

Balance.
Stability.
Performance.

CapitalSource Inc.

2005 Annual Report



CAPITALSOURCE INC. (NYSE: CSE) is a leading independent commercial finance company with over \$6.0 billion in commercial lending assets and more than 500 employees in 23 offices throughout the United States and the United Kingdom. Unique among real estate investment trusts (REITs), we specialize in asset-based, corporate and real estate lending for a wide range of small to mid-size companies. We offer investors all the advantages of a dividend-paying REIT, combined with balance and stability that derive from our broad, diversified lending platform.

FINANCIAL HIGHLIGHTS

(\$ in thousands, except per share data)

	2005	2004
Total Loans	\$5,987,743	\$4,274,525
Total Borrowings	5,375,582	3,706,154
Shareholders' Equity	1,199,938	946,391
Total Interest and Fee Income	645,290	400,151
Net Interest and Fee Income	459,355	321,098
Provision for Loan Losses	65,680	25,710
Operating Expenses	143,836	107,748
Other Income	19,233	17,781
Net Income	164,672	124,851
Fully Diluted Earnings Per Common Share	1.33	1.06
Return on Average Assets	3.04%	3.59%
Return on Average Equity	15.05%	14.17%
Net Interest Margin	8.65%	9.30%
Total Debt to Equity (period end)	3.63x*	3.93x

* Pro-forma to reflect stock dividend payable as equity

Balance.

A DIVERSE PORTFOLIO MINIMIZES EXPOSURE AND MAXIMIZES PREDICTABILITY.

Stability.

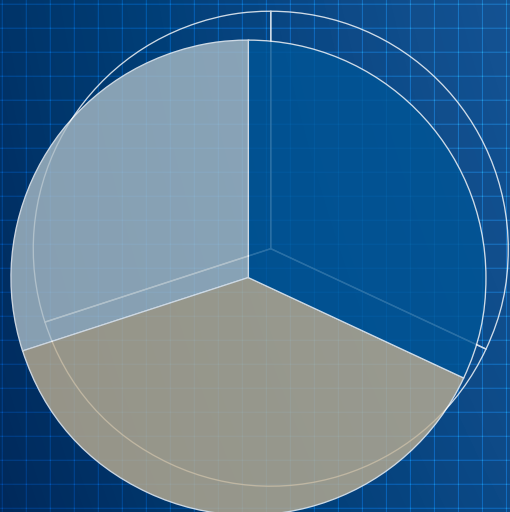
A STRONG MIX OF FUNDING SOURCES PROVIDES STABILITY.

Performance.

OUR FINANCIAL MODEL GENERATES SUPERIOR RETURNS.

Balance.

A DIVERSE PORTFOLIO MINIMIZES EXPOSURE AND MAXIMIZES PREDICTABILITY.



\$6.0 billion

in commercial lending assets

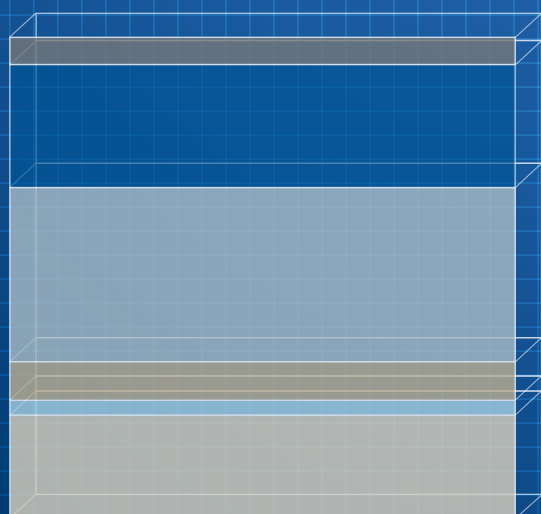
- Structured Finance—32%
- Healthcare & Specialty Finance—38%
- Corporate Finance—30%

At CapitalSource, we achieve balance by maintaining a diversified portfolio across products and businesses. Our commercial loan portfolio encompasses investments in more than a dozen specific sectors and represents a mix of senior secured asset-based, senior secured cash flow, first mortgage and mezzanine loans. This diversified platform limits our exposure to a single sector and makes our growth more predictable. It also lets us identify the best growth prospects and allocate capital where it generates the best returns for our investors. That process makes us disciplined and promotes best practices. It gives us balance.



Stability.

A STRONG MIX OF FUNDING SOURCES PROVIDES STABILITY.



3.63x
debt/equity*

- Repurchase Agreements—5%
- Term Debt—26%
- Credit Facilities—36%
- Convertible Debentures—8%
- Subordinated Debt—3%
- Equity—22%

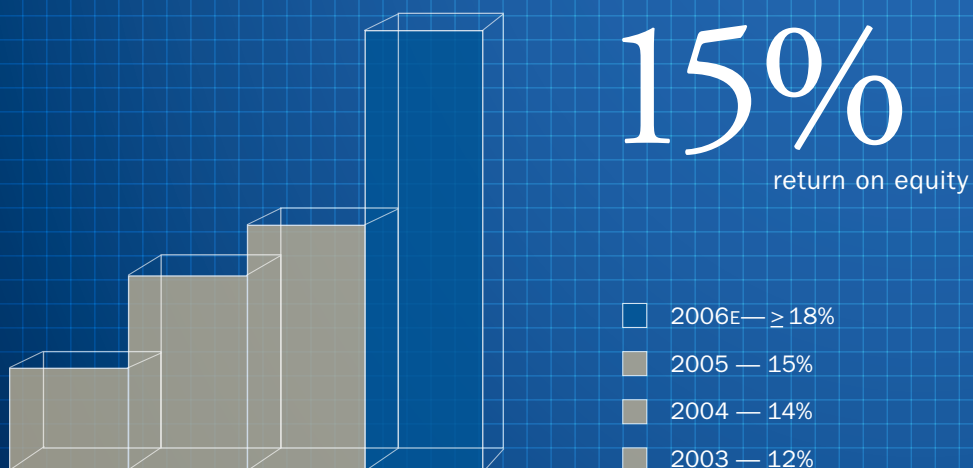
Modestly leveraged, we invest through a mix of diverse, stable, low cost funding sources. We continue to expand and diversify our funding base. Our broad funding platform is combined with a highly selective, disciplined approach to investing that incorporates unforgiving credit standards—all of which provide stability.

* Pro-forma to reflect stock dividend payable as equity



Performance.

OUR FINANCIAL MODEL GENERATES SUPERIOR RETURNS.



Our financial model is working. Since 2003, our commercial loan portfolio has grown from nearly \$2.5 billion in assets to over \$6.0 billion at year-end 2005. We've achieved that growth by continually focusing on asset classes where we can earn high risk adjusted returns, and on lending products with relatively less competitors. For 2005, CapitalSource achieved a return on equity (ROE) of 15%. On a pre-tax basis, our ROE was 24.6%. We expect our new, more tax efficient REIT structure to contribute to stronger ROE in the years ahead, enabling our shareholders to further benefit from our performance.



DEAR SHAREHOLDER:

2005 was an exciting year for our company on many levels. We delivered superior financial results, driven by strong net asset growth, high risk adjusted yields, and good credit outcomes. We also announced our intention to elect real estate investment trust (“REIT”) status in 2006. The REIT election was well received by our shareholders and makes our various real estate lending businesses much more competitive while opening new avenues for growth to which we can apply our resident real estate expertise.

In October, we completed a successful follow-on stock offering, generating net proceeds of approximately \$414 million. This was the first time we have raised equity capital for the company since our initial public offering, and we had strong participation from our original investors and Board members. That participation, together with additional insider purchases in the open market, resulted in over \$130 million of stock acquired last year, bringing total ownership by management and the Board to approximately 70 million shares. We believe this significant insider ownership strongly aligns the interests of our management and Board with that of our stockholders.

CapitalSource is now one of the first of what we are calling “Hybrid REITs” (that is, real estate investment trusts that blend real estate assets with corporate assets into one integrated lending and investment platform). With the lower corporate taxation afforded



John K. Delaney
Chairman and Chief Executive Officer

by REIT status, our real estate businesses can compete more effectively in their markets while generating improved returns on equity. We are using our enhanced competitive position to pursue larger deals with stronger sponsors. As a result, we expect strong but prudent growth from both our market-leading corporate lending business units and our real estate lending business units.

CapitalSource is now a collection of disciplined and focused business lending and asset management platforms that share many common attributes, including: best-in-class credit and risk management technology, unique credit insight, a senior secured debt orientation, a proprietary origination platform, and a deep understanding of the needs and characteristics of customers. These attributes provide a balanced business platform through which we allocate capital appropriately based on opportunities driven by market capital flows, secular changes in the economy, and the growth prospects of our underlying customers. Our shareholders should expect



Jason M. Fish
Vice Chairman and Chief Investment Officer

this balance to produce stability, durability and growth across the next several years—a profile significantly different from “mono-line” financial services firms.

It is with our balanced approach that CapitalSource trends carefully into a global economy characterized by rapid change, a strong supply of capital, and a shrinking risk premium. It is our view that opportunities abound, but superior returns on equity can be consistently realized only through investment in direct in-house origination and credit capabilities and a balanced business model, both of which we have made the foundations of CapitalSource.

In 2006, we expect to see a reasonably stable environment for commercial lending. Due to the global supply and efficiency of capital, we expect spreads and risk premiums to continue to tighten. Our view, however, is that CapitalSource can continue to grow and improve our return on equity by maintaining our focus on opportunities where we can add value through

industry expertise, a creative lending approach and timely execution, including in out-of-favor segments of the economy, and by continuing to serve our customers well. In addition, during 2006, we will have opportunities to make our business more efficient through operating, funding and tax efficiencies.

We feel good about our business. We know our portfolio, we know the quality of our opportunities, and we know the quality of the team. We also know that our balance and the diversity of our product offerings will make us more stable than our competitors, and reward our shareholders.

We look forward to 2006 with a renewed sense of energy and excitement. We expect 2006 to be characterized by strong net asset growth, improving operating and funding efficiencies, and improving returns on equity. We believe that we are on the path toward building great shareholder value and thank you for your continued support.

A stylized, cursive signature in black ink, appearing to read "John K. Delaney".

John K. Delaney
Chairman and
Chief Executive Officer

A cursive signature in black ink, clearly legible as "Jason M. Fish".

Jason M. Fish
Vice Chairman and
Chief Investment Officer

TEN BUSINESS PRINCIPLES

1. ECONOMIC GOAL

Our long-term economic goal is to manage our business to achieve a return on invested equity in excess of 18%.

2. BUSINESS PLAN

Our business is principally originating commercial and real estate loans and investments. It is our view that the most direct way to achieve our long-term economic goal is by building platforms which originate loans and make investments that have superior risk-adjusted returns. Put another way, we seek to originate loans and make investments that have high returns relative to their risk profile. In general, this is achieved if multiple, balanced lending and investing platforms target inefficiencies in the debt markets, are staffed with experienced professionals, deliver a superior product to the customer, execute efficiently against their strategy, and maintain a strong and disciplined credit culture.

3. EMPLOYEES

Our people are our single greatest asset, and we work hard to reward them with a good working environment. We are a meritocracy and seek to advance talent at a rapid pace. We allow original ideas—driven by smart, creative people—to shape out-of-the-box solutions for our customers.

4. CUSTOMER SERVICE

Our current lending and investment platforms offer two distinct services to our customers. First, we try to act, in all respects, faster than our competition. We believe speed is a virtue in commercial finance, and the orientation of the company is to respond as quickly as we can to our clients. Second, we deliver unique solutions to our customers. We call this “the original path to yes.” In addition to these core elements of our service, we focus on providing our customers with the highest level of courtesy, service and professionalism. Unless it compromises credit quality, asset value or our business principles, no request from a customer should be denied.

5. CREDIT

We operate with a “credit first” approach and always stress that the first order of business is to maintain a good credit culture. Good credit work will be achieved by: (a) sticking to our lending discipline and (b) making decisions based on complete and accurate information. The

company's lending discipline is to make loans only when they are secured by either: (a) a business, at a discount to the enterprise value of that business in all market conditions, or (b) an asset, at a discount to the liquidation value of that asset in all market conditions. We have created a series of completely independent checks and balances in each step of the credit and investment process.

6. RISK MANAGEMENT

We manage risk in our business through strict financial controls, through an independent series of checks and balances in the credit process, and through the creation of a culture of transparency related to the underwriting and portfolio management process. It is our view that "group think" is the most successful orientation for a business that has risk management at its core. We, therefore, force active discourse on all credit decisions from groups within the business that have a different orientation on risk and return.

7. USE OF LEVERAGE

We will limit leverage to a level below what we could obtain from the debt capital markets. While this will limit returns, we believe our business will always have some dependence upon the capital markets. From time to time, the capital markets experience disruptions that cannot be predicted. The only way we know to manage through these disruptions is to maintain an adequate cushion in our balance sheet.

8. CORPORATE GOVERNANCE

We will engage in best practices with respect to financial reporting, corporate governance and overall business ethics. We try, on a regular basis, to be frank about the relative strengths and weaknesses of our business, since both will exist in varying degrees at all times.

9. BUSINESS ETHICS

We take great pride in the integrity of the firm. Honesty and fair dealings drive the daily activities of our staff.

10. OUR WORK

We take great pride in the quality of our work. Our people make a significant effort to do the best work they can in all situations.

OUR BUSINESS MODEL

STRUCTURED FINANCE

Through Structured Finance, we provide sophisticated, customized financing solutions to the commercial real estate industry and smaller finance companies. We supply capital to real estate developers and investors, mortgage companies, and commercial and consumer lenders through a mix of products including medium-term senior mortgages, bridge loans and “gap equity” financing. We also make residential mortgage investments to facilitate compliance with REIT rules and optimize the value of the REIT structure. Our senior management team has significant expertise in real estate finance, and lender and rediscount finance. That knowledge and our financial strength differentiate CapitalSource from the competition.

HEALTHCARE & SPECIALTY FINANCE

The Healthcare and Specialty Finance team at CapitalSource provides in-depth industry experience and rapid execution capabilities to deliver financing solutions to a broad range of middle market companies including healthcare, security and other general businesses. Our HealthCare and Specialty Finance business breaks down into five specialized operating groups, including healthcare real estate, and we offer a diverse suite of financial products. As a specialty lender, CapitalSource can offer both cash flow-based and asset-based transactions ranging from \$1 million to \$300 million for companies seeking all types of capital across all industries.

CORPORATE FINANCE

Through Corporate Finance, we work with middle market companies and their investors to deliver sophisticated financings for extraordinary corporate transactions such as leveraged buyouts, leveraged build-ups, consolidations, recapitalizations and growth financings. Our Corporate Finance team has significant expertise in specific industry sectors. That, combined with an ability to tailor our financial products to meet the needs of individual companies, a high level of personal service, and internal systems that speed the lending process, make CapitalSource an attractive lending partner for small and medium-sized businesses.

CAPITAL ANALYTICS

CapitalSource utilizes best-in-class analytics, credit work and risk management practices to minimize our exposure to risk and maximize our returns. CapitalAnalytics, a wholly owned subsidiary of the firm, provides in-house due diligence services to the company. This in-house capability, provided principally by underwriting officers, helps ensure the integrity and independence of the underwriting and credit analysis process. It also enables our unique dual-track approach to loan approvals. CapitalAnalytics reviews each transaction while a review is underway within each of our operating groups. That, combined with a series of checks and balances, supports our high credit standards.

CORPORATE INFORMATION

CORPORATE HEADQUARTERS

CapitalSource Inc.
4445 Willard Avenue, 12th Floor
Chevy Chase, MD 20815
Telephone: (866) 876-8723
www.capitalsource.com

INVESTOR INFORMATION

Stock Exchange Information

CapitalSource Inc. is listed on the New York Stock Exchange under the ticker symbol "CSE." As of February 23, 2006, there were approximately 233 shareholders of record and 18,967 beneficial shareholders of the company.

Quarterly Stock Prices

	High	Low
First Quarter 2004	\$24.50	\$18.85
Second Quarter 2004	\$25.02	\$20.00
Third Quarter 2004	\$23.71	\$19.15
Fourth Quarter 2004	\$25.98	\$21.25

	High	Low
First Quarter 2005	\$25.78	\$22.01
Second Quarter 2005	\$24.28	\$17.95
Third Quarter 2005	\$23.70	\$18.64
Fourth Quarter 2005	\$25.20	\$20.81

Dividend Information

From our initial public offering in August 2003 through December 31, 2005, we did not pay any dividends. On January 25, 2006, we paid a special dividend of \$2.50 per share, or \$350.9 million in the aggregate, to common shareholders of record as of November 23, 2005. This amount represents an estimate of our cumulative undistributed earnings and profits attributable to taxable years ended prior to January 1, 2006, which we are required to pay to our shareholders in connection with our REIT election for the year commencing January 1, 2006. In connection with our REIT election, we intend to begin paying a regular quarterly dividend. On February 21, our Board of Directors declared a first quarter dividend in the amount of \$0.49 per share. This dividend will be paid on or about March 31, 2006 to shareholders of record as of March 3, 2006.

Certifications

Our Chairman and Chief Executive Officer and Chief Financial Officer have delivered, and we have filed with our Annual Report on Form 10-K for the year ended December 31, 2005, all certifications required by rules of the SEC and relating to, among other things, the company's financial statements, internal controls and the public disclosures contained in the Form 10-K. In addition, following our 2005 annual meeting, our Chairman and Chief Executive Officer certified to the New York Stock Exchange that he was not aware of any violation by the company of the NYSE's corporate governance listing standards and, as required by the rules of the NYSE, expects to provide a similar certification following the 2006 annual meeting.

Cautionary Note Regarding Forward-Looking Statements and Projections

This annual report, including the footnotes to our audited consolidated financial statements included herein, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act of 1934, as amended, and as such may involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from future results, performance or achievements expressed or implied by these forward-looking statements. Forward-looking statements, which are based on certain assumptions and describe our future plans, strategies and expectations, are generally identified by our use of words such as "intend," "plan," "may," "should," "will," "project," "estimate," "anticipate," "believe," "expect," "continue," "potential," "opportunity," and similar expressions, whether in the negative or affirmative. Our ability to predict results or the mutual effect of future plans or strategies is inherently uncertain. Although we believe that the expectations reflected in such forward-looking statements are based on reasonable assumptions, actual results and performance could differ materially from those set forth in the forward-looking statements. All statements regarding our expected financial position, business and financing plans are forward-looking statements. All forward-looking statements speak only to events as of the date on which the statements are made. All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are qualified by the cautionary statements in this section. We undertake no obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in expectations after the date on which the statement is made. More detailed information about these factors is contained in our Form 10-K as filed with the Securities and Exchange Commission on March 9, 2006. The information contained in this section should be read in conjunction with our consolidated financial statements and related notes and the information contained elsewhere in this report under the caption "Selected Financial Data."

Dividend Reinvestment and Stock Purchase Plan

We provide our current and future investors with a Dividend Reinvestment and Stock Purchase Plan, which enables investors to reinvest dividends in common stock and purchase additional common stock through optional cash payments. For more information, please contact American Stock Transfer & Trust Company at (866) 673-8057 or our Investor Relations department at (800) 370-9431.

SHAREHOLDER SERVICES

American Stock & Transfer Company
59 Maiden Lane
New York, New York 10038
Telephone: (866) 668-6550
Local: (718) 921-8346
Fax: (718) 236-2641
E-mail: investors@amstock.com

FORM 10-K AND OTHER REPORTS

A copy of our Form 10-K and all quarterly filings on Form 10-Q, our Board Committee Charters, Principles of Corporate Governance and Code of Business Conduct are available without charge through our Website at www.capitalsource.com or upon written request to:

Investor Relations Department
CapitalSource Inc.
4445 Willard Avenue, 12th Floor
Chevy Chase, MD 20815

For additional information, please call (866) 876-8723 or send an e-mail to info@capitalsource.com.

ANNUAL MEETING DATE AND LOCATION

On behalf of your Board of Directors and management, we cordially invite you to attend the Annual Meeting of Shareholders to be held on Thursday, April 27, 2006, at 8:30 a.m. at our headquarters located at 4445 Willard Avenue, 12th Floor, Chevy Chase, MD 20815.

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Ernst & Young LLP
McLean, Virginia

MEDIA INQUIRIES

Requests for general information or questions from news media should be directed to:

Paul L. Wardour
Director of Marketing
CapitalSource Inc.
4445 Willard Avenue, 12th Floor
Chevy Chase, MD 20815

Telephone: (301) 841-2745

E-mail: pwardour@capitalsource.com

INVESTOR INQUIRIES

Research analysts and investors may direct their questions to:

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Finance Director
CapitalSource Inc.
4445 Willard Avenue, 12th Floor
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E-mail: tskarupa@capitalsource.com

