profit	4,390	3,624	6,815	5,280
Depr & Amortization	$ 972	$ 611	$ 2,544	$ 1,826
Segment assets			$ 55,111	$ 55,212

	Three months ended		Nine months ended	
	May 31, 2006	May 31, 2005	May 31, 2006	May 31, 2005
Sugarcane and sod				
Revenue	$ 2,792	$ 1,902	$ 9,922	$ 9,641
Costs and expenses	1,866	1,763	9,327	9,100
Segment profit	926	139	595	541
Depreciation	$ 526	$ 499	$ 1,474	$ 1,576
Segment assets			$ 49,010	$ 50,191
Cattle				
Revenue	$ 758	$ 4,660	$ 3,408	$ 8,979
Costs and expenses	671	3,558	2,700	7,169
Segment profit	87	1,102	708	1,810
Depreciation	$ 422	$ 375	$ 1,246	$ 1,128
Segment assets			$ 23,908	$ 20,885
Other				
Revenue	$ 4,599	$ 3,223	$ 21,175	$ 10,317
Costs and expenses	6,370	3,864	19,542	12,331
Segment profit (loss)	(1,771)	(641)	1,633	(2,014)
Depreciation	$ 329	$ 250	$ 896	$ 676
Segment assets			$ 132,263	$ 118,893
Total				
Revenue	$ 36,425	$ 20,031	$ 76,755	$ 49,648
Costs and expenses	32,793	15,807	67,004	44,031
Segment profit (loss)	3,632	4,224	9,751	5,617
Depr & Amortization	$ 2,249	$ 1,735	$ 6,160	$ 5,206
Segment assets			$ 260,292	$ 245,181

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11. Stock Compensation Plans:

On November 3, 1998, the Company adopted the Alico, Inc., Incentive Equity Plan ("the Incentive Plan") pursuant to which the Board of Directors of the Company may grant options, stock appreciation rights, and/or restricted stock to certain directors and employees. The Incentive Plan authorizes grants of shares or options to purchase up to 650,000 shares of authorized but unissued common stock. Stock options granted have a strike price and vesting schedules, which are at the discretion of the Board of Directors
and determined on the effective date of the grant. The strike price cannot be less than 55% of the market price. No stock options were issued during the nine months ended May 31, 2006 and 2005.

In April 2006 the Company granted 20,000 restricted shares which vest 25% per year beginning in April 2010. The total fair market value of the 20,000 shares on the date of grant was $908 thousand. Employee compensation expense will be recognized over the seven year period during which the employee is required to provide service. Compensation expense recorded during the three months ended May 31, 2006 was $21 thousand.

At May 31, 2006 and August 31, 2005, there were 9,158 and 16,371 stock options, respectively, fully vested and exercisable and 272,844 and 292,844 shares, respectively, available for grant.

12. Other Comprehensive Income:

Other comprehensive income, arising from market fluctuations in the Company's securities portfolio, was as follows:

ALICO, INC.
Schedule of Other Comprehensive Income
(unaudited)
(in thousands)

	For the three months ended		For the nine months ended	
	May 31, 2006	May 31, 2005	May 31, 2006	May 31, 2005
Accumulated Other Comprehensive Income (loss) at beginning of period	$ (73)	$ 3,252	$ 2,195	$ 1,529
Unrealized Security gains (losses)	(68)	(1,187)	(2,374)	1,548
Taxes provided for unrealized (gains) losses	29	439	67	(573)
Net change in Other Comprehensive Income	(39)	(748)	(2,307)	975
Other Comprehensive Income at end of period	$ (112)	$ 2,504	$ (112)	$ 2,504

13. New Accounting Pronouncements:

In May 2005 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 154, “Accounting Changes and Error Corrections”. SFAS 154 replaces APB No. 20, “Accounting Changes”, and SFAS No. 3, “Reporting Changes in Interim Financial Statements”. SFAS No. 154 changes the accounting for, and reporting of, a change in accounting principle. SFAS No. 154 requires retrospective application to the prior period’s financial statements of voluntary changes in accounting principle and changes required by new accounting standards when the standard does not include specific transition provisions, unless it is impractical to do so. SFAS No. 154 is effective for accounting changes and corrections of errors in fiscal years beginning after December 15, 2005. Currently, the Company is not aware of any financial impact that the adoption of this statement will have on its consolidated financial statements.

In February 2006, the FASB issued SFAS No. 155 "Accounting for Certain Hybrid Financial Instruments - an amendment of FASB Statements 133 and 140". This Statement amends FASB Statements 133, *Accounting for Derivative Instruments and Hedging Activities,* and 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets." The Statement permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives and amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS 155 is effective for an entity's first fiscal year beginning after September 15, 2006. Currently, the Company is not aware of any financial impact that the adoption of this statement will have on its consolidated financial statements.

In March 2006, the FASB issued SFAS No. 156 "Accounting for Servicing of Financial Assets - an amendment of FASB Statement 140". This Statement amends FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* with respect to the accounting for separately recognized servicing assets and servicing liabilities. This Statement requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations, requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable, and permits an entity to choose from the Amortization method or the Fair value measurement method for each class of separately recognized servicing assets and servicing liabilities. At its initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under Statement 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value. SFAS also requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. SFAS 156 is effective for an entity's first fiscal year beginning after September 15, 2006. Currently, the Company is not aware of any financial impact that the adoption of this statement will have on its consolidated financial statements.

14. Treasury Stock

The following table provides information relating to purchases of the Company's common shares by the Company on the open market pursuant to the Director Compensation Plan approved by the Company's shareholders on June 10, 2005 for the first nine months of fiscal 2006:

Date	Total Number of Shares Purchased	Average price paid per share	Total Shares Purchased as Part of Publicly Announced Plans or Programs(1)	Total Dollar value of shares purchased
11/28/2005	10,000	$ 43.30	10,000	$ 433,000
5/9/2006	3,000	$ 54.46	13,000	$ 163,380

(1) The Company may purchase an additional 17,000 shares pursuant to the approved Director Compensation Plan.

15. Casualty Losses:

Hurricane Wilma caused extensive damage to the Company's crops and infrastructure in Collier and Hendry Counties during the first quarter of fiscal year 2006. Additionally, in fiscal year 2006, canker was confirmed in three groves totaling 420 acres. During August and September of 2004 a series of three hurricanes struck a portion of the Company's citrus groves in Polk County Florida. The Company recognized losses resulting from damages caused by the hurricanes and canker as follows:

	Three months ended		**Nine months ended**	
	May 31, 2006 (unaudited)	**May 31, 2005 (unaudited)**	**May 31, 2006 (unaudited)**	**May 31, 2005 (unaudited)**
Inventoried costs	$ 40	$ -	$ 4,089	$ 408
Basis of property and equipment	-	-	$ 875	-
Insurance proceeds received	(38)	-	$ (2,196)	-
Total casualty losses to inventories	$ 2	$ -	$ 2,768	$ 408

Crop damages estimates during the three months ended November 30, 2005 as a result of hurricane Wilma were replaced by actual results as harvests were completed.

Citrus canker is a highly contagious bacterial disease of citrus that causes premature leaf and fruit drop. Citrus canker causes no threat to humans, animals or plant life other than citrus. Prior to January 10, 2006, Florida law required infected and exposed trees within 1,900 feet of the canker find to be removed and destroyed. The Company's traditional policy has been to recognize a loss estimate for the total destruction of all trees within 1,900 feet of the canker find as soon as canker was confirmed. This estimate of loss damage preceded the actual destruction of the trees. During the second quarter of fiscal year 2006, the USDA determined that due to the potential spread of canker from hurricanes they did not believe that canker eradication was feasible. Due to this determination, the rule requiring the destruction of citrus groves testing positive for canker was suspended. Upon suspension of the rule requiring the destruction of citrus groves, those portions of grove that were previously estimated as lost but had not yet been destroyed were reestablished, reducing the casualty loss accrued.

16. Subsequent Event:

At its meeting on June 30, 2006, the Board declared a regular quarterly dividend of $0.275 per share payable to shareholders of record as of September 30, 2006 with payment expected on or about October 15, 2006.

ITEM 2.

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

Cautionary Statement

Some of the statements in this document include statements about future expectations. Statements that are not historical facts are "forward-looking statements" for the purpose of the safe harbor provided by Section 21E of the Exchange Act and Section 27A of the Securities Act. These forward-looking statements, which include references to one or more potential transactions, and strategic alternatives under consideration, are predictive in nature or depend upon or refer to future events or conditions, are subject to known, as well as, unknown risks and uncertainties that may cause actual results to differ materially from Company expectations. There can be no assurance that any future transactions will occur or be structured in the manner suggested or that any such transaction will be completed. The Company undertakes no obligation to update publicly any forward-looking statements, whether as a result of future events, new information or otherwise.

When used in this document, or in the documents incorporated by reference herein, the words "anticipate", "believe", "estimate", "may", "intend", "expect", "should", "could" and other words of similar meaning, are likely to address the Company's growth strategy, financial results and/or product development programs. Actual results, performance or achievements could differ materially from those contemplated, expressed or implied by the forward-looking statements contained herein. The considerations listed herein represent certain important factors the Company believes could cause such results to differ. These considerations are not intended to represent a complete list of the general or specific risks that may affect the Company. It should be recognized that other risks, including general economic factors and expansion strategies, may be significant, presently or in the future, and the risks set forth herein may affect the Company to a greater or lesser extent than indicated.

LIQUIDITY AND CAPITAL RESOURCES:

Working capital decreased to $88.5 million at May 31, 2006, from $111.2 million at August 31, 2005. As of May 31, 2006, the Company had cash and cash equivalents of $21.1 million compared to $13.4 million at August 31, 2005. Marketable securities decreased to $51.4 million from $70.8 million during the same period. The ratio of current assets to current liabilities decreased to 5.25 to 1 at May 31, 2006 from 7.24 to 1 at August 31, 2005. Total assets increased by $12.6 million to $260.3 million at May 31, 2006, compared to $247.7 million at August 31, 2005.

Management believes that the Company will be able to meet its working capital requirements for the foreseeable future with internally generated funds. In addition, the Company entered into a credit facility in fiscal year 2006 which increased its credit commitments to provide for revolving credit of up to $175.0 million compared with credit commitments of $44.0 million in fiscal year 2005. Of the $175.0 million credit commitment, $123.9 million was available for the Company's general use at May 31, 2006 (see Note 7 to condensed consolidated financial statements).

Hurricane Wilma, a category three hurricane, swept through southwest Florida in October 2005, causing extensive damage to the Company’s crops and infrastructure in Collier and Hendry Counties. The Company has recorded an estimated casualty loss of $2.8 million of damages to crop inventories and property and equipment resulting from the hurricane.

Management expects continued profitability from the Company’s agricultural operations. Citrus operations are expected to remain profitable in fiscal year 2006. A smaller crop resulting from hurricanes, citrus canker and land development has caused the unit price of citrus products to increase and thus profits from the citrus division are expected to exceed those of the prior year.

Sugarcane and sod operations are expected to approximate prior year levels. The Company's cattle operations in fiscal year 2006 are expected to remain profitable but at lower levels than in fiscal year 2005. To take advantage of favorable market conditions in fiscal year 2005, the Company elected to sell a portion of its calves instead of delivering them to feedlots for later sale. This decision resulted in a decrease of beef cattle inventory at August 31, 2005 and in fewer cattle available for sale in fiscal year 2006 compared with fiscal year 2005.

Cash outlays for land, equipment, buildings, and other improvements totaled $31.4 million during the nine months ended May 31, 2006, compared to $11.6 million during the nine months ended May 31, 2005. In May 2006, Alico purchased 523 acres of riverfront mining property in Hendry County, Florida for $10.6 million. In February 2006, Alico, through its newly formed subsidiary Bowen Brothers Fruit, LLC, purchased the assets of Bowen Brothers Fruit Co., Inc. for $1.9 million. In October 2005, the Company through Alico-Agri, purchased 291 acres of lake-front property in Polk County, Florida, for $9.2 million. In September 2004, the Company, through Alico-Agri Ltd., purchased the assets of La Belle Plant World, Inc. The purchase price was $4.9 million for the land, office building, greenhouses and associated equipment.

In accordance with guidelines established by the Company's Board of Directors, the Company restructured its investment portfolio during the first quarter of fiscal 2006, focusing on high quality fixed income securities with original maturities of less than 12 months. As a result of staggered maturity dates, a greater portion of the Company's portfolio is classified as cash equivalents than under previous investment policies.

The sale of a Lee County parcel closed in escrow during July 2005. The sales price was $62.9 million consisting of $6.2 million in cash at closing with the balance held as a 2.5% mortgage note receivable of $56.7 million payable in four equal principal installments together with accrued interest annually for the next four years after a final development order for the property is issued. The first principal and interest installment under the contract will not be due until 12 months after the order is issued. The development order has not yet been issued; however, in any event the first installment is due and payable in July 2008, if not paid before that date.

Another sale in Lee County is expected to close in fiscal year 2007. This contract is for a gross sales price of $75.5 million, consisting of $7.6 million in cash at closing with the balance payable as a 2.5% mortgage note receivable of $67.9 million. The agreement is subject to various contingencies and there is no assurance that it will close or that it will close within the time period stated.

In November 2005, the Company sold approximately 280 acres of citrus grove land located south of LaBelle, Florida in Hendry County for $5.6 million cash placed in escrow. The Company will retain operating rights to the grove until residential development begins. The Company used the proceeds from the sale as part of a section 1031 like kind exchange for the mining property acquired in May 2006.

The Company paid regular quarterly dividends of $0.25 per share on October 15, 2005, January 15, 2006 and April 15, 2006. At its March Board meeting, the Board declared a regular quarterly dividend of $0.25 per share payable to shareholders of record as of June 30, 2006 with payment expected on or about July 15, 2006. At its June Board meeting, the Board declared a regular quarterly dividend of $0.275 per share payable to shareholders of record as of September 30, 2006 with payment expected on or about October 15, 2006.

The Internal Revenue Service is examining the Company's tax returns for the years ended August 31, 2004, 2003, 2002, 2001 and 2000, and Agri tax returns for calendar years 2003, 2002, 2001 and 2000. The examinations began in October 2003. Any assessments resulting from the examinations will be currently due and payable. A revenue agent issued a report in May 2004, challenging Agri's tax exempt status for the years examined; however, the report did not quantify the adjustment or assessment proposed. Agri responded with a written report that disputed the facts, interpretation of law, and conclusions cited in the Agent's report. Upon receipt of Agri's response in July 2004, the Agent proposed requesting a Technical Advice Memorandum (TAM) from the national office to assist in settling the differences. After reviewing the proposed TAM request from the IRS, Agri responded with a written report that disputed the facts the IRS cited in its request. Due to the breadth and substantial nature of the dispute, the IRS has chosen not to pursue the TAM.

In June 2006 the IRS issued notices of proposed adjustments that take the position that the determination letter issued to Agri should be retroactively revoked, and the value of the assets contributed from Alico to Agri should be taxed at their fair market value at the date of transfer. Additionally, the notices allege that Alico expensed certain fees and expenses that should have been capitalized. Although the proposed adjustments do not quantify the tax, penalty or interest proposed, the total proposed adjustments would result in additional taxable income to the Company of $0.3 million, $76.6 million and $42.8 million for the fiscal years ended August 31, 2002, 2001 and 2000, respectively. The notices of proposed adjustments also contain an alternative IRS position alleging that even if the determination letter was valid, that under the Code Section 482, Alico, Inc. remains liable for tax on the sale of the real estate transferred. This alternative proposed adjustment does not quantify the tax, penalty or interest proposed, but the proposed adjustment would result in additional taxable income to the Company of $19.4 million, $13.4 million, $11.1 million, $1.4 million and $10.3 million for the fiscal years ended August 31, 2004, 2003, 2002, 2001 and 2000, respectively. A third and fourth alternative position taken by the IRS alleges that Alico acted as Agri's agent or that two real estate sales be taxable to Alico under the assignment of income doctrine. These alternative positions do not quantify the adjustment to income, tax, penalty or interest proposed, but the Company estimates that the adjustment under either of these alternative positions would result in additional taxable income to the Company of approximately $0.3 million, $1.2 million, and $10.3 million for the fiscal years ended August 31, 2002, 2001, and 2000, respectively. The Company does not agree with the proposed adjustments and plans to defend against the challenges vigorously. See also footnote 8 to the condensed consolidated financial statements.

RESULTS OF OPERATIONS:

The basic business of the Company is agriculture, which is of a seasonal nature and is subject to the influence of natural phenomena and wide price fluctuations. The results of operations for the stated periods are not necessarily indicative of results to be expected for the full year.

Net income for the three and nine months ended May 31, 2006 was $2.5 million and $6.4 million respectively compared with net income of $2.6 million and $3.6 million for the three and nine months ended May 31, 2005, respectively. Increased earnings from bulk real estate sales ($4.4 million compared with $0.0 million for the nine months ended May 31, 2006 and May 31, 2005, respectively) and interest and investment income ($8.1 million for the nine months ended May 31, 2006 compared with $2.7 million for the nine months ended May 31, 2005) offset the casualty loss of $2.8 million for the nine months ended May 31, 2006. The Company accrued interest on a mortgage note receivable of $56.6 million during the nine months ended May 31, 2006 from the Lee County land sale in July 2005. This accrual combined with higher interest rates for investments and realized gains from the sale of equities, caused interest and investment income to exceed prior year results for the three and nine months ended.

Pretax income from operations was $2.9 million for the quarter ended May 31, 2006 compared with $4.2 million for the quarter ended May 31, 2005. The decrease was primarily due to lower pretax income from rock and sand royalties ($0.2 million compared with $0.9 million for the quarters ended May 31, 2006 and 2005, respectively) and increased general and administrative expenses ($3.1 million compared with $2.5 million for the quarter ended May 31, 2006 and 2005).

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Operations reported a pretax loss of $0.2 million for the nine months ended May 31, 2006, compared with a pretax profit of $4.1 million for the nine months ended May 31, 2005. A casualty loss related to citrus canker and Hurricane damages of $2.8 million coupled with decreased rock and sand royalties ($0.7 million compared with $2.6 million for the nine months
ended May 31, 2006 and 2005, respectively) caused the decrease. The property where a large rock mine was located was sold in July 2005. The Company has begun limited mining operations on a new site and recently purchased a 523 acre riverfront mine site suitable for mining operations.

Pretax income from agricultural operations (excluding casualty losses) were $5.5 million compared with $5.1 million for the quarters ended May 31, 2006 and 2005, respectively, and $8.3 million compared with $8.1 million for the nine months ended May 31, 2006 and 2005, respectively. The factors causing the increase in pretax income from agricultural operations excluding casualty losses are discussed in detail below.

Citrus

The Citrus division recorded pretax profits of $4.4 million and $6.8 million for the quarter and nine months ended May 31, 2006, respectively, compared with $3.6 million and $5.3 million for the quarter and nine months ended May 31, 2005. Hurricanes, citrus canker finds and increased real estate development in the central and southern portions of Florida where the majority of citrus is produced have combined to reduce the supply of citrus for the past two years, resulting in price increases for citrus products across the industry. During the first nine months of fiscal year 2006 the Company has averaged $7.20 per box for its citrus products as compared with $6.41 per box for the same period in the prior fiscal year, causing the current year profit to increase.

The price increase described above has served to more than offset the damages caused by hurricane Wilma. The hurricane caused extensive damage to the Company’s crops and infrastructure in Collier and Hendry Counties. Due primarily to the damages caused by hurricane Wilma, the Company estimates its total citrus harvest for fiscal year 2006 at 3.2 million boxes, compared with 4.0 million for fiscal year 2005.

Alico, through its newly formed subsidiary Bowen Brothers Fruit, LLC (Bowen), purchased the assets of Bowen Brothers Fruit Co., Inc. for $1.9 million in February, 2006. The purchase was made in order to provide Alico with additional marketing expertise and with the ability to harvest its own fruit crop. Bowen’s operations generated revenues of $19.8 million and expenses of $19.8 million for the quarter ended May 31, 2006 and revenues of $25.5 million and expenses of $25.5 million for the period from the date of acquisition to May 31, 2006. A portion of the purchase price was allocated to intangible assets and generated an amortization cost of $0.3 million and $0.6 million for the quarter ended May 31, 2006 and the period from the date of acquisition to May 31, 2006, respectively, which was included in the total expenses reported for each respective period. Bowen’s operations are seasonal in nature and the results of operations for the stated periods are not necessarily indicative of results to be expected for the full year. Due to the amortization discussed above, Management estimates that Bowen will breakeven during fiscal 2006.

Sugarcane and Sod

Sugarcane and sod generated a pretax profit of $0.9 million for the three months ended May 31, 2006 compared with earnings of $0.1 million for the three months ended May 31, 2005. For the nine months ended May 31, 2006 and 2005, the sugarcane and sod division generated pretax profits of $0.6 million and a profit of $0.5 million, respectively. Recent price increases in the price of raw sugar improved sugarcane profitability during the quarter ended May 31, 2006, and returned the division to its prior year profitability levels.

Cattle

Pretax profits from the sale of cattle were $0.1 million and $0.7 million for the three and nine months ended May 31, 2006, respectively, compared with $1.1 million and $1.8 million for the three and nine months ended May 31, 2005. The number of cattle sold was less during the first nine months of fiscal year 2006 than for the same period in the prior fiscal year (4,133 for the first nine months of fiscal year 2006 compared with 9,995 for the first nine months of fiscal year 2005). During fiscal year 2005, in order to take advantage of record high prices for calves, the Company sold a portion of its calf crop that would have normally been delivered to western feedlots. Calves delivered to western feedlots require an additional nine months of preparation before they are ready for sale. Due to the sale of the calves in the prior fiscal year as described above, fewer animals were available for sale in the current fiscal year.

Other Agricultural Operations

The Company also sells vegetable transplants through its subsidiary, Alico Plant World, LLC, as well as native plants from its ranch location, and grows and sells corn and beans. Pretax income from these operations totaled $0.1 million and $0.2 million for the three and nine months ended May 31, 2006, respectively. Income from plants, vegetables and trees was $0.3 million and $0.5 million for the three and nine month periods ended May 31, 2005, respectively.

General Corporate

In May 2006, the Company purchased a 523 acre riverfront mine site for rock and fill. The purchase price was $10.6 million. The property was purchased in order to partially replace the revenue stream from the Lee County rock mine which was sold in fiscal year 2005. A portion of the purchase price was designated as like kind exchange property resulting from the sale of the citrus grove described below.

In November 2005, the Company sold approximately 280 acres of citrus grove land located south of Labelle, Florida in Hendry County for $5.6 million cash placed in escrow and used as proceeds for a like kind exchange to acquire the mine site. The Company will retain operating rights to the grove until residential development begins.

The Company through Alico-Agri Ltd., purchased approximately 291 acres in Polk County, Florida in October 2005 for $9.2 million. The property contains 2,100 feet of road frontage on U.S. 27 and 2,600 feet of road frontage on County road 640. The property also includes approximately 2,640 feet of lakefront along Crooked Lake, a 6,000 acre lake. The Company identified the property as an exchange property under section 1031 of the Internal Revenue Code and was able to defer tax on $9.2 million of proceeds from the sale of a Lee County parcel that closed in escrow in July 2005 and is described below.

The sale of a Lee County parcel closed in escrow during July 2005. The sales price was $62.9 million consisting of $6.2 million in cash at closing with the balance held as a 2.5% mortgage note receivable of $56.7 million payable in four equal principal installments together with accrued interest annually for the next four years after a final development order for the property is issued. The first principal and interest installment under the contract will not be due until 12 months after the order is issued. The development order has not yet been issued; however, in any event the first installment is due and payable in July 2008, if not paid before that date.

An agreement to sell the remaining property in Lee County is expected to close in fiscal year 2007. This contract is for a gross sales price of $75.5 million, consisting of $7.6 million in cash at closing with the balance payable as a 2.5% mortgage note receivable of $67.9 million. The Company is exploring its options under the contract, including the possibility of a like-kind exchange. The agreement is subject to various contingencies and there is no assurance that it will close or that it will close within the time period stated.

Agri-Insurance, Co. Ltd., a wholly owned subsidiary of Alico, Inc., wrote an insurance policy in 2004 for Tri-County Grove, LLC, a subsidiary of Atlantic Blue Trust, Inc., the holder of approximately 51% of the Company's common stock. The coverage term was from August 2004 to July 2005. Total coverage under the policy was $2.7 million and Agri charged a premium of $45 thousand. Tri-County Grove LLC discovered citrus canker in their groves in 2005, requiring the total destruction of the majority of its citrus trees. Agri accrued a loss reserve in fiscal year 2005 equal to the total potential exposure under the policy for this claim of $1.4 million. The claim was paid in full in March of 2006.

Premiums for coverages quoted are set by independent actuaries and underwriters hired by Agri based on underwriting considerations established by them. Premiums vary depending upon the size of the property, its age and revenue-producing history, as well as the proximity of the insured property to known disease-prone areas or other insured hazards.

In September 2004, the Company, through Alico-Agri Ltd., purchased the assets of La Belle Plant World, Inc., a wholesale grower and shipper of commercial vegetable transplants to commercial farmers. The purchase price was $4.9 million for the land, office building, greenhouses and associated equipment. Alico Plant World, LLC ("Plant World") was set up as a wholly owned subsidiary of Alico-Agri, Ltd to operate these assets.

Off Balance Sheet Arrangements

The Company through its wholly owned subsidiary Bowen Brothers Fruit, LLC enters into forward purchase contracts for the purchase of citrus products during the normal course of its business. Typically, these purchases are covered by forward sales contracts. The total forward purchase contracts under these agreements totaled $1.7 million at May 31, 2006. All of these purchases were covered by forward sales agreements. None of these agreements were in a net loss position as of May 31, 2006. All of these contracts will be fulfilled by the end of the fiscal year 2006. Additionally, the Company hedges its fuel requirements through the purchase of fuel stocks at fixed prices for future deliveries. The net obligations under these arrangement totaled $480 thousand at May 31, 2006. Deliveries under these contracts will occur before October 31, 2006.

Disclosure of Contractual Obligations

The contractual obligations of the Company at May 31, 2006 are set forth in the table below:

May 31, 2006
(in thousands)

Contractual obligations	Total	Less than 1 year	1 - 3 years	3-5 years	5 + years
Long-term debt	$ 63,157	$ 3,312	$ 2,633	$ 53,623	$ 3,589
Expected interest on debt	17,187	$ 3,918	$ 7,341	$ 5,688	$ 240
Commissions	2,833	-	1,417	1,416	-
Citrus purchase contracts	1,692	1,692	-	-	-
Retirement benefits	4,799	637	688	688	2,786
Deferred taxes	15,869	2,928	3,800	3,800	5,341
Other non-current liability (a)	16,954	-	16,954	-	-
Building & equipment additions	1,634	1,634			
Real Estate contract obligations	726	726			
Purchase obligations (donation)	781	781	-	-	-
Fuel purchase contract	480	480	-	-	-
Sugarcane harvesting obligation	136	136			
Leases (operating & capital)	37	25	12	-	-
Total	$ 126,285	$ 16,269	$ 32,845	$ 65,215	$ 11,956

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Critical Accounting Policies and Estimates

The preparation of the Company's financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires Management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis, Management evaluates the estimates and assumptions based upon historical experience and various other factors and circumstances. Management believes that the estimates and assumptions are reasonable in the circumstances; however, actual results may vary from these estimates and assumptions under different future circumstances. The critical accounting policies that affect the more significant judgments and estimates used in the preparation of our consolidated financial statements are discussed below.

Alico records inventory at the lower of cost or market. Management regularly assesses estimated inventory valuations based on current and forecasted usage of the related commodity and any other relevant factors that affect the net realizable value.

Based on fruit buyers' and processors' advances to growers, stated cash and futures markets, together with combined experience in the industry, Management reviews the reasonableness of the citrus revenue accrual. Adjustments are made throughout the year to these estimates as relevant information regarding the citrus market becomes available. Fluctuation in the market prices for citrus fruit has caused the Company to recognize additional revenue from the prior year's crop totaling $839 thousand for the nine months ended May 31, 2006, and $357 thousand for the nine months ended May 31, 2005.

In accordance with Statement of Position 85-3 "Accounting by Agricultural Producers and Agricultural Cooperatives", the cost of growing crops (citrus and sugarcane) are capitalized into inventory until the time of harvest. Once a given crop is harvested, the related inventoried costs are recognized as cost of sales to provide an appropriate matching of costs incurred with the related revenue earned. The inventoried cost of each crop is then compared with the estimated net realizable value (NRV) of the crop and any costs in excess of the NRV are immediately recognized as cost of sales.

Hurricane Wilma caused extensive damage to the Company’s crops and infrastructure in Collier and Hendry Counties. In calculating the estimated amount of loss resulting from the hurricane, Management estimated the amount of crop loss and property damage. The estimates were based on information obtained from observation, provided by insurance claims adjusters, and discussions with other industry experts. These estimates will continue to be revised as actual losses are confirmed.

In June of 2000, Alico formed a wholly owned insurance subsidiary, Agri Insurance Company, Ltd. (Bermuda), in response to the lack of available insurance, both in the traditional commercial insurance markets and governmental sponsored insurance programs, suitable to provide coverages for the increasing number and potential severity of agricultural related events. Such events typically include citrus canker, crop diseases, livestock related maladies and weather. By forming Agri, Alico hoped to prefund its potential exposures related to the referenced events, and also attract new underwriting capital to the extent that Agri is successful in profitably underwriting both its own potential risks, and those of its historic business partners.

Alico capitalized Agri by contributing real estate located in Lee County, Florida. The real estate was transferred at its historical cost basis. Agri received a determination letter from the Internal Revenue Service (IRS) stating that Agri was exempt from taxation provided that net premium levels, consisting only of premiums with third parties, were below an annual stated level ($350 thousand). Third party premiums have remained below the stated annual level. As the Lee county real estate was sold, substantial gains were generated in Agri, creating permanent book and tax differences.

Since receiving the favorable IRS determination letter, certain transactions, entered into by other taxpayers under the same IRS Code Section came under scrutiny and criticism by the news media. In reaction, Management has recorded a contingent liability of $17.0 million at May 31, 2006 and August 31, 2005 for income taxes in the event of an IRS challenge. Management's decision has been influenced by perceived changes in the regulatory environment. Because Management believes it is probable that a challenge will be made and that it may be successful as to some of the possible assertions, Management has provided for this contingency.

The Internal Revenue Service is examining the Company's tax returns for the years ended August 31, 2004, 2003, 2002, 2001 and 2000, and Agri tax returns for calendar years 2003, 2002, 2001 and 2000. The examinations began in October 2003. Any assessments resulting from the examinations will be currently due and payable. A revenue agent issued a report in May 2004, challenging Agri's tax exempt status for the years examined; however, the report did not quantify the adjustment or assessment proposed. Agri responded with a written report that disputed the facts, interpretation of law, and conclusions cited in the Agent's report. Upon receipt of Agri's response in July 2004, the Agent proposed requesting a Technical Advice Memorandum (TAM) from the national office to assist in settling the differences. After reviewing the proposed TAM request from the IRS, Agri responded with a written report that disputed the facts the IRS cited in its request. Due to the breadth and substantial nature of the dispute, the IRS has chosen not to pursue the TAM.

In June 2006 the IRS issued notices of proposed adjustments that take the position that the determination letter issued to Agri should be retroactively revoked, and the value of the assets contributed from Alico to Agri should be taxed at their fair market value at the date of transfer. Additionally, the notices allege that Alico expensed certain fees and expenses that should have been capitalized. Although the proposed adjustments do not quantify the tax, penalty or interest proposed, the total proposed adjustments would result in additional taxable income to the Company of $0.3 million, $76.6 million and $42.8 million for the fiscal years ended August 31, 2002, 2001 and 2000, respectively. The notices of proposed adjustments also contain an alternative IRS position alleging that even if the determination letter was valid, that under the Code Section 482, Alico, Inc. remains liable for tax on the sale of the real estate transferred. This alternative proposed adjustment does not quantify the tax, penalty or interest proposed, but the proposed adjustment would result in additional taxable income to the Company of $19.4 million, $13.4 million, $11.1 million, $1.4 million and $10.3 million for the fiscal years ended August 31, 2004, 2003, 2002, 2001 and 2000, respectively. A third and fourth alternative position taken by the IRS alleges that Alico acted as Agri's agent or that two real estate sales be taxable to Alico under the assignment of income doctrine. These alternative positions do not quantify the adjustment to income, tax, penalty or interest proposed, but the Company estimates that the adjustment under either of these alternative positions would result in additional taxable income to the Company of approximately $0.3 million, $1.2 million, and $10.3 million for the fiscal years ended August 31, 2002, 2001, and 2000, respectively. The Company does not agree with the proposed adjustments and plans to defend against the challenges vigorously. See also footnote 8 to the condensed consolidated financial statements.

Since January 1, 2004 Agri has been filing as a taxable entity as a result of changes in the Internal Revenue Code.

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

The table below provides information about the Company's investment in marketable debt securities and its loan obligations that are sensitive to changes in interest rates. The table also provides information about the Company's purchase and sales contracts that are sensitive to changes in the citrus juice prices.

Investments are placed with high quality issuers and, by policy, limit the amount of credit exposure to any one issuer. Alico is averse to principal loss and provides for the safety and preservation of invested funds by limiting default, market and reinvestment risk. The Company classifies cash equivalents and investments as fixed-rate if the rate of return on such instruments remains fixed over their term. These fixed-rate investments include fixed-rate U.S. government securities, municipal bonds, time deposits and certificates of deposit. Cash equivalents and investments are classified as variable-rate if the rate of return on such investments varies based on the change in a predetermined index or set of indices during their term. These variable-rate investments primarily include money market accounts, mutual funds and debt instruments held at various securities brokers and investment banks.

Fixed rate securities tend to decline with market rate interest increases. Variable rate securities are generally affected more by general market expectations and conditions. Additionally, the Company has debt with interest rates that vary with the LIBOR. A 1% increase in this rate would impact the Company's annual interest expense by approximately $511 thousand based on the Company's outstanding debt under these agreements at May 31, 2006.

The Company through its wholly owned subsidiary Bowen Brothers Fruit, LLC, purchases citrus from growers and resells the fruit to various processing plants. Both the purchase and sales prices may be fixed or variable. At May 31, 2006 all variable purchase contracts had been settled. The table below shows the total commitment for variable sales price contracts calculated using the base contract price. These variable price contracts were closed out in June for an additional $108 thousand in revenue.

	Expected Maturity Date							
	Year 1	Year 2	Year 3	Year 4	Year 5	Thereafter	Total	Fair Value
Interest Rate Sensitivity								
Assets								
Marketable Debt Securities								
Fixed Rate Securities	$ 19,238	4,042	143	261	199	3,260		27,143
Average Interest Rate	4.66%	6.14%	5.03%	5.32%	5.03%	4.96%		4.92%
Variable Rate Securities	$ 7,759	2,700	-	-	-	13,380		23,839
Liabilities								
Notes Payable								
Fixed Rate Notes	$ 3,312	1,315	1,318	1,267	1,267	3,589	12,068	
Average Interest Rate	6.16%	6.69%	6.69%	6.68%	6.68%	6.68%	6.54%	
Variable Rate Notes					51,089		51,089	
Average Interest Rate					5.63%		5.63%	
Commodity Price Sensitivity								

Variable Pricing Contracts		
Fruit Purchase Commitments	-	0
Fruit Sales Commitments	$ 4,064	4,064

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ITEM 4. Controls and Procedures

Evaluation of disclosure controls and procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is recorded, processed, summarized and reported within the time periods specified
in the SEC's rules and forms and that such information is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. The Company periodically reviews the design and effectiveness of its disclosure controls and internal control over financial reporting. The Company makes modifications to improve the design and effectiveness of its disclosure controls and internal control structure, and may take other corrective action if its reviews identify a need for such modifications or actions.

A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls could be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions. Additionally, the degree of compliance with the policies or procedures may deteriorate over time. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

In connection with the preparation of the Company's Annual Report on Form 10-K, as of August 31, 2005, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act). The Company concluded that control deficiencies in its internal control over financial reporting as of August 31, 2005 constituted a material weakness within the meaning of the Public Company Accounting Oversight Board's Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.

The material weakness identified by the Company was disclosed in its Annual Report on Form 10-K, which was filed with the SEC on November 23, 2005. Based on that and subsequent evaluations, the Chief Executive Officer and Chief Financial Officer have concluded that, as of May 31, 2006, the Company's disclosure controls and procedures are not effective, for the reasons described above (relating to the previously-identified material weakness in internal control over financial reporting).

Changes in internal control over financial reporting

Management, with oversight from the Audit Committee of the Board of Directors, has been addressing the material weakness disclosed in its Form 10-K and is committed to effectively remediating known weaknesses as expeditiously as possible. Although the Company's remediation efforts are well underway, control weaknesses will not be considered remediated until new internal controls over financial reporting are implemented and operational for a sufficient period of time to allow for effective testing and are tested, and management and its independent registered certified public accounting firm conclude that these controls are operating effectively. Management has therefore concluded that there have been no changes made in the Company's internal controls over financial reporting in connection with its third quarter evaluation that would materially affect, or are reasonably likely to materially affect, its internal control over financial reporting.

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The current status of the Company's remediation efforts to address the material weakness in internal control over financial reporting identified in its Annual Report for the year ended August 31, 2005 is as follows:

Management assessed the effectiveness of the Company’s internal control over financial reporting as of August 31, 2005. In making the assessment, Management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) in Internal Control - Integrated Framework. Based upon this assessment and as more fully explained below, management identified a material weakness in Alico’s internal control over financial reporting as of August 31, 2005. A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. Management identified the following material weakness as of August 31, 2005:

A lack of qualified financial reporting personnel with sufficient depth, skills, and experience to apply generally accepted accounting principles to the Company's transactions and to prepare financial statements that comply with generally accepted accounting principles. Specifically, monitoring controls to ensure journal entries are posted accurately and in a timely fashion were ineffective during the fiscal 2005 closing process. This resulted in a missed elimination entry to inter-company accounts and an incorrect entry to deferred income taxes and other comprehensive income. Although the missed or incorrect entries were not prevented or detected by the Company's existing system of internal controls, the entries were identified by the Company’s independent registered certified public accounting firm, and were corrected and properly reflected in the fiscal 2005 year end financial statements.

Although the Company does not believe that the material weakness identified impacted any previously filed financial statements, the existence of a material weakness or weaknesses is an indication that there is more than a remote likelihood that a material misstatement of the Company's financial statements will not be prevented or detected in a future period.

The Company has substantially completed implementation of the changes it believes are required to remediate the previously reported material weaknesses in internal control over financial reporting related to maintaining an effective control environment by: (i) adding a certified public accountant, a qualified and experienced financial reporting manager, to the Company's Accounting Department to ensure that the Company has sufficient depth, skills and experience within the department to prepare the Company's financial statements and disclosures in accordance with generally accepted accounting principles in the United States of America; (ii) hiring an assistant controller to process transactions and allowing the controller more time to perform in depth reviews of financial accounting information; (iii) enhancing and strengthening its written accounting and reporting policies pertaining to the elimination of inter-company balances and training employees with respect to the new policies; and (iv) purchasing accounting software specifically designed to handle consolidating entries, schedules and issues. All these changes have taken place subsequent to the year ended August 31, 2005. Management will continue to evaluate the progress and abilities of accounting personnel in order to assess whether weakness has been effectively remediated. While the remediation measures are expected to improve the design and effectiveness of the Company's internal control over financial reporting, certain of the corrective processes, procedures and controls have not been tested. In general, the controls have not yet operated effectively for a sufficient period of time to demonstrate operating effectiveness. Accordingly, the CEO and CFO have concluded that the Company's disclosure controls and procedures were not effective as of August 31, 2005 and May 31, 2006. Management is committed to correcting this material weakness.

As a result of the material weakness and factors identified above, we have concluded that as of August 31, 2005, and May 31, 2006, the Company did not maintain effective internal control over financial reporting.

FORM 10-Q
PART II. OTHER INFORMATION

ITEM 1.Has been omitted as there are no items to report during this interim period.

ITEM 2. Unregistered sales of Equity Securities

On November 30, 2005 pursuant to the Director Compensation Plan approved by the Company's shareholders on June 10, 2005, the Company issued 6,447 of its common stock as restricted shares privately placed in reliance on rule 144 to the independent directors as follows:

Evelyn D'An	725 shares
Phillip S. Dingle	896 shares
Gregory T. Mutz	2,809 shares
Charles L. Palmer	923 shares
Gordon Walker	1,094 shares

The Directors received the shares in lieu of cash Director fees as provided under the Director Compensation Plan. The Company did not receive any cash for these transactions.

The following table provides information relating to purchases by Alico, Inc. of Alico, Inc. common shares on the open market pursuant to the Director Compensation Plan approved by the Company's shareholders on June 10, 2005 for the first nine months of fiscal 2006:

Date	Total Number of Shares Purchased	Average price paid per share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(1)	Approximate Dollar Value of Shares that May Yet Be Purchased Under Publicly Announced Plans or Programs
11/28/2005	10,000	$ 43.30	10,000	$ 902,600
5/9/2006	3,000	$ 54.46	13,000	$ 925,820

ITEM 3. has been omitted as there are no items to report during this interim period.

ITEM 4. has been omitted as there are no items to report during this interim period.

ITEM 5 has been omitted as there are no items to report during this interim period.

ITEM 6. Exhibits

Exhibit 3.1 Restated Certificate of Incorporation, dated February 17, 1971, as amended (incorporated by reference to the Company's Registration Statement on form S-1, File No. 2-43156).
Exhibit 3.2 Bylaws of the Company, as amended (incorporated by reference to the Company's Registration Statement on form S-8, File No. 333-130575).

Exhibit 10.1 Loan Agreement, dated October 11, 2005 (incorporated by reference to Exhibit 10.01 of the Company's Current Report on Form 8-K filed October 17, 2005).
Exhibit 10.2 Amended and Restated Loan Agreement, dated May 26, 2006 (incorporated by reference to Exhibit 10.01 of the Company's Current Report on Form 8-K filed June 1, 2006).
Exhibit 11 Computation of Earnings per share May 31, 2006.
Exhibit 31.1 Rule 13a-14(a) certification.
Exhibit 31.2 Rule 13a-14(a) certification.
Exhibit 32.1 Section 1350 certification.
Exhibit 32.2 Section 1350 certification.

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.

ALICO, INC.
(Registrant)

July 10, 2006
John R. Alexander
Chairman
Chief Executive Officer
(Signature)

July 10, 2006
Patrick W. Murphy
Vice President
Chief Financial Officer
(Signature)

July 10, 2006
Jerald R. Koesters
Controller
(Signature)
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