

CapLease, Inc.  
Form 10-Q  
August 07, 2008

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**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

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**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended June 30, 2008**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 001-32039**

**CapLease, Inc.**

**(Exact name of registrant as specified in its charter)**

**Maryland**

**(State or Other Jurisdiction of  
Incorporation or Organization)**

**52-2414533**

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

**1065 Avenue of the Americas, New York, NY**

**(Address of Principal Executive Offices)**

**10018**

**(ZIP Code)**

**Registrant's Telephone Number, Including Area Code: (212) 217-6300**

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

As of August 7, 2008, there were 44,996,589 shares of common stock of CapLease, Inc., \$0.01 par value per share, outstanding ("Common Stock").

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**CapLease, Inc.**

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

CapLease, Inc. and Subsidiaries  
 Consolidated Balance Sheets  
 As of June 30, 2008 (unaudited) and December 31, 2007

| (Amounts in thousands, except share and per share amounts)  | As Of<br>June 30,<br>2008 | As Of<br>December 31,<br>2007 |
|---|---------------------------|-------------------------------|
| <b>Assets</b>   |                           |                               |
| Real estate investments, net  | \$ 1,533,510              | \$ 1,563,570                  |
| Loans held for investment   | 290,635                   | 269,293                       |
| Commercial mortgage-backed securities   | 169,377                   | 198,187                       |
| Cash and cash equivalents   | 21,452                    | 34,047                        |
| Asset held for sale   | 5,413                     | 5,413                         |
| Structuring fees receivable   | 2,226                     | 2,576                         |
| Other assets  | 84,156                    | 85,183                        |
| <b>Total Assets</b>   | <b>\$ 2,106,769</b>       | <b>\$ 2,158,269</b>           |
| <b>Liabilities and Stockholders' Equity</b>   |                           |                               |
| Mortgages on real estate investments  | \$ 978,485                | \$ 983,769                    |
| Collateralized debt obligations   | 268,246                   | 268,227                       |
| Repurchase agreement obligations  | -                         | 232,869                       |
| Credit facility   | 208,089                   | -                             |
| Secured term loan   | 126,676                   | 129,521                       |
| Convertible senior notes  | 75,000                    | 75,000                        |
| Other long-term debt  | 30,930                    | 30,930                        |
| Intangible liabilities on real estate investments   | 50,544                    | 51,811                        |
| Accounts payable, accrued expenses and other liabilities  | 27,923                    | 24,233                        |
| Dividends and distributions payable   | 9,737                     | 9,634                         |
| <b>Total Liabilities</b>  | <b>1,775,630</b>          | <b>1,805,994</b>              |
| Minority interest   | 2,492                     | 2,616                         |
| Commitments and contingencies   |                           |                               |
| Stockholders' equity:   |                           |                               |
| Preferred stock, \$0.01 par value, 100,000,000 shares authorized, Series A cumulative redeemable preferred, liquidation preference \$25.00 per share, 1,400,000 shares issued and outstanding | 33,657                    | 33,657                        |
| Common stock, \$0.01 par value, 500,000,000 shares authorized, 44,865,560 and 44,350,330 shares issued and outstanding, respectively  | 449                       | 444                           |
| Additional paid in capital  | 322,386                   | 341,578                       |
| Accumulated other comprehensive loss  | (27,845)                  | (26,020)                      |
| <b>Total Stockholders' Equity</b>   | <b>328,647</b>            | <b>349,659</b>                |
| <b>Total Liabilities and Stockholders' Equity</b>   | <b>\$ 2,106,769</b>       | <b>\$ 2,158,269</b>           |

See notes to consolidated financial statements.

CapLease, Inc. and Subsidiaries  
Consolidated Statements of Operations  
(Unaudited)

| (Amounts in thousands, except per share amounts)                        | For the Three Months<br>Ended June 30 |                   | For the Six Months<br>Ended June 30 |                   |
|---|---------------------------------------|-------------------|-------------------------------------|-------------------|
|   | 2008                                  | 2007              | 2008                                | 2007              |
| <b>Revenues:</b>  |                                       |                   |                                     |                   |
| Rental revenue  | \$ 34,359                             | \$ 32,266         | \$ 68,720                           | \$ 56,387         |
| Interest income from loans and securities                               | 8,698                                 | 8,586             | 17,863                              | 16,987            |
| Property expense recoveries   | 2,844                                 | 2,624             | 5,604                               | 5,117             |
| Other revenue   | 217                                   | 145               | 407                                 | 294               |
| <b>Total revenues</b>   | <b>46,118</b>                         | <b>43,621</b>     | <b>92,594</b>                       | <b>78,785</b>     |
| <b>Expenses:</b>  |                                       |                   |                                     |                   |
| Interest expense  | 24,311                                | 26,948            | 48,794                              | 46,000            |
| Property expenses   | 4,973                                 | 4,668             | 9,684                               | 8,988             |
| (Gain) loss on derivatives  | (198)                                 | (300)             | 1,862                               | (290)             |
| Loss on securities  | -                                     | 372               | -                                   | 372               |
| General and administrative expenses                                     | 3,249                                 | 2,991             | 6,245                               | 5,600             |
| General and administrative expenses-stock based compensation            | 627                                   | 482               | 1,061                               | 805               |
| Depreciation and amortization expense on real property                  | 13,442                                | 12,423            | 26,869                              | 20,626            |
| Loan processing expenses  | 70                                    | 79                | 127                                 | 152               |
| <b>Total expenses</b>   | <b>46,474</b>                         | <b>47,663</b>     | <b>94,642</b>                       | <b>82,253</b>     |
| Gain on extinguishment of debt  | -                                     | 621               | -                                   | 621               |
| Loss before minority interest and taxes                                 | (356)                                 | (3,421)           | (2,048)                             | (2,847)           |
| Minority interest in consolidated entities                              | 5                                     | 24                | 19                                  | 25                |
| Loss from continuing operations   | (351)                                 | (3,397)           | (2,029)                             | (2,822)           |
| Income from discontinued operations                                     | 105                                   | 105               | 213                                 | 148               |
| Net loss  | (246)                                 | (3,292)           | (1,816)                             | (2,674)           |
| Dividends allocable to preferred shares                                 | (711)                                 | (711)             | (1,422)                             | (1,422)           |
| <b>Net loss allocable to common stockholders</b>                        | <b>\$ (957)</b>                       | <b>\$ (4,003)</b> | <b>\$ (3,238)</b>                   | <b>\$ (4,096)</b> |
| Earnings per share:   |                                       |                   |                                     |                   |
| Net loss per common share, basic and diluted                            | \$ (0.02)                             | \$ (0.10)         | \$ (0.07)                           | \$ (0.11)         |
| Weighted average number of common shares outstanding, basic and diluted | 44,763                                | 38,566            | 44,572                              | 36,356            |
| Dividends declared per common share                                     | \$ 0.20                               | \$ 0.20           | \$ 0.40                             | \$ 0.40           |
| Dividends declared per preferred share                                  | \$ 0.51                               | \$ 0.51           | \$ 1.02                             | \$ 1.02           |

See notes to consolidated financial statements.

CapLease, Inc. and Subsidiaries  
Consolidated Statement of Changes in Stockholders' Equity  
(Unaudited)  
*(in thousands)*

|   | Preferred<br>Stock | Common<br>Stock<br>at Par | Additional<br>Paid-In<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Retained<br>Earnings | Total      |
|---|--------------------|---------------------------|----------------------------------|---|----------------------|------------|
| Balance at December 31, 2007  | \$ 33,657          | \$ 444                    | \$ 341,578                       | \$ (26,020)   | -                    | \$ 349,659 |
| Incentive stock plan<br>compensation expense  | -                  | -                         | 1,061                            | -   | -                    | 1,061      |
| Incentive stock plan grants<br>issued   | -                  | 4                         | (4)                              | -   | -                    | -          |
| Net loss  | -                  | -                         | (1,816)                          | -   | -                    | (1,816)    |
| Issuance of common stock  | -                  | 1                         | 911                              | -   | -                    | 912        |
| Dividends declared-preferred  | -                  | -                         | (1,422)                          | -   | -                    | (1,422)    |
| Dividends declared-common   | -                  | -                         | (17,922)                         | -   | -                    | (17,922)   |
| Amortization of unrealized<br>loss on securities previously<br>classified as available for sale | -                  | -                         | -                                | 248   | -                    | 248        |
| Increase (decrease) in fair<br>value of securities available<br>for sale                        | -                  | -                         | -                                | (3,005)   | -                    | (3,005)    |
| Increase (decrease) in fair<br>value of derivatives   | -                  | -                         | -                                | (12)  | -                    | (12)       |
| Reclassification of derivative<br>items into earnings   | -                  | -                         | -                                | 2,175   | -                    | 2,175      |
| Realized loss on derivatives  | -                  | -                         | -                                | (1,231)   | -                    | (1,231)    |
| Balance at June 30, 2008  | \$ 33,657          | \$ 449                    | \$ 322,386                       | \$ (27,845)   | -\$                  | 328,647    |

See notes to consolidated financial statements.

CapLease, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
(Unaudited)  
*(in thousands)*

|   | For the Six Months<br>Ended June 30, |            |
|---|--------------------------------------|------------|
|   | 2008                                 | 2007       |
| <b>Operating activities</b>   |                                      |            |
| Net loss  | \$ (1,816)                           | \$ (2,674) |
| Adjustments to reconcile net loss to cash provided by operating activities: |                                      |            |
| Depreciation and amortization   | 27,032                               | 20,845     |
| Stock based compensation  | 1,061                                | 805        |
| Amortization of above and below market leases                               | 718                                  | 23         |
| Minority interest in consolidated entities                                  | (19)                                 | (25)       |
| Gain on extinguishment of debt  | –                                    | (621)      |
| Loss on securities available for sale                                       | –                                    | 372        |
| Loss on sale of real estate properties                                      | –                                    | 55         |
| Loss (gain) on derivatives  | 1,862                                | (290)      |
| Straight-lining of rents  | 5,065                                | 1,327      |
| Amortization of discounts/premiums, and origination fees/costs, net         | (192)                                | (212)      |
| Amortization of debt issuance costs and fair market value of debt assumed   | 656                                  | 647        |
| Changes in operating assets and liabilities:                                |                                      |            |
| Structuring fees receivable   | 349                                  | 323        |
| Other assets  | 6,922                                | (15,763)   |
| Accounts payable, accrued expenses and other liabilities                    | (2,540)                              | 1,023      |
| Deposits and escrows  | (463)                                | (52)       |
| Amounts due to servicer   | (1)                                  | (131)      |
| Net cash provided by operating activities                                   | 38,634                               | 5,652      |
| <b>Investing activities</b>   |                                      |            |
| Additions to loans held for investment                                      | –                                    | (599)      |
| Principal received from borrowers   | 3,071                                | 9,627      |
| Purchase of securities available for sale                                   | –                                    | (37,919)   |
| Principal amortization on commercial mortgage-backed securities             | 1,832                                | 1,027      |
| Proceeds from sale of real estate investments                               | –                                    | 2,887      |
| Purchases of real estate investments  | –                                    | (276,457)  |
| Real estate improvements, additions, rebates and construction in progress   | 1,205                                | (1,099)    |
| Deposits on potential equity investments                                    | –                                    | (20,800)   |
| Return of deposits on potential equity investments                          | –                                    | 21,800     |
| Investments in partially-owned entities                                     | –                                    | (1,139)    |
| Purchases of furniture, fixtures, equipment and leasehold improvements      | (15)                                 | (59)       |
| Net cash provided by (used in) investing activities                         | 6,093                                | (302,731)  |
| <b>Financing activities</b>   |                                      |            |
| Borrowings under repurchase agreement obligations                           | –                                    | 207,849    |
| Repayments of repurchase agreement obligations                              | (232,869)                            | (18,331)   |
| Borrowings under bridge-financing facility                                  | –                                    | 210,273    |
| Repayments under bridge-financing facility                                  | –                                    | (137,000)  |
| Borrowings from mortgages on real estate investments                        | 688                                  | 42,424     |

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|  |                 |              |
|--|-----------------|--------------|
| Repayments of mortgages on real estate investments                 | (5,310)         | (98,289)     |
| Borrowings from credit facility                                    | 210,392         | —            |
| Repayments on credit facility                                      | (2,303)         | —            |
| Repayments on secured term loan                                    | (2,845)         | —            |
| Debt issuance costs  | (1,783)         | (546)        |
| Escrows held with mortgage lender                                  | 600             | —            |
| Funds (used in) provided by hedging and risk management activities | (5,458)         | 389          |
| Common stock issued, net of offering costs                         | 912             | 109,753      |
| Cash distributions to minority limited partners                    | (105)           | (105)        |
| Dividends paid on common and preferred stock                       | (19,241)        | (15,123)     |
| Net cash (used in) provided by financing activities                | (57,322)        | 301,294      |
| <b>Net (decrease) increase in cash and cash equivalents</b>        | <b>(12,595)</b> | <b>4,215</b> |
| Cash and cash equivalents at beginning of period                   | 34,047          | 4,425        |
| Cash and cash equivalents at end of period                         | \$ 21,452       | \$ 8,640     |

See notes to consolidated financial statements.



CapLease, Inc. and Subsidiaries  
 Consolidated Statements of Cash Flows – continued  
 (Unaudited)  
 (in thousands)

|  | For the Six Months<br>Ended June 30, |           |
|--|--------------------------------------|-----------|
|  | 2008                                 | 2007      |
| <b>Supplemental disclosure of cash flow information</b>                                  |                                      |           |
| Cash paid for interest expense (excluding capitalized interest)                          | \$ 47,951                            | \$ 42,635 |
| Distributions declared but not paid  | 53                                   | 53        |
| Dividends declared but not paid  | 9,684                                | 9,757     |
| <b>Supplemental disclosure of noncash operating, investing and financing information</b> |                                      |           |
| Value of in-place leases and above-market leases acquired                                | –                                    | 64,086    |
| Value of below-market leases acquired  | –                                    | 34,326    |
| Securities transferred to loans held for investment                                      | 24,583                               | –         |
| Mortgage notes payable assumed on properties acquired                                    | –                                    | 189,996   |

See notes to consolidated financial statements.

CapLease, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
(Dollar amounts in thousands, except per share amounts)

June 30, 2008 (unaudited)

## 1. Organization

CapLease, Inc. (“CapLease” and collectively with its majority-owned subsidiaries, the “Company”) is a diversified real estate investment trust, or REIT, that invests primarily in single tenant commercial real estate assets subject to long-term leases to high credit quality tenants. The Company focuses on properties that are subject to a net lease, or a lease that requires the tenant to pay all or substantially all expenses normally associated with the ownership of the property (such as utilities, taxes, insurance and routine maintenance) during the lease term. The Company also has made and expects to continue to make investments in single tenant properties where the owner has exposure to property expenses when it determines it can sufficiently underwrite that exposure and isolate a predictable cash flow.

The Company invests at all levels of the capital structure of net lease and other single tenant properties, including equity investments in real estate (owned real properties), debt investments (mortgage loans and net lease mortgage backed securities) and mezzanine investments secured by net leased or other single tenant real estate collateral.

CapLease is organized and conducts its operations to qualify as a REIT for federal income tax purposes. As such, it generally will not be subject to federal income tax on that portion of its income that is distributed to stockholders if it distributes at least 90% of its REIT taxable income to its stockholders by prescribed dates and complies with various other requirements.

CapLease conducts its business through a variety of subsidiaries, including its predecessor and operating partnership, Caplease, LP (the “Operating Partnership”). CapLease is the indirect sole general partner of, and owns approximately 98.5% of the common equity of, the Operating Partnership.

The accompanying consolidated financial statements and related notes of the Company have been prepared in accordance with accounting principles generally accepted in the United States for interim financial reporting and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in the financial statements prepared under accounting principles generally accepted in the United States have been condensed or omitted. In the opinion of management, all adjustments considered necessary for a fair presentation of the Company’s financial position, results of operations and cash flows have been included and are of a normal and recurring nature. The operating results presented for interim periods are not necessarily indicative of the results that may be expected for any other interim period or for the entire year. These financial statements should be read in conjunction with the Company’s consolidated financial statements for the fiscal year ended December 31, 2007 and notes thereto, included in the Company’s Form 10-K filed with the SEC on March 4, 2008.

## 2. Summary of Significant Accounting Policies

### *Basis of Presentation and Principles of Consolidation*

The accompanying consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States and include the assets, liabilities, and results of operations of the Company. Results of operations of properties acquired are included in the Consolidated Statements of Operations from the date of acquisition. The Company assesses whether consolidation of any entity in which it has an equity interest is necessary based on applicable accounting guidance. Any entities that do not meet the criteria for consolidation where the

Company does not exercise significant influence are accounted for using the cost method. All significant intercompany transactions, balances and accounts have been eliminated in consolidation.

*Purchase Accounting for Acquisition of Real Estate*

The Company's purchase price of rental real estate acquired is allocated to the following based on fair values:

- acquired tangible assets, consisting of land, building and improvements; and

CapLease, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
(Dollar amounts in thousands, except per share amounts)

June 30, 2008 (unaudited)

identified intangible assets and liabilities, consisting of above-market and below-market leases, in-place leases and tenant relationships.

In estimating the fair value of the tangible and intangible assets acquired, the Company considers information obtained about each property as a result of its due diligence activities and other market data, and utilizes various valuation methods, such as estimated cash flow projections utilizing appropriate discount and capitalization rates, estimates of replacement costs, and available market information. The fair value of the tangible assets of an acquired property considers the value of the property as if it were vacant (the "dark value").

Above-market and below-market lease values for acquired properties are recorded based on the present value of the differences between (i) the contractual amounts to be paid pursuant to each in-place lease and (ii) management's estimate of fair market lease rates for each corresponding in-place lease. Fair market lease rates are measured over a period equal to the remaining term of the lease for above-market leases and the initial term plus the term of any below-market rate renewal options for below-market leases. In computing present value, the Company considers the costs which would need to be invested to achieve the fair market lease rates. The Company uses a discount rate which reflects the risks associated with the leases acquired. The capitalized above-market lease values are amortized as a reduction of base rental revenue over the remaining term of the respective leases, and the capitalized below-market lease values are amortized as an increase to base rental revenue over the remaining initial terms plus the terms of any below-market renewal options of the respective leases.

Other intangible assets acquired include amounts for in-place lease values and tenant relationship values which are based on management's evaluation of the specific characteristics of each tenant's lease and the Company's overall relationship with the respective tenant. Factors considered by management in its analysis of in-place lease values include estimates of the dark value of the property, carrying costs during the hypothetical expected time it would take management to find a tenant to lease the space for the existing lease term (a "lease-up period") considering current market conditions, and costs to execute similar leases. Management estimates carrying costs, including such factors as real estate taxes, insurance and other operating expenses during the expected lease-up period, considering current market conditions and costs to execute similar leases. In estimating costs to execute similar leases, management considers leasing commissions and other related expenses. Characteristics considered by management in valuing tenant relationships include the nature and extent of the Company's existing business relationships with the tenant, growth prospects for developing new business with the tenant, the tenant's credit quality and expectations of lease renewals. The value of in-place leases is amortized to expense over the remaining initial terms of the respective leases. The value of tenant relationship intangibles is amortized to expense over the anticipated life of the relationships. Through June 30, 2008, the Company has assigned no value to tenant relationships on any of its acquisitions.

For property acquisitions where the Company assumes existing mortgage debt, the debt is recorded at its fair value, based on management's estimate of current market yields available for comparable financing. The Company amortizes any discount or premium as part of interest expense on the related debt using the effective interest method.

Depreciation is determined by the straight-line method over the remaining estimated economic useful lives of the properties. The Company generally depreciates buildings and building improvements over periods not exceeding 40 years. Direct costs incurred in acquiring properties are capitalized. Expenditures for maintenance and repairs are charged to operations as incurred. Significant renovations which extend the useful life of the properties are capitalized.

*Loan Investments*

The Company classifies its loans as long-term investments, as its strategy is to hold the loans for the foreseeable future or until maturity. Loan investments are carried on the Company's Consolidated Balance Sheet at amortized cost (unpaid principal balance adjusted for unearned discount or premium and loan origination fees). Unearned discounts or premiums and loan origination fees are amortized as a component of interest income using the effective interest method over the life of the loan.

CapLease, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
(Dollar amounts in thousands, except per share amounts)

June 30, 2008 (unaudited)

The Company periodically evaluates each of its loans held for investment for possible impairment. Impairment is indicated when it is deemed probable that the Company will be unable to collect all amounts due according to the contractual terms of the asset. Upon determination of impairment, the Company must establish a specific valuation allowance with a corresponding charge to earnings. Significant judgment is required both in determining impairment and in estimating the resulting loss allowance. In determining impairment and any loan loss allowance, the Company evaluates factors such as the status of the loans (i.e., current or actual or expected payment or other defaults), the credit quality of the underlying tenants, the present value of expected future cash flows on the loans, the fair market value of any collateral, and the amount and status of any senior debt. As of June 30, 2008, the Company had no loss allowances on any of the loans in its portfolio.

*Commercial Mortgage-Backed Securities*

The Company designates its commercial mortgage-backed securities and other real estate securities ("CMBS") investments pursuant to SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. SFAS 115 creates two classifications that are relevant with respect to the Company's securities investments:

- "Held to maturity" are those securities that the Company has the positive intent and ability to hold until maturity. Under SFAS 115, securities classified as held to maturity are presented at cost plus the amortization of any premiums or discounts. For a security transferred into the held to maturity category, the security is recorded at fair value on the date of transfer, with any unrealized gain or loss amortized against the related fair value adjustment recorded as a component of Other Comprehensive Income (Loss) within Stockholders' Equity over the expected term of the security using the effective interest method.
- "Available for sale" are those securities that the Company does not hold for the purpose of selling in the near-term, but may dispose of prior to maturity. They are presented on the Consolidated Balance Sheet at fair value with the net unrealized gains or losses included in Accumulated Other Comprehensive Income (Loss), a component of Stockholders' Equity on the Company's Consolidated Balance Sheet.

Any premiums or discounts on securities are amortized into interest income using the effective interest method.

Until January 2008, the Company classified all of its securities investments as "available for sale," as it concluded that its securities may be disposed of prior to maturity as part of the Company's gain on sale activities. In January 2008, the Company reclassified a total of 11 securities that are financed in its March 2005 collateralized debt obligation or in the December 2007 secured term loan transaction discussed at Note 10, from "available for sale" to "held to maturity," as the Company has the positive intent and ability to hold all of those securities until maturity and the terms of the financings significantly restrict or prohibit a sale. As of the date of transfer, the unrealized loss on the securities reclassified as held to maturity included in Other Comprehensive Income (Loss) was \$(9,722).

The Company estimates fair value on all securities investments quarterly, and unrealized losses that in the judgment of management are "other-than-temporary" are charged against earnings as a loss on the Consolidated Statement of Operations. In estimating other-than-temporary impairment losses, management considers (1) the financial condition and near-term prospects of the underlying credit, (2) the intent and ability of the Company to retain its investment in the underlying credit for a period of time sufficient to allow for anticipated recovery in fair value and (3) the length of time and the extent to which the fair value has been below cost. The Company had no losses on securities charged to

the Statement of Operations during the three and six months ended June 30, 2008. The Company had losses on securities of \$372 charged to the Statement of Operations during the three and six months ended June 30, 2007. See Note 5.

*Deferred Origination Fees and Costs*

In accordance with SFAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, the Company defers the recognition of fees and expenses associated with the origination of its loans held for investment. These items include lender fee income, rate lock income, direct loan origination costs, certain legal fees, insurance costs, rating agency fees and certain other expenses. Deferred fees and costs are recognized as an adjustment to the effective yield over the life of the related asset.

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*Cash and Cash Equivalents*

The Company defines cash equivalents as highly liquid investments purchased with maturities of three months or less at date of purchase. From time to time, the Company's account balance held at financial institutions exceeds Federal Depository Insurance Corporation ("FDIC") insurance coverage and, as a result, there is a concentration of credit risk related to the balance on deposit in excess of FDIC insurance coverage. The Company believes that the risk of loss is not significant.

*Revenue Recognition*

Rental revenue on real estate is recognized in accordance with SFAS No. 13, *Accounting for Leases*. Rental revenue is recognized on a straight-line basis over the non-cancelable term of the lease unless another systematic and rational basis is more representative of the time pattern in which the use benefit is derived from the leased property. This includes the effects of rent steps and rent abatements under the leases.

Interest income from loans, securities, and structuring fees receivable, is recognized on the accrual basis of accounting. Interest income from securities (including interest-only strips) is recognized over the life of the investment using the effective interest method. The cost basis of interest-only strips is adjusted to reflect any prepayments from underlying assets, using the initial yield-to-maturity at the purchase date.

*Impairment of Long-Lived Assets*

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company reviews its investment in long-lived assets (owned real properties) for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company began acquiring owned real properties in the third quarter of 2004. The Company recognized no impairment losses on long-lived assets during the three and six months ended June 30, 2008 and June 30, 2007.

*Income Taxes*

CapLease is subject to federal income taxation at corporate rates on its "REIT taxable income." However, CapLease is allowed a deduction for the amount of dividends paid to its stockholders, thereby subjecting the distributed net income of CapLease to taxation at the stockholder level only. CapLease intends to continue to operate in a manner consistent with and it has elected to be treated as a REIT for tax purposes. From time to time, the Company may conduct a portion of its business through a taxable REIT subsidiary ("TRS"), and the income from the activities of the TRS is subject to federal and state taxation at the applicable corporate rates.

*Earnings per Share*

In accordance with SFAS No. 128, *Earnings per Share*, the Company presents both basic and diluted earnings per share ("EPS"). Basic EPS excludes dilution and is computed by dividing net income allocable to common stockholders by the weighted average number of shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock, where such exercise or conversion would result in a lower EPS amount. For the 2008 period, the



Company's computation of diluted earnings per share does not include 6,627,780 weighted average common shares that may be issued in the future upon conversion of the convertible senior notes issued in October 2007, as the impact would not be dilutive.

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The following summarizes the Company's EPS computations for the three and six months ended June 30, 2008 and June 30, 2007 (in thousands, except per share amounts):

|   | For the three months<br>ended June 30, |            | For the six months<br>ended June 30, |            |
|---|--|------------|--------------------------------------|------------|
|   | 2008                                   | 2007       | 2008                                 | 2007       |
| Net loss allocable to common stockholders   | \$ (957)                               | \$ (4,003) | \$ (3,238)                           | \$ (4,096) |
| Weighted average number of common shares outstanding, basic and diluted           | 44,763                                 | 38,566     | 44,572                               | 36,356     |
| Loss per share, basic and diluted   | \$ (0.02)                              | \$ (0.10)  | \$ (0.07)                            | \$ (0.11)  |
| Non-vested shares included in weighted average number of shares outstanding above | 935                                    | 700        | 935                                  | 700        |

#### *Recently Issued Accounting Pronouncements*

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements* ("SFAS No. 157"). SFAS No. 157 provides guidance for using fair value to measure assets and liabilities. This statement clarifies the principle that fair value should be based on the assumptions that market participants would use when pricing the asset or liability. SFAS No. 157 establishes a fair value hierarchy, giving the highest priority to quoted prices in active markets and the lowest priority to unobservable data. SFAS No. 157 applies whenever other standards require assets or liabilities to be measured at fair value. This statement is effective in fiscal years beginning after November 15, 2007 and, therefore, the effective date for the Company is January 1, 2008. The Company's adoption of SFAS No. 157 on January 1, 2008 did not have a material effect on its consolidated financial statements, although it has resulted in new disclosures (see Note 7).

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ("SFAS No. 159"). SFAS No. 159 expands opportunities to use fair value measurement in financial reporting and permits entities to choose to measure many financial instruments and certain other items at fair value. This statement is effective for fiscal years beginning after November 15, 2007 and, therefore, the effective date for the Company is January 1, 2008. The Company's adoption of SFAS No. 159 on January 1, 2008 did not have a material effect on its consolidated financial statements, as it has not elected the fair value option for any of its existing financial instruments on the effective date. The Company may elect the fair value option for eligible financial instruments it acquires in the future.

In December 2007, the FASB issued Statement No. 141R, *Business Combinations* ("SFAS No. 141R"). SFAS No. 141R broadens the guidance of SFAS No. 141, extending its applicability to all transactions and other events in which one entity obtains control over one or more other businesses. It broadens the fair value measurement and recognition of assets acquired, liabilities assumed, and interests transferred as a result of business combinations; and stipulates that

acquisition related costs be expensed rather than included as part of the basis of the acquisition. SFAS No. 141R expands required disclosures to improve the ability to evaluate the nature and financial effects of business combinations. SFAS No. 141R is effective for all transactions entered into on or after January 1, 2009. The Company is currently evaluating the impact SFAS No. 141R will have on its consolidated financial statements.

In December 2007, the FASB issued Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51* ("SFAS No. 160"). SFAS No. 160 requires a noncontrolling interest in a subsidiary to be reported as equity and the amount of consolidated net income specifically attributable to the noncontrolling interest to be identified in the consolidated financial statements. SFAS No. 160 also calls for consistency in the manner of reporting changes in the parent's ownership interest and requires fair value measurement of any noncontrolling equity investment retained in a deconsolidation. SFAS No. 160 is effective on January 1, 2009. The Company is currently evaluating the impact SFAS No. 160 will have on its consolidated financial statements.

#### *Reclassifications*

Certain prior year amounts have been reclassified to conform to the current presentation. There was no effect on net loss or equity related to these reclassifications.

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### 3. Real Estate Investments

Real estate held for investment and related intangible liabilities on real estate investments consisted of the following at June 30, 2008 and December 31, 2007:

|   | Jun 30, 2008<br>Unaudited | Dec 31, 2007 |
|---|---------------------------|--------------|
| <b>Real estate investments, at cost:</b>                  |                           |              |
| Land  | \$ 190,771                | \$ 190,771   |
| Building and improvements                                 | 1,274,175                 | 1,275,381    |
| Intangible assets under SFAS 141                          | 185,457                   | 185,457      |
| Less: Accumulated depreciation and amortization           | (116,893)                 | (88,039)     |
| Real estate investments, net                              | \$ 1,533,510              | \$ 1,563,570 |
| <b>Intangible liabilities on real estate investments:</b> |                           |              |
| Intangible liabilities under SFAS 141                     | \$ 55,999                 | \$ 55,999    |
| Less: Accumulated amortization                            | (5,455)                   | (4,188)      |
| Intangible liabilities on real estate investments, net    | \$ 50,544                 | \$ 51,811    |

During the three months ended June 30, 2008, the Company did not complete any new real estate acquisitions.

Acquisition costs capitalized as part of buildings and improvements were \$0 for each of the three and six months ended June 30, 2008, and \$1,303 and \$1,398 for the three and six months ended June 30, 2007, respectively.

The impact on rental revenue of the straight-line rent adjustment under SFAS No. 13 is recorded on the Company's Consolidated Balance Sheet through accrued rental income and deferred rental income. Amounts for accrued rental income and deferred rental income as of June 30, 2008 and December 31, 2007, were as follows:

|                        | Jun 30,<br>2008<br>Unaudited | Dec 31,<br>2007 |
|------------------------|------------------------------|-----------------|
| Accrued Rental Income  | \$ 30,436                    | \$ 28,782       |
| Deferred Rental Income | 6,835                        | 116             |

Accrued rental income is included in "Other assets" on the Company's Consolidated Balance Sheet. Deferred rental income is included in "Accounts payable, accrued expenses and other liabilities" on the Company's Consolidated Balance Sheet.

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Depreciation expense and amortization of intangible assets and liabilities on real estate investments for the three and six months ended June 30, 2008 and June 30, 2007, were as follows:

|   | For the three months<br>ended June 30, |          | For the six months<br>ended June 30, |           |
|---|--|----------|--------------------------------------|-----------|
|   | 2008                                   | 2007     | 2008                                 | 2007      |
| Depreciation on real estate (included in depreciation and amortization expense)     | \$ 8,313                               | \$ 7,804 | \$ 16,627                            | \$ 13,432 |
| Amortization of in-place leases (included in depreciation and amortization expense) | 5,129                                  | 4,619    | 10,241                               | 7,195     |
| Amortization of above-market leases (included as a reduction of rental revenue)     | 998                                    | 823      | 1,986                                | 963       |
| Amortization of below-market leases (included as a component of rental revenue)     | 634                                    | 579      | 1,267                                | 940       |

As of June 30, 2008, the Company's weighted average amortization period on intangible assets was 8.6 years, and the weighted average amortization period on intangible liabilities was 26.6 years.

Scheduled amortization on existing intangible assets and liabilities on real estate investments as of June 30, 2008 was as follows:

|                          | Intangible<br>Assets | Intangible<br>Liabilities |
|--------------------------|----------------------|---------------------------|
| 6 Months Ending December |                      |                           |
| 31, 2008                 | \$ 12,227            | \$ 1,267                  |
| 2009                     | 22,635               | 2,535                     |
| 2010                     | 20,088               | 2,535                     |
| 2011                     | 19,376               | 2,535                     |
| 2012                     | 14,958               | 2,535                     |
| Thereafter               | 51,782               | 39,137                    |
|                          | \$ 141,066           | \$ 50,544                 |

Substantially all of the Company's owned properties are pledged as collateral to the Company's lender that has provided financing on the property. The Company strategy is to own and finance on a long-term basis each property

through a separate and distinct single purpose entity, or SPE, with each property and the related lease or leases on the property generally representing the sole assets of the SPE and the sole collateral available to the Company's lender in the event the Company defaults on the debt that finances the property. Also see Note 10.

#### **4. Asset Held for Sale**

During the fourth quarter of 2005, the Company acquired a portfolio of three office properties from Allstate Insurance Company in a sale/leaseback transaction. The smallest of the three buildings is an approximately 19,500 square foot office building located in Pittsburgh, Pennsylvania. Because of the small size of this property, management concluded, prior to completing the acquisition, to resell the property promptly following its acquisition. The Company sold the property in March 2007, at a loss of approximately \$55. This loss is included on the Company's Statement of Operations for the six months ended June 30, 2007 as a component of "Income from discontinued operations."

In accordance with SFAS No. 144, the Company reported the revenues from the Allstate Pittsburgh property as income from discontinued operations on the Consolidated Statement of Operations for the six months ended June 30, 2007. Revenue and net income for the Allstate Pittsburgh property were \$38 and \$38, respectively, for the six months ended June 30, 2007.

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In accordance with SFAS No. 144, the Company reported the carrying value of the Cott Corporation property it acquired in July 2006 as asset held for sale on the June 30, 2008 and December 31, 2007 Consolidated Balance Sheets, and the revenues from the property as income from discontinued operations on the Consolidated Statements of Operations for each of the three and six months ended June 30, 2008 and June 30, 2007. Cott has ceased operations at this property and has requested a termination of its lease which has a remaining lease term of about 9 years (until June 2017). The Company is negotiating a transaction with Cott and a third party that contemplates the sale of the property to the third party and a release of Cott from the lease in exchange for a lease termination payment. The Company expects to sell this property within the next twelve months and any gain or loss on the sale to be modest. Revenue and net income for the Cott Corporation property were \$215 and \$213, respectively, for the six months ended June 30, 2008, and \$209 and \$166, respectively, for the six months ended June 30, 2007.

### 5. Loans Held for Investment

Loans held for investment at June 30, 2008 and December 31, 2007, are summarized in the following table. These investments consist predominantly of mortgage loans on properties subject to leases to high credit quality tenants. As of June 30, 2008, the weighted average credit rating of the underlying tenants was BBB+ from Standard & Poor's. As of June 30, 2008, none of the Company's loans held for investment were on non-accrual status or past due 90 days or more.

|                                | Jun 30, 2008<br>Unaudited | Dec 31, 2007 |
|--------------------------------|---------------------------|--------------|
| Principal                      | \$ 288,202                | \$ 268,417   |
| Premium                        | 3,251                     | 1,726        |
| Carrying amount of loans       | 291,453                   | 270,143      |
| Deferred origination fees, net | (818)                     | (850)        |
| Total                          | \$ 290,635                | \$ 269,293   |

The Company reclassified a \$24,583 (amortized cost basis on the date of transfer) certificated mortgage loan investment previously classified as "Securities available for sale" into "Loans held for investment" during the quarter ended March 31, 2008, in connection with the dissolution of the trust holding the loan collateral.

From time to time, the Company makes mezzanine loan and other investments. These investments are typically shorter-term in nature and are often subordinate to other financing. As of June 30, 2008, these investments aggregated \$7,802, and are included in the table above.

At each of June 30, 2008 and December 31, 2007, the Company's loan investments carried interest rates ranging from 5.28% to 10.00%. At June 30, 2008 and December 31, 2007, the weighted average effective interest rate on the Company's loan investments, as measured against its cost basis, was 6.81% and 6.79%, respectively.

### 6. Commercial Mortgage-Backed Securities and Structuring Fees Receivable

The following is a summary of the Company's securities investments at June 30, 2008:

| Description | Number of Securities | Face Value | Carry Value | Amortized Cost | Fair Value | Gross Unrecognized | Gross Unrecognized |
|-------------|----------------------|------------|-------------|----------------|------------|--------------------|--------------------|
|-------------|----------------------|------------|-------------|----------------|------------|--------------------|--------------------|

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|                    |    |            |            |            |            | Gain | Loss     |
|--------------------|----|------------|------------|------------|------------|------|----------|
| Held to Maturity   | 11 | \$ 151,066 | \$ 136,210 | \$ 145,683 | \$ 121,356 | 196  | (24,523) |
| Available For Sale | 9  | 51,911     | 33,167     | 40,170     | 33,167     | 78   | (7,081)  |
| Total              | 20 | \$ 202,977 | \$ 169,377 | \$ 185,854 | \$ 154,523 | 274  | (31,604) |

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A detailed schedule of the Company's securities investments at June 30, 2008 follows:

|   | Jun 30, 2008<br>Unaudited   |
|---|-----------------------------|
| BSCMS 1999 CLF1, Class E (rated CCC) Face Amount                    | Available For Sale \$ 3,326 |
| BSCMS 1999 CLF1, Class F (not rated) Face Amount                    | Available For Sale 251      |
| CMLBC 2001-CMLB-1, Class H (rated B-) Face Amount                   | Available For Sale 11,907   |
| CMLBC 2001-CMLB-1, Class J (rated D) Face Amount                    | Available For Sale 6,383    |
| NLFC 1999-LTL-1, Class X (IO) (rated AAA) Carry Value               | Available For Sale 5,932    |
| WBCMT 2004-C15 180E (rated B) Face Amount                           | Available For Sale 8,000    |
| BACMS 2002-2, Class V-1 (7-Eleven, Inc.) (rated A) Face Amount      | Available For Sale 486      |
| BACMS 2002-2, Class V-2 (Sterling Jewelers) (not rated) Face Amount | Available For Sale 744      |
| Yahoo, Inc. (rated BBB-) Face Amount                                | Available For Sale 14,883   |
| BACM 2006-4, Class H (rated BBB+) Face Amount                       | Held To Maturity 8,000      |
| CALFS 1997-CTL1, Class D (rated BBB-) Face Amount                   | Held To Maturity 6,000      |
| CMLBC 2001-CMLB-1, Class E (rated BBB+) Face Amount                 | Held To Maturity 9,526      |
| CMLBC 2001-CMLB-1, Class G (rated BB-) Face Amount                  | Held To Maturity 9,526      |
| NLFC 1999-LTL-1, Class E (rated BB) Face Amount                     | Held To Maturity 11,081     |
| WBCMT 2004-C15 180D (rated B+) Face Amount                          | Held To Maturity 15,000     |
| WBCMT 2006-C27, Class C (rated AA-) Face Amount                     | Held To Maturity 11,000     |
| CVS Corporation (rated BBB+) Face Amount                            | Held To Maturity 18,865     |
| Koninklijke Ahold, N.V. 7.82% Jan 2020 (rated BBB-) Face Amount     | Held To Maturity 8,586      |
| Lucent 6.70% due 9/1/2020 (rated BB-) Face Amount                   | Held To Maturity 36,616     |
| Yahoo, Inc. (rated BBB-) Face Amount                                | Held To Maturity 16,867     |
| Unearned Discount   | (17,125)                    |
| Cost Basis  | 185,854                     |
| Net unrealized gain (loss) on securities                            | (16,477)                    |
| Total   | \$ 169,377                  |

All credit ratings in the above table are as of June 30, 2008.

As discussed further in Note 5, one security was reclassified to “Loans held for investment” during the quarter ended March 31, 2008.

As discussed further in Note 2, the Company reclassified a total of 11 securities investments from “available for sale” to “held to maturity” during January 2008.

The Company recognized impairment losses of \$372 on securities available for sale during the three and six months ended June 30, 2007. The losses were on two CMBS investments: BSCMS Class E (\$172) and CMLBC Class J (\$200). These losses represent management’s determination that other-than-temporary declines in the Company’s fair value below its cost basis had occurred on these two investments. Key factors that management relied on in determining the decline was other-than-temporary include:

- an analysis of the impact of changes in credit spreads;
- subordination levels within the CMBS capital structure; and
- the ratings or changes in ratings of the security and underlying collateral.

Unrealized gains and losses on securities at June 30, 2008 and December 31, 2007, included as a component of Other Comprehensive Income (Loss) on the Company’s Consolidated Balance Sheet, consisted of the following:

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|   | Jun 30, 2008<br>Unaudited | Dec 31, 2007 |
|---|---------------------------|--------------|
| Unrealized losses on securities previously available for sale | \$ (9,474)                | \$ -         |
| Unrealized gains on securities available for sale             | 78                        | 1,785        |
| Unrealized losses on securities available for sale            | (7,081)                   | (15,505)     |

The following table summarizes the Company's securities in an unrealized loss position as of June 30, 2008.

|   | Aggregate<br>Fair Value | Aggregate<br>Unrealized<br>Loss | Number of<br>Securities |
|---|-------------------------|---------------------------------|-------------------------|
| In unrealized loss position less than 12 months | \$ 19,521               | \$ 8,581                        | 4                       |
| In unrealized loss position 12 or more months   | 102,406                 | 23,023                          | 9                       |

The collateral backing our securities investments is primarily net lease loan assets and loss experience on the assets has historically been de minimis. Credit ratings on the nine securities in a continuous unrealized loss position for more than 12 months range from AA- to D with a weighted average of BBB- and those securities have a weighted average maturity of approximately 10.4 years. The Company believes that none of the unrealized losses on investment securities are other than temporary because substantially all of the unrealized losses relate to market interest rate changes, and the Company has both the intent and the ability to hold these securities for a period of time sufficient to allow for a full recovery in fair value. In addition, management considers the underlying credits to be financially sound and believes the Company will receive all contractual principal and interest related to these investments.

At June 30, 2008 and December 31, 2007, the weighted average effective interest rate (yield to maturity on adjusted cost basis) on securities was approximately 7.5% and 7.4%, respectively.

Structuring fees receivable of \$2,226 and \$2,576 at June 30, 2008 and December 31, 2007, respectively, represented fees earned by the Company in conjunction with the structuring and subsequent sale of certain net lease loans. Such fees are payable to the Company monthly without interest through March 2020 and, accordingly, have been discounted based on imputed interest rates estimated by management to approximate market. Structuring fees receivable are shown at their amortized cost.

## 7. Fair Value

The Company adopted SFAS No. 157 on January 1, 2008. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not impose any new requirements around which assets and liabilities are to be measured at fair value, and instead applies to asset and liability balances required or permitted to be measured at fair value under existing accounting pronouncements. Under existing accounting pronouncements, the Company measures its securities available for sale and its derivative assets and liabilities at fair value.

SFAS No. 157 establishes a valuation hierarchy based on the transparency of inputs used in the valuation of an asset or liability. Classification is based on the lowest level of inputs that is significant to the fair value measurement. The valuation hierarchy contains three levels:

- Level 1 – Valuation inputs are unadjusted quoted market prices in active markets for identical assets or liabilities.
- Level 2 – Valuation inputs are quoted prices for identical assets or liabilities that are not active, quoted market prices for similar assets and liabilities in active markets and other observable inputs directly or indirectly related to the asset or liability being measured.
- Level 3 – Valuation inputs are unobservable and significant to the fair value measurement.

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*Securities Available for Sale*

The Company has determined that the valuations of its securities available for sale are classified in Level 2 of the fair value hierarchy. The Company estimates the fair value of securities available for sale by obtaining broker quotations, where available, based upon reasonable market order indications or a good faith estimate thereof. For securities where market quotes are not readily obtainable, management may also estimate values, and considers factors including the credit characteristics and term of the underlying security, market yields on securities with similar credit ratings, and sales of similar securities, where available.

*Derivative Assets and Liabilities*

Currently, the Company uses forward starting interest rate swaps to manage its interest rate risk. The valuation of these instruments is determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. The fair values of interest rate swaps are determined using the market standard methodology of netting the discounted future fixed cash receipts (or payments) and the discounted expected variable cash payments (or receipts). The variable cash payments (or receipts) are based on an expectation of future interest rates (forward curves) derived from observable market interest rate curves.

To comply with the provisions of SFAS No. 157, the Company incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, the Company has considered the impact of netting and any applicable credit enhancements, such as collateral postings, thresholds and guarantees.

Although the Company has determined that the majority of the inputs used to value its derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by itself and its counterparties. However, as of June 30, 2008, the Company has assessed the significance of the impact of the credit valuation adjustments on the overall valuation of its derivative positions and has determined that the credit valuation adjustments are not significant to the overall valuation of its derivatives. As a result, the Company has determined that its derivative valuations in their entirety are classified in Level 2 of the fair value hierarchy.

The table below presents the Company's assets and liabilities measured at fair value as of June 30, 2008, aggregated by the level in the fair value hierarchy within which those measurements fall.

|                                  | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>and Liabilities (Level 1) | Significant Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Balance at<br>June 30,2008 |
|----------------------------------|---|--|--|----------------------------|
| <b>Assets</b>                    |   |  |  |                            |
| Securities available for<br>sale | \$  | – \$   | 33,167 \$  | – \$ 33,167                |

**Liabilities**

|                        |    |      |       |    |      |       |
|------------------------|----|------|-------|----|------|-------|
| Derivative liabilities | \$ | – \$ | 4,348 | \$ | – \$ | 4,348 |
|------------------------|----|------|-------|----|------|-------|

The Company does not have any fair value measurements using significant unobservable inputs (Level 3) as of June 30, 2008.

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**8. Other Assets**

Other assets as of June 30, 2008 and December 31, 2007, consisted of the following:

|   | Jun 30, 2008<br>Unaudited | Dec 31, 2007     |
|---|---------------------------|------------------|
| Receivables and accrued interest                            | \$ 9,981                  | \$ 9,524         |
| Prepaid expenses and deposits                               | 5,293                     | 1,712            |
| Reserve accounts  | 16,929                    | 14,348           |
| Escrow held with mortgage lender                            | 212                       | 812              |
| Funds with CDO trustee pending distribution or reinvestment | 5,080                     | 11,910           |
| Restricted cash   | 174                       | 15               |
| Amounts held by servicer                                    | 405                       | 3,048            |
| Accrued rental income                                       | 30,436                    | 28,782           |
| Debt issuance costs, net                                    | 12,114                    | 11,316           |
| Investment in partially-owned entities                      | 1,139                     | 1,139            |
| Investment in statutory trust                               | 930                       | 930              |
| Other   | 1,463                     | 1,647            |
| <b>Total</b>  | <b>\$ 84,156</b>          | <b>\$ 85,183</b> |

**9. Joint Venture Investments**

In April 2007, the Company invested in Matapeake Partners LLC (“Matapeake”), a newly formed real estate investment and management company. The Company agreed, pursuant to the limited liability company agreement, to invest up to \$5,000 of capital from time to time, subject to the satisfaction of certain terms and conditions by the principals of Matapeake. The Company expects its contributions will comprise less than 50% of the total capital contributed to Matapeake. As of June 30, 2008, the Company had invested \$1,139 toward its aggregate \$5,000 commitment.

The Company also may from time to time source owned property investments to Matapeake. The Company intends to retain an interest in any property sourced to Matapeake. To date, the Company has not sourced any properties to Matapeake.

**10. Debt Obligations**

*Credit Agreement*

On April 29, 2008, the Company (through its wholly-owned subsidiary Caplease Debt Funding, LP) entered into a new credit agreement with Wachovia Bank, N.A. Pursuant to the agreement, Wachovia Bank agreed to make an aggregate of \$250,000 of term and revolving credit loans available to the Company. The Company drew a \$210,392 term loan upon closing of the borrowing facility and may make draws of revolving credit loans from time to time during the agreement term to finance commercial real estate assets that are approved by Wachovia Bank in its discretion.

The credit agreement is for a term of two years with a one-year extension option at the Company's option provided it meets certain conditions. The Company can prepay its borrowings under the facility in whole or in part at any time (subject to a \$1,000 minimum) without any penalty or premium. The Company is required to use a portion of its future debt or equity issuances to prepay borrowings under the facility. The Company is required to pay interest on its borrowings at prevailing short-term rates (30-day LIBOR) plus a pricing spread. During the quarter ended June 30, 2008, the pricing spread ranged from 200 to 250 basis points. As of June 30, 2008, the Company's weighted average effective financing rate on the credit agreement was 5.41%.



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In connection with the financing transaction, the Company and Wachovia also agreed to consolidate their existing lending arrangements into this new facility and, as a result, the Company's \$250,000 repurchase agreement and a \$30,000 revolving loan agreement (the "Revolver"), were terminated. The Company's borrowings under the new facility are secured by the same collateral that previously secured its obligations under the repurchase agreement and Revolver, which includes a combination of first mortgage loan investments, intercompany mortgage loans on owned property investments, commercial mortgage backed securities and a first lien on the Company's ownership interest in the real property located in Johnston, Rhode Island and leased to Factory Mutual Insurance Company. The Company's obligations under the new credit agreement are also fully recourse to all of its other assets. In the event Wachovia determines that the value of the Company's collateral assets has declined, Wachovia may require the Company to prepay a portion of its borrowings, provided that Wachovia may not reduce the value of any of the Company's collateral other than CMBS securities due to general credit spread or interest rate fluctuations.

The Company is required to comply with the following financial covenants under the new credit agreement: minimum liquidity and minimum consolidated net worth.

The Company repaid \$14,628 of debt it owed to Wachovia upon closing of the new credit facility.

Amounts related to the Company's credit agreement and repurchase agreement as of June 30, 2008 and December 31, 2007, were as follows:

|   | At June 30, 2008          |  | At December 31, 2007 |                           |
|---|---------------------------|--|----------------------|---------------------------|
|   | Borrowings<br>(unaudited) | Collateral<br>Carry Value<br>(unaudited) | Borrowings           | Collateral<br>Carry Value |
| <b>Credit Agreement</b>                                     |                           |  |                      |                           |
| Loans held for investment                                   | \$ 59,309                 | \$ 78,675                                | \$ -                 | \$ -                      |
| Intercompany mortgage loans and investments in CapLease CDO | 125,772                   | 149,519                                  | -                    | -                         |
| Commercial mortgage-backed securities                       | 23,008                    | 31,027                                   | -                    | -                         |
| Owned property  | -                         | 47,479                                   | -                    | -                         |
| <b>Repurchase Agreement</b>                                 |                           |  |                      |                           |
| Loans held for investment                                   | -                         | -  | 56,888               | 67,255                    |
| Intercompany mortgage loans on CapLease properties          | -                         | -  | 132,572              | 167,544                   |
| Commercial mortgage-backed securities                       | -                         | -  | 43,409               | 59,464                    |
| <b>Total</b>  | <b>\$ 208,089</b>         | <b>\$ 306,700</b>                        | <b>\$ 232,869</b>    | <b>\$ 294,263</b>         |

The following interest rates apply with respect to the Company's credit agreement and repurchase agreement borrowings for the three and six months ended June 30, 2008 and June 30, 2007:

| For the three months<br>ended June 30, |      | For the six months<br>ended June 30, |      |
|--|------|--------------------------------------|------|
| 2008                                   | 2007 | 2008                                 | 2007 |

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|   |       |       |       |       |
|---|-------|-------|-------|-------|
| Weighted average effecting financing rate | 5.03% | 6.27% | 4.65% | 6.27% |
| 30-Day LIBOR rate                         | 2.70% | 5.32% | 3.10% | 5.32% |

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*Mortgage Notes on Real Estate Investments*

The Company has financed most of its owned real properties with third party fixed rate mortgage debt. The Company's mortgage notes payable are summarized in the following table:

| Property Level Debt - Fixed Rate  | Jun 30, 2008     |                         | Dec 31, 2007 |             | Coupon | Effective Financing Rate (1) | Maturity |
|---|------------------|-------------------------|--------------|-------------|--------|------------------------------|----------|
|   | Face (unaudited) | Carry Value (unaudited) | Face         | Carry Value |        |                              |          |
| The Travelers Corporation, Hartford, CT                                   | \$ 17,293        | \$ 18,481               | \$ 19,406    | \$ 20,944   | 9.80%  | 5.53%                        | Sep 2011 |
| The Travelers Corporation, Hartford, CT                                   | 13,199           | 14,592                  | 12,511       | 14,046      | 10.76% | 7.67%                        | Oct 2011 |
| Nestle Holdings, Inc., Breinigsville, PA; Fort Wayne, IN; and Lathrop, CA | 117,000          | 117,000                 | 117,000      | 117,000     | 6.32%  | 5.65%                        | Aug 2012 |
| Choice Hotels International, Inc., Silver Spring, MD                      | 30,517           | 30,517                  | 30,937       | 30,937      | 5.30%  | 5.34%                        | May 2013 |
| Omnicom Group, Inc., Irving, TX   | 13,495           | 13,495                  | 13,575       | 13,575      | 5.24%  | 5.30%                        | May 2013 |
| Capital One Financial Corporation, Plano, TX                              | 20,758           | 20,758                  | 20,866       | 20,866      | 5.24%  | 5.29%                        | Nov 2013 |
| Aon Corporation, Glenview, IL   | 64,173           | 64,173                  | 64,708       | 64,708      | 5.23%  | 5.75%                        | Mar 2014 |
| Cadbury Schweppes Holdings (US), Whippany, NJ                             | 34,782           | 34,782                  | 35,065       | 35,065      | 5.26%  | 5.34%                        | Jun 2015 |
| ITT Industries, Inc., Herndon, VA   | 41,458           | 41,458                  | 41,591       | 41,591      | 5.33%  | 5.40%                        | Jul 2015 |
| Lowes Companies, Inc., Aliso Viejo, CA                                    | 42,125           | 42,125                  | 42,125       | 42,125      | 5.10%  | 5.37%                        | Aug 2015 |
| Abbott Laboratories, Waukegan, IL   | 15,194           | 15,194                  | 15,224       | 15,224      | 5.11%  | 5.16%                        | Sep 2015 |
| United States Government (FBI), Birmingham, AL                            | 18,800           | 18,800                  | 18,800       | 18,800      | 5.23%  | 5.31%                        | Sep 2015 |
| United States Government (NIH), N. Bethesda, MD                           | 62,986           | 62,986                  | 63,632       | 63,632      | 5.32%  | 5.56%                        | Sep 2015 |
| United States Government (SSA), Austin, TX                                | 5,391            | 5,391                   | 5,391        | 5,391       | 5.23%  | 5.46%                        | Sep 2015 |
| United States Government (DEA), Birmingham, AL                            | 11,280           | 11,280                  | 11,280       | 11,280      | 5.23%  | 5.42%                        | Oct 2015 |
| Tiffany & Co., Parsippany, NJ   | 58,400           | 58,400                  | 58,400       | 58,400      | 5.33%  | 5.34%                        | Jan 2016 |
| Allstate Insurance Company, Charlotte, NC                                 | 20,209           | 20,209                  | 20,209       | 20,209      | 5.68%  | 5.71%                        | Jan 2016 |
| Allstate Insurance Company, Roanoke, VA                                   | 21,516           | 21,516                  | 21,516       | 21,516      | 5.68%  | 5.76%                        | Jan 2016 |

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|   |            |            |            |            |       |       |          |
|---|------------|------------|------------|------------|-------|-------|----------|
| Farmers New World Life Insurance Company, Mercer Island, WA | 30,200     | 30,200     | 30,200     | 30,200     | 5.69% | 5.72% | Jan 2016 |
| TJX Companies, Inc., Philadelphia, PA                       | 71,071     | 71,071     | 71,273     | 71,273     | 5.57% | 5.59% | Mar 2016 |
| United States Government (VA), Ponce, PR                    | 6,131      | 6,364      | 6,386      | 6,642      | 7.30% | 6.41% | Apr 2016 |
| Pearson Plc., Lawrence, KS                                  | 16,025     | 16,025     | 16,025     | 16,025     | 5.84% | 5.95% | May 2016 |
| Koninklijke Ahold, N.V., Levittown, PA                      | 14,532     | 14,532     | 14,621     | 14,621     | 6.05% | 6.11% | Jul 2016 |
| AMVESCAP PLC, Denver, CO                                    | 43,700     | 43,700     | 43,700     | 43,700     | 6.03% | 6.08% | Jul 2016 |
| Walgreen Co., Pennsauken, NJ                                | 1,711      | 1,818      | 1,783      | 1,901      | 7.65% | 6.04% | Oct 2016 |
| United States Government (FBI), Albany, NY                  | 10,137     | 10,137     | 10,137     | 10,137     | 5.50% | 5.68% | Nov 2016 |
| Aetna Life Insurance Company, Fresno, CA                    | 16,043     | 16,043     | 16,043     | 16,043     | 5.63% | 5.68% | Dec 2016 |
| T-Mobile USA, Inc., Nashville, TN                           | 10,885     | 10,885     | 10,885     | 10,885     | 5.59% | 5.69% | Dec 2016 |
| Time Warner Entertainment Company, L.P., Milwaukee, WI      | 17,500     | 17,500     | 17,500     | 17,500     | 5.55% | 5.59% | Dec 2016 |
| Farmers Group, Inc., Simi Valley, CA                        | 25,620     | 25,620     | 25,620     | 25,620     | 5.81% | 5.85% | Jan 2017 |
| Johnson Controls, Inc., Largo, FL                           | 16,200     | 16,200     | 16,200     | 16,200     | 5.48% | 5.52% | Jan 2017 |
| County of Yolo, California, Woodland, CA                    | 10,332     | 10,332     | 10,332     | 10,332     | 5.68% | 5.75% | Feb 2017 |
| Bunge North America, Inc., Fort Worth, TX                   | 6,262      | 6,262      | 6,262      | 6,262      | 5.45% | 5.55% | May 2017 |
| AmeriCredit Corp., Arlington, TX                            | 28,370     | 28,034     | 28,586     | 28,234     | 5.28% | 5.51% | Sep 2017 |
| Walgreen Co., Portsmouth, VA                                | 3,004      | 3,175      | 3,068      | 3,249      | 7.20% | 6.18% | Jul 2018 |
| United States Government (EPA), Kansas City, KS             | 20,775     | 23,970     | 20,775     | 24,082     | 7.57% | 5.74% | Oct 2022 |
| United States Government (OSHA), Sandy, UT                  | 14,541     | 15,462     | 14,605     | 15,555     | 6.28% | 5.52% | Jan 2024 |
| Total   | \$ 971,615 | \$ 978,487 | \$ 976,237 | \$ 983,770 |       |       |          |

<sup>(1)</sup>The effective rate is the Company's approximate borrowing cost, including the effect of hedge gains or losses and other deferred financing costs associated with the related borrowing.

The mortgage notes are secured by the respective properties and an assignment of the relevant leases on the properties. See Note 3 regarding the separate and distinct nature of the Company's SPEs. The Company's book value before accumulated depreciation and amortization on owned properties encumbered with mortgage debt aggregated \$1,454,546 at June 30, 2008, and \$1,455,751 at December 31, 2007.

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*Collateralized Debt Obligations*

The Company issued a collateralized debt obligation, or CDO, in March 2005. The CDO was an entirely fixed rate financing. The Company aggregated approximately \$300,000 of assets and then transferred these assets into a wholly-owned securitization vehicle, and issued \$285,000 face amount of multi-class notes and \$15,000 of preferred equity through the securitization vehicle. The assets serve as collateral for the Company's obligations under the notes. The securitization vehicle is an SPE, with its business limited to the issuance of the notes and the preferred equity, the acquisition of the collateral and certain other related matters. The net amount of the debt the Company issued was \$268,130, inclusive of a \$370 discount to face, as the Company retained the three most junior note classes aggregating a face amount of \$16,500 and the full \$15,000 of preferred equity. Each of the five note classes of the CDO was rated investment grade. Through October 2009, the Company expects to reinvest principal repayments on the underlying assets into qualifying replacement collateral. The CDO notes have a stated maturity in January 2040, but are expected to mature in January 2015 when they become subject to an auction call procedure. The Company's weighted average effective financing rate (inclusive of original issue discount and debt issuance and hedge costs) on its CDO is approximately 5.67%. The CDO debt is non-recourse to the Company but is secured by the collateral assets. The following table summarizes the assets posted as CDO collateral as of June 30, 2008.

|   | Carry Value |
|---|-------------|
| Loans held for investment                             | \$ 160,902  |
| Intercompany mortgage loans on<br>CapLease properties | 48,972      |
| Commercial mortgage-backed<br>securities              | 77,166      |
| Total   | \$ 287,040  |

*Secured Term Loan*

On December 18, 2007, the Company completed a \$129,521 secured term loan with KBC Bank, N.V. Upon closing of the financing, the Company pledged approximately \$163,145 principal amount of collateral to secure its obligations under the loan. The interest coupon on the loan is fixed at 5.81% annually until the loan matures in January 2018. The Company's effective financing rate on the loan is 6.02% annually (inclusive of hedge and closing costs). The loan is non-recourse to the Company, subject to limited non-recourse exceptions. The following table summarizes the assets pledged as collateral for the Company's obligations under the loan as of June 30, 2008.

|   | Carry Value |
|---|-------------|
| Loans held for investment                             | \$ 44,074   |
| Intercompany mortgage loans on<br>CapLease properties | 54,165      |
| Commercial mortgage-backed<br>securities              | 59,044      |
| Total   | \$ 157,283  |

*Convertible Senior Notes*

On October 9, 2007, CapLease completed a private offering to qualified institutional buyers pursuant to Rule 144A of the Securities Act of 1933, as amended, of \$75,000 principal amount of 7.50% convertible senior notes due 2027. The notes represent general unsecured obligations of CapLease and rank equally in right of payment with all of its other existing and future obligations that are unsecured and unsubordinated. The notes are jointly and severally, fully and unconditionally guaranteed, on a senior unsecured basis by four of CapLease's subsidiaries, Caplease, LP, Caplease Debt Funding, LP, Caplease Services Corp. and Caplease Credit LLC.

The net proceeds of the offering, after deducting the initial purchasers' discount and offering expenses, were approximately \$72,774. CapLease used \$15,000 of the net proceeds to purchase shares of its common stock at the closing of the offering, and the remaining proceeds for general corporate purposes, including to repay borrowings under the Company's repurchase agreement.

The notes bear interest at an annual fixed rate of 7.50% and will mature on October 1, 2027, unless earlier converted, redeemed or repurchased. The Company's effective financing rate on the notes, which includes the effect of the offering discount and expenses of the transaction, is approximately 8.24%.

The holders may convert their notes into cash, shares of CapLease common stock, or any combination thereof, at CapLease's option, under certain circumstances, including in connection with certain change of control events defined in the note indenture (each, a "change of control") or a transaction that results in CapLease's common stock or other securities into which the notes are convertible not being approved for listing on a U.S. national securities exchange (a "termination of trading"). Upon conversion, if CapLease does not elect otherwise, it will settle its conversion obligation in shares of its common stock.

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The initial conversion rate for each \$1 principal amount of notes is 88.3704 shares of CapLease's common stock, which is equivalent to an initial conversion price of approximately \$11.32 per share. The initial conversion rate will be adjusted for certain events, including in the event CapLease makes any quarterly cash dividend in excess of \$0.20 per share.

CapLease has the right to redeem the notes in whole or in part, for cash at any time or from time to time on or after October 5, 2012. Prior to October 5, 2012, CapLease may also redeem the notes to preserve its status as a real estate investment trust. The redemption price will be 100% of the principal amount of the notes to be redeemed, plus any accrued and unpaid interest.

Holders may require CapLease to repurchase their notes, in whole or in part, on October 1, 2012, October 1, 2017 and October 1, 2022, for a cash price equal to 100% of the principal amount of the notes to be repurchased, plus any accrued and unpaid interest.

Holders will also have the right to require CapLease to repurchase their notes, in whole or in part for cash, if a change of control or termination of trading occurs prior to October 1, 2012. The repurchase price will be 100% of the principal amount of the notes to be repurchased, plus any accrued and unpaid interest.

#### *Trust Preferred Securities*

In December 2005, the Operating Partnership issued \$30,000 in aggregate principal amount of fixed/floating rate preferred securities through its wholly-owned subsidiary, Caplease Statutory Trust I. The trust simultaneously issued 930 of its common securities to the Operating Partnership for a purchase price of \$930, which constitutes all of the issued and outstanding common securities of the trust. The trust used the proceeds from the sale of the trust preferred securities together with the proceeds from the sale of the common securities to purchase \$30,930 in aggregate principal amount of unsecured fixed/floating rate junior subordinated notes due January 30, 2036, issued by the Operating Partnership. The junior subordinated notes, the common and the trust preferred securities have substantially identical terms, requiring quarterly interest payments calculated at a fixed interest rate equal to 7.68% per annum through January 30, 2016, and subsequently at a variable interest rate equal to LIBOR plus 2.60% per annum. The notes mature on January 30, 2036, and may be redeemed, in whole or in part, at par, at the Company's option, beginning on January 30, 2011. The trust preferred and common securities do not have a stated maturity date; however, they are subject to mandatory redemption upon the redemption or maturity of the notes.

The principal amount of the junior subordinated notes of \$30,930 is reported as "Other long-term debt" on the Company's Consolidated Balance Sheet. However, because the Company is not deemed to be the primary beneficiary of the trust under FASB Interpretation Number 46, *Consolidation of Variable Interest Entities*, the Company's investment in the trust is not eliminated from the Company's financial statements in consolidation. Instead, the Company records its investment in the trust's common shares of \$930 as part of "Other assets" on the Company's Consolidated Balance Sheet.

The Company incurred issuance costs associated with the offering of \$972. These costs are included as a component of "Other assets" on the Company's Consolidated Balance Sheet, and are being amortized into interest expense using the effective yield method through the date the fixed interest period expires (the expected maturity date of the trust preferred securities). The Company's effective financing rate on the trust preferred securities, inclusive of deferred issuance costs, is approximately 8.30% per annum.





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Scheduled principal amortization and balloon payments for all of the Company's outstanding debt obligations as of June 30, 2008 for the next five years and thereafter are as follows:

|                                   | Scheduled<br>Amortization | Balloon<br>Payments | Total        |
|-----------------------------------|---------------------------|---------------------|--------------|
| 6 Months Ending December 31, 2008 | \$ 13,415                 | \$ -                | \$ 13,415    |
| 2009                              | 32,479                    | -                   | 32,479       |
| 2010                              | 53,984                    | 191,014             | 244,998      |
| 2011                              | 42,171                    | 18,861              | 61,032       |
| 2012                              | 43,750                    | 192,000             | 235,750      |
| Thereafter                        | 165,579                   | 934,174             | 1,099,753    |
|                                   | \$ 351,378                | \$ 1,336,049        | \$ 1,687,427 |

For purposes of the above table and with respect to the convertible senior notes issued in October 2007, the Company has assumed a balloon payment date in October 2012 when the notes become subject to a holder redemption right (rather than the stated maturity date in 2027).

## 11. Risk Management Transactions

The Company enters into risk management transactions as an integral component of its overall portfolio financing strategy. The Company employs risk management transactions to manage its exposure to changes in interest rates associated with the Company's expected future debt issuances. Through these risk management transactions, the Company seeks to significantly secure its cost of financing on the associated long-term debt issuance and, thus, attempt to significantly secure its positive spread on the assets financed.

Since its initial public offering, the Company's risk management transactions have consisted primarily of forward starting interest rate swaps, and they are expected to continue to consist primarily of forward starting interest rate swaps for the foreseeable future. These swap contracts are generally entered into at the time the Company concludes to issue long-term fixed rate debt in the future and are closed-out or terminated at the time of pricing or issuance of the debt.

Pursuant to the swap contract, the Company agrees to exchange a series of interest rate cash flows with a third party (the counterparty) over a prescribed period. For example, a typical swap contract entered into by the Company provides that the Company will pay fixed interest payments to the counterparty in exchange for floating rate interest payments to the Company by the counterparty. Payments are established based on a notional amount which generally represents the amount of long-term fixed rate debt the Company expects to issue. The parties do not exchange notional amounts. The Company typically terminates swap contracts at the time of pricing or debt issuance, and termination results in payment or receipt of cash in an amount that approximates the present value of the expected future cash flows remaining on the swap contract. Payments are normally exchanged beginning on the date of the expected debt issuance. Since April 2008, the Company's counterparty has required that the Company deposit cash to collateralize all amounts it may owe at settlement of the hedge.

The Company does not use risk management transactions for trading or speculative purposes and it only enters into swap contracts with major financial institutions and, therefore, the Company considers the risk of counterparty default to be remote.

For financial reporting purposes, the interest rate swaps are treated as cash flow hedges to the extent they have been designated and qualify as such, which basically means the Company has satisfied a variety of technical requirements under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (“SFAS No. 133”), such as hedge documentation requirements and initial and subsequent quarterly hedge effectiveness tests. The swap transactions are marked to fair value at each reporting date and the effective portion of the Company’s realized and unrealized gains and losses on such transactions are treated as a component of “Other Comprehensive Income (Loss)” on the Company’s Consolidated Balance Sheet and are not reported as a component of current income or loss on the Company’s Consolidated Statement of Operations. The effective portion of the Company’s realized gains and losses, which generally represent the net payments the Company makes or receives on the interest rate swaps, are then reclassified and amortized as part of interest expense on the Company’s Consolidated Statement of Operations beginning at issuance of the related debt and continuing over the expected term of such issuance.

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To the extent the SFAS No. 133 cash flow hedge criteria are not met or the hedge is deemed ineffective, some or all of the realized and unrealized gains and losses on such transactions are treated as a component of current income or loss on the Company's Statement of Operations. No assurance can be made that the Company will continue to satisfy the cash flow hedge requirements of SFAS No. 133 and as to the portion of the Company's gains and losses that will be deemed effective under SFAS No. 133. Changes in management's initial assumptions regarding the proposed debt issuance (e.g., timing and the amount and type of debt) and changes in the shape of the yield curve (which represents market expectations of future interest rates) are among the factors that could cause the Company to include a greater portion of its gains and losses from the associated risk management transactions as current income or loss.

While the Company's risk management transactions are expected to hedge the Company's risk related to changes in interest rates, these transactions are not intended or expected to hedge the risk of changes in credit spreads. As a result, to the extent credit spreads widen in advance of our issuance of long-term financing, the Company expects that its cost of financing will increase.

There can be no assurance that the Company's use of risk management transactions to manage its exposure to changes in interest rates will be completely or even partially successful.

As of June 30, 2008, the Company was using interest rate swaps, which have been designated and qualified as cash flow hedges, to hedge its exposure to changes in the interest-related cash outflows on forecasted future borrowings through November 2017. Amounts related to open swap positions, as of June 30, 2008 and December 31, 2007, which consisted of a single interest swap contract, were as follows:

| <i>Description</i> | Jun 30, 2008<br>Unaudited |            | Dec 31, 2007       |            |
|--------------------|---------------------------|------------|--------------------|------------|
|                    | Notional<br>Amount        | Fair value | Notional<br>Amount | Fair value |
| Interest rate swap | \$ 173,563                | \$ (4,348) | \$ 177,442         | \$ (4,559) |

At June 30, 2008 and December 31, 2007, the Company had hedged the following future borrowings:

|                                      | Jun 30, 2008<br>Unaudited | Dec 31, 2007 |
|--------------------------------------|---------------------------|--------------|
| Future borrowings (principal amount) | \$ 173,563                | \$ 177,442   |

At June 30, 2008 and December 31, 2007, derivative liabilities with a fair value of \$4,348 and \$4,559, respectively, were included in "Accounts payable, accrued expenses and other liabilities" on the Company's Consolidated Balance Sheet. At June 30, 2008, the Company determined the fair value of derivative liabilities in accordance with the fair value measurement guidance of SFAS No. 157. See Note 7 for more information on the Company's fair value measurements.

For the three months ended June 30, 2008 and June 30, 2007, the Company had net realized gains and (losses) of \$(932) and \$193, respectively, related to cash flow hedges. For the three months ended June 30, 2008 and June 30, 2007, the Company reclassified \$157 and \$307, respectively, from Accumulated Other Comprehensive Income (Loss)

into interest expense related to the underlying debt issuances.

For the six months ended June 30, 2008 and June 30, 2007, the Company had net realized gains and (losses) of \$(1,231) and \$389, respectively, related to cash flow hedges. For the six months ended June 30, 2008 and June 30, 2007, the Company reclassified \$313 and \$610, respectively, from Accumulated Other Comprehensive Income (Loss) into interest expense related to the underlying debt issuances.

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Within the next twelve months, the Company estimates that \$645 of net losses currently held within Accumulated Other Comprehensive Income (Loss) will be reclassified to earnings as additional interest expense.

The change in net unrealized gains and (losses) of \$(12) and \$10,701 in the six months ended June 30, 2008 and June 30, 2007, respectively, for derivatives designated as cash flow hedges is separately disclosed in the Company's Consolidated Statement of Changes in Stockholders' Equity.

Included in "(Gain)/loss on derivatives" on the Consolidated Statements of Operations, the Company had net income from derivatives of \$198 and \$300 for the three months ended June 30, 2008 and June 30, 2007, respectively, and net (expense) income of \$(1,862) and \$290 for the six months ended June 30, 2008 and June 30, 2007, respectively. The loss in the six month 2008 period includes approximately \$1,550 of hedge ineffectiveness resulting from changes in (i) management's estimates of when the related hedged debt will be issued, and (ii) the shape of the yield curve (which represents market expectations of future interest rates). The Company revised its expected long-term debt issuance date due to the current dislocations in the credit markets.

Consistent with the cash flows of the related financing, the Company classifies the cash flows from derivatives that are accounted for as cash flow hedges as a financing activity on the Consolidated Statements of Cash Flows.

#### **12. Commitments and Contingencies**

The Company is involved from time to time in litigation arising in the ordinary course of business. The Company is not currently involved in any matter which management believes will have a material adverse effect on the Company's business, results of operations or financial condition.

As an owner of commercial real estate, the Company is subject to potential environmental costs. At June 30, 2008, the Company was not aware of any environmental concerns that would have a material adverse effect on the Company's business, results of operations or financial condition.

The Company is obligated under a letter of credit with respect to one of its prior securitization transactions (BSCMS 1999-CLF1). The maximum potential amount of future required payments under the letter of credit is \$2,850. The letter of credit expires on February 18, 2009. The trustee may draw the letter of credit if there are realized losses on the collateral mortgage loans that would create a shortfall in the interest or principal on any investment grade certificate. The letter of credit may be withdrawn when the ratings of the investment grade certificates are no longer dependent upon the credit support provided by the letter of credit. During February 2005, one of the mortgage loans in the securitization on a property leased to Winn-Dixie defaulted, in connection with the bankruptcy of Winn-Dixie. However, management does not expect any draw on the letter of credit as a result of this mortgage default, or otherwise. Letter of credit fees included in interest expense were \$25 and \$25 for the three months ended June 30, 2008 and June 30, 2007, respectively, and \$50 and \$50 for the six months ended June 30, 2008 and June 30, 2007, respectively.

During October 2006, the Company acquired a real property in Fresno, California leased to Aetna Life Insurance Company, and agreed to fund expected improvements to the real property of approximately \$812. During November 2006, the Company arranged long-term financing on this property and it funded a reserve account with its lender for the full amount of this obligation. The Company expects these funds will be disbursed in full as improvements are completed. As of June 30, 2008, \$779 of these funds has been disbursed.

As discussed under Note 9 above, the Company has agreed to contribute up to \$5,000 of capital to Matapeake, a real estate investment and management company, subject to the satisfaction of certain terms and conditions by the principals of Matapeake. As of June 30, 2008, the Company had invested \$1,139 toward its aggregate \$5,000 commitment.

### **13. Minority Interests**

As of June 30, 2008, the Operating Partnership had issued and outstanding 263,157 common units of limited partnership to a minority interest holder. All of these units were issued in connection with the Company's acquisition of a property in June 2006 from the minority interest holder. Beginning on June 13, 2008, the units of limited partnership are redeemable by the holder, at its option, on the basis of one unit for either one share of CapLease common stock or cash equal to the fair market value of a share of common stock at the time of the redemption. The units of limited partnership do not have a liquidation preference.

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Cash distributions by the Operating Partnership will be paid in the following priority: first, to the minority interest holder until such holder receives the amount it would have received if the holder's units of limited partnership interest were converted to an equal number of shares of CapLease common stock, and then, to CapLease. Since July 2006, the minority interest holder has been paid a cash dividend of \$0.20 per limited partnership unit simultaneous with the payment of CapLease's cash dividend of \$0.20 per share of common stock.

Net income, if any, is allocated to the minority interest holder on an "as converted" basis. In other words, the limited partnership units are treated as converted to shares of CapLease common stock, and the minority interest holder is allocated a percentage of the Company's net income, if any, based on its percentage of as converted common shares outstanding.

#### 14. Stockholders' Equity

##### *Stock Issuances*

CapLease's authorized capital stock consists of 500,000,000 shares of common stock, \$0.01 per share, and 100,000,000 shares of preferred stock, \$0.01 per share. As of June 30, 2008, CapLease had issued and outstanding 44,865,560 shares of common stock, and 1,400,000 shares of 8.125% Series A cumulative redeemable preferred stock.

During the six months ended June 30, 2008, CapLease issued 121,280 shares of common stock through its dividend reinvestment and stock purchase plan at an average price of \$7.84 per share. During the six months ended June 30, 2007, CapLease issued 465,578 shares of common stock through the plan at an average price of \$10.88 per share.

During March 2008, CapLease issued 393,950 shares of common stock to its executive officers, other employees and directors pursuant to the Company's stock incentive plan. As of June 30, 2008, the Company had awarded 1,791,195 shares of common stock under the stock plan, all in the form of stock awards to executive officers, other employees and directors of the Company (see Note 15 below).

During May and June 2007, CapLease issued 10,350,000 shares of common stock in a public offering at a price to the public of \$10.75 per share, for net proceeds of approximately \$104,773. We used the net proceeds to repay short-term debt borrowings incurred in connection with our acquisition of the EntreCap portfolio acquired in April 2006.

##### *Dividends*

CapLease has paid cash dividends to its common stockholders each quarter since the third quarter of 2004, and to its Series A preferred stockholders each quarter since the fourth quarter of 2005.

The following table summarizes the dividend history on shares of CapLease common stock for the periods indicated.

| Quarter Ended | Record Date | Payment Date | Dividend Per Share | Total Amount |
|---------------|-------------|--------------|--------------------|--------------|
| 12/31/2006    | 12/29/2006  | 1/16/2007    | \$ 0.20            | \$ 6,818     |
| 3/31/2007     | 3/30/2007   | 4/16/2007    | 0.20               | 6,883        |

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|            |            |            |      |       |
|------------|------------|------------|------|-------|
| 6/30/2007  | 6/29/2007  | 7/16/2007  | 0.20 | 9,046 |
| 9/30/2007  | 9/28/2007  | 10/15/2007 | 0.20 | 9,175 |
| 12/31/2007 | 12/31/2007 | 1/15/2008  | 0.20 | 8,870 |
| 3/31/2008  | 3/31/2008  | 4/15/2008  | 0.20 | 8,949 |
| 6/30/2008  | 6/30/2008  | 7/15/2008  | 0.20 | 8,973 |

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The following table summarizes the dividend history on shares of CapLease Series A preferred stock for the periods indicated.

| Quarter Ended | Record Date | Payment Date | Dividend Per Share | Total Amount |
|---------------|-------------|--------------|--------------------|--------------|
| 12/31/2006    | 12/29/2006  | 1/16/2007    | \$ 0.5078125       | \$ 711       |
| 3/31/2007     | 3/30/2007   | 4/16/2007    | 0.5078125          | 711          |
| 6/30/2007     | 6/29/2007   | 7/16/2007    | 0.5078125          | 711          |
| 9/30/2007     | 9/28/2007   | 10/15/2007   | 0.5078125          | 711          |
| 12/31/2007    | 12/31/2007  | 1/15/2008    | 0.5078125          | 711          |
| 3/31/2008     | 3/31/2008   | 4/15/2008    | 0.5078125          | 711          |
| 6/30/2008     | 6/30/2008   | 7/15/2008    | 0.5078125          | 711          |

## 15. Stock Based Compensation

The Company adopted a stock incentive plan for its employees and directors during March 2004 in connection with its initial public offering. 2,323,000 shares of common stock are authorized for issuance under the stock plan. As of June 30, 2008, the Company had awarded 1,791,195 shares of common stock under the stock plan, all in the form of stock awards to executive officers, other employees and directors of the Company. The Company has not awarded any options, stock appreciation rights or other stock based compensation under the stock plan.

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (Revised 2004) – *Share-Based Payment* (“SFAS No. 123R”), using the modified prospective transition method. SFAS No. 123R replaces SFAS No. 123, which the Company adopted on January 1, 2003. Under that transition method, compensation cost recognized on and after January 1, 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted on or after January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R.

Because the Company has historically valued compensation cost for stock awards at fair value under SFAS No. 123, the adoption of SFAS No. 123R had no impact on the Company’s income from continuing operations, net income, earnings per share (basic and diluted), cash flows from operations or cash flows from financing activities.

The Company uses the closing stock price on the grant date as its estimate of the fair value of the award.

A summary of the Company’s activity under the stock plan from January 1, 2007 through the six months ended June 30, 2008, is presented below:

|   | Number of Shares |
|---|------------------|
| Stock Awards at January 1, 2007                 | 1,081,995        |
| Granted During the Year Ended December 31, 2007 | 315,250(1)       |
| Stock Awards at January 1, 2008                 | 1,397,245        |

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|  |                        |
|--|------------------------|
| Granted During the Period Ended June 30,<br>2008 | 393,950 <sup>(2)</sup> |
| Stock Awards at June 30, 2008                    | 1,791,195              |

<sup>(1)</sup> Shares are scheduled to vest between March 2008 and March 2012, but will generally be forfeited if the recipient either terminates his employment with the Company or ceases to be a member of CapLease's Board of Directors at any time prior to the vesting date. Vesting of an aggregate of 156,750 shares is also subject to satisfaction of objective and subjective performance criteria, to be determined by CapLease's Compensation Committee.

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(2) Shares are scheduled to vest between March 2009 and March 2013, but will generally be forfeited if the recipient either terminates his employment with the Company or ceases to be a member of CapLease's Board of Directors at any time prior to the vesting date. Vesting of an aggregate of 196,725 shares is also subject to satisfaction of objective and subjective performance criteria, to be determined by CapLease's Compensation Committee.

A summary of the status of unvested shares from January 1, 2007 through the six months ended June 30, 2008, is presented below:

|                              | Shares<br>Awarded<br>Under Plan | Shares Priced<br>Under SFAS<br>123 and 123R | Weighted<br>Average Fair<br>Value |
|------------------------------|---------------------------------|---|-----------------------------------|
| Nonvested at January 1, 2007 | 588,113                         | 436,891                                     | \$ 10.99                          |
| Current period awards        | 315,250                         | 189,850                                     | 10.91                             |
| Prior period awards          | N/A                             | 30,770                                      | 10.91                             |
| Vested                       | (210,781)                       | (210,781)                                   | 10.97                             |
| Nonvested at January 1, 2008 | 692,582                         | 446,731                                     | 10.99                             |
| Current period awards        | 393,950                         | 236,570                                     | 8.43                              |
| Prior period awards          | N/A                             | 79,799                                      | 8.43                              |
| Vested                       | (151,467)                       | (151,467)                                   | 10.99                             |
| Nonvested at June 30, 2008   | 935,065                         | 611,633                                     | 9.67                              |

As the immediately preceding table indicates, not all Company share awards have been valued for purposes of SFAS 123R, as the Company's stock awards include shares awarded with vesting dependant upon satisfaction of performance criteria and with the performance criteria on a portion of the shares to be determined in the future. "Prior period awards" represent share awards made in a prior period which have been valued for purposes of SFAS 123R in the current period when the CapLease Compensation Committee determined the performance criteria.

As of June 30, 2008, \$5,224 of unvested shares (fair value at the grant dates) is expected to be charged to the Company's Consolidated Statement of Operations ratably over the remaining vesting period (through March 2013). As of June 30, 2008, the grant date fair value for awards of 24,886 shares made in 2005, 47,116 shares made in 2006, 94,050 shares made in 2007 and 157,380 shares made in 2008, has not yet been determined because the grant date (as defined under SFAS 123R) has not yet occurred.

## 16. Other Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances, excluding those resulting from investments by and distributions to owners. For the Company's purposes, comprehensive income (loss) represents net income (loss), as presented in the Company's Consolidated Statements of Operations, adjusted for unrealized gains or losses on securities available for sale, unrealized gains or losses on derivatives designated as cash flow hedges, and realized gains and losses on derivatives designated as cash flow hedges (net of amortization of those realized gains and losses reclassified into interest expense). The Company's comprehensive income (loss) for the three and six months ended June 30, 2008 and June 30, 2007 is summarized below:



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|   | June 30, 2008 (unaudited)              |            |                                      |            |
|---|--|------------|--------------------------------------|------------|
|   | For the three months<br>ended June 30, |            | For the six months<br>ended June 30, |            |
|   | 2008                                   | 2007       | 2008                                 | 2007       |
| Net loss  | \$ (246)                               | \$ (3,292) | \$ (1,816)                           | \$ (2,674) |
| Increase (decrease) in fair value on securities available for sale                        | 1,031                                  | (6,999)    | (3,005)                              | (7,252)    |
| Amortization of unrealized loss on securities previously classified as available for sale | 107                                    | -          | 248                                  | -          |
| Increase (decrease) in fair value of derivatives  | 5,237                                  | 10,811     | (12)                                 | 10,701     |
| Reclassification of derivative items into earnings  | (41)                                   | 6          | 2,175                                | 320        |
| Realized gain (loss) on derivatives   | (932)                                  | 193        | (1,231)                              | 389        |
| Comprehensive income (loss)   | \$ 5,156                               | \$ 719     | \$ (3,641)                           | \$ 1,484   |

SFAS No. 130, *Reporting Comprehensive Income*, divides comprehensive income (loss) into “net income (loss)” and “other comprehensive income (loss).” Other comprehensive income (loss) is defined as revenues, expenses, gains and losses that under generally accepted accounting principles are included in comprehensive income (loss) but excluded from net income (loss). Other comprehensive income (loss) is a component of Stockholders’ Equity and is shown on the Company’s Consolidated Statement of Changes in Stockholders’ Equity (fourth column). The following table summarizes the Company’s Accumulated Other Comprehensive Income (Loss) as reported on the Consolidated Statement of Changes in Stockholders’ Equity.

|   | Jun 30, 2008 | Dec 31, 2007 |
|---|--------------|--------------|
| Net unrealized losses on securities available for sale                          | \$ (7,003)   | \$ (13,720)  |
| Net unrealized losses on securities previously classified as available for sale | (9,474)      | -            |
| Net unrealized losses on derivatives  | (4,533)      | (4,522)      |
| Net realized losses on derivatives  | (6,835)      | (7,778)      |
| Accumulated other comprehensive loss  | \$ (27,845)  | \$ (26,020)  |

## 17. Rental Income

The Company is the lessor to tenants under operating leases with expiration dates ranging from 2008 to 2026 (not including incidental leases). The minimum rental amounts due under the leases are generally subject to scheduled fixed increases. The leases generally also require that the tenants pay for or reimburse the Company for the occupancy and operating costs of the properties, or in certain cases reimburse the Company for increases in certain operating costs and real estate taxes above their base year costs. Approximate future minimum rents to be received over the next five years and thereafter for non-cancelable operating leases in effect at June 30, 2008, are as follows:

\$ 57,389

|                                      |              |
|--------------------------------------|--------------|
| 6 Months Ending December 31,<br>2008 |              |
| 2009                                 | 128,976      |
| 2010                                 | 114,063      |
| 2011                                 | 113,875      |
| 2012                                 | 115,865      |
| Thereafter                           | 629,510      |
|                                      | \$ 1,159,678 |

### **18. Pro Forma Condensed Consolidated Statements of Operations**

The accompanying unaudited Pro Forma Condensed Consolidated Statements of Operations are presented as if, at January 1, 2007, the Company acquired all real properties purchased during 2008 and 2007. Earnings per share are presented using the weighted average shares outstanding during the relevant periods. In management's opinion, all adjustments necessary to reflect the effects of the above transactions have been made.

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The unaudited Pro Forma Condensed Consolidated Statements of Operations are not necessarily indicative of what the actual results of operations would have been assuming the acquisition transactions had occurred at the date indicated above, nor do they purport to represent our future results of operations.

|   | For the three months<br>ended June 30, |           | For the six months<br>ended June 30, |           |
|---|--|-----------|--------------------------------------|-----------|
|   | 2008                                   | 2007      | 2008                                 | 2007      |
| Total revenues  | \$ 46,118                              | \$ 45,551 | \$ 92,594                            | \$ 90,809 |
| Income (loss) from continuing operations                                    | \$ (351)                               | \$ 470    | \$ (2,029)                           | \$ 2,592  |
| Net income (loss) allocable to common stockholders                          | \$ (957)                               | \$ (136)  | \$ (3,238)                           | \$ 1,318  |
| Income (loss) per basic and diluted common share from continuing operations | \$ (0.01)                              | \$ 0.01   | \$ (0.05)                            | \$ 0.07   |
| Net income (loss) per basic and diluted common share                        | \$ (0.02)                              | \$ 0.00   | \$ (0.07)                            | \$ 0.04   |

## 19. Segment Reporting

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes the manner in which public businesses report information about operating segments in annual and interim financial reports issued to stockholders. SFAS No. 131 defines a segment as a component of an enterprise about which separate financial information is available and that is evaluated regularly to allocate resources and assess performance. The Company conducts its business through two segments: operating real estate (including its investments in owned properties) and lending investments (including its loan investments as well as its investments in securities). For segment reporting purposes, the Company does not allocate interest income on short-term investments or general and administrative expenses.

Selected results of operations by segment for the three months ended June 30, 2008 and June 30, 2007, are as follows:

|  | Corporate /<br>Unallocated |              | Operating<br>Real Estate |              | Lending<br>Investments |              |
|--|----------------------------|--------------|--------------------------|--------------|------------------------|--------------|
|  | Jun 30, 2008               | Jun 30, 2007 | Jun 30, 2008             | Jun 30, 2007 | Jun 30, 2008           | Jun 30, 2007 |
| Total revenues                           | \$ 194                     | \$ 108       | \$ 37,373                | \$ 35,080    | \$ 8,552               | \$ 8,432     |
| Total expenses and minority interest     | 6,001                      | 4,073        | 35,091                   | 37,423       | 5,377                  | 6,142        |
| Gain on extinguishment of debt           | -                          | -            | -                        | 621          | -                      | -            |
| Income (loss) from continuing operations | (5,807)                    | (3,965)      | 2,282                    | (1,722)      | 3,174                  | 2,290        |
| Total assets                             | 46,903                     | 51,691       | 1,594,492                | 1,641,921    | 465,373                | 482,709      |

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Selected results of operations by segment for the six months ended June 30, 2008 and June 30, 2007, are as follows:

|   | Corporate /<br>Unallocated |              | Operating<br>Real Estate |              | Lending<br>Investments |              |
|---|----------------------------|--------------|--------------------------|--------------|------------------------|--------------|
|   | Jun 30, 2008               | Jun 30, 2007 | Jun 30, 2008             | Jun 30, 2007 | Jun 30, 2008           | Jun 30, 2007 |
| Total revenues                              | \$ 576                     | \$ 244       | \$ 74,691                | \$ 61,889    | \$ 17,328              | \$ 16,652    |
| Total expenses and<br>minority interest     | 11,544                     | 7,629        | 70,011                   | 62,912       | 13,068                 | 11,688       |
| Gain on<br>extinguishment of<br>debt        | -                          | -            | -                        | 621          | -                      | -            |
| Income (loss) from<br>continuing operations | (10,968)                   | (7,385)      | 4,680                    | (402)        | 4,259                  | 4,964        |
| Total assets                                | 46,903                     | 51,691       | 1,594,492                | 1,641,921    | 465,373                | 482,709      |

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## 20. Variable Interest Entities

In January 2003, the FASB issued Interpretation Number 46, *Consolidation of Variable Interest Entities*. FIN 46 was revised by FIN 46(R) in December 2003 (as revised, "FIN 46"). FIN 46 defines a variable interest entity ("VIE") as an entity with one or more of the following characteristics:

- the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties;
- equity holders either (a) lack direct or indirect ability to make decisions about the entity, (b) are not obligated to absorb expected losses of the entity or (c) do not have the right to receive expected residual returns of the entity if they occur; or
- equity holders have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest.

If an entity is deemed to be a VIE, an enterprise that absorbs a majority of the expected losses of the entity is considered the primary beneficiary and must consolidate the VIE.

As part of the Company's developer loan program, the Company funds loans to an entity that owns an undeveloped property. These loans are used to finance pre-construction costs related to the property, such as due diligence costs and land acquisition contract deposits, rather than costs to build on the property. The Company has funded two such loans as of June 30, 2008, with an aggregate unpaid principal amount of approximately \$1,148 as of that date. The Company has determined that its borrowers are VIEs under FIN 46. Each loan is secured, in part, by a personal guarantee by the borrowing entity's owner. The Company has concluded it is not the primary beneficiary of the VIE (and, therefore, the Company has not consolidated the VIE under FIN 46). The Company's maximum exposure to loss as a result of its involvement with these VIEs is the amount funded on the loans.

During June 2006, the Company entered into a revolving credit agreement with a third party borrower pursuant to which the Company agreed to provide up to \$12,000 to support the borrower's capital contributions to a joint venture that provides franchise loans to franchisees of YUM! Brands, Inc. restaurant concepts such as Taco Bell, Kentucky Fried Chicken and Pizza Hut. The Company's commitment to make new loans was terminated in October 2007. As of June 30, 2008, the Company had advanced \$6,654 under the agreement. The Company has determined that the borrower is a VIE under FIN 46. The Company's advances are secured by a pledge of the borrower's membership interest in the joint venture and a guaranty by one of the principals of the borrower. The Company has determined it is not the primary beneficiary of the VIE (and, therefore, the Company has not consolidated the VIE under FIN 46). The Company's maximum exposure to loss as a result of this investment is the amount advanced under the credit agreement.

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

*The following discussion should be read in conjunction with the consolidated financial statements and the notes to those financial statements, included elsewhere in this filing.*

### **General**

We are a diversified REIT that invests primarily in single tenant commercial real estate assets subject to long-term leases to high credit quality tenants. We focus on properties that are subject to a net lease, or a lease that requires the tenant to pay all or substantially all expenses normally associated with the ownership of the property (such as utilities, taxes, insurance and routine maintenance) during the lease term. We also continue to be opportunistic and have made and expect to continue to make investments in single tenant properties where the owner has exposure to property expenses when we determine we can sufficiently underwrite that exposure and isolate a predictable cash flow.

Our primary business objective is to generate stable, long-term and attractive returns based on the spread between the yields generated by our assets and the cost of financing our portfolio. We invest at all levels of the capital structure of net lease and other single tenant properties, including equity investments in real estate (owned real properties), debt investments (mortgage loans and net lease mortgage backed securities) and mezzanine investments secured by net leased or other single tenant real estate collateral. For properties that we own, in addition to high quality tenant credit, we also seek to invest in strong real estate locations that will appreciate over time.

The principal sources of our revenues are rental income on our owned real properties and interest income from our debt investments (loans and securities). The principal sources of our expenses are interest expense on our assets financed, depreciation expense on our real properties, general and administrative expenses and property expenses (net of expense recoveries).

We rely on leverage to allow us to invest in a greater number of assets and enhance our asset returns. We expect our leverage to average 70% to 85% of our assets in portfolio. Our overall portfolio leverage as of June 30, 2008 was approximately 79.5%.

Our portfolio financing strategy is to finance our assets with long-term fixed rate debt as soon as practicable after we invest, generally on a secured, non-recourse basis. We seek to match-fund our assets, or obtain long-term fixed rate debt whose maturity matches the maturity of the asset financed. Through June 30, 2008, our long-term fixed rate asset financings have been in the form of traditional third party mortgage financings (on most of our owned real properties) and two term financings, including a secured term loan (completed in December 2007) and one CDO (completed in March 2005). For assets not yet financed with long-term fixed rate debt, we employ a hedging strategy to manage our exposure to changes in interest rates prior to the time we obtain long-term fixed rate financing. We enter into hedging transactions at the discretion of our management team, and we may determine that it is not in our company's best interests to hedge the interest rate risks with respect to certain expected long-term financings.

We rely primarily on equity and debt capital to fund our portfolio growth. Through June 30, 2008, our primary capital issuances have been our initial public offering of common stock in March 2004 (net proceeds of \$221.8 million), a Series A preferred stock issuance in October 2005 (net proceeds of \$33.7 million), trust preferred debt issued in December 2005 (net proceeds of \$29.9 million), a follow-on common stock offering in each of May 2006 and May/June 2007 (net proceeds of \$57.3 million and \$104.8 million, respectively), and a \$75.0 million 7.50% Convertible Senior Note offering in October 2007 (net proceeds of \$72.8 million).

### **Business Environment**

Conditions within the United States credit markets in general and United States real estate credit markets in particular continue to experience historic levels of dislocation and stress that began in the summer of 2007. After some modest improvement in the first half of the second quarter of 2008, credit market dislocations continued and intensified in the second half of the second quarter and are continuing in the third quarter. These conditions continue to impact us in a variety of ways, including by:

- making it difficult for us to price and finance new investment opportunities on attractive terms. As a result of market conditions, we have not been adding new asset investments to our investment portfolio.

·causing us to preserve our liquidity rather than make new investments due to the lack of debt or equity capital on attractive terms.

·causing a delay in the long-term fixed rate financing of the mortgage assets previously financed under our repurchase agreement, which were scheduled to be financed through a CDO. In April 2008, we entered into a two year credit agreement with an option for a third year with Wachovia Bank and refinanced these assets on the new facility at closing. While this new facility relieves short-term refinancing risk, it is priced at floating rates based on 30-day LIBOR, or the London Interbank Offered Rate, is recourse to all of our other assets and enables the lender to exercise margin calls primarily for credit events related to the assets financed. We may experience increases in our borrowing costs as a result of increases in LIBOR. We intend to refinance these assets on a longer-term fixed rate non-recourse basis as soon as credit market conditions improve and we can do so at a favorable cost to our company. We expect credit market conditions to impact our ability to refinance these assets and, therefore, we cannot provide any assurance as to the timing or our ability to do so.

Widening credit spreads and reduced market trading activity for real estate securities have resulted in lower valuations on our real estate securities. To date, consistent with prevailing accounting guidance, these lower valuations have impacted us primarily through reductions in Stockholders' Equity on our Consolidated Balance Sheet, rather than through impairment charges directly to our Consolidated Statement of Operations.

We do not know when market conditions will stabilize, if adverse conditions will intensify or the full extent to which the disruptions will affect us. If market instability persists or intensifies, the trends discussed above may continue and we may be impacted in a variety of additional ways. For example, we may experience challenges in raising additional capital, margin calls on our new credit facility and impairment charges on our assets, particularly on our loan and securities investments.

We may also take a variety of actions such as asset sales to increase our liquidity levels until credit markets normalize. Credit market conditions have resulted in reduced trading activity and lower valuations for our securities, which could impact the amount at which and how quickly we could sell our assets if needed to generate liquidity. Our ability to sell collateral to generate liquidity could also be impacted by factors such as the relative illiquidity of certain of our assets (i.e., our owned property and loan investments) and limitations on sale imposed pursuant to the debt financing terms of our assets.

Economic conditions in the United States have also been experiencing a period of weakness. Continued weak economic conditions could adversely impact the financial condition of one or more of our tenants, including tenants underlying our loan and securities investments, and therefore, could make a tenant bankruptcy and payment default on the related lease more likely.

### **Application of Critical Accounting Policies**

A summary of our critical accounting policies is included in our Annual Report on Form 10-K for the year ended December 31, 2007 in Management's Discussion and Analysis of Financial Condition and Results of Operations. There have been no significant changes to those policies during 2008.

### **Investment and Financing Activities**

During the three months ended June 30, 2008, we did not make any new investments. We also did not complete any new asset financings other than the new credit agreement with Wachovia Bank discussed below under "Liquidity and Capital Resources."

### **Business Segments**

We conduct our business through two operating segments:

- operating real estate (including our investments in owned real properties); and
- lending investments (including our loan investments as well as our investments in securities).

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Selected results of operations by segment for the three months ended June 30, 2008 and June 30, 2007, are as follows (dollar amounts in thousands):

|  | Corporate /<br>Unallocated |              | Operating<br>Real Estate |              | Lending<br>Investments |              |
|--|----------------------------|--------------|--------------------------|--------------|------------------------|--------------|
|  | Jun 30, 2008               | Jun 30, 2007 | Jun 30, 2008             | Jun 30, 2007 | Jun 30, 2008           | Jun 30, 2007 |
| Total revenues                           | \$ 194                     | \$ 108       | \$ 37,373                | \$ 35,080    | \$ 8,552               | \$ 8,432     |
| Total expenses and minority interest     | 6,001                      | 4,073        | 35,091                   | 37,423       | 5,377                  | 6,142        |
| Gain on extinguishment of debt           | –                          | –            | –                        | 621          | –                      | –            |
| Income (loss) from continuing operations | (5,807)                    | (3,965)      | 2,282                    | (1,722)      | 3,174                  | 2,290        |
| Total assets                             | 46,903                     | 51,691       | 1,594,492                | 1,641,921    | 465,373                | 482,709      |

Selected results of operations by segment for the six months ended June 30, 2008 and June 30, 2007, are as follows (dollar amounts in thousands):

|  | Corporate /<br>Unallocated |              | Operating<br>Real Estate |              | Lending<br>Investments |              |
|--|----------------------------|--------------|--------------------------|--------------|------------------------|--------------|
|  | Jun 30, 2008               | Jun 30, 2007 | Jun 30, 2008             | Jun 30, 2007 | Jun 30, 2008           | Jun 30, 2007 |
| Total revenues                           | \$ 576                     | \$ 244       | \$ 74,691                | \$ 61,889    | \$ 17,328              | \$ 16,652    |
| Total expenses and minority interest     | 11,544                     | 7,629        | 70,011                   | 62,912       | 13,068                 | 11,688       |
| Gain on extinguishment of debt           | –                          | –            | –                        | 621          | –                      | –            |
| Income (loss) from continuing operations | (10,968)                   | (7,385)      | 4,680                    | (402)        | 4,259                  | 4,964        |
| Total assets                             | 46,903                     | 51,691       | 1,594,492                | 1,641,921    | 465,373                | 482,709      |

**Comparison of Results of Operations of the Quarter Ended June 30, 2008 to the Quarter Ended June 30, 2007**

The following discussion compares our operating results for the quarter ended June 30, 2008 to the comparable period in 2007.

*Revenue.*

Total revenue increased \$2.5 million, or 6%, to \$46.1 million. The increase was primarily attributable to an increase in rental revenue.

Rental revenue and property expense recoveries, in the aggregate, increased \$2.3 million, or 7%, to \$37.2 million. The increase was due to an increase in the underlying property investments from the prior year period.

Interest income was largely unchanged, as it increased \$0.1 million, or 1%, to \$8.7 million, as aggregate debt investments were largely unchanged from the prior year period.

*Expenses.*

Total expenses decreased \$1.2 million, or 2%, to \$46.5 million. The decrease in expenses was primarily attributable to lower interest expense, offset in part by higher levels of depreciation and amortization expense on real property and

general and administrative expenses.

Interest expense decreased \$2.6 million, or 10%, from \$26.9 million to \$24.3 million. The decrease in 2008 resulted from \$7.0 million of lower interest expense on floating rate borrowings (resulting from lower borrowings and interest rates in the 2008 period and the impact in the 2007 period of \$2.6 million of fees and \$2.4 million of interest expense under the bridge facility we entered into in connection with the acquisition of the EntreCap portfolio in April 2007), partially offset by \$1.9 million of interest expense on the secured term loan we issued in December 2007, \$1.5 million of interest expense on the convertible senior notes we issued in October 2007, and \$0.9 million of additional interest expense on property mortgages. The Company's average balance outstanding and interest rate under its floating rate borrowings other than the bridge facility was approximately \$214 million at 5.03% during the 2008 period (average 30-day LIBOR of 2.70%), compared with approximately \$338 million at 6.27% during the 2007 period (average 30-day LIBOR of 5.32%).

Depreciation and amortization expense on real property increased \$1.0 million, or 8%, from \$12.4 million to \$13.4 million, due to the increase in property investments compared with the prior year period.

Property expenses increased \$0.3 million, or 7%, to \$5.0 million. The net amount of property expenses we incurred (net of expense recoveries) was largely unchanged from the prior year period, with \$2.1 million in 2008, and \$2.0 million in 2007.

We had losses on securities of \$372,000 in the 2007 period, compared with no losses in the 2008 period. The 2007 losses represent impairment charges on two CMBS securities during the second quarter of 2007. These losses represent management's determination that other-than-temporary declines in the fair value below cost basis had occurred on these two investments. The 2007 losses are discussed at Note 6 of the consolidated financial statements included in this Form 10-Q.

General and administrative expense increased \$0.3 million, or 9%, to \$3.2 million, primarily reflecting higher legal expenses associated with litigation involving the real property we own in Johnston, Rhode Island and leased to Factory Mutual Insurance Company.

General and administrative expense-stock based compensation increased \$0.1 million, or 30%, to \$0.6 million. The increase was primarily a result of an additional year of stock awards impacting the 2008 expense. As of June 30, 2008, \$5.2 million of unvested shares (fair value at the grant dates) is expected to be charged to our Consolidated Statement of Operations ratably over the remaining vesting period (through March 2013). As of June 30, 2008, the grant date fair value for awards of 24,886 shares made in 2005, 47,116 shares made in 2006, 94,050 shares made in 2007 and 157,380 shares made in 2008, has not yet been determined because the grant date (as defined under SFAS 123R) has not yet occurred.

#### *Gain on extinguishment of debt.*

We had a \$0.6 million non-cash gain on extinguishment of debt in the 2007 period, relating to our retirement of debt we assumed when we purchased the EntreCap portfolio in April 2007. This gain resulted from interest rate changes between the date we assumed the debt and the date it was repaid.

#### *Net loss.*

Net loss decreased \$3.0 million, to \$(0.2) million, from \$(3.3) million, primarily as a result of lower interest expense and an increase in rental revenue, offset in part by an increase in depreciation and amortization expense on real property and the gain on debt extinguishment in the 2007 period. Net loss allocable to common stockholders was \$(1.0) million in the second quarter of 2008, reflecting dividends to preferred stockholders of \$0.7 million.

### **Comparison of the Six Months Ended June 30, 2008 to the Six Months Ended June 30, 2007**

The following discussion compares our operating results for the six months ended June 30, 2008 to the comparable period in 2007.

#### *Revenue.*

Total revenue increased \$13.8 million, or 18%, to \$92.6 million. The increase was primarily attributable to increases in rental revenue and property expense recoveries and an increase in interest income.

Rental revenue and property expense recoveries, in the aggregate, increased \$12.8 million, or 21%, to \$74.3 million. The increase was due to a substantial increase in the underlying property investments from the prior year period.

Interest income increased \$0.9 million, or 5%, to \$17.9 million, reflecting an increase in aggregate loan and securities investments.



*Expenses.*

Total expenses increased \$12.4 million, or 15%, to \$94.6 million. The increase in expenses was primarily attributable to higher levels of depreciation and amortization expense on real property, interest expense, loss on derivatives, property expenses and general and administrative expenses, offset in part by losses on two CMBS investments in the 2007 period.

Interest expense increased \$2.8 million, or 6%, from \$46.0 million to \$48.8 million. The increase in 2008 resulted from \$3.5 million of additional interest expense on property mortgages, \$3.5 million of interest expense on the secured term loan we issued in December 2007, and \$3.0 million of interest expense on the convertible senior notes we issued in October 2007, partially offset by \$7.4 million of lower interest expense on floating rate borrowings (resulting from lower borrowings and interest rates in the 2008 period and the impact in the 2007 period of \$2.6 million of fees and \$2.4 million of interest expense under the bridge facility we entered into in connection with the acquisition of the EntreCap portfolio in April 2007). The Company's average balance outstanding and interest rate under its floating rate borrowings other than the bridge facility was approximately \$222 million at 4.65% during the 2008 period (average 30-day LIBOR of 3.10%), compared with approximately \$281 million at 6.27% during the 2007 period (average 30-day LIBOR of 5.32%).

Depreciation and amortization expense on real property increased \$6.2 million, due to the significant increase in property investments compared with the prior year period.

Property expenses increased \$0.7 million, or 8%, to \$9.7 million. The net amount of property expenses we incurred (net of expense recoveries) was largely unchanged from the prior year period, with \$4.1 million in 2008, and \$3.9 million in 2007.

Loss on derivatives increased \$2.2 million, to \$1.9 million in the 2008 period, compared with a gain of \$0.3 million in the 2007 period. During the 2008 period, credit market dislocations triggered a delay in the expected issuance date of the hedged debt and shifts in the yield curve, which have resulted in a portion of our hedge losses being reported as current income (loss) on our Consolidated Statement of Operations rather than deferred as a component of equity on our Consolidated Balance Sheet.

We had losses on securities of \$372,000 in the 2007 period, compared with no losses in the 2008 period. The 2007 losses represent impairment charges on two CMBS securities during the second quarter of 2007. These losses represent management's determination that other-than-temporary declines in the fair value below cost basis had occurred on these two investments. The 2007 losses are discussed at Note 6 of the consolidated financial statements included in this Form 10-Q.

General and administrative expense increased \$0.6 million, or 12%, to \$6.2 million, primarily reflecting higher legal expenses associated with litigation involving the real property we own in Johnston, Rhode Island and leased to Factory Mutual Insurance Company.

General and administrative expense-stock based compensation increased \$0.3 million, or 32%, to \$1.1 million. The increase was primarily a result of an additional year of stock awards impacting the 2008 expense.

#### *Gain on extinguishment of debt.*

We had a \$0.6 million non-cash gain on extinguishment of debt in the 2007 period, relating to our retirement of debt we assumed when we purchased the EntreCap portfolio in April 2007. This gain resulted from interest rate changes between the date we assumed the debt and the date it was repaid.

#### *Net loss.*

Net loss decreased \$0.9 million, to \$(1.8) million, from \$(2.7) million, primarily as a result of increases in rental revenue, offset in part by increases in depreciation and amortization expense on real property, interest expense, loss on derivatives and general and administrative expenses. Net loss allocable to common stockholders was \$(3.2) million in the 2008 period, reflecting dividends to preferred stockholders of \$1.4 million.

### **Funds from Operations**

Funds from operations, or FFO, is a non-GAAP financial measure. We believe FFO is a useful additional measure of our performance because it facilitates an understanding of our operating performance after adjustment for real estate depreciation, a non-cash expense which assumes that the value of real estate assets diminishes predictably over time. In addition, we believe that FFO provides useful information to the investment community about our financial performance as compared to other REITs, since FFO is generally recognized as an industry standard for measuring the operating performance of an equity REIT. FFO does not represent cash generated from operating activities in accordance with GAAP and is not indicative of cash available to fund cash needs. FFO should not be considered as an alternative to net income or earnings per share determined in accordance with GAAP as an indicator of our operating performance or as an alternative to cash flow as a measure of liquidity. Since all companies and analysts do not

calculate FFO in a similar fashion, our calculation of FFO may not be comparable to similarly titled measures reported by other companies.

We calculate FFO in accordance with standards established by the National Association of Real Estate Investment Trusts (“NAREIT”) which defines FFO as net income (loss) (computed in accordance with GAAP) excluding gains (or losses) from sales of property, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures.

The following table reconciles our net loss allocable to common stockholders to FFO for the three and six months ended June 30, 2008 and June 30, 2007.

| (Amounts in thousands, except per share amounts)                           | For the Three Months<br>Ended June 30 |            | For the Six Months<br>Ended June 30 |            |
|--|---------------------------------------|------------|-------------------------------------|------------|
|  | 2008                                  | 2007       | 2008                                | 2007       |
| Net loss allocable to common stockholders                                  | \$ (957)                              | \$ (4,003) | \$ (3,238)                          | \$ (4,096) |
| Add (deduct):  |                                       |            |                                     |            |
| Minority interest—OP units   | (5)                                   | (24)       | (19)                                | (25)       |
| Depreciation and amortization expense on real property                     | 13,442                                | 12,423     | 26,869                              | 20,626     |
| Depreciation and amortization expense on discontinued operations           | —                                     | —          | —                                   | 43         |
| Funds from operations  | \$ 12,480                             | \$ 8,396   | \$ 23,612                           | \$ 16,548  |
| Weighted average number of common shares outstanding, basic and diluted    | 44,763                                | 38,566     | 44,572                              | 36,356     |
| Weighted average number of OP units outstanding                            | 263                                   | 263        | 263                                 | 263        |
| Weighted average number of common shares and OP units outstanding, diluted | 45,026                                | 38,829     | 44,835                              | 36,619     |
| Net loss per common share, basic and diluted                               | \$ (0.02)                             | \$ (0.10)  | \$ (0.07)                           | \$ (0.11)  |
| Funds from operations per share  | \$ 0.28                               | \$ 0.22    | \$ 0.53                             | \$ 0.45    |

### Liquidity and Capital Resources

We rely on leverage to allow us to invest in a greater number of assets and enhance our asset returns. Leverage also exposes us to a variety of risks which are discussed in more detail in elsewhere in our most recent Annual Report on Form 10-K under the heading “Risk Factors.” We expect our leverage to average 70% to 85% of our assets in portfolio. Our overall portfolio leverage as of June 30, 2008 was approximately 79.5%.

Our portfolio financing strategy is to finance our assets with long-term fixed rate debt as soon as practicable after we invest, generally on a secured, non-recourse basis. We seek to match-fund our assets, or obtain long-term fixed rate debt whose maturity matches the maturity of the asset financed. Through June 30, 2008, our long-term fixed rate asset financings have been in the form of traditional third party mortgage financings (on most of our owned real properties) and two term financings, including a secured term loan (completed in December 2007) and one CDO (completed in March 2005). As of June 30, 2008, we have financed on a long-term fixed rate basis an aggregate of approximately \$1.81 billion of assets in portfolio with third party mortgage debt of \$978.5 million and term financings of \$395.2 million.

As a REIT, we are required to distribute at least 90% of our taxable income to our stockholders on an annual basis, and we intend to distribute all or substantially all of our REIT taxable income in order to comply with the distribution requirements of the Code and to avoid federal income tax and the nondeductible excise tax. We declared a dividend of \$0.20 per share of common stock in the each of the quarters ended March 31, 2008 and June 30, 2008. We also declared a dividend of \$0.5078125 per share of 8.125% Series A cumulative redeemable preferred stock in each of the

quarters ended March 31, 2008 and June 30, 2008.

*Short-Term Liquidity and Financing.*

We expect to meet our short-term liquidity requirements generally through our available cash and cash equivalents, cash provided by operations, and through revolving loan borrowings under our new credit agreement with Wachovia Bank discussed below. We also expect that a portion of the proceeds from our issuances of debt and/or equity capital will be used for short-term liquidity. As of June 30, 2008, we had \$21.5 million in available cash and cash equivalents. As of August 7, 2008, we had \$20.2 million in available cash and cash equivalents.

On April 29, 2008, we entered into a new credit agreement with Wachovia Bank. Pursuant to the agreement, Wachovia Bank agreed to make an aggregate of \$250 million of term and revolving credit loans available to us. We drew a \$210.4 million term loan upon closing of the borrowing facility and may make draws of revolving credit loans from time to time during the agreement term to finance commercial real estate assets that are approved by the Wachovia Bank in its discretion.

The credit agreement is for a term of two years with a one-year extension option at our option provided we meet certain conditions. We can prepay our borrowings under the facility in whole or in part at any time (subject to a \$1 million minimum) without any penalty or premium. We are required to use a portion of our future debt or equity issuances to prepay borrowings under the facility. We are required to pay interest on our borrowings at prevailing short-term rates (30-day LIBOR) plus a pricing spread. During the quarter ended June 30, 2008, the pricing spread ranged from 200 to 250 basis points.

In connection with the financing transaction, we also agreed to consolidate our existing lending arrangements with Wachovia Bank into this new facility and, as a result, our repurchase agreement and \$30 million revolving loan agreement were terminated. Our borrowings under the new facility are secured by the same collateral that previously secured our obligations under the repurchase agreement and \$30 million revolver, which includes a combination of first mortgage loan investments, intercompany mortgage loans on our owned property investments, commercial mortgage-backed securities and a first lien on our ownership interest in the real property located in Johnston, Rhode Island and leased to Factory Mutual Insurance Company. Our obligations under the new credit agreement are also recourse to all of our other assets. In the event Wachovia determines that the value of our collateral assets has declined, Wachovia may require us to prepay a portion of our borrowings, provided that Wachovia may not reduce the value of any of our collateral other than CMBS securities due to general credit spread or interest rate fluctuations.

We had \$208.1 million outstanding as of June 30, 2008 under our new credit agreement, which borrowings were secured by loan investments with an aggregate carry value of \$78.7 million, intercompany mortgage loans and investments in our CDO with an aggregate carry value of \$149.5 million, CMBS investments with a carry value of \$31.0 million and a single owned property with a carry value of \$47.5 million.

#### *Long-Term Liquidity and Financing.*

We expect to meet our long-term liquidity requirements generally through cash provided by operations, long-term fixed-rate financings on our asset investments and issuances of debt and equity capital.

Through June 30, 2008, our primary capital issuances have been our initial public offering of common stock in March 2004 (net proceeds of \$221.8 million), a Series A preferred stock issuance in October 2005 (net proceeds of \$33.7 million), trust preferred debt issued in December 2005 (net proceeds of \$29.9 million), a follow-on common stock offering in each of May 2006 and May/June 2007 (net proceeds of \$57.3 million and \$104.8 million, respectively), and a \$75.0 million 7.50% Convertible Senior Note offering in October 2007 (net proceeds of \$72.8 million).

In March 2007, we implemented a dividend reinvestment and direct stock purchase plan. The plan provides us with an additional source of equity capital. The plan allows interested stockholders to reinvest all or a portion of their cash dividends in shares of our common stock and to make monthly purchases of our common stock generally up to a maximum of \$10,000 (unless a higher amount is approved by us in our sole discretion). Shares purchased through the plan may be either (i) newly issued by us or (ii) purchased by the plan administrator in the open market, at our discretion. During the six months ended June 30, 2008, we issued 121,280 shares of common stock through the plan at an average price of \$7.84 per share. During the six months ended June 30, 2007, we issued 465,578 shares of common stock through the plan at an average price of \$10.88 per share. As of June 30, 2008, we have reserved an aggregate of 3,767,079 shares of common stock for future issuance pursuant to the dividend reinvestment and direct stock purchase plan.

We expect to continue to raise additional capital from time to time to enable us to continue to implement our growth strategy, although the precise timing of our next capital raise will be impacted by our pace of investment activity and market conditions. Our ability to raise capital is influenced by market conditions, and we cannot assure you that conditions for raising capital will be favorable for us at any time. As of June 30, 2008, we have an effective shelf registration statement under which we can offer an aggregate of \$500 million of common stock, preferred stock and/or

senior or subordinated debt securities from time to time.

*Long-Term Mortgage Financings.*

During the quarter ended June 30, 2008, we did not obtain any new mortgage financings.

Our mortgage financings are fixed rate financings. The notes typically mature over a long-term period of approximately ten years, and debt service is payable monthly. The notes are non-recourse to us subject to limited recourse exceptions and are secured by a mortgage on the property and an assignment of the underlying lease and rents on the property. The notes are often interest only for all or a portion of the note term, and thus require a balloon payment at maturity. We believe the value of the assets financed is, and will continue to be, sufficient to repay or refinance our debt at maturity.

*Term Financings.*

In December 2007, we completed a \$129.5 million original principal balance secured term loan. Upon closing of the financing, we pledged approximately \$163.1 million principal amount of collateral to secure our obligations under the loan. The interest coupon on the loan is fixed at 5.81% annually until the loan matures in January 2018. Our effective financing rate on the loan is 6.02% annually (inclusive of hedge and closing costs). The loan is non-recourse to us, subject to limited non-recourse exceptions.

We also completed an entirely fixed rate CDO financing in March 2005. We aggregated approximately \$300 million of assets and then transferred these assets into a wholly-owned securitization vehicle, and issued \$285 million face amount of multi-class notes and \$15 million of preferred equity through the securitization vehicle. The assets serve as collateral for our obligations under the notes. The securitization vehicle is an SPE, with its business limited to the issuance of the notes and the preferred equity, the acquisition of the collateral and certain other matters related thereto. The net amount of the debt we issued was \$268.1 million, inclusive of a \$0.4 million discount to face, as we retained the three most junior note classes aggregating a face amount of \$16.5 million and the full \$15 million of preferred equity. Each of the five note classes of the CDO was rated investment grade. Through October 2009, we expect to reinvest principal repayments on the underlying assets into qualifying replacement collateral. The CDO notes have a stated maturity in January 2040, but are expected to mature in January 2015 when the notes become subject to an auction call procedure. Our weighted average effective financing rate (inclusive of original issue discount and debt issuance and hedge costs) on our CDO is approximately 5.67%. Our CDO debt is non-recourse to us but is secured by the collateral assets.

We entered into a \$250 million two year credit agreement with an option for an additional year with Wachovia Bank, N.A on April 29, 2008. The agreement is a floating rate LIBOR based facility. At closing, we refinanced the assets previously financed on our short-term repurchase agreement into this new facility. We intend to refinance the assets securing our new credit agreement on a longer-term fixed rate basis as soon as credit market conditions improve and we can do so at a favorable cost to our company, although we cannot provide any assurance as to the timing or our ability to do so.

**Statement of Cash Flows**

Operating activities provided \$38.6 million of cash during the six months ended June 30, 2008, primarily driven by net (loss) as adjusted by various non-cash gains, income and charges of \$34.4 million and decreases in other assets of \$6.9 million, partially offset by decreases in accounts payable, accrued expenses and other liabilities of \$2.5 million. Operating activities provided \$5.7 million of cash during the six months ended June 30, 2007, primarily driven by net income as adjusted by various non-cash gains, income and charges of \$20.3 million, partially offset by increases in other assets of \$15.8 million.

We recognize rental income on our owned properties on a straight line basis in accordance with SFAS 13. As of June 30, 2008, this has resulted in the Company accruing \$23.6 million of rental income in excess of actual rents due under the various leases. During the six months ended June 30, 2008, actual rents due under the leases exceeded rents on a straight-line basis by \$5.1 million. We expect the impact of straight-lining of rents to fluctuate over time as contractual rents step up and actual rents due increase under the various leases and we purchase additional properties. Certain of our owned properties are also subject to rents which pay semi-annually, rather than monthly, and this also impacts the quarter-to-quarter changes due to straight-lining of rents.

Investing activities provided \$6.1 million of cash during the six months ended June 30, 2008, which primarily resulted from principal received on loans of \$3.1 million and securities of \$1.8 million and a \$1.2 million purchase price adjustment we received on two properties we purchased in 2005. Investing activities used \$302.7 million during the six months ended June 30, 2007, which primarily resulted from net investments in real estate of \$277.6 million,



investments in securities available for sale of \$37.9 million and investments in partially-owned entities of \$1.1 million, partially offset by proceeds from sales of real estate investments of \$2.9 million and principal received on loans of \$9.6 million and securities of \$1.0 million.

Cash used in financing activities during the six months ended June 30, 2008 was \$57.3 million, which primarily resulted from net repayments of principal on debt of \$32.2 million (net of \$24.8 million on the Wachovia repurchase agreement and credit facility, net of \$4.6 million on property mortgages and \$2.9 million on the secured term loan with KBC Bank), dividends and distributions paid of \$19.3 million, and cash deposited to collateralize an open hedge position of \$5.5 million. Cash provided by financing activities during the six months ended June 30, 2007 was \$301.3 million, which primarily resulted from net borrowings of \$305.0 million, including a net of \$189.5 million under the repurchase agreement, a net of \$73.3 million under the EntreCap portfolio bridge facility, and \$42.4 million under mortgages on real estate investments, and proceeds from a common stock offering of \$109.8 million, partially offset by repayments of mortgages on real estate of \$98.1 million and dividends and distributions paid of \$15.2 million.

See our consolidated statements of cash flows included in the historical consolidated financial statements included elsewhere in this filing for a reconciliation of our cash position for the periods described above.

### **Risk Management Transactions**

Since our initial public offering, we have employed a hedging strategy to manage our exposure to interest rate fluctuations prior to the time we obtain long-term fixed rate financing for our assets. Our risk management activities during this period have consisted primarily of interest rate swaps, and we expect they will continue to consist primarily of interest rate swaps in the future. We may determine that it is not in our company's best interests to hedge the interest rate risks with respect to certain expected long-term financings.

In accordance with SFAS 133, the interest rate swaps are treated as cash flow hedges for accounting purposes to the extent that they have been designated and qualify as such. The effective portion of our realized and unrealized gains and losses on such transactions are treated as a component of "Other Comprehensive Income (Loss)" on our Consolidated Balance Sheet and are not reported as a component of current income or loss on our Consolidated Statement of Operations. The effective portion of our realized gains and losses, which generally represent the net payments we make or receive on the interest rate swaps, are then reclassified and amortized as part of interest expense on our Consolidated Statement of Operations beginning at issuance of the related debt and continuing over the expected term of such issuance.

To the extent the SFAS No. 133 cash flow hedge criteria are not met or the hedge is deemed ineffective, some or all of the realized and unrealized gains and losses on such transactions are treated as a component of current income or loss on our Statement of Operations. No assurance can be made that we will continue to satisfy the cash flow hedge requirements of SFAS No. 133 and as to the portion of our gains and losses that will be deemed effective under SFAS No. 133. Changes in management's initial assumptions regarding the proposed debt issuance (e.g., timing and the amount and type of debt) and changes in the shape of the yield curve (which represents market expectations of future interest rates) are among the factors that could cause us to include a greater portion of our gains and losses from the associated risk management transactions as current income or loss.

See Note 11 in our consolidated financial statements included in this Form 10-Q for additional discussion of our hedging and risk management transactions.

We settle our derivative and other risk management transactions in cash. Therefore, upon settlement, we will pay or receive cash for the net amount due. These amounts could be material and could have a material impact (positive or negative) on our liquidity. Since April 2008, our counterparty has required that we deposit cash to collateralize all amounts we may owe at settlement of the hedge.

## CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

We may from time to time make written or oral forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements contained in our filings with the Securities and Exchange Commission and in our press releases and webcasts. Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts. In some cases, you can identify forward-looking statements by terms such as “anticipate,” “believe,” “could,” “estimate,” “expect,” “intend,” “may,” “plan,” “potential,” “should,” “strategy,” “will” and other words of similar meaning. The forward-looking statements are based on our beliefs, assumptions and expectations of future performance, taking into account all information currently available to us. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to us or are within our control. If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. In connection with the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995, we are hereby identifying important factors that could cause actual results and outcomes to differ materially from those contained in any forward-looking statement made by or on our behalf. Such factors include, but are not limited to:

- our ability to make additional investments in a timely manner or on acceptable terms;
- our ability to obtain long-term financing for our asset investments in a timely manner and on terms that are consistent with those we project when we invest in the asset;
- adverse changes in the financial condition of the tenants underlying our investments;
- increases in our financing costs (including as a result of LIBOR rate increases), our general and administrative costs and/or our property expenses;
- changes in our industry, the industries of our tenants, interest rates or the general economy;
- the success of our hedging strategy;
- our ability to raise additional capital;
- impairments in the value of the collateral underlying our investments; and
- the degree and nature of our competition.

These risks and uncertainties should be considered in evaluating any forward-looking statement we may make from time to time. Any forward-looking statement speaks only as of its date. 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 made.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk refers to the risk of loss from adverse changes in the level of one or more market prices, rate indices or other market factors. We are exposed to market risk primarily from changes in interest rates, credit spreads, tenant credit ratings and equity prices. We attempt to mitigate certain of these risks by entering into hedge and other risk management transactions during the short-term and fixed-rate financings for the long-term. We seek to obtain long-term fixed rate financing as soon as practicable after we make an asset investment. There can be no assurance,

however, that such mitigation strategies will be completely or even partially successful. The level of our exposure to market risk is subject to factors beyond our control, including political risk (including terrorism), monetary and tax policy, general economic conditions and a variety of other associated risks.

*Interest Rate Exposure*

We are exposed to interest rate risk in various aspects of our business. The most significant ways we can be impacted by interest rates are as follows. Increases in the level of interest rates may impact our ability to add new assets, as spreads on assets we are targeting may compress (unless there is a corresponding increase in asset returns) and demand for our products may be adversely affected.

Also, to the extent we finance assets in our portfolio on our floating rate borrowing facilities, our net income from these fixed rate assets will decrease as interest rates rise (particularly LIBOR rates) and our borrowing cost increases. In addition, as interest rates rise, our anticipated cost to finance these assets on a long-term fixed rate basis may rise, causing our expected spread on these assets to be reduced. We attempt to mitigate these risks by entering into risk management transactions that react in a manner that offsets our increased interest costs and by locking our long-term financing cost as soon as practicable after we commit to an asset. As noted above, there can be no assurance that our mitigation strategies will be successful.

Furthermore, shifts in the U.S. Treasury yield curve, which represents the market's expectations of future interest rates, would also affect the yield required on our loans and real estate securities. Changes in the required yield would result in a higher or lower value for these assets. If the required market yields increase as a result of these interest rate changes, the value of our loans and real estate securities would decline relative to U.S. Treasuries. Conversely, if the required market yields decrease as a result of interest rate changes, the value of our loans and real estate securities would increase relative to U.S. Treasuries. These changes in the market value may affect the equity on our balance sheet or, if the value is less than our cost basis and we determine the losses to be other-than-temporary, our Statement of Operations through impairment losses on our loans or securities. These value changes may also affect our ability to borrow and access capital.

#### *Credit Spread Curve Exposure*

We are subject to credit spread risk in various aspects of our business. Credit spreads represent the portion of the required yield on an income investment attributable to credit quality. Credit spreads fluctuate over time as investor appetite for credit risk changes.

Changes in credit spreads can have many of the same impacts on us as a change in interest rates, or principally:

- increases in credit spreads can result in spread compression on investments we target and, thus, a slowing of our new investment pace;
- increases in credit spreads can increase our anticipated cost to finance assets not yet financed with long-term fixed rate debt, causing our expected spread on these assets to be reduced; and
- increases in credit spreads can lower the value of our loans and securities as required yields on these assets increase.

#### *Tenant Credit Rating Exposure*

Substantially all of our portfolio assets are subject to risks due to credit rating changes of the underlying tenant or tenants. Deterioration in the underlying tenant's credit rating can result in a lower value for the related asset, which could result in a reduction in the equity on our balance sheet or, if the value is less than our cost basis and we determine the loss to be other-than-temporary, an impairment loss on our Statement of Operations. In addition, declines in the credit rating of a particular tenant prior to our obtaining long-term fixed rate financing could result in a margin call by the related lender, and precipitous declines may significantly impede or eliminate our ability to finance the asset. We manage these risks by maintaining diversity among our credits and assessing our aggregate exposure to ratings classes, in particular lower rated classes. We also seek to lock or procure long-term financing on our assets as promptly as practicable after we commit to invest.

#### *Equity Price Risk Exposure*

We may seek to raise capital by sale of our common stock. Our ability to do so is dependent upon the market price of our common stock and general market conditions.

*Fair Value*

For certain of our financial instruments, fair values are not readily available since there are no active trading markets as characterized by current exchanges between willing parties. Accordingly, we derive or estimate fair values using various valuation techniques, such as computing the present value of estimated future cash flows using discount rates commensurate with the risks involved. However, the determination of estimated cash flows may be subjective and imprecise. Changes in assumptions or estimation methodologies can have a material affect on these estimated fair values. The fair values indicated below are indicative of the interest rate and credit spread environment as of June 30, 2008, and may not take into consideration the effects of subsequent interest rate or credit spread fluctuations, or changes in the ratings of the underlying tenants.

The following summarizes certain data regarding our interest rate sensitive instruments as of June 30, 2008 (dollars in thousands):

|                                       | Carrying<br>Amount | Notional<br>Amount | Weighted<br>Average<br>Effective<br>Interest /<br>Financing<br>Rate | Maturity Date | Fair Value |
|---------------------------------------|--------------------|--------------------|---|---------------|------------|
| <i>(dollars in thousands)</i>         |                    |                    |   |               |            |
| <b>Assets:</b>                        |                    |                    |   |               |            |
| Loans held for investment             |                    |                    |   |               |            |
| (1)                                   | \$ 291,453         | \$ 288,202         | 6.81%   | Various       | \$ 279,058 |
| Commercial mortgage-backed securities |                    |                    |   |               |            |
| (2)                                   | 169,377            | 202,977            | 7.47%   | 2009-2028     | 154,523    |
| Structuring fees receivable           | 2,226              | N/A                | 8.04%   | 2010-2020     | 2,226      |
| <b>Liabilities</b>                    |                    |                    |   |               |            |
| Mortgage notes payable (5)            | \$ 978,487         | \$ 971,615         | 5.63%   | 2011-2024     | \$ 840,792 |
| Collateralized debt obligations (5)   | 268,246            | 268,500            | 5.67%   | 2015          | 200,270    |
| Credit facility (4)                   | 208,089            | 208,089            | 5.41%   | 2010          | 208,089    |
| Secured term loan (5)                 | 126,676            | 126,676            | 6.02%   | 2018          | 118,719    |
| Convertible senior notes (6)          | 75,000             | 75,000             | 8.24%   | 2012          | 64,489     |
| Other long-term debt (7)              | 30,930             | 30,930             | 8.30%   | 2016          | 21,867     |
| Derivative liabilities (3)            | 4,348              | 173,563            | N/A   | N/A           | 4,348      |

(1) This portfolio of loans bears interest at fixed rates. We have estimated the fair value of this portfolio of loans based on sales of loans with similar credit and structural characteristics where available, and management's estimate of fair values where comparable sales information is not available. The maturity dates for the loans range from 2008 through 2033.

(2) Commercial mortgage-backed securities represent subordinate interests in securitizations, as well as pass-through certificates representing our pro rata investments in a pool of mortgage loans (collectively, CMBS). Structuring fees receivable represent cash flows receivable by us from the sale of loans to third-party purchasers. The notional values for the CMBS are shown at their respective face amounts. Fair value for the CMBS is based on third-party quotations, where obtainable, or our estimate of fair value, based on yields of comparably rated securities in the CMBS market. Fair value for the structuring fees receivable is shown at our amortized cost for these items. For the CMBS, we expect to receive monthly interest coupon payments, and contractual principal payments as scheduled.

(3) These instruments represent hedging and risk management transactions involving interest rate swaps. They have been valued by reference to market quotations.

(4) Our credit facility bears interest at floating rates, and we believe that for similar financial instruments with comparable credit risks, the effective rates approximate market value. Accordingly, the carrying amounts outstanding are believed to approximate fair value.

(5)

We estimate the fair value of mortgage notes on real estate investments, collateralized debt obligations and the secured term loan using a discounted cash flow analysis, based on our estimates of market interest rates. For mortgages where we have an early payment right, we also consider the prepayment amount to evaluate the fair value. The maturity date of the collateralized debt obligations reflects our expected maturity date in January 2015 and is used to compute the related fair value and weighted average effective interest rate.

- (6) We estimate the fair value of our convertible senior notes using a discounted cash flow analysis, based upon management's estimates of market interest rates, and indications of market yields, where available. The maturity date of our convertible senior notes reflects our expected maturity date in October 2012 when the note investors have the right to require us to repurchase their notes for cash and is used to compute the related fair value and weighted average effective interest rate.
- (7) We estimate the fair value of our other long-term debt using a discounted cash flow analysis, based upon management's estimates of market interest rates. The maturity date of our other long-term debt reflects our expected maturity date in January 2016 and is used to compute the related fair value and weighted average effective interest rate.



Scheduled maturities of interest rate sensitive instruments as of June 30, 2008 are as follows:

|                                       | <b>Expected Maturity Dates</b>  |             |             |             |             |                   |
|---------------------------------------|---|-------------|-------------|-------------|-------------|-------------------|
|                                       | <b>2008</b>   | <b>2009</b> | <b>2010</b> | <b>2011</b> | <b>2012</b> | <b>Thereafter</b> |
|                                       | <i>(in thousands, notional amounts where appropriate, otherwise carrying amounts)</i> |             |             |             |             |                   |
| Loans held for investment             | \$ 11,094   | \$ 9,667    | \$ 11,972   | \$ 13,219   | \$ 13,977   | \$ 228,273        |
| Commercial mortgage-backed securities | 651   | 25,378      | 2,783       | 3,423       | 3,933       | 166,809           |
| Structuring fees receivable           | 363   | 771         | 767         | 72          | 79          | 174               |
| Mortgages on real estate investments  | 6,163   | 13,371      | 15,741      | 36,433      | 132,081     | 774,698           |
| Collateralized debt obligations       | (19)  | (41)        | 22,792      | 10,861      | 13,290      | 221,363           |
| Credit facility                       | 4,315   | 9,500       | 194,274     |             |             |                   |
| Secured term loan                     | 2,956   | 9,649       | 12,191      | 13,737      | 15,380      | 72,763            |
| Convertible senior notes              | -   | -           | -           | -           | 75,000      |                   |
| Other long-term debt                  | -   | -           | -           | -           | -           | 30,930            |
| Derivative liabilities                | 4,348   | -           | -           | -           | -           | -                 |

Negative amounts shown with respect to our collateralized debt obligations represent amortization of original issue discount.

The expected maturity dates shown for loan investments, commercial mortgage-backed securities and structuring fees receivable are based on the contractual terms of the underlying assets. These assets, based on our current operating strategy, are held for investment. The material assumptions used to determine fair value are included in footnotes 1 through 7 in the immediately preceding table.

#### **Item 4. Controls and Procedures**

##### *Evaluation of Disclosure Controls and Procedures*

We maintain disclosure controls and procedures (as defined under Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) that are designed to ensure that information required to be disclosed in our Exchange Act reports 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 our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Pursuant to Rule 13a-15(b) under the Exchange Act, we carried out an evaluation, with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective.

##### *Changes in Internal Controls*

There has been no change in our internal control over financial reporting during the quarter ended June 30, 2008, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II.**

## **OTHER INFORMATION**

**Item 1. Legal Proceedings**

From time to time, we are involved in legal proceedings in the ordinary course of business. We do not believe any matter we are currently involved in will have a material adverse effect on our business, results of operations or financial condition.

One of our tenants, Factory Mutual Insurance Company, is constructing a new 350,000 square foot office building adjacent to the property we currently own and lease to them as their corporate headquarters in Johnston, Rhode Island. We understand that construction of the new building commenced in late March 2008. Our lease with Factory Mutual expires on July 31, 2009. Factory Mutual's option to renew its current lease on our building expired unexercised on June 1, 2008.

In order to ensure that the extensive development Factory Mutual is proposing does not adversely affect our property, in April and May 2008, we filed a series of legal challenges first at the local level (Town of Johnston Zoning Board of Appeals) and then at the state level (Rhode Island Superior Court) related to the issuance by the Town of Johnston Planning Board, of approvals of two separate plan applications and two separate building permits to Factory Mutual with respect to its proposed new building.

Our legal actions basically allege that the Planning Board violated state and local law by expediting consideration of Factory Mutual's applications and circumventing our rights and those of other neighboring property owners to review and comment on Factory Mutual's proposed development. Among the violations we allege are that the Planning Board failed to provide proper notice of the public meeting to review the applications, failed to make Factory Mutual's public applications available to us for review on a timely basis, and issued the building permits prior to proper review and approval of Factory Mutual's plan applications. As a result of the Planning Board's violations of law, we were denied an opportunity to present substantial evidence regarding serious traffic and stormwater drainage issues we have with respect to Factory Mutual's project. Through our legal challenges, we basically have sought or are seeking a stay of Factory Mutual's construction activities, removal of all work done to date and a reversal of the decisions of the Planning Board and a remand for a hearing of our substantive issues with the project.

On April 21, 2008, the Town of Johnston issued a "Cease and Desist Order" enforcing the stay that arose automatically by virtue of our appeals to the Zoning Board, but allowing Factory Mutual to continue foundation and certain other construction work on the project "in order to insure the safety of the site for the public and to protect the structural integrity of the work completed to date." On May 13, 2008, the Town's Cease and Desist Order was essentially adopted by the Rhode Island Superior Court. On May 14, 2008, the Town of Johnston Zoning Board of Appeals denied our appeals of the Planning Board's decisions. On June 4, 2008, the Rhode Island Superior Court denied our request for a stay, vacated the stay it had adopted on May 13 and ruled that Factory Mutual could proceed with construction beyond the foundation "at its own risk and with full knowledge of the potential of ultimately being required to tear down any construction and to restore the property to its prior state."

On July 10, 2008, the Rhode Island Superior Court issued an order remanding the matter to the Town of Johnston Planning Board for the purposes of conducting a public hearing on the issues of traffic and drainage. The Superior Court elected to retain jurisdiction of our appeal during the remand and ordered that Factory Mutual may continue construction of its new building at its own risk during the period of remand. The Planning Board held a public hearing on the issues of traffic and drainage on August 5, 2008. We presented our concerns regarding these issues at the hearing and the Planning Board is expected to render a decision within 30 days.

There are a variety of possible outcomes in the above matter and we cannot predict the outcome and whether or not we will be successful in achieving our objectives.

#### **Item 1A.**

#### **Risk Factors**

The following additional risk factor should be considered together with the other Risk Factors included at Item 1A of our Form 10-K for the fiscal year ended December 31, 2007 filed with the SEC on March 4, 2008.

#### **Our April 2008 credit facility with Wachovia Bank is a secured, recourse obligation and exposes us to interest rate and margin call risks.**

In April 2008, we entered into a two year credit agreement with an option for a third year with Wachovia Bank, and we refinanced the assets securing our short-term repurchase agreement on the new facility at closing. As part of the transaction, we repaid all of our borrowings under and terminated the repurchase agreement. While this new facility relieves short-term refinancing risk, it exposes us to a variety of risks, including the following:

- It is priced at floating rates based on 30-day LIBOR, or the London Interbank Offered Rate. Therefore, increases in 30-day LIBOR rates will cause our borrowing costs to increase and our net income to decrease.
- The facility is recourse to all of our other assets. In the event we experience a default under the assets securing the facility, we will remain obligated to satisfy our obligations to Wachovia out of other assets of our company.
- We are subject to margin call risk under the loan facility documents. Wachovia has the right to revalue our collateral under certain circumstances primarily related to adverse credit events of the underlying tenants. Wachovia may also revalue our CMBS securities financed on the facility based on changes in market interest rates and credit spreads. In the event Wachovia determines that the value of our collateral has decreased, it has the right to make a margin call. A margin call would require us to make up any collateral shortfall with cash or additional portfolio assets. We may not have sufficient cash or portfolio assets to do so. A failure to meet a margin call could cause us to default under the facility and otherwise have a material adverse effect on our financial condition and operating results.

· We have borrowed the full amount permitted under the loan documents based on the lender's current valuation of our collateral. In order to borrow any additional amounts under the facility, we will be required to post additional collateral. Further, Wachovia has the right to reject any asset that we seek to finance on the facility.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

Our annual meeting of stockholders was held in New York, New York on June 11, 2008. 35,742,332 shares of common stock, or 79.9% of our outstanding shares as of the April 2, 2008 record date, were represented in person or by proxy.

The six directors listed below were elected to a one-year term expiring in 2009.

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|                      | Number of Shares |           |
|----------------------|------------------|-----------|
|                      | For              | Withheld  |
| Paul H. McDowell     | 35,014,548       | 727,783   |
| William R. Pollert   | 34,478,682       | 1,263,649 |
| Michael E. Gagliardi | 35,057,680       | 684,651   |
| Stanley Kreitman     | 34,764,626       | 977,705   |
| Jeffrey F. Rogatz    | 35,052,755       | 689,576   |
| Howard A. Silver     | 35,056,320       | 686,011   |

The appointment of McGladrey & Pullen LLP as independent registered public accounting firm was ratified: 35,665,090 votes in favor, 26,714 votes against and 50,527 shares abstained.

## Item 5. Other Information

None.

## Item 6. Exhibits

- 10.1 Credit Agreement among Caplease Debt Funding, LP, as the borrower, PREFCO II Limited Partnership, as a guarantor, CapLease, Inc., as a guarantor, Caplease, LP, as a guarantor, Caplease Services Corp., as a guarantor, and Wachovia Bank, National Association, as administrative agent and lender, dated as of April 29, 2008 (incorporated by reference from Exhibit 10.1 to the registrant's Form 8-K filed with the Securities and Exchange Commission on May 1, 2008)
- 10.2 Summary of Independent Director Compensation for Fiscal 2008
- 12.1 Computation of ratio of earnings to fixed charges and ratio of earnings to combined fixed charges and preferred stock dividends
- 31.1 Certification of the Registrant's Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Registrant's Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of the Registrant's Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of the Registrant's Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

**CAPLEASE, INC.**

*Registrant*

Date: August 7, 2008

/s/ Paul H. McDowell

Paul H. McDowell

*Chairman and Chief Executive Officer*

Date: August 7, 2008

/s/ Shawn P. Seale

Shawn P. Seale

*Senior Vice President, Chief Financial Officer  
and Treasurer*