CAPITAL LEASE FUNDING INC
Form 10-K
March 07, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K
(Mark One)

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

For the fiscal year ended December 31, 2006

OR

o 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

CAPITAL LEASE FUNDING, 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)

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

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

Title of each Class	**Name of each exchange on which registered**
Common Stock, $0.01 par value	New York Stock Exchange
8.125% Series A Cumulative Redeemable Preferred Stock, $0.01 par value	New York Stock Exchange

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

As of June 30, 2006, the aggregate market value of the common stock, $0.01 par value per share, of Capital Lease Funding, Inc. ("Common Stock"), held by non-affiliates (outstanding shares, excluding shares held by executive officers and directors) of the registrant was approximately $369 million, based upon the closing price of $11.41 on the New York Stock Exchange on such date.

As of February 15, 2007, there were 34,097,829 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for the registrant's 2007 Annual Meeting, to be filed within 120 days after the close of the registrant's fiscal year, are incorporated by reference into Part III of this Annual Report on Form 10-K.

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Note: Items 10, 11, 12, 13 and 14 are incorporated by reference herein from the Proxy Statement.

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PART I.

Item 1. Business.

Explanatory Note for Purposes of the "Safe Harbor Provisions" of Section 21E of the Securities Exchange Act of 1934, as amended

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, which involve certain risks and uncertainties. Our actual results or outcomes may differ materially from those projected. Important factors that we believe might cause such differences are discussed in Item 1A (Risk Factors) of this Form 10-K or otherwise accompany the forward-looking statements contained in this Form 10-K. In assessing all forward-looking statements, readers are urged to read carefully all cautionary statements contained in this Form 10-K.

Overview

We are 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. 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 or 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.

Our current portfolio produces stable, high quality cash flows generated by long-term leases to primarily investment grade tenants. Tenants underlying our investments are primarily large public companies or their significant operating subsidiaries and governmental and quasi-governmental entities with investment grade credit ratings, defined as a published senior unsecured credit rating of BBB-/Baa3 or above from one or both of Standard & Poor's Corporation ("S&P") and Moody's Investors Service ("Moody's"). We also imply an investment grade credit rating for tenants that are not publicly rated by S&P or Moody's but (i) are 100% owned by an investment grade parent, (ii) for which we have obtained a private investment grade rating from either S&P or Moody's, and (iii) are governmental entity branches or units of another investment grade rated governmental entity.

As of December 31, 2006, our investment portfolio had a carry value of approximately $1.6 billion, and included the following assets by type:

	Carry Value (in thousands)	Percentage
Owned properties	$ 1,115,001	70.8%
Debt investments		
Loans		

Long-term mortgage loans	231,094	14.7%
Corporate credit notes	33,480	2.1%
Mezzanine and other investments	9,511	0.6%
Commercial mortgage-backed and other real estate securities	183,066	11.6%
Other	3,253	0.2%
Total	$ 1,575,405	100.0%

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). See "Management's Discussion and Analysis of Financial Condition and Results of Operations" below, for financial data by segment.

We have been in the net lease business since 1994. We completed our initial public offering in March 2004 and, during 2006, we completed our first follow-on common stock offering. Prior to our initial public offering, we were primarily a lender focused on originating net lease mortgage loan transactions and selling substantially all of the loans we originated, either through whole-loan or small pool sales or through gain-on-sale commercial mortgage-backed securitizations.

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Investment Strategy

We focus on the following core business strategies:

- *Investing in High Quality Cash Flows*. We invest primarily in owned real properties and real estate loans where the underlying tenant is of high credit quality. As of December 31, 2006, our top ten credit exposures had a weighted average credit rating of A. As of December 31, 2006, our portfolio had the following credit characteristics:

Credit Rating (1)		Total (in thousands)	Percentage
Investment grade rating of A- or A3 and above	$	607,373	38.6%
Investment grade rating of below A- or A3		512,037	32.5%
Implied investment grade rating		231,982	14.7%
Non-investment grade rating		214,502	13.6%
Unrated (2)		9,511	0.6%
	$	1,575,405	100.00%

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(1) Four of our owned real properties with an aggregate carry value of $253,655 are leased to more than one tenant and, for purposes of determining the underlying tenant's credit rating on these properties, we have considered the credit rating of only our primary tenant.

(2) Includes our mezzanine and other investments as described under "Our Portfolio—Loan Investments." While the tenants on the underlying properties generally may be rated by S&P and/or Moody's, we classify these investments as unrated because of the subordinated nature of our investment.

- *Long-Term Assets Held for Investment*. We invest in commercial real estate assets subject to long-term leases. The weighted average remaining lease term on the leases on our owned properties is approximately 12 years and on the leases underlying our loan investments is approximately 19 years. We intend to hold our assets for the long-term, capturing the stable cash flows that will be produced from the underlying high credit quality tenants. On a limited and opportunistic basis, we also continue to acquire and promptly resell assets through our taxable REIT subsidiary.

- *Flexible Investment Approach*. We invest at all levels of the capital structure of net lease or other single tenant properties but remain flexible within that structure, investing where we see the greatest market opportunity to earn attractive returns. During 2005 and 2006, we saw the greatest opportunity on the equity side of the business (owned real properties). As of December 31, 2006, owned real properties comprised approximately 71% of our portfolio, and we expect this percentage to continue to increase in 2007.

- *Stringent Underwriting Process.* We maintain a comprehensive underwriting and due diligence process that is overseen by our investment committee, which consists of six of our key employees, including the chief executive officer, president, chief financial officer and chief investment officer. Our investment committee formally reviews and approves each transaction prior to funding. We also have an investment oversight committee of the Board of Directors that approves investments in excess of $50 million.

- *Finance with Long-Term Fixed Rate Debt*. We seek to borrow against, or leverage, our assets with long-term fixed rate debt, effectively locking in the spread we expect to generate on our assets. Our financing strategy allows 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. We believe this leverage level is conservative given the high credit quality of the underlying tenants and the length and quality of the related leases.

Our Competitive Strengths

- *Established Origination and Investment Capabilities.* We have an experienced in-house team of investment originators and underwriters that originate, structure, underwrite and close our transactions. In addition, we have developed an extensive national network of property owners, investment sale brokers, tenants, borrowers, mortgage brokers, lenders, institutional investors and other market participants that helps us to identify and originate a variety of net lease or other single tenant financing and investment opportunities. During 2006, we originated approximately $538.6 million of new investments (including approximately $78.0 million of investments sold in the ordinary course of business).

- *Experienced Senior Management Team.* Our senior management team has worked together for more than 10 years. During this period, we built a nationwide origination network and underwriting platform, initially focused on net lease mortgage lending. Since our initial public offering in 2004, we have expanded our strategy to include the

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ownership of net lease or other single tenant properties by drawing on our extensive experience in evaluating tenant credit quality, lease structures and commercial real properties. Since that time, we have purchased more than $1.1 billion of net lease or other single tenant properties. Since 1996, we have originated and underwritten more than $4.0 billion in net lease or other single tenant transactions, involving more than 500 properties with more than 75 underlying tenants. During this 10-year period, we have experienced only one loan default and foreclosure on the loans and properties we have originated and underwritten.

- *Financing Expertise.* We have substantial experience in financing and securitizing net lease assets. During 2005, we completed what we believe was the first ever 100% fixed rate real estate primarily whole loan CDO. We financed an approximately $300 million pool of net lease mortgage loans and securities, with 85% of the obligations rated AAA/Aaa by S&P/Moody's, and 95% of the obligations rated investment grade by S&P/Moody's. We expect our next CDO issuance to occur in the second quarter of 2007. Prior to our initial public offering in 2004, we structured four "gain-on-sale" securitizations aggregating $1.5 billion.

- *Market Expertise.* We have recognized expertise in the net lease marketplace. In February 2005, we received a U.S. patent for our 10-year credit tenant loan product. In addition to serving as one of our loan products, we use this product to create additional leverage on many of our owned property investments. We have worked extensively with S&P and Moody's to develop ratings criteria for net lease financing, and continue to provide ongoing advice and assistance to these rating agencies on net lease financing issues. We also developed the specialized lease enhancement mechanisms that are now market standard for net lease lending transactions.

Our Portfolio

Owned Properties

All of our equity investments in real estate have been made since the closing of our initial public offering. We invest in all commercial property types (e.g., office, retail or industrial), and our investment underwriting includes an analysis of the credit quality of the underlying tenant and the strength of the related lease. We also analyze the property's real estate fundamentals, including location and type of the property, vacancy rates and trends in vacancy rates in the property's market, rental rates within the property's market, recent sales prices and demographics in the property's market. For more detail on our underwriting process, please see "Underwriting Process" below. We target properties that have one or more of the following characteristics:

- included in primary metropolitan markets such as New York/New Jersey, Chicago and Washington D.C./Northern Virginia;
- fungible asset type that will facilitate a re-let of the property if the tenant does not renew;
- barriers to entry in the property's market, such as zoning restrictions or limited land for future development; and
- core facility of the tenant.

As of December 31, 2006, our owned property portfolio had a carry value of $1.1 billion. We believe the strength of our portfolio is exhibited by the following:

- approximately 6.0 million rentable square feet with 99.8% occupancy;
- 36 properties in 21 states leased to 26 different tenants;

- 94% investment grade or implied investment grade tenants;
- weighted average tenant credit rating of A;
- weighted average remaining lease term of approximately 12 years; and
- well diversified portfolio by property type, geography and credit rating.

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The following pie chart depicts the credit quality[(1)] of our owned property portfolio as of December 31, 2006.

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(1) Reflects tenant's or lease guarantor's actual or implied S&P rating or equivalent S&P rating if rated only by Moody's.

Our owned property portfolio is expected to generate the following annual cash flows[(1)] through the year 2016.

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(1) Reflects scheduled rent payments under all of our leases with all of our tenants. Does not reflect straight-line rent adjustments required under Statement of Financial Accounting Standards ("SFAS") No. 13. Also does not include expense recoveries or above or below market rent amortization adjustments required by SFAS No. 141. Assumes no additions to the portfolio and no lease renewals at expiration of the primary lease term. Actual results may differ materially from those projected. Please see "Risk Factors" section.

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The following is a tabular presentation of our owned property portfolio as of December 31, 2006:

Tenant or Guarantor	Location	Property Type	Square Feet	Purchase Date	Lease Maturity	2007 Estimated Annual Rent (1) (in thousands)	Purchase Price (in thousands)	Carry Value (2) (in thousands)
Abbott Laboratories	6480 Busch Blvd, Columbus, OH	Office	111,776	11/2004	10/2016	$ 893	$ 12,025	$ 11,347
Abbott Laboratories	1850 Norman Drive North, Waukegan, IL	Office	131,341	8/2005	8/2017	1,338	20,325	19,543
Aetna Life Insurance Company	1333 - 1385 East Shaw Avenue, Fresno, CA	Office	122,605	10/2006	11/2016	1,622	24,255	24,721
Allstate Insurance Company	401 McCullough Drive, Charlotte, NC	Office	191,681	12/2005	12/2015	1,916	27,172	26,293
Allstate Insurance Company	1819 Electric Road (aka State hwy. 419), Roanoke, VA	Office	165,808	12/2005	12/2015	2,039	28,928	27,905
AmeriCredit Corp.	4001 Embarcadero Drive, Arlington, TX	Office	246,060	12/2006	8/2017	2,965	43,000	43,359
AMVESCAP PLC	4340, 4346 & 4350 South Monaco St., Denver, CO	Office	263,770	3/2006	10/2016	4,934	69,300	67,838
Aon Corporation (3)	1000 Milwaukee Ave, Glenview, IL	Office	412,409	8/2004	4/2017	6,517	85,750	81,401
Baxter International, Inc.	555 North Daniels Way, Bloomington, IN	Warehouse	125,500	10/2004	9/2016	790	10,500	10,196
Cadbury Schweppes Holdings (US)	945 Route 10, Whippany, NJ	Office	149,475	1/2005	3/2021	3,400	48,000	48,356
Capital One Financial	3905 N. Dallas	Office	159,000	6/2005	2/2015	1,823	27,900	29,565

Corporation	Parkway, Plano, TX							
Choice Hotels International, Inc. (4)	10720, 10750 & 10770 Columbia Pike, Silver Spring, MD	Office	223,912	11/2004	5/2013	4,908	43,500	42,914
Cott Corporation	1090 and 1091 Spring Street, Reading, PA	Mfg/Dist	120,000	7/2006	6/2017	362	5,350	5,397
Crozer-Keystone Health System (5)	8 Morton Avenue, Ridley, PA	Medical Office	22,708	8/2004	4/2019	404	4,477	5,553
CVS Corporation	100 Mazzeo Drive, Randolph, MA	Retail Drug	88,420	9/2004	1/2014	744	10,450	13,661
Farmers New World Life Insurance Company	3003 77th Avenue Southeast, Mercer Island, WA	Office	155,200	12/2005	12/2020	2,392	39,550	38,974
ITT Industries, Inc.	12975 Worldgate Drive, Herndon, VA	Office	167,285	5/2005	3/2019	4,888	46,081	54,871
Johnson Controls, Inc.	6750 Bryan Dairy Road, Largo, FL	Office	307,275	12/2006	8/2016	1,862	27,000	27,219
Koninklijke Ahold, N.V.	4001 New Falls Road, Levittown, PA	Retail	70,020	6/2006	4/2026	1,439	18,575	20,851
Lowes Companies, Inc. (6)	26501 Aliso Creek Rd., Aliso Viejo, CA	Retail	181,160	5/2005	8/2024	3,450	52,860	51,534
Omnicom Group, Inc.	1660 North Westridge Circle, Irving, TX	Office	101,120	6/2005	5/2013	1,278	18,100	16,984
Pearson Plc.	3833 Greenway and 2201 Noria Road, Lawrence, KS	Office	194,665	4/2006	4/2021	1,351	20,750	20,389
T-Mobile USA, Inc.	695 Grassmere Park, Nashville, TN	Office	69,287	11/2006	1/2017	1,298	16,195	16,187

Tiffany & Co.	15 Sylvan Way, Parsippany, NJ	Office/Warehouse	367,740	9/2005	9/2025	4,613	75,000	75,179
Time Warner Entertainment Company, L.P.	1320 N. Dr. Martin Luther King Jr. Dr., Milwaukee, WI	Office	154,849	11/2006	12/2016	1,865	28,530	29,074
TJX Companies, Inc.	2760 Red Lion Road, Philadelphia, PA	Warehouse	1,015,500	3/2006	6/2021	5,915	90,125	91,025
United States Government (DEA)	1003 17th Street North, Birmingham, AL	Office	35,616	8/2005	12/2020	1,229	14,100	13,754
United States Government (EPA)	300 Minnesota Avenue, Kansas City, KS	Office	71,979	8/2005	3/2023	2,452	29,250	32,012
United States Government (FBI)	200 McCarty Avenue, Albany, NY	Office	74,300	10/2006	9/2018	1,312	16,350	16,964
United States Government (FBI)	1100 18th Street, North, Birmingham, AL	Office	86,199	8/2005	4/2020	2,202	23,500	23,323
United States Government (NIH) (7)	6116 Executive Bvd, N. Bethesda, MD	Office	207,055	9/2005	5/2012	8,151	81,500	77,806
United States Government (OSHA)	8660 South Sandy Parkway, Sandy, UT	Office	75,000	8/2005	1/2024	1,883	23,750	23,969
United States Government (SSA)	1029 Camino La Costa, Austin, TX	Office	23,311	8/2005	12/2015	710	6,900	6,756
United States Government (VA)	Lot 37, Santiago De los Caballeros Avenue, Ponce, PR	Medical Office	56,500	11/2004	2/2015	1,300	13,600	12,853
Walgreen Co.	4601 Westfield Avenue, Pennsauken, NJ	Retail Drug	18,500	11/2004	10/2016	297	3,089	3,081
Walgreen Co.		Retail Drug	13,905	11/2004	7/2018	357	4,165	4,147

	700 Frederick Blvd, Portsmouth, VA					
Total		5,980,931		$ 84,899	$ 1,109,902	$ 1,115,001

(1) Reflects scheduled rent due for 2007 under our lease with the tenant or tenants. Does not reflect straight-line rent adjustments required under SFAS No. 13. Also does not include expense recoveries or above or below market rent amortization adjustments required by SFAS No. 141.
(2) Includes carry value of any related intangible assets under SFAS No. 141.
(3) As of December 31, 2006, approximately 2% of the property was leased to one other tenant.
(4) As of December 31, 2006, approximately 28% of the property was leased to six other tenants.
(5) We own a leasehold interest in the land, or a ground lease, where an affiliate of our tenant owns the underlying land and improvements and has leased them to us through 2032 with an option to extend through 2046. Our ground rent is prepaid through 2032. At the end of the ground lease, unless extended, the land and improvements revert to the landowner.
(6) As of December 31, 2006, approximately 18% of the property was leased to two other tenants.
(7) As of December 31, 2006, approximately 11% of the property was leased to five other tenants.

Loan Investments

Our loan products are targeted primarily to owners of real properties net leased on a long-term basis to high credit quality tenants. Most of the loans we hold in portfolio are fully amortizing over the primary lease term of the underlying tenant, thus reducing our risk over time and eliminating the refinance risk associated with a balloon payment at maturity. We target loans on real properties with strong real estate fundamentals and with a strong long-term lease in place.

Our existing loan investments include long-term mortgage loans, corporate credit notes and a small number of mezzanine and other investments. The following describes each of these investments.

Long-Term Mortgage Loans. We offer long-term fully or nearly fully amortizing or insured balloon loans secured by first mortgages on properties subject to long-term net leases (typically at least 15 years). This product enables a borrower to receive the highest proceeds that a property’s rent payments will support. As of December 31, 2006, our portfolio included $231.1 million of long-term mortgage loans.

Corporate Credit Notes. We also offer a 10-year non-fully amortizing loan product for borrowers who prefer a shorter loan term and for net lease properties that do not meet the criteria for our long-term mortgage loan product, for example, because of a shorter lease term or a lower rated tenant. We have received a United States patent for this product. We typically split these loans into two notes, a non-fully amortizing real estate note which we generally sell promptly following origination, and a fully amortizing corporate credit note, which we retain in our portfolio. The corporate credit note will generally range from 10% to 20% of the loan amount, and has a junior claim on the real estate collateral, but a senior claim on the rents in the event of a tenant bankruptcy. As of December 31, 2006, our portfolio included $33.5 million of corporate credit notes.

Mezzanine and Other Investments. Our largest mezzanine investment as of December 31, 2006 was loans aggregating $5.7 million made pursuant to a revolving credit agreement we entered into with a third party borrower in June 2006. We agreed to fund loans from time to time of up to $12 million to support the borrower's capital contributions to a joint venture that makes franchise loans to franchisees of YUM! Brands, Inc. restaurant concepts such as Taco Bell, Kentucky Fried Chicken and Pizza Hut. We also offer and expect that our mezzanine investments will include from time to time a variety of other loan and loan type products to owners of net leased or other single tenant properties, including mezzanine loans, bridge loans, development loans and preferred equity financings. These investments are typically shorter term in nature and are often subordinate to other financing on the property. We typically make these investments in connection with the development of a property or an expected recapitalization of the property, giving us an advantage in providing the long-term financing on or purchasing the property. As of December 31, 2006, we had $9.5 million of mezzanine and other investments.

As of December 31, 2006, our loan portfolio had a carry value of $274.1 million. We believe the strength of our loan portfolio is exhibited by the following:

- weighted average remaining lease term on the underlying leases of approximately 19 years;
- 78% investment grade or implied investment grade underlying tenants;
- loan investments on 65 properties in 26 states with 24 different underlying tenant obligors; and
- weighted average underlying tenant credit rating of BBB+.

The following pie chart depicts the credit quality[(1)] of the long-term mortgage loans in our loan portfolio as of December 31, 2006. As of December 31, 2006, long-term mortgage loans comprised approximately 84% of our loan portfolio.

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(1) Reflects underlying tenant's or lease guarantor's actual or implied S&P rating or equivalent S&P rating if rated only by Moody's.

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The long-term mortgage loans in our loan portfolio are expected to generate the following annual cash flows[1] through the year 2016.

(1) Reflects scheduled payments of interest and principal on our long-term mortgage loans. Actual results may differ materially from those projected. Please see "Risk Factors" section.

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The following is a tabular presentation of our loan portfolio as of December 31, 2006:

Tenant or Guarantor	Location	Property Type	Square Feet	Coupon	Lease Expiration	Loan Maturity	Original Principal Balance	Principal Balance	Carry Value	Loan to Realty Value (1)
							(in thousands)			
Long-Term Mortgage Loans										
Autozone, Inc.	Douglas and Valdosta, GA	Retail	13,383	6.50%	4/2024	11/2022	$ 2,108	$ 1,971	$ 1,971	73%
Bank of America, N.A.	Mt. Airy, MD	Bank Branch	4,500	6.42%	12/2026	12/2026	3,469	3,469	3,469	78%
Best Buy Co., Inc.	Chicago, IL	Retail	45,720	6.40%	3/2025	3/2025	18,522	18,038	18,038	93%
City of Jasper, Texas	Jasper, TX	Office	12,750	7.00%	12/2024	11/2024	1,736	1,673	1,624	84%
CVS Corporation	Asheville, NC	Retail Drug	10,880	6.53%	1/2026	1/2026	2,360	2,255	2,317	88%
CVS Corporation	Athol, MA	Retail Drug	13,013	6.46%	1/2025	1/2025	1,502	1,423	1,424	75%
CVS Corporation	Bangor, PA	Retail Drug	13,013	6.28%	1/2026	1/2026	2,521	2,353	2,312	84%
CVS Corporation	Bluefield, WV	Retail Drug	10,125	8.00%	1/2021	1/2021	1,439	1,284	1,402	76%
CVS Corporation	Greensboro, GA	Retail Drug	11,970	6.52%	1/2030	1/2030	1,395	1,355	1,355	80%
CVS Corporation	Oak Ridge, NC	Retail Drug	10,880	6.99%	1/2025	8/2024	3,243	3,097	3,097	80%
CVS Corporation	Shelby Twp., MI	Retail Drug	11,970	5.98%	1/2031	1/2031	2,540	2,521	2,521	88%
CVS Corporation	Southington, CT	Retail Drug	10,125	8.26%	1/2020	1/2020	1,768	1,703	1,899	83%
CVS Corporation	Stow, OH	Retail Drug	10,125	8.26%	1/2020	1/2020	2,407	2,301	2,565	81%
CVS Corporation	Sunbury, PA	Retail Drug	10,125	7.50%	1/2021	1/2021	1,829	1,603	1,564	76%
CVS Corporation	Washington, DC	Retail Drug	7,920	8.10%	1/2023	1/2023	2,781	2,434	2,600	74%
CVS Corporation	Willimantic, CT	Retail Drug	10,125	8.26%	1/2023	1/2023	2,028	1,961	2,194	80%
Harris Bankcorp, Inc.	Chicago, IL	Bank Branch	4,750	6.81%	8/2025	8/2025	4,467	4,388	4,388	72%
Home Depot USA, Inc.	Chelsea, MA	Retail	117,034	5.36%	1/2036	1/2031	8,501	8,384	8,384	91%

Home Depot USA, Inc.	Tullytown, PA	Retail	116,016	6.62%	1/2033	1/2033	8,447	8,419	8,419	98%
Kohls Corporation	Chicago, IL	Retail	133,000	6.69%	5/2030	5/2030	48,270	47,517	47,517	92%
Koninklijke Ahold, N.V.	Bensalem, PA	Retail	67,000	7.24%	5/2020	5/2020	3,153	3,005	3,063	22%
Koninklijke Ahold, N.V.	North Kingstown, RI	Retail	125,772	7.50%	11/2025	11/2025	6,794	6,549	6,529	72%
Koninklijke Ahold, N.V.	Tewksbury, MA	Retail	58,450	7.50%	1/2027	1/2027	6,625	6,444	6,439	73%
Koninklijke Ahold, N.V.	Upper Darby Township, PA	Retail	54,800	7.29%	4/2024	4/2024	6,867	6,503	6,215	89%
Lowes Companies, Inc.	Framingham, MA	Retail	156,543	5.87%	10/2031	9/2031	27,864	27,829	27,829	85%
Lowes Companies, Inc.	Matamoras, PA	Retail	162,070	6.61%	5/2030	5/2030	7,208	7,119	7,119	95%
National City Bank	Chicago, IL	Bank Branch	5,274	5.89%	12/2024	12/2024	3,114	3,005	3,084	76%
Natural Gas Pipeline Company of America	Lombard, IL	Office	201,189	5.97%	5/2008	6/2007	15,244	4,202	4,202	17%
Neiman Marcus Group, Inc.	Las Vegas, NV	Retail	167,000	6.06%	11/2022	11/2021	8,267	6,830	7,426	72%
United States Postal Service	Scammon Bay, AK	Post Office	2,080	7.05%	10/2021	10/2021	1,015	921	940	71%
University of Connecticut Health Center	Farmington, CT	Medical Office	100,000	6.34%	11/2029	11/2024	22,800	21,537	22,333	86%
Walgreen Co.	Dallas, TX	Retail Drug	14,550	6.46%	12/2029	12/2029	3,534	3,419	3,419	80%
Walgreen Co.	Montebello, CA	Retail Drug	14,414	6.10%	3/2030	2/2030	4,680	4,548	4,548	67%
Walgreen Co.	Nacogdoches, TX	Retail Drug	14,820	6.80%	9/2030	9/2030	3,649	3,629	3,629	71%
Walgreen Co.	Rosemead, CA	Retail Drug	12,004	6.26%	12/2029	12/2029	5,333	5,259	5,259	74%
							247,480	228,948	231,094	
Corporate Credit Notes										
Albertsons, LLC	Los Angeles, CA	Retail Drug	16,475	6.50%	7/2028	9/2013	437	327	297	82%
	Norwalk, CA		14,696	6.33%	11/2028	12/2013	470	359	355	74%

Albertsons, LLC		Retail Drug								
Best Buy Co., Inc.	Olathe, KS	Retail	48,744	5.40%	1/2018	6/2013	1,779	1,323	1,270	80%
Best Buy Co., Inc.	Wichita Falls, TX	Retail	30,038	6.15%	1/2017	11/2012	743	509	485	76%
CVS Corporation	Clemmons, NC	Retail Drug	10,880	5.54%	1/2022	1/2015	285	242	232	63%
CVS Corporation	Commerce, MI	Retail Drug	10,880	5.85%	4/2025	5/2013	501	374	361	84%
CVS Corporation	Garwood, NJ	Retail Drug	11,970	6.12%	6/2025	8/2013	879	644	627	83%
CVS Corporation	Kennett Square, PA	Retail Drug	12,150	6.40%	1/2025	10/2012	857	566	547	85%
CVS Corporation	Knox, IN	Retail Drug	10,125	7.60%	1/2024	12/2011	322	192	191	71%
CVS Corporation	Rockingham, NC	Retail Drug	10,125	6.12%	1/2025	10/2013	435	325	318	77%
CVS Corporation	Rutherford College, NC	Retail Drug	10,125	6.12%	1/2025	10/2013	346	274	268	78%
Federal Express Corporation	Bellingham, WA	Warehouse	30,313	5.78%	10/2018	3/2015	362	317	310	71%
FedEx Ground Package System, Inc.	McCook, IL	Warehouse	159,699	5.89%	1/2019	2/2015	2,737	2,350	2,323	82%
FedEx Ground Package System, Inc.	Reno, NV	Warehouse	106,396	5.90%	9/2018	10/2014	1,374	1,143	1,132	77%
Hercules Incorporated	Wilmington, DE	Office	518,409	9.32%	5/2013	5/2013	20,000	19,964	19,964	82%

Lowes Companies, Inc.	N. Windham, ME	Retail	138,134	5.28%	1/2026	9/2015	1,140	1,070	1,048	85%
PerkinElmer, Inc.	Beltsville, MD	Office/Industrial	65,862	7.35%	11/2021	12/2011	707	419	416	80%
PerkinElmer, Inc.	Daytona Beach, FL	Office/Industrial	34,196	7.35%	11/2021	12/2011	321	190	188	76%
PerkinElmer, Inc.	Phelps, NY	Office/Industrial	32,700	7.35%	11/2021	12/2011	299	177	174	83%
PerkinElmer, Inc.	Warwick, RI	Industrial	95,720	7.68%	12/2021	1/2012	939	567	555	81%
Staples, Inc.	Odessa, TX	Retail	23,942	6.41%	6/2015	9/2012	408	275	262	77%
Walgreen Co.	Delray Beach, FL	Retail Drug	15,120	6.20%	1/2021	1/2013	595	405	403	74%
Walgreen Co.	Jefferson City, TN	Retail Drug	14,266	5.49%	3/2030	5/2015	786	689	689	89%
Walgreen Co.	Riverside, CA	Retail Drug	12,804	6.10%	10/2028	12/2013	571	435	426	74%
Walgreen Co.	Waterford, MI	Retail Drug	14,490	5.50%	1/2023	6/2013	953	676	639	81%
							38,246	33,812	33,480	
Mezzanine and Other Investments										
84th Avenue Development, LLC	Tinley Park, IL	Retail Drug	N/A	10.00%	N/A	3/2007	498	498	498	N/A
Eden Hylan Seaview LLC	Staten Island, NY	Retail Drug	N/A	10.00%	N/A	7/2007	650	650	650	N/A
Wemo Franchise Funding LLC	Various	Other	N/A	10.00%	N/A	2/2007	6,648	2,648	2,648	N/A
West End Mortgage Finance Fund I L.P.	Various	Other	N/A	10.00%	N/A	9/2009	5,715	5,715	5,715	N/A
							13,511	9,511	9,511	
Total							$ 299,237	$ 272,271	$ 274,085	

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(1) All percentages have been rounded to the nearest whole percentage. Loan to realty value is the ratio of the principal balance of the loan as of December 31, 2006 to the appraised value of the real estate that secures the loan at the time of the loan. The current value of the real estate may be different. The loan to realty value for each corporate credit note includes the principal balance of the portion of the loan we have sold.

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Commercial Mortgage-Backed and Other Real Estate Securities

We also invest in commercial mortgage-backed securities, or CMBS, and other real estate securities. Our CMBS investments include senior, subordinate and interest-only classes of primarily net lease loan securitizations or pass through trusts. Our real estate securities represent our pro rata investments in a pool of mortgage loans on properties net leased to a single tenant. We believe we are well-positioned to evaluate net lease CMBS investments and real estate securities due to our expertise with net lease loan assets and our experience in structuring CMBS investments. We structured four CMBS securitizations aggregating approximately $1.5 billion prior to our initial public offering. As a result of our familiarity with the collateral included in these transactions, many of our CMBS investments to date have been made in classes of our prior securitizations.

The following pie chart depicts the credit quality[1] of our portfolio of CMBS and other real estate securities as of December 31, 2006.

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(1) Reflects actual ratings on our CMBS securities and underlying tenant ratings on our other real estate securities.

Our CMBS and other real estate securities are expected to generate the following annual cash flows[1] through the year 2016.

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(1) Reflects scheduled payments of interest and principal on all of our securities. Actual results may differ materially from those projected. Please see "Risk Factors" section.

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Our CMBS and other real estate securities as of December 31, 2006 are summarized in the following table:

Security Description	CUSIP No.	(in thousands) Face Amount (1)	Carry Value	Coupon	Yield (2)	Maturity Date
Investments in Commercial Mortgage Loan Securitizations						
BACM 2006-4, Class H	05950WAT5	$ 8,000	$ 8,219	6.01%	5.78%	Aug 2016
BSCMS 1999 CLF1, Class E	07383FCC0	3,076	1,710	7.11%	15.74%	Nov 2023
CALFS 1997-CTL1, Class D	140281AF3	6,000	5,977	6.16%	6.28%	Nov 2018
CMLBC 2001-CMLB-1, Class E	201736AJ4	9,526	11,213	7.86%	6.21%	Jul 2022
CMLBC 2001-CMLB-1, Class G	201736AL9	9,526	10,393	7.86%	7.06%	Feb 2023
CMLBC 2001-CMLB-1, Class H	201736AM7	11,907	8,127	6.25%	10.36%	Mar 2024
CMLBC 2001-CMLB-1, Class J	201736AN5	6,383	2,205	6.25%	20.00%	Oct 2025
NLFC 1999-LTL-1, Class E	63859CCL5	11,081	7,208	5.00%	9.60%	Feb 2022
NLFC 1999-LTL-1, Class X (IO)	63859CCG6	7,597	8,127	0.49%	8.82%	Jan 2024
WBCMT 2004-C15 180D	929766YG2	15,000	14,349	5.58%	7.17%	Nov 2009
WBCMT 2004-C15 180E	929766YH0	8,000	7,633	5.58%	7.27%	Nov 2009
WBCMT 2006-C27, Class C	92977QAK4	11,000	11,289	5.89%	5.57%	Aug 2016
BACMS 2002-2, Class V-1 (7-Eleven, Inc.)	05947UJE9	428	305	8.72%	12.30%	Sep 2019
BACMS 2002-2, Class V-2 (Sterling Jewelers)	05947UJF6	655	455	8.68%	12.30%	Jan 2021
		108,179	97,210			
Investments in Certificated Loan Transactions						
CVS Corporation	126650BB5	19,603	19,248	5.88%	6.18%	Jan 2028
Koninklijke Ahold, N.V. 7.82% Jan 2020	008686AA5	8,980	9,350	7.82%	7.15%	Jan 2020
Koninklijke Ahold, N.V. 7.9% May 2026	52467@AL9	23,395	24,976	7.90%	7.15%	May 2026
Yahoo, Inc.	984332AC0	31,955	32,282	6.65%	6.62%	Aug 2026

		83,933		85,856
Total	$	192,112	$	183,066

(1) Represents face amount, or, in the case of the NLFC 1999-LTL-1, Class X (IO) bond, our cost basis.
(2) Represents the yield to maturity, computed using the effective interest method, based on our carry value.

Co-Investment Programs

Beginning in 2007, we intend to enter into co-investment or joint venture programs for a limited number of our current or future owned property investments. We believe that these arrangements will enable us to earn incremental returns on our property investments and provide us with an additional source of capital not dependent on United States capital markets.

Consistent with this strategy, in December 2006, we entered into an agreement pursuant to which we have committed to contribute up to $5.0 million of capital to a newly formed management company organized to form and manage real estate investment funds offered and sold to European investors, subject to the satisfaction of certain terms and conditions by the principals of the management company. We expect our investment will entitle us to a preferred return on our investment. We also expect from time to time to source properties for the management company's investment funds. We intend to retain an interest in any property sourced to any investment fund.

Portfolio Financing

Our portfolio returns reflect the yields generated by our assets less our cost of financing. We believe that our cost of financing is one of the lowest in the REIT industry, primarily as a result of the strong credit characteristics of our tenants. Such strong credit characteristics enable us to finance a component of our property acquisitions through our CDO. CDO financing also enables us to exercise greater control over our financing activities, particularly as it relates to our property acquisitions.

Our portfolio financing strategy is to finance our portfolio assets with long-term fixed rate debt as soon as practicable after we invest. We seek to finance our assets on a long-term basis with debt of a like maturity, commonly referred to as "match-funding." Since our initial public offering, our long-term fixed rate financings have been in the form of mortgage debt and collateralized debt obligations, or CDOs. Most of our real property acquisitions have been financed on a long-term basis with third party mortgage debt, with some of our smaller owned real properties financed through our CDO. As noted above, we also use CDO financing to provide incremental leverage on property acquisitions financed with mortgage debt. Most of our loan and CMBS investments are financed or we expect will be financed on a long-term basis through our existing or a future CDO. A limited number of our generally higher yielding portfolio assets are not financed.

We have short-term borrowing arrangements in place to facilitate our investment activity while we arrange long-term financing. Through Wachovia Bank, N.A. and its affiliates, we have a $250 million repurchase agreement through which we

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principally finance our loan and securities investments and a $100 million real property acquisition facility through which we can finance our owned real properties. Our interest cost on our short-term borrowings is at floating rates.

In anticipation of our next CDO issuance, in December 2006 Wachovia Bank agreed to temporarily expand our borrowing capacity under our repurchase agreement to $350 million.

Since our initial public offering, all of our financings have been on-balance sheet financings, meaning the assets we finance and liabilities we incur are reported on our balance sheet for accounting purposes.

In March 2005, we completed our first CDO. Our CDO was an entirely fixed rate financing. We aggregated approximately $300 million of assets into the pool, and we created $285 million face amount of multi-class notes and $15 million of preferred equity through the CDO trust. 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. During the first five years of the CDO term, we expect to reinvest principal repayments on the underlying assets into qualifying replacement collateral. The CDO notes are expected to mature in January 2015. Our effective blended financing rate (inclusive of original issue discount and debt issuance and hedge costs) on our CDO is approximately 5.67%.

We are currently aggregating assets for our next CDO financing. We expect our next CDO issuance to occur in the second quarter of 2007.

As of December 31, 2006, the following statistics summarize our portfolio financing position:

- leverage of approximately 79.8% (short-term and long-term secured debt divided by assets in portfolio);

- $794.8 million of total mortgage debt at a weighted average coupon of 5.46% and a weighted average effective financing rate of 5.58%; and

- $268.2 million of CDO debt at an effective blended financing rate of approximately 5.67%.

Hedging Strategy

We employ a hedging and risk management strategy to protect our investments from interest rate fluctuations prior to the time we obtain long-term fixed rate financing. We do so by having derivative and other risk management transactions that react in a corresponding but opposite manner to offset changes in the value of our investments due to changes in underlying U.S. Treasury interest rates and, to a lesser degree, swap spreads. For example, as underlying interest rates fall, the value of our fixed-rate investment increases, while the value of our derivative and other risk management transaction declines. Conversely, as underlying interest rates rise, the value of our fixed-rate investment falls while the value of our derivative and other risk management transaction increases. We use forward starting interest rate swaps to hedge the variability of changes in the interest-related cash outflows on our forecasted future borrowings. Interest rate swaps are agreements between two parties to exchange, at particular intervals, payment streams calculated on a specified notional amount. The interest rate swaps that we have entered into are single currency interest rate swaps and, as such, do not require the exchange of a notional amount. As of December 31, 2006, we were hedging our exposure to such variability through October 2016.

Some assets, including investments in franchise loans and development loans and subordinated CMBS securities, may not be hedged at all. We intend generally to continue to seek to manage our interest rate exposure taking into account the cost of such derivative and other risk management transactions and the limitations on derivative and other risk management transactions imposed by the REIT tax rules.

Revenue Concentrations in 2006

None of our tenants accounted for more than 10% of our total revenues during 2006. Two of our tenants, Aon Corporation and the United States Government, accounted for more than 10% of our total revenue from our owned real properties segment (i.e., our operating real estate segment). We had no revenue concentrations of greater than 10% in our loan and securities segment (i.e., lending investments).

Asset Pipeline

Owned Property Pipeline.

Our owned property pipeline includes potential acquisitions in various stages of review. We generally have from 5 to 10 potential transactions in different stages in our property acquisition qualification, pricing and due diligence process at any given time. Once we determine that a transaction meets our criteria for purchase, we negotiate an expression of interest or proceed directly to a purchase and sale agreement with the owner for the purchase of the property. The expression of interest does not bind us to purchase, but may bind the seller not to accept another offer to purchase the property during the negotiation

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of a purchase and sale contract. We generally seek to negotiate a due diligence period during which we can terminate our obligations for any reason and receive back any deposit we paid into escrow. After that due diligence period, any deposit we paid into escrow typically becomes non-refundable. We seek to close our real property acquisitions within four to eight weeks after the purchase and sale agreement is signed.

Loan Pipeline.

Our loan pipeline includes potential loans in various stages of review. We receive frequent requests for net lease or other single tenant financing and typically have several potential transactions in different stages in our loan origination qualification, pricing and due diligence process at any given time. Once we have reviewed and determined that a lease is financeable under our program, we will, at the borrower's request, issue a term sheet, which briefly outlines the pricing and terms under which we propose to finance the property. Upon acceptance of the term sheet by the borrower, we issue a form of application, which sets forth the detailed terms of the transaction. Once the borrower signs an application and delivers it to us with a deposit and the application is accepted, we consider such loans to be committed loans, subject to our due diligence process and final approval by our investment committee. We generally close a committed loan within four to eight weeks after the application is signed. At any time from the date of acceptance of the application until closing, the borrower may lock in the interest rate on the loan by submission of an additional deposit, payment of an additional fee and execution of a rate lock agreement.

Origination Network

We maintain a comprehensive marketing, advertising and public relations program that supports our origination efforts. The objective of the program is to build our name recognition and credibility and to promote our products. We believe, based upon our experience and responses from customers, that we have been successful in achieving our objectives of market awareness and prominence.

Property Acquisitions.

Since our initial public offering, we have leveraged our relationships within our loan origination business and our knowledge of the net lease and other single tenant business to develop relationships with investment sale brokers, through which we primarily identify real property for purchase. We also source property acquisition opportunities directly from developers and owners or investors in real estate assets. Because of the inherent synergies among our products, from time to time we identify property acquisition opportunities through our loan origination network and vice versa.

Our property acquisition network is smaller and less specialized than our loan origination network. As a result, we have found that our sources for property acquisition opportunities require less marketing and training efforts than those required in our loan origination business. We frequently meet with investment sale brokers to discuss our investment criteria. We also include members of our property acquisition network on distributions of our bimonthly newsletters, brochures and other written marketing materials.

Loan Origination.

Our principal source of loan origination is our national network of independent mortgage brokers. We also originate loans directly from developers and owners or investors in net leased or other single tenant properties. A significant portion of our loan business is with repeat customers.

Mortgage brokers working with net lease products need specialized knowledge and skills not generally required for traditional real estate debt and equity activities. We routinely meet with mortgage brokers to discuss the latest developments in net lease financing. As part of our efforts to educate our mortgage broker network about net lease financing, we provide bimonthly newsletters, brochures and other written material intended to keep mortgage brokers up to date on the latest underwriting requirements for net lease financings and net leases, lease enhancements, and changes in tenant credit ratings, as well as to provide information on our latest programs.

Underwriting Process

Once a prospective investment opportunity is identified, the potential transaction undergoes a comprehensive underwriting and due diligence process that is overseen by our investment committee, which consists of six of our key employees, including the chief executive officer, president, chief financial officer and chief investment officer. The focus of our asset underwriting falls into three primary areas:

- credit and financial reviews of the tenant as well as an assessment of the tenant's business, the overall industry segment and the tenant's market position within the industry;

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- lease quality, including an analysis of the term, tenant termination and abatement rights, landlord obligations and other lease provisions; and
- a real estate fundamentals review and analysis.

The credit quality of the tenant under the lease is an important aspect of the underwriting of the transaction. Prior to entering into any transaction, our underwriter, assisted by our chief investment officer and chief financial officer as necessary, conducts a review of the tenant's credit quality. This review may include reviews of publicly available information, including any public credit ratings, audited financial statements, debt and equity analyst reports, and reviews of corporate credit spreads, stock prices and market capitalization.

While we have no defined minimum credit rating or balance sheet size for tenants, we anticipate that a significant majority of the tenants underlying our investments will have investment grade or implied investment grade credit ratings. For those tenants that either are below investment grade or are unrated, we may conduct additional due diligence, including additional financial reviews of the tenant and a more comprehensive review of the business segment and industry in which the tenant operates.

Assuming that the credit of the tenant under the lease is satisfactory, a thorough review is then conducted into the quality of the lease, focusing primarily on the landlord's obligations under the lease and those provisions of the lease that would permit the tenant to terminate or abate rent prior to the conclusion of the primary lease term. We analyze the lease to ensure that all or substantially all of the property expenses are borne by the tenant or that any property expenses not borne by the tenant are sufficiently underwritten to assure that we can isolate a predictable cash flow from the asset. For our loan investments, we isolate any lease provisions that provide for tenant abatement or termination rights or landlord's obligations, and determine whether to apply appropriate forms of lease enhancements, including as necessary, specialized insurance, reserves or debt service coverage covenants. In addition, each lease is reviewed by outside counsel and a lease summary is provided to our underwriter for use in underwriting the transaction.

Finally, we conduct a review with respect to the quality of the real estate subject to the lease. In all cases, the property is reviewed from a traditional real estate perspective, including quality of construction and maintenance, location and value of the real estate and technical issues such as title, survey and environmental. As necessary, appraisals and environmental and engineering reports are obtained from third-parties and reviewed by our underwriter and/or legal counsel. The level of additional review will then vary depending on whether the investment is an owned property or a loan. For our owned properties, we thoroughly review the property's real estate fundamentals, including location and type of the property, vacancy rates and trends in vacancy rates in the property's market, rental rates within the property's market, recent sales prices and demographics in the property's market. As described in detail under "Our Portfolio—Owned Properties" above, we target properties with one or more of the following: located in a primary metropolitan market, fungible asset type, barriers to entry in the market, and a core facility of the tenant. In addition, we may evaluate, or engage a third-party provider to evaluate, alternative uses for the real estate and the costs associated with converting to such alternative uses, as well as examine the surrounding real estate market in greater detail.

In the case of a loan to a property owner, our real estate due diligence includes a review of the background and financial capabilities of the owner.

In the case of CMBS investments, our underwriter, assisted by our chief investment officer and chief financial officer, thoroughly evaluates the credit, the legal and financial structures and the collateral quality underlying the transaction.

In addition to our review of the quality of any individual transaction, our investment committee also:

- evaluates our current portfolio, including consideration of how the subject transaction affects asset diversity and credit concentrations in the tenant, industry or credit level;

- determines whether we can implement appropriate legal and financial structures, including our ability to control the asset in a variety of circumstances, such as an event of default by the tenant or the borrower, as applicable;

- evaluates the leveraged and unleveraged yield on the asset and how that yield compares to our target yields for that asset class and our analysis of the risk profile of the investment; and

- determines our plans for financing and hedging the asset.

We use integrated systems such as customized software and models to support our decisions on pricing and structuring investments. Before issuing any form of commitment to fund an investment transaction, the transaction must be approved by our investment committee. Our investment committee consists of our chief executive officer, president, chief financial officer, chief investment officer, and two of our senior originators. The committee meets frequently and on an as-needed basis to evaluate potential investments.

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In addition, we have a four-member investment oversight committee of our board of directors, which approves all transactions in excess of $50.0 million. Our chief executive officer is the only member of this committee who is an employee of our company.

We believe that we can continue to grow our business more rapidly than we need to expand our general and administrative costs and headcount.

Asset Management

We manage a diverse portfolio of real estate assets. For our owned properties where we are responsible for day-to-day management of the property, we typically hire third party property managers who are overseen by employees of our company. Our owned property investments also require that we perform a variety of asset management functions, such as:

- meeting periodically with our tenants;
- monitoring lease expirations and tenant space requirements;
- monitoring the financial condition and credit ratings of our tenants;
- performing physical inspections of our properties;
- making periodic improvements to properties where required;
- monitoring portfolio concentrations (e.g., tenant, industry); and
- monitoring real estate market conditions where we own properties.

Asset Surveillance System

We also have created an on-going asset surveillance system that allows us to:

- track the status of our assets and asset opportunities;
- link into a management program that includes the underlying asset origination or acquisition documents;
- load expected asset cash flows from our underwriting files into the system;
- import data from the system into our financial accounting system;
- monitor actual cash flows on each asset through servicer reports;
- immediately identify issues such as non-payment of rent and servicer advances of rent or debt service through servicer exception reports;
- track credit ratings of underlying tenants; and
- compute coverage and compliance tests for our CDO transactions.

Through this single system we are able to track and document the entire lifecycle of our assets.

Closing Process

From the time we begin to consider an investment until the investment is closed, the prospective transaction undergoes a variety of defined steps and procedures. In connection with the closing process, we will typically need to rely on certain third parties not under our control, including tenants, borrowers, sellers, warehouse lenders, brokers, outside counsel, insurance companies, title companies, environmental consultants, appraisers, engineering consultants and other product or service providers. Our personnel carefully manage the closing process and have developed a streamlined set of procedures, checklists and relationships with many of the third-party providers with whom we do business on an on-going basis.

As set forth above under "Underwriting Process" above, each transaction goes through a multi-stage underwriting process including review by our investment committee. Transaction underwriting and the documentary process surrounding it is supported by the use of standardized transaction documents, including closing checklists and form acquisition and loan documents, and is further supported by proprietary underwriting and pricing software. All of our transactions are closed by our in-house closing and underwriting staff, many of whom have more than five years of experience with us. That staff seeks to close our loan transactions four to eight weeks after the application is signed and close property acquisitions four to eight weeks after a purchase and sale agreement is signed, while at the same time maintaining our underwriting standards.

Competition

We are subject to significant competition in each of our business segments. We compete with specialty finance companies, insurance companies, commercial banks, investment banks, savings and loan associations, mortgage bankers, mutual funds, institutional investors, pension funds, hedge funds, other lenders, governmental bodies and individuals and other entities, including REITs. We may face new competitors and, due to our focus on net lease and other single tenant properties located throughout the United States, and because many of our competitors are locally and/or regionally focused, we will not encounter the same competitors in each region of the United States.

Many of our competitors have greater financial and other resources and may have other advantages over our company. Our competitors may be willing to accept lower returns on their investments and may succeed in buying the assets that we have targeted for acquisition. We may also incur costs on unsuccessful acquisitions that we will not be able to recover.

Environmental Matters

Under various federal, state and local environmental laws, a current owner of real estate may be required to investigate and clean up contaminated property. Under these laws, courts and government agencies have the authority to impose cleanup responsibility and liability even if the owner did not know of and was not responsible for the contamination. For example, liability can be imposed upon us based on the activities of our tenants or a prior owner. In addition to the cost of the cleanup, environmental contamination on a property may adversely affect the value of the property and our ability to sell, rent or finance the property, and may adversely impact our investment in that property.

Prior to acquisition of a property, we obtain Phase I environmental reports. These reports are prepared in accordance with an appropriate level of due diligence based on our underwriting standards and generally include a physical site inspection, a review of relevant federal, state and local environmental and health agency database records, one or more interviews with appropriate site-related personnel, review of the property's chain of title and review of historic aerial photographs and other information on past uses of the property and nearby or adjoining properties. We may also obtain a Phase II investigation which may include limited subsurface investigations and tests for substances of concern where the results of the Phase I environmental reports or other information indicates possible contamination or where our consultants recommend such procedures.

We believe that our portfolio is in compliance in all material respects with all federal, state and local laws and regulations regarding hazardous or toxic substances and other environmental matters.

At December 31, 2006, we were not aware of any environmental concerns that would have a material adverse effect on our financial position or results of operations.

Employees

As of December 31, 2006, we had 21 employees. We have an experienced staff, many of the members of which have been previously employed by the real estate departments from major financial institutions, law firms and rating agencies. We believe that our relations with our employees are good. None of our employees are unionized.

Available Information

We are required to file annual, quarterly and current reports, proxy statements and other information with the SEC. Investors may read and copy any document that we file, including this Annual Report on Form 10-K, at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Investors may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site at http://www.sec.gov that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC, from which investors can electronically access our SEC filings.

We also make available free of charge on or through our Web site (www.caplease.com), our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Investors can access our filings with the SEC by visiting the investor relations section of our web site at www.caplease.com.

The information on our web site is not, and shall not be deemed to be, a part of this report or incorporated into any other filings we make with the SEC.

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Item 1A. Risk Factors.

Set forth below and elsewhere in this annual report on Form 10-K and in other documents we file or furnish with the SEC are risks and uncertainties that could adversely affect our business and operations and cause actual results to differ materially from the results contemplated by any forward-looking statements made by us or on our behalf.

Risks Related to Operations

The market price of our stock may be adversely impacted by our pace of investment activity.

The markets in which we compete for investments are highly competitive and our pace of investment activity continues to be impacted by competitive conditions. If our pace of investment activity does not match market expectations the market price of our stock could be adversely affected.

We conduct a significant part of our business with Wachovia Bank, N.A. and its affiliates, and their continued business with us is not guaranteed.

We rely on Wachovia Bank, N.A. and its affiliates in various aspects of our business. For example:

- Wachovia Bank, N.A. and its affiliates provide us with short-term financing through a repurchase agreement and a real property acquisition facility.

- Many of our real property acquisitions have been and we expect will continue to be financed on a long-term basis through traditional mortgage debt obtained from Wachovia Bank.

- Affiliates of Wachovia Bank, N.A. have performed investment banking services for us, including in connection with our initial public offering, our initial CDO transaction and our Series A preferred stock and first follow-on common stock offering.

- Wachovia Bank, N.A. acts as loan servicer of our loan investments financed under our repurchase facility.

- We enter into derivative transactions from time to time with Wachovia Bank, N.A.

These parties are not obligated to do business with us, and any adverse developments in their business or in our relationship with them could result in these parties choosing not to do business with us or a significant reduction in our business with them. Termination of our business with Wachovia Bank, N.A. or its affiliates or a significant reduction in our business with these parties could have a material adverse effect on our business, operating results and financial condition.

If we lower our dividend, the market value of our common stock may decline.

The level of our common stock dividend is established by our board of directors from time to time based on a variety of factors, including our cash available for distribution, our funds from operations and our maintenance of REIT status. Various factors could cause our board of directors to decrease our common stock dividend level, including tenant defaults resulting in a material reduction in our cash flows or a material loss resulting from an adverse change in one or more of the tenants underlying our investments. If we are required to lower our common stock dividend, the market value of common stock in our company could be adversely affected.

Risks Related to Portfolio Assets

Single tenant leases involve significant risks of tenant default.

We focus our investment activities on properties and loans on properties that are leased to single tenants. Therefore, a default by the sole tenant is likely to cause a significant or complete reduction in the cash flows from that investment and a reduction in the value of our investment.

An adverse change in the financial condition of one or more tenants underlying our investments could have a material adverse impact on us.

We make portfolio investments based on the financial strength of the underlying tenant and our expectations of their continued payment of rent under the lease. We rely on rent payments under the lease for our cash flows. Therefore, adverse changes in the financial condition of the tenants or the certainty of their ability to pay rents could have a material adverse impact on us. For example:

· The bankruptcy or insolvency of any of our tenants could result in that tenant ceasing to make rental payments, resulting in a reduction of our cash flows and losses to our company.

- The value of our investments is substantially driven by the credit quality of the underlying tenant or tenants, and an adverse change in the subject tenant's financial condition or a decline in the credit rating of such tenant may result in a decline in the value of our investments and a charge to our income statement.

- An adverse change in the financial condition of one or more tenants underlying our investments or a decline in the credit rating of one or more tenants underlying our investments could result in a margin call if the related asset is being financed on our short-term borrowing facilities, and could make it more difficult for us to arrange long-term financing for that asset, including by increasing our cost of financing.

- We own the subordinate classes in our CDO financings. If the underlying tenant on any asset financed in our CDO fails to make rental payments, we may fail to satisfy coverage tests under the CDO, which could result in our cash flows from the assets in the CDO being redirected to senior class owners.

We are subject to tenant credit concentrations that make us more susceptible to adverse events with respect to certain tenants.

We are subject to the following tenant credit concentrations as of December 31, 2006:

- approximately $207.4 million, or 13.2%, of our assets in portfolio involve properties leased to the United States Government;

- approximately $91.0 million, or 5.8%, of our assets in portfolio involve properties leased to, or leases guaranteed by, TJX Companies, Inc.;

- approximately $87.5 million, or 5.6%, of our assets in portfolio involve properties leased to, or leases guaranteed by, Lowe's Companies Inc.; and

- approximately $81.4 million, or 5.2%, of our assets in portfolio involve properties leased to, or leases guaranteed by, Aon Corporation.

Any bankruptcy, insolvency or failure to make rental payments by, or any adverse change in the financial condition of, one or more of these tenants, or any other tenant to whom we may have a significant credit concentration in the future, could result in a material reduction of our cash flows or material losses to our company.

We are subject to tenant industry concentrations that make us more susceptible to adverse events with respect to certain industries.

We are subject to the following industry concentrations as of December 31, 2006:

- approximately $199.3 million, or 12.7%, of our assets in portfolio involve properties leased to, or leases guaranteed by, companies in the insurance industry (e.g., Aon Corporation, Allstate Insurance Company, Farmers New World Life Insurance Company, Aetna Life Insurance Company);

- approximately $138.5 million, or 8.8%, of our assets in portfolio involve properties leased to, or leases guaranteed by, companies in the retail department stores industry (e.g., TJX Companies, Inc., Kohl's Corporation);

- approximately $104.3 million, or 6.6%, of our assets in portfolio involve properties leased to, or leases guaranteed by, companies in the retail home improvements industry (e.g., Lowe's Companies, Inc., Home Depot USA, Inc.);

- approximately $89.3 million, or 5.7%, of our assets in portfolio involve properties leased to, or leases guaranteed by, companies in the retail drug industry (e.g., CVS Corporation, Walgreen Co.); and

- approximately $83.9 million, or 5.3%, of our assets in portfolio involve properties leased to, or leases guaranteed by, companies in the banking industry (e.g., AmeriCredit Corp., Capital One Financial Corporation, Harris Bankcorp, Inc., Bank of America, N.A., National City Bank).

Any downturn in one or more of these industries, or in any other industry in which we may have a significant credit concentration in the future, could result in a material reduction of our cash flows or material losses to our company.

We are subject to geographic concentrations that make us more susceptible to adverse events in these areas.

We are subject to the following geographic concentrations as of December 31, 2006:

- approximately $181.0 million, or 11.5%, of our assets in portfolio are investments in properties located in the Chicago, Illinois metropolitan area;

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- approximately $178.6 million, or 11.3%, of our assets in portfolio are investments in properties located in the Washington, D.C. metropolitan area;

- approximately $146.1 million, or 9.3%, of our assets in portfolio are investments in properties located in the New York City and Northern New Jersey area;

- approximately $135.2 million, or 8.6%, of our assets in portfolio are investments in properties located in the Philadelphia, Pennsylvania metropolitan area; and

- approximately $93.3 million, or 5.9%, of our assets in portfolio are investments in properties located in the Dallas, Texas metropolitan area.

An economic downturn or other adverse events or conditions such as terrorist attacks or natural disasters in one or more of these areas, or any other area where we may have a significant credit concentration in the future, could result in a material reduction of our cash flows or material losses to our company.

Our investments in assets backed by below investment grade credits have a greater risk of default.

We invest in assets where the underlying tenant's credit rating is below investment grade (approximately $214.5 million, or 13.6%, of our assets in portfolio as of December 31, 2006). These investments will have a greater risk of default and bankruptcy than investments in properties leased exclusively to investment grade tenants.

Our investments in assets where we obtain "private" credit ratings expose us to certain risks.

In order to effectively implement our financing strategy, we are required to have ratings for all of the underlying tenants on our loans and properties. When we invest in a loan or property where the underlying tenant does not have a publicly available credit rating, we rely on our own estimates of the tenant's credit rating and later obtain a private rating from S&P or Moody's to allow us to finance the asset as we had planned. If S&P or Moody's disagrees with our ratings estimates, we may not be able to obtain our desired level of leverage and/or our financing costs may exceed those that we projected. This outcome could have an adverse impact on our returns on that asset and hence our operating results.

Risks Related to Ownership of Real Estate

Bankruptcy laws will limit our remedies if a tenant becomes bankrupt and rejects our lease.

We rely on rent payments under our lease with the tenant to fund our financing of the property and to generate the spread we earn on the asset. If the tenant becomes insolvent or bankrupt, our lease may be rejected and rent payments could cease. In such a case, our remedies will be limited under the United States Bankruptcy Code. We may not be able to recover the premises promptly from the tenant and our claim for damages, which is limited to rent under the lease for the greater of one year or 15 percent (but not more than three years) of the remaining term, plus rent already due but unpaid, may not be sufficient to cover our debt service and any other expenses with respect to the property.

The success of our owned properties business will depend on our ability to obtain third-party management for the real properties we purchase.

For certain of our owned properties, we are responsible for day-to-day management of the property. In these instances, we typically retain third party property managers to perform our obligations. A failure of these managers or us to perform could trigger the tenant's right to terminate the lease or abate rent. In addition, if the managers or we fail to perform our obligations in a cost-effective manner, our returns and net cash flows from the property and hence our overall operating results and cash flows could be materially adversely affected.

Operating expenses of our properties could reduce our cash flow and funds available for future dividends.

For certain of our owned properties, we are responsible for operating costs of the property. In these instances, our lease requires the tenant to reimburse us for all or a portion of these costs, either in the form of an expense reimbursement or increased rent. Our reimbursement may be limited to a fixed amount or a specified percentage annually. To the extent operating costs exceed our reimbursement, our returns and net cash flows from the property and hence our overall operating results and cash flows could be materially adversely affected.

We have greater exposure to operating costs when we invest in owned properties leased to the United States Government.

Our leases with the United States Government are typical Government Services Administration, or GSA, type leases. These leases do not provide that the United States Government is wholly responsible for operating costs of the property, but include an operating cost component within the rent we receive that increases annually by an agreed upon percentage based

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upon the Consumer Price Index, or CPI. Thus, we have greater exposure to operating costs on our properties leased to the United States Government because if the operating costs of the property increase faster than CPI, we will bear those excess costs.

We may not be able to renew our leases or re-lease our properties.

Upon the expiration of leases on our properties, we may not be able to re-let all or a portion of that property, or the terms of re-letting (including the cost of concessions to tenants) may be less favorable to us than current lease terms. There can be no assurance that we will be able to retain tenants upon the expiration of their leases. If we are unable to re-let promptly, or if the rental rates upon re-letting are significantly lower than the current rates, our financial condition and operating results will be adversely affected.

It may be difficult for us to buy and sell real estate quickly.

Real estate investments are relatively illiquid. Our ability to vary our portfolio by selling and buying properties in response to changes in economic and other conditions is limited. In addition, the mortgage debt we put on the property and REIT tax requirements restrict our ability to quickly re-sell properties we have purchased. If we must sell a property, we cannot assure you that we will be able to dispose of the property in the time period we desire or that the sales price of the property will recoup or exceed our cost for the property.

An uninsured loss or a loss that exceeds the insurance policy limits on our owned properties could subject us to lost capital or revenue on those properties.

Our comprehensive loss insurance policies may include substantial deductibles and certain exclusions. For example, our earthquake insurance coverage for properties we own in seismic zones 3 or 4 will typically include a customary deductible of five percent of our insurable value. If we are subject to an uninsured loss or a loss that is subject to a substantial deductible, we could lose part of our capital invested in, and anticipated revenue from, the property, which could harm our operating results and financial condition and our ability to pay dividends.

Noncompliance with environmental laws could adversely affect our financial condition and operating results.

The real properties we own are subject to various federal, state and local environmental laws. Under these laws, courts and government agencies have the authority to require the current owner of a contaminated property to clean up the property, even if the owner did not know of and was not responsible for the contamination. For example, liability can be imposed upon us based on activities of one of our tenants or a prior owner.

Prior to acquisition of a property, we obtain Phase I environmental reports and, in some cases, a Phase II environmental report. However, these reports may not reveal all environmental conditions at a property and we may incur material environmental liabilities of which we are unaware. The costs incurred to clean up a contaminated property, to defend against a claim, or to comply with environmental laws could be material and could adversely affect our financial condition and operating results.

Our real estate investments are subject to risks particular to real property.

As an owner of real property (including any real property we may acquire upon a loan foreclosure), we are subject to various additional risks not otherwise discussed in these risk factors and generally incident to the ownership of the real estate. These risks may include those listed below:

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civil unrest, acts of God, including earthquakes, floods and other natural disasters, which may result in uninsured losses, and acts of war or terrorism, including the consequences of the terrorist attacks, such as those that occurred on September 11, 2001;

- adverse changes in national and local economic and market conditions;
- the costs of complying or fines or damages as a result of non-compliance with the Americans with Disabilities Act;
- changes in governmental laws and regulations, fiscal policies and zoning ordinances and the related costs of compliance with laws and regulations, fiscal policies and ordinances;
- the ongoing need for capital improvements, particularly in older structures; and
- other circumstances beyond our control.

Should any of these events occur, our financial condition and operating results could be adversely affected.

Risks Related to Debt Assets

Our investments in commercial mortgage-backed securities may be subordinated.

As of December 31, 2006, our CMBS investments included $51.6 million of below investment grade bond classes (approximately 3.3% of our assets in portfolio as of December 31, 2006). Generally, these classes represent subordinate classes of the securitization pool, meaning that we hold the "first loss" position or a near "first loss" position in the event of losses on the assets within the pool. We may not be able to recover our investment in these subordinated CMBS classes. In addition, the value of these subordinated investments may be adversely affected by defaults or decreases in the value of the underlying collateral, increases in market rates for similar collateral pools or economic downturns, and we may be required under GAAP to record an impairment loss on our investment if any of these developments occur.

We have limited recourse in the event of a default on any of our mortgage loans.

Our mortgage loan investments are non-recourse obligations of the property owner, and, in the event of default, we are generally dependent entirely on the loan collateral to recover our investment. Our loan collateral consists of a mortgage on the underlying property and an assignment of the tenant's lease. To the extent the tenant fails to make its lease payments, recovery of our investment will depend upon the liquidation value of the underlying real property. The liquidation value of a commercial property may be adversely affected by risks generally incident to interests in real property, including changes in general or local economic conditions and/or specific industry segments, declines in real estate values, increases in interest rates, real estate tax rates and other operating expenses including energy costs, changes in governmental rules, regulations and fiscal policies, including environmental legislation, acts of God, and other factors which are beyond our or our borrower's control. There can be no assurance that our remedies with respect to the loan collateral will provide us with a recovery adequate to recover our investment.

We may experience losses on our mortgage loans.

We originate mortgage loans on properties subject to a net lease as part of our investment strategy. The typical net lease requires the borrower or tenant to maintain casualty insurance on the underlying property. These insurance policies may include substantial deductibles and certain exclusions. If the underlying property is subject to a casualty loss that is uninsured or subject to a substantial deductible, rent payments on the related lease may cease, our loan may default and we could lose some or all of our investment.

Our collateral rights under our 10-year credit tenant loan program are limited.

As part of our 10-year credit tenant loan program, we split a loan secured by a mortgage on real estate and an assignment of the lease on the property into two notes, a real estate note (which we generally sell promptly following origination), and a corporate credit note (which we retain in our portfolio). The corporate credit note has a junior claim on the real estate mortgage. Further, while the corporate credit note has a first priority claim on the lease assignment in a tenant bankruptcy, our claim for damages will be limited to an amount defined under the Bankruptcy Code (the greater of one year's rent or 15% (but not more than three years) of rent over the remaining lease term, plus rent already due but unpaid). Therefore, in the event of a default on the loan, our collateral rights on our corporate credit notes will be more limited than the collateral rights we have under our long-term mortgage loans.

Our mezzanine investments have a greater risk of loss than mortgage loans.

We make mezzanine and other generally subordinate investments. These investments generally involve a higher degree of risk than our first mortgage loans. While we expect most of these investments will be secured, we expect our right to payment and security interest will be subordinated to one or more senior lenders. Therefore, we may be limited in our rights to collect scheduled payments on these investments and to recover any of our investment through a foreclosure of collateral.

Our mezzanine investments may also include an interest only payment schedule, with the principal amount remaining outstanding and at risk until the maturity of the obligation. In this case, a borrower’s ability to repay its obligation may be dependent upon a liquidity event, such as a sale or refinancing of the related property or other collateral.

We may be subject to losses from the investments we make in franchise loans.

During 2006, we entered into a revolving credit agreement with a third party borrower. We agreed to fund loans from time to time of up to $12 million to support the borrower’s capital contributions to a joint venture that makes franchise loans to franchisees of YUM! Brands, Inc. restaurant concepts such as Taco Bell, Kentucky Fried Chicken and Pizza Hut. These loans are secured by a pledge of the borrower’s interest in the joint venture and a limited guarantee by one of the principals of the borrower. We also have made and may make in the future investments in franchise loans funded outside of the joint venture. Our loans expose us to various unique risks, which could result in losses to us. These risks include the following:

- Because our investments ultimately fund franchise loans, our ability to collect interest on and principal at maturity of our loans will be dependent upon the financial health of the underlying franchisees' business. We have very limited experience evaluating franchise loans and we do not re-underwrite the underlying franchise loans, but rely primarily on the underwriting efforts performed by or on behalf of our borrower.

- Our loans are typically interest only with a balloon payment due at maturity.

- Adverse events with respect to one or more of the YUM! Brands franchises, such as the recent E. coli outbreak associated with Taco Bell Stores, could adversely impact the underlying franchisee borrowers and hence our investment.

- A third party lender has a first priority lien in the underlying franchise loans, and therefore, our collateral is limited in the event of a default by our borrower as a result of non-payment by a franchisee.

Development loans involve greater risk of loss than loans secured by income producing properties.

We make investments in development loans that involve a higher degree of risk than long-term senior mortgage loans secured by income-producing real property, due to a variety of factors. These factors include the subordinate status of our loan investment, dependence for repayment on successful completion and operation of the project, difficulties in estimating construction or rehabilitation costs, loan terms that often require little or no amortization, and the possibility that a foreclosure by the holder of the senior loan could result in a substantial decrease in the value of our collateral. Accordingly, in the event of a borrower default, we may not recover some or all of our investment in our development loans.

Fluctuating interest rates may adversely affect the quantity of loan assets we can originate.

Higher interest rates may reduce overall demand for loans and accordingly reduce our origination of loan assets, which could have a material adverse effect on our financial condition and operating results.

Unscheduled principal payments on our loans could adversely affect our financial condition and operating results.

The rate and timing of unscheduled payments of principal on our loans is impossible to predict accurately and will be affected by a variety of factors, including the level of prevailing interest rates, restrictions on voluntary prepayments contained in the loans, the availability of credit generally and other economic, demographic, geographic, tax and legal factors. In general, however, if prevailing interest rates fall significantly below the interest rate on a loan, the borrower is more likely to prepay the then higher-rate loan than if prevailing rates remain at or above the interest rate on the loan.

While our loan documents generally prohibit prepayment without a premium to preserve our yield, this premium may not be required or may not be recoverable under various circumstances, including in the event of a casualty or condemnation of the related property or a loan default. Unscheduled principal prepayments could adversely affect our financial condition and operating results to the extent we are unable to reinvest the funds we receive at an equivalent or higher yield rate. In addition, a large amount of prepayments, especially prepayments on loans with interest rates that are high relative to the rest of our portfolio, will likely decrease the overall spread we anticipate receiving on our portfolio.

We may be required to repurchase assets that we have sold or to indemnify holders of our CDOs.

If any of the assets we originate or acquire and sell or pledge to obtain long-term financing do not comply with representations and warranties that we make about certain characteristics of the assets, the borrowers and the underlying properties, we may be required to repurchase those assets or replace them with substitute assets. In addition, in the case of assets that we have sold, we may be required to indemnify persons for losses or expenses incurred as a result of a breach of a representation or warranty. Repurchased assets may require a significant allocation of working capital to carry on our books, and our ability to borrow against such assets may be limited. Any significant repurchases or indemnification payments could materially and adversely affect our financial condition and operating results.

The success of our loan business will depend upon our ability to service effectively, or to obtain effective third-party servicing for, the loans we invest in.

We have entered into a servicing arrangement with Wachovia Bank, N.A. for servicing of our loans. We may in the future undertake to retain the servicing of our loan assets. We have no experience servicing a large portfolio of loans for an extended period of time. We cannot assure you that our third-party contractor or we will be able to service the loans according to industry standards. Failure to service the loans properly could harm our financial condition and operating results.

Maintenance of our Investment Company Act of 1940 exemption imposes limits on our operations.

We intend to continue to conduct our business in a manner that allows us to avoid registration as an investment company under the Investment Company Act of 1940 (the “1940 Act”). Under Section 3(c)(5)(C) of the 1940 Act, entities that

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are primarily engaged in the business of purchasing or otherwise acquiring “mortgages and other liens on and interests in real estate” are not treated as investment companies. The position of the SEC staff generally requires us to maintain at least 55% of our assets directly in qualifying real estate interests in order for us to rely on this exemption (the “55% Requirement”). To constitute a qualifying real estate interest under this 55% Requirement, a real estate interest must meet various criteria. Mortgage securities that do not represent all of the certificates issued with respect to an underlying pool of mortgages may be treated as securities separate from the underlying mortgage loans and, thus, may not qualify for purposes of the 55% Requirement. Our ownership of these mortgage securities, therefore, is limited by the provisions of the 1940 Act and SEC staff interpretations. We cannot assure you that efforts to pursue our investment strategy will not be adversely affected by operation of the 1940 Act.

Risks Related to Borrowings

Leveraging our portfolio is an important component of our strategy and subjects us to increased risk of loss.

A key component of our strategy is to borrow against, or leverage, our assets to allow us to invest in a greater number of assets and enhance our asset returns. However, leverage also subjects us to increased risk of loss. The use of leverage may result in increased losses to us in the following ways:

- We rely on the cash flows from the assets financed to fund our debt service requirements. Therefore, in the event of a tenant default on its rent payments, our losses are expected to increase as we will need to fund our debt service requirements from other sources.

- To the extent we have financed our assets under our variable rate short-term borrowing facilities, our debt service requirements will increase as short-term interest rates rise. Therefore, if short-term interest rates rise in excess of the yields on our assets financed, we will be subject to losses.

- Our lenders will have a first priority claim on the collateral we pledge and the right to foreclose on the collateral. Therefore, if we default on our debt service obligations, we would be at risk of losing the related collateral.

- Our short-term borrowing facilities are fully recourse lending arrangements. Therefore, if we default on these obligations, our lenders will have general recourse to our company’s assets, rather than limited recourse to just the assets financed.

Increases in our cost of financing may cause our expected spreads on new assets to erode.

The profitability of our portfolio (and, in turn, our business) is driven by the returns on our assets, based on the spread between the yields generated by our assets and the cost of financing our portfolio. We generally secure long-term financing for our assets after we agree to acquire them. Therefore, if our cost to finance our assets increases over our assumptions at the time we commit to invest, the spread we expected to earn on the asset (and hence our overall portfolio) will erode. Various factors could cause our financing cost to increase, including:

- a decline in the credit rating of the underlying tenant;

- increases in long-term interest rates;

- market dislocations caused by the failure or financial difficulties of a large financial institution or institutions;

- ineffectiveness of our hedging strategies;

- weakening economic conditions; and
- United States military activity and terrorist activities.

Spread erosion could have a material adverse effect on our cash flows, results of operations and financial condition.

We may not be able to implement our long-term financing strategy.

We secure long-term financing of our assets to enable 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 ability to implement our long-term financing strategy is subject to the following risks:

- We may not be able to achieve our desired leverage level due to decreases in the market value of our assets, increases in interest rates and other factors.
- We are subject to conditions in the mortgage, CDO and other long-term financing markets which are beyond our control, including the liquidity of these markets and maintenance of attractive credit spreads.

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- In the event of an adverse change in the financial condition of our underlying tenant, it may not be possible or it may be uneconomical for us to obtain long-term financing for the subject asset.

Our inability to implement our long-term financing strategy may cause us to experience lower leveraged returns on our assets than would otherwise be the case, and could have a material adverse effect on our operating results.

Our use of debt financing could have a material adverse effect on our financial condition.

We are subject to the risks normally associated with debt financing, including the risk that our cash flows will be insufficient to meet required principal and interest payments and the risk that we will be unable to refinance our existing indebtedness, or that the terms of such refinancing will not be as favorable as the terms of our existing indebtedness. As of December 31, 2006, the scheduled principal payments on our long-term debt over the next five years and thereafter were as follows:

	Expected Maturity Dates					
	2007	**2008**	**2009**	**2010**	**2011**	**Thereafter**
	(in thousands, notional amounts where appropriate, otherwise carrying amounts)					
Mortgages on real estate investments	$ 5,207	$ 7,565	$ 9,296	$ 11,289	$ 13,852	$ 747,564
Collateralized debt obligations	(36)	(38)	(41)	22,792	10,861	234,652
Other long-term debt	-	-	-	-	-	30,930

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

If our debt cannot be paid, refinanced or extended, we may not be able to make distributions to stockholders at expected levels or at all. Further, if prevailing interest rates or other factors at the time of a refinancing result in higher interest rates or other restrictive financial covenants upon the refinancing, then such refinancing would adversely affect our cash flows and funds available for operation and distribution.

Hedging transactions may not effectively protect us against anticipated risks and may subject us to certain other risks and costs.

Our current policy is to enter into hedging transactions primarily to protect us from the effect of interest rate fluctuations on our asset portfolio from the date on which we commit a rate or price to a borrower or seller and until the date our cost to finance the asset on a long-term basis is fixed. Our hedging policy exposes us to certain risks, among them the following:

- No hedging activity can completely insulate us from the risks associated with changes in interest rates and, therefore, our hedging strategy may not have the desired beneficial impact on our results of operations or financial condition.

- There will be many market risks against which we may not be able to hedge effectively, including changes in the spreads of corporate bonds, CMBS or CDOs over the underlying U.S. Treasury rates.

- We may or may not hedge any risks with respect to certain of our asset investments.

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Our hedging strategy may serve to reduce the returns which we could possibly achieve if we did not hedge certain risks.

- Because we intend to structure our hedging transactions in a manner that does not jeopardize our status as a REIT, we will be limited in the type of hedging transactions that we may use.

- Hedging costs increase as the period covered by the hedge increases and during periods of rising and volatile interest rates. We may increase our hedging activity and thus increase our hedging costs during periods when interest rates are volatile or rising.

We may fail to qualify for hedge accounting treatment.

We record derivative and hedge transactions in accordance with United States generally accepted accounting principles, specifically Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (“SFAS 133”). Under these standards, we may fail to qualify for hedge accounting treatment for a number of reasons, including if we use instruments that do not meet the SFAS 133 definition of a derivative (such as short sales), we fail to satisfy SFAS 133 hedge documentation requirements or we fail initial or subsequent quarterly hedge effectiveness assessment requirements. If we fail to qualify for hedge accounting treatment, our operating results may suffer because any losses on the derivatives we enter into would be charged to our income statement without any offset from the change in fair value of the related hedged transaction.

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Our existing short-term borrowing facilities may be unavailable to us.

We borrow money under short-term borrowing facilities to fund all or part of our investment in most of our assets. These facilities are uncommitted as the lender must agree to each asset financed. We cannot assure you that we will be able to finance assets on these facilities at any given time.

Our short-term financings may expose us to interest rate risks and margin calls.

Our borrowings under our short-term borrowing facilities are currently at variable rates and will be adjusted monthly relative to market interest rates. Increases in short-term rates will cause our borrowing rates to rise and our net income to decrease. If interest rates on our borrowings rise in excess of the yields on our assets financed, we will be subject to losses on those assets.

The amount available to us under our short-term borrowing facilities depends in large part on the lender’s valuation of the assets that secure our financings. The facilities provide the lender the right, under certain circumstances, to re-evaluate the collateral that secures our outstanding borrowings. In the event the lender determines that the value of the collateral has decreased (for example, in connection with a decline in the credit rating of the underlying tenant), it has the right to initiate a margin call. A margin call would require us to provide the lender with additional collateral or to repay a portion of the outstanding borrowings at a time when we may not have a sufficient portfolio of assets or cash to satisfy the margin call. Any failure by us to meet a margin call could cause us to default on our short-term borrowing facilities and otherwise have a material adverse effect on our financial condition and operating results.

The use of CDO financings with coverage tests may have a negative impact on our operating results and cash flows.

We have purchased, and expect to purchase in the future, subordinate classes of bonds in our CDO financings. The terms of the CDO securities issued by us include, and we expect will include in the future, cash flow coverage tests that are used primarily to determine whether and to what extent principal and interest proceeds on the underlying assets may be used to pay principal of and interest on the subordinate classes of bonds in the CDO. These cash flow coverage tests consist of an overcollateralization test and an interest coverage test. The overcollateralization test ensures that a minimum amount of collateral par amount secures the related notes. The interest coverage test ensures that cash coupon payments generated from the CDO collateral will be adequate to pay fees and interest due on the related notes.

In the event the cash flow coverage tests are not satisfied, interest and principal that would otherwise be payable on the subordinate classes may be re-directed to pay principal on the senior bond classes. Therefore, failure to satisfy these coverage tests could adversely affect our operating results and cash flows.

Risks Related to Lease Enhancements

Our lease enhancement mechanisms may fail.

We have developed certain lease enhancement mechanisms designed to reduce the risks inherent in our net lease investments. These lease enhancement mechanisms include:

- casualty and condemnation insurance policies that protect us from any right the tenant may have to terminate the underlying net lease or abate rent as a result of a casualty or condemnation; and

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borrower reserve funds that protect us from any rights the tenant may have to terminate the underlying net lease or abate rent as a result of the failure of the property owner to maintain and repair the property or related common areas.

These lease enhancement mechanisms may not protect us against all losses. For example, our casualty and condemnation policies typically contain exclusions relating to war, insurrection, rebellion, revolution or civil riot and radioactive matter, earthquakes (in earthquake zones) and takings (other than by condemnation) by reason of danger to public health, public safety or the environment. In addition, amounts in the borrower reserve fund may be insufficient to cover the cost of maintenance or repairs, and the borrower may fail to perform such maintenance or repairs at its own expense. The failure of our lease enhancement mechanisms may result in the loss of our capital invested in, and profits anticipated from, our investment, and could adversely affect our financial condition and operating results.

We depend on our insurance carriers to provide and honor lease enhancements.

We presently obtain specialized lease enhancement insurance policies from two carriers. The limited number of insurance carriers available to provide lease enhancements restricts our ability to replace such insurers. Any of the following developments with respect to our carriers may have a material adverse effect on our financial condition and operating results:

- a deterioration in our relationship with one or both of our carriers;
- a bankruptcy or other material adverse financial development with respect to one or both of our carriers; and
- a dispute as to policy coverage with one or both of our carriers.

We may fail to analyze leases adequately or apply appropriate lease enhancement mechanisms.

In determining whether a lease enhancement mechanism is appropriate, we examine the costs and benefits of the lease enhancement mechanism in light of our analysis of the risks associated with the underlying net lease. As a result of this analysis, we may decline to apply a lease enhancement mechanism that would otherwise protect us. Our failure to analyze leases adequately or apply appropriate lease enhancement mechanisms could cause a decline in the value of our net lease asset and adversely affect our financial condition and operating results.

Risks Related to Business Strategy and Policies

We face significant competition that could harm our business.

We are subject to significant competition in each of our business segments. We compete with specialty finance companies, insurance companies, investment banks, savings and loan associations, banks, mortgage bankers, mutual funds, institutional investors, pension funds, hedge funds, other lenders, governmental bodies and individuals and other entities, including REITs. We may face new competitors and, due to our focus on net lease and other single tenant properties located throughout the United States, and because many of our competitors are locally and/or regionally focused, we may not encounter the same competitors in each region of the United States. Many of our competitors have greater financial and other resources and may have other advantages over our company. Our competitors may be willing to accept lower returns on their investments, may have access to lower cost capital and may succeed in buying the assets that we target for acquisition. We may incur costs on unsuccessful acquisitions that we will not be able to recover. Our failure to compete successfully could have a material adverse effect on our financial condition and operating results.

Our network of independent mortgage brokers and investment sale brokers may sell investment opportunities to our competitors.

An important source of our investments comes from independent mortgage brokers and investment sale brokers. These brokers are not contractually obligated to do business with us. Further, our competitors also have relationships with many of these brokers and actively compete with us in our efforts to obtain investments from these brokers. As a result, we may lose potential transactions to our competitors, causing our investment pace to slow, which could have a material adverse effect on the market price of our stock.

Our joint venture investments will expose us to certain risks.

We intend from time to time to co-invest in real properties with third parties through partnerships or other entities. Investing in this manner subjects us to certain risks, among them the following:

- For joint venture properties, we will not exercise sole decision-making authority regarding the property and, thus, we may not be able to take actions that we believe are in our company's best interests. For example, we expect that in most cases we will need our partner's approval before selling or refinancing the subject property or entering into or amending any space lease of the property.

- We may be required to accept liability for obligations of the joint venture (such as recourse carve-outs on mortgage loans) beyond our economic interest.

- Our returns on joint venture properties may be adversely affected if the properties are not held for the long-term, or a period of about ten years.

As part of our joint venture efforts, we also intend to make a passive investment in a real estate investment fund management company. The management entity is a start-up company and, thus, our investment is highly speculative. If the management company is unable to execute its business plan, which includes raising sufficient capital, or if we or other investors fail to make required capital contributions, our investment could be adversely affected. Our investment also generally does not entitle us to voting rights and, therefore, our ability to influence management policy is very limited. We could lose some or all of this investment.

Our ability to grow our business will be limited by our ability to attract debt or equity financing