

CapLease, Inc.  
Form 10-Q  
November 09, 2012

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

OR

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

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

Commission file number 001-32039

CapLease, Inc.  
(Exact name of registrant as specified in its charter)

Maryland 52-2414533  
(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)

1065 Avenue of the Americas, New York, NY 10018  
(Address of Principal Executive Offices) (ZIP Code)

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

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes x No

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

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

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

As of November 8, 2012, there were 66,766,965 shares of common stock of CapLease, Inc., \$0.01 par value per share, outstanding (“Common Stock”).

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CapLease, Inc.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

CapLease, Inc. and Subsidiaries  
Consolidated Balance Sheets  
As of September 30, 2012 (unaudited) and December 31, 2011

(Amounts in thousands, except share and per share amounts)	As Of September 30, 2012	As Of December 31, 2011
<b>Assets</b>		
Real estate investments, net	\$1,457,284	\$1,401,526
Loans held for investment, net	28,569	33,139
Commercial mortgage-backed securities	59,904	59,435
Cash and cash equivalents	40,192	71,160
Other assets	89,018	76,363
<b>Total Assets</b>	<b>\$1,674,967</b>	<b>\$1,641,623</b>
<b>Liabilities and Equity</b>		
Mortgages on real estate investments	\$986,629	\$972,924
Credit agreements	48,097	70,668
Secured term loan	76,100	88,142
Convertible senior notes	35,007	34,522
Other long-term debt	30,930	30,930
<b>Total Debt Obligations</b>	<b>1,176,763</b>	<b>1,197,186</b>
Intangible liabilities on real estate investments	33,579	35,219
Accounts payable and other liabilities	28,055	17,371
Dividends and distributions payable	7,532	5,946
<b>Total Liabilities</b>	<b>1,245,929</b>	<b>1,255,722</b>
<b>Commitments and contingencies</b>		
<b>Stockholders' equity:</b>		
Preferred stock, \$0.01 par value, 100,000,000 shares authorized:		
Series A cumulative redeemable preferred, liquidation preference \$25.00 per share, 3,401,107 and 3,204,900 shares issued and outstanding, respectively	78,649	73,880
Series B cumulative redeemable preferred, liquidation preference \$25.00 per share, 2,140,913 and 0 shares issued and outstanding, respectively	51,800	-
Common stock, \$0.01 par value, 500,000,000 shares authorized, 66,766,965 and 66,275,535 shares issued and outstanding, respectively	668	663
Additional paid in capital	300,522	321,303
Accumulated other comprehensive loss	(3,653)	(11,051)
<b>Total Stockholders' Equity</b>	<b>427,986</b>	<b>384,795</b>
Non-controlling interest in consolidated subsidiaries	1,052	1,106
<b>Total Equity</b>	<b>429,038</b>	<b>385,901</b>
<b>Total Liabilities and Equity</b>	<b>\$1,674,967</b>	<b>\$1,641,623</b>

See notes to consolidated financial statements.

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

(Amounts in thousands, except per share amounts)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>Revenues:</b>				
Rental revenue	\$35,137	\$32,362	\$101,815	\$95,302
Interest income from loans and securities	1,921	4,774	6,026	17,386
Tenant reimbursements	4,552	3,574	11,939	10,072
Other revenue	182	156	693	601
Total revenues	41,792	40,866	120,473	123,361
<b>Expenses:</b>				
Interest expense	16,723	19,147	50,666	59,197
Property expenses	7,209	6,600	20,242	19,174
General and administrative expenses	2,754	2,558	8,604	8,050
General and administrative expenses-stock based compensation	830	796	2,441	2,264
Depreciation and amortization expense on real property	12,166	11,676	35,878	34,538
Other expenses	930	38	962	167
Total expenses	40,612	40,815	118,793	123,390
<b>Other gains (losses):</b>				
Gain on investments, net	300	3,861	1,009	648
Gain (loss) on extinguishment of debt, net	–	(3,698 )	11,012	(3,698 )
Total other gains (losses)	300	163	12,021	(3,050 )
Income (loss) from continuing operations	1,480	214	13,701	(3,079 )
<b>Discontinued operations:</b>				
Loss from discontinued operations	(6 )	(727 )	(1,372 )	(2,188 )
Gain (loss) on investments	–	1,426	(15,229 )	1,426
Provision for loss on property investment	–	(14,119 )	–	(14,119 )
Total discontinued operations	(6 )	(13,420 )	(16,601 )	(14,881 )
Net income (loss) before non-controlling interest in consolidated subsidiaries	1,474	(13,206 )	(2,900 )	(17,960 )
Non-controlling interest in consolidated subsidiaries	5	36	23	55
Net income (loss)	1,479	(13,170 )	(2,877 )	(17,905 )
Dividends allocable to preferred shares	(2,731 )	(1,627 )	(6,812 )	(4,882 )
Net loss allocable to common stockholders	\$(1,252 )	\$(14,797 )	\$(9,689 )	\$(22,787 )
<b>Income (loss) per common share, basic and diluted:</b>				
Income (loss) from continuing operations	\$(0.02 )	\$(0.02 )	\$0.10	\$(0.12 )
Loss from discontinued operations	\$–	\$(0.20 )	\$(0.25 )	\$(0.23 )
Net loss per common share, basic and diluted	\$(0.02 )	\$(0.22 )	\$(0.15 )	\$(0.35 )
	66,767	67,615	66,616	64,238

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Weighted average number of common shares outstanding,  
basic and diluted

Dividends declared per common share	\$0.070	\$0.065	\$0.20	\$0.195
Dividends declared per preferred A share	\$0.508	\$0.508	\$1.523	\$1.523
Dividends declared per preferred B share	\$0.523	\$-	\$1.024	\$-

See notes to consolidated financial statements.

CapLease, Inc. and Subsidiaries  
Consolidated Statements of Comprehensive Income (Loss)  
(Unaudited)

(Amounts in thousands)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income (loss) before non-controlling interest in consolidated subsidiaries	\$1,474	\$(13,206 )	\$(2,900 )	\$(17,960 )
Other comprehensive income:				
Amortization of unrealized loss on securities previously classified as available for sale	–	–	–	150
Increase (decrease) in fair value of securities available for sale	919	13,194	7,376	5,595
Reclassification of derivative items into earnings	40	2,391	22	3,544
Other comprehensive income	959	15,585	7,398	9,289
Comprehensive income (loss)	2,433	2,379	4,498	(8,671 )
Comprehensive (income) loss attributable to non-controlling interests	(10 )	(6 )	(11 )	21
Comprehensive income (loss) attributable to CapLease, Inc.	\$2,423	\$2,373	\$4,487	\$(8,650 )

See notes to consolidated financial statements.



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

	Stockholders' Equity							Total Equity
	Preferred Stock	Common Stock at Par	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Non-controlling Interest		
Balance at December 31, 2011	\$73,880	\$663	\$321,303	\$ (11,051 )	\$—	\$ 1,106		\$385,901
Incentive stock plan compensation expense	—	—	2,441	—	—	—		2,441
Incentive stock plan grants issued and forfeited	—	5	(5 )	—	—	—		—
Net loss	—	—	(2,877 )	—	—	—		(2,877 )
Non-controlling interest in consolidated subsidiaries	—	—	—	—	—	(23 )		(23 )
Issuance of preferred stock	56,569	—	—	—	—	—		56,569
Dividends declared-preferred	—	—	(6,986 )	—	—	—		(6,986 )
Dividends declared-common	—	—	(13,354 )	—	—	—		(13,354 )
Distributions declared-operating partnership units	—	—	—	—	—	(31 )		(31 )
Increase in fair value of securities available for sale	—	—	—	7,376	—	—		7,376
Reclassification of derivative items into earnings	—	—	—	22	—	—		22
Balance at September 30, 2012	\$130,449	\$668	\$300,522	\$ (3,653 )	\$—	\$ 1,052		\$429,038

See notes to consolidated financial statements.

## CapLease, Inc. and Subsidiaries

Consolidated Statements of Cash Flows  
(Unaudited)  
(in thousands)

	For the Nine Months Ended September 30,	
	2012	2011
<b>Operating activities</b>		
Net income (loss)	\$(2,877	) \$(17,905
<b>Adjustments to reconcile net loss to cash provided by operating activities:</b>		
Depreciation and amortization	36,434	37,240
Stock based compensation	2,441	2,264
Amortization of above and below market leases	(612	) 1,258
Loss (gain) on investments, net	14,220	(2,074
Provision for loss on property investment	–	14,119
(Gain) loss on extinguishment of debt, net	(11,012	) 3,698
Non-controlling interest in consolidated subsidiaries	(23	) (55
Straight-lining of rents	11,261	3,271
Amortization of discounts/premiums, and origination fees/costs, net	(331	) (419
Amortization of debt issuance costs, leasing commissions and fair market value of debt issued or assumed	1,921	1,789
<b>Changes in operating assets and liabilities:</b>		
Other assets	(14,364	) (4,434
Accounts payable and other liabilities	6,230	614
Deposits and escrows	1	45
Net cash provided by operating activities	43,289	39,411
<b>Investing activities</b>		
Proceeds from sale or prepayments of loans	–	86,946
Principal received from borrowers	5,401	8,525
Proceeds from sale of securities	3,744	31,285
Repayments of commercial mortgage-backed securities	3,671	3,409
Proceeds from sale of real estate investments	9,611	5,171
Purchases of real estate investments	(88,397	) (9,576
Real estate improvements, additions and construction in progress	(29,465	) (14,386
Proceeds from sale of CDO, net of liabilities assumed	–	22,273
Leasing commission costs	(3,601	) (118
Deposits on potential equity investments	(3,000	) (600
Return of deposits on potential equity investments	3,000	550
Purchases of furniture, fixtures, equipment and leasehold improvements	(16	) (11
Net cash (used in) provided by investing activities	(99,052	) 133,468
<b>Financing activities</b>		
Borrowings from mortgages on real estate investments	68,580	19,318
Repayments of mortgages on real estate investments	(43,506	) (15,653
Funds held by trustee of CDO pending distribution	–	3,757
Repayments of collateralized debt obligations	–	(105,266
Collateralized debt obligations repurchased	–	(1,605
Borrowings from credit agreements	78,056	–
Repayments on credit agreements	(100,627	) (33,858
Repayments on secured term loan	(12,042	) (10,530
Debt issuance costs	(3,451	) (829

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Common stock issued, net of offering costs	–	54,269
Common stock repurchased	–	(6,055 )
Preferred stock issued, net of offering costs	56,569	–
Distributions to non-controlling interest	(30 )	(30 )
Dividends paid on common and preferred stock	(18,754 )	(16,806 )
Net cash provided by (used in) financing activities	24,795	(113,288 )
Net (decrease) increase in cash and cash equivalents	(30,968 )	59,591
Cash and cash equivalents at beginning of period	71,160	32,742
Cash and cash equivalents at end of period	\$40,192	\$92,333

Supplemental disclosure of cash flow information

Cash paid for interest expense	\$48,822	\$58,580
Capitalized interest on development properties	443	–
Distributions declared but not paid	11	10
Dividends declared but not paid	7,521	5,948

Supplemental disclosure of noncash operating, investing and financing information

Value of in-place leases and above-market leases acquired	\$6,725	\$–
Mortgage notes payable assumed on properties acquired	–	16,706
Mortgage note payable-notional amount repurchased	11,000	–
Collateralized debt obligations transferred on sale (notional)	–	152,950
Collateralized debt obligations reclassified to mortgages on real estate investments (notional)	–	30,718
Collateralized debt obligations reclassified to commercial mortgage-backed securities (fair value)	–	4,903

See notes to consolidated financial statements.

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except per share amounts; totals may not add due to rounding)

September 30, 2012 (unaudited)

1. Organization and Business

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

The Company’s tenants are primarily large public companies or their significant operating subsidiaries and 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 (“S&P”) and Moody’s Investors Service (“Moody’s”). The Company also implies 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 it has obtained a private investment grade rating from either S&P or Moody’s, (iii) for which it has evaluated the creditworthiness of the tenant and estimated a credit rating that is consistent with an investment grade rating from S&P or Moody’s, or (iv) are governmental entity branches or units of another investment grade rated governmental entity.

In addition to its portfolio of owned properties, the Company has a modest portfolio of first mortgage loans and other debt investments on single tenant properties. That debt portfolio was reduced significantly during 2011 as a result of the Company’s sale of the assets and associated liabilities comprising its collateralized debt obligation, or CDO, as well as the individual sale of certain other loans and securities. The remaining debt portfolio will continue to decrease over time as principal payments are received on the investments. While the focus of the Company’s investment activity is expected to remain the ownership of real properties, the Company may continue to make debt investments from time to time on an opportunistic basis in the future.

We have invested in certain owned properties that are leased primarily but not exclusively by one tenant. We have also invested in certain owned properties which were previously leased by one tenant but as a result of lease non-renewals have now become multi-tenant properties. We expect these types of properties will continue to comprise a portion of our portfolio for the foreseeable future.

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

CapLease conducts its business through a variety of subsidiaries. CapLease owns most of its owned properties through its predecessor and operating partnership, Caplease, LP (the “Operating Partnership”). CapLease is the indirect sole general partner of, and owns approximately 99.8% of the common equity of, the Operating Partnership.

The accompanying consolidated financial statements and related notes of the Company have been prepared in accordance with accounting principles generally accepted in the United States, or GAAP, for interim financial

reporting and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in the financial statements prepared under GAAP have been condensed or omitted. In the opinion of management, all adjustments considered necessary for a fair presentation of the Company's financial position, results of operations and cash flows have been included and are of a normal and recurring nature. The operating results presented for interim periods are not necessarily indicative of the results that may be expected for any other interim period or for the entire year. These financial statements should be read in conjunction with the Company's consolidated financial statements for the fiscal year ended December 31, 2011 and notes thereto, included in the Company's Form 10-K filed with the SEC on February 23, 2012.

CapLease, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
(Dollar amounts in thousands, except per share amounts; totals may not add due to rounding)

September 30, 2012 (unaudited)

2. Summary of Significant Accounting Policies

Basis of Presentation and Principles of Consolidation

The accompanying consolidated financial statements include the assets, liabilities, and results of operations of the Company. Results of operations of properties acquired are included in the Consolidated Statements of Operations from the date of acquisition. All significant intercompany transactions, balances and accounts have been eliminated in consolidation.

References in these financial statements to the Company's carrying amount or value of an asset or liability means such asset's or liability's book value reported on the Company's Consolidated Balance Sheet in accordance with GAAP.

Accounting for Real Estate

Real estate held for investment is carried on the Company's Consolidated Balance Sheets at historical cost to the Company, less accumulated depreciation, amortization and impairment charges. Depreciation and amortization are determined by the straight-line method over the remaining estimated economic useful lives of the properties. The Company generally depreciates building and building improvements over periods not exceeding 40 years. Direct costs incurred in acquiring completed properties that meet the classification of a business for financial accounting purposes are charged to operations as incurred. Expenditures for maintenance and repairs of owned properties are also charged to operations as incurred. Significant renovations which extend the useful life of the properties are capitalized.

The Company reviews its owned real properties for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. The evaluation includes estimating and reviewing anticipated future undiscounted cash flows to be derived from the asset. If such cash flows are less than the asset's net carrying value, an impairment charge is recognized to earnings to the extent by which the asset's carrying value exceeds the estimated fair value. Estimating future cash flows is highly subjective and includes an evaluation of factors such as the anticipated cash flows from the property, which may include rent from current leases in place and projected future leases, estimated capital expenditures, and an estimate of proceeds to be realized upon sale of the property. The Company's estimates could differ materially from actual results. The Company has determined that the significant inputs used to evaluate its owned properties for impairment primarily rely on Level 3 inputs in accordance with the fair value measurement topic in the applicable accounting guidance as described in Note 7 below. The Company did not recognize any impairment losses on long-lived assets during the nine months ended September 30, 2012, although it did recognize a loss on sale of one real property during the nine months ended September 30, 2012. See Note 6. The Company recognized impairment losses of \$14,119 on one long-lived asset located in Hartford, Connecticut during the nine months ended September 30, 2011. The foregoing loss is included a component of discontinued operations under the caption "Provision for loss on property investment" on the Company's Consolidated Statement of Operations. During December 2011, the Hartford, Connecticut property was transferred to the lender in full satisfaction of the related mortgage debt, and another \$2,304 of losses on the property and gain on extinguishment of the related mortgage debt of \$18,861 were recorded by the Company during the quarter ended December 31, 2011.

Assets and liabilities of properties that meet various held for sale criteria, including that it is probable that a sale will occur within 12 months, are presented separately in the Consolidated Balance Sheets, with assets and liabilities being separately stated. The operating results of these properties are reflected as discontinued operations in the Consolidated Statements of Operations. Properties that the Company has determined to classify as held for sale are also required to be simultaneously reviewed for impairment and carried on the Company's Consolidated Balance Sheets at the lower of net carrying value or estimated fair value.

The Company is required under GAAP to allocate the purchase price of rental real estate acquired to the following based on estimated fair values on the acquisition date:

- acquired tangible assets, consisting of land, building and improvements; and
- identified intangible assets and liabilities, consisting of above-market and below-market leases, in-place leases and tenant relationships.

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except per share amounts; totals may not add due to rounding)

September 30, 2012 (unaudited)

The fair value of tangible and intangible assets acquired is considered to be a Level 3 input in accordance with the fair value measurement topic in the applicable accounting guidance as described in Note 7 below. In estimating the fair value of the tangible and intangible assets acquired, the Company considers information obtained about each property as a result of its due diligence activities and other market data, and utilizes various valuation methods, such as estimated cash flow projections utilizing appropriate discount and capitalization rates, estimates of replacement costs, and available market information. The fair value of the tangible assets of an acquired property considers the value of the property as if it were vacant (the “dark value”).

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

Other intangible assets acquired include amounts for in-place lease values and tenant relationship values which are based on management’s evaluation of the specific characteristics of each tenant’s lease and the Company’s overall relationship with the respective tenant. Factors considered by management in its analysis of in-place lease values include estimates of the dark value of the property, carrying costs during the hypothetical expected time it would take management to find a tenant to lease the space for the existing lease term (a “lease-up period”) considering current market conditions, and costs to execute similar leases. Management estimates carrying costs, including such factors as real estate taxes, insurance and other operating expenses during the expected lease-up period, considering current market conditions and costs to execute similar leases. In estimating costs to execute similar leases, management considers leasing commissions and other related expenses. Characteristics considered by management in estimating the value of tenant relationships include the nature and extent of the Company’s existing business relationships with the tenant, growth prospects for developing new business with the tenant, the tenant’s credit quality and expectations of lease renewals. The value of in-place leases is amortized as a component of depreciation expense over the remaining initial terms of the respective leases. The value of tenant relationship intangibles, if any, is amortized as a component of depreciation expense over the anticipated life of the relationships. Through September 30, 2012, the Company has assigned no value to tenant relationships on any of its acquisitions.

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

#### Development Activities



Project costs and expenses, which include interest expense, associated with the development, construction and lease-up of a real estate project are capitalized as construction in progress. Once the development and construction of the building is substantially completed, the amounts capitalized to construction in progress are transferred to (i) land and (ii) buildings and improvements. As required by GAAP, the Company computes interest expense on the full amount it has invested in the project, whether or not such investment is externally financed.

#### Loan Investments

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

CapLease, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
(Dollar amounts in thousands, except per share amounts; totals may not add due to rounding)

September 30, 2012 (unaudited)

From time to time, the Company may determine to sell a loan in which case it must reclassify the asset as held for sale. Loans held for sale are carried at lower of cost or estimated fair value. The Company did not sell any of its loan investments during the nine months ended September 30, 2012, and as of September 30, 2012, the Company has not classified any of its loans as held for sale. During the nine months ended September 30, 2011, the Company significantly reduced the size of its loan investments portfolio through the sale of the assets and associated liabilities comprising its collateralized debt obligation, or CDO, as well as the individual sale of certain loan investments. See Note 6 below for a discussion of these and other sale transactions.

The Company evaluates its loan investments for possible impairment on a quarterly basis. The Company's impairment analysis includes both a general reserve component and an asset-specific component. The general reserve component covers performing loans and in accordance with relevant accounting guidance an allowance for loan losses is recorded when (i) available information as of each balance sheet date indicates that it is probable a loss has occurred in the portfolio and (ii) the amount of the loss can be reasonably estimated. Actual loan losses are then charged against the allowance when management believes that uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Significant judgment is required in determining reserve balances for the performing loan portfolio, including estimates of the likelihood of default and lease rejection given the credit characteristics of the tenant, and estimates of stressed collateral values and potential bankruptcy claim recoveries. These estimates are highly subjective and could differ materially from actual results. As of September 30, 2012, the Company has a general loan loss reserve of \$500. See Note 4.

The asset-specific component of the loan loss impairment analysis relates to specific loans where the Company has deemed it probable that it will not be able to collect all amounts due according to the contractual terms of the loan. Any resulting loan specific loss is measured based on the present value of expected future cash flows from the loan or the fair value of the loan collateral, if the loan is collateral dependent. Significant judgment is required in determining any resulting loan specific loss, including factors such as the status of the loans (i.e., current or actual or expected payment or other defaults), the credit quality of the underlying tenants, the present value of expected future cash flows on the loans, the fair value of any collateral, and the amount and status of any senior debt. These estimates are highly subjective and could differ materially from actual results. The Company's accounting policy is to continue to accrue interest income on specific impaired loans as long as it concludes it is likely to collect it. As of September 30, 2012, the Company did not have any asset-specific loan loss reserves.

#### Commercial Mortgage-Backed Securities

The Company classifies all of its securities investments as "available for sale" for financial accounting purposes. Under GAAP, securities classified as "available for sale" are carried on the Consolidated Balance Sheet at fair value with the net unrealized gains or losses included in Accumulated Other Comprehensive Income (Loss), a component of Stockholders' Equity on the Company's Consolidated Balance Sheet.

Any premiums or discounts on securities are amortized as a component of interest income using the effective interest method.

The Company estimates fair value on all securities investments quarterly based on a variety of inputs. Under applicable accounting guidance, securities where the fair value is less than the Company's cost are deemed "impaired," and, therefore, must be measured for "other-than-temporary impairment." If an impaired security (i.e., fair value below cost) is intended to be sold or required to be sold prior to expected recovery of the impairment loss, the full amount of the loss must be charged to earnings as other-than-temporary impairment. Otherwise, impairment losses on the security must be further analyzed for separation into two categories: (i) credit losses and (ii) losses due to factors other than credit. The portion which is considered credit loss is charged to earnings as other-than-temporary impairment. The portion which is due to other factors is not charged to earnings. Also, if the security is classified as available for sale, the non-credit portion of the impairment loss is charged to other comprehensive income (loss), a component of equity on the Company's Consolidated Balance Sheet.

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except per share amounts; totals may not add due to rounding)

September 30, 2012 (unaudited)

In estimating credit or other-than-temporary impairment losses, management considers a variety of factors including (1) the financial condition and near-term prospects of the credit, including credit rating of the security and the underlying tenant and an estimate of the likelihood, amount and expected timing of any default, (2) whether the Company expects to hold the investment for a period of time sufficient to allow for anticipated recovery in fair value, (3) the length of time and the extent to which the fair value has been below cost, (4) current market conditions, (5) expected cash flows from the underlying collateral and an estimate of underlying collateral values, and (6) subordination levels within the securitization pool. These estimates are highly subjective and could differ materially from actual results. The Company had no other-than-temporary impairment losses on securities charged to the Statement of Operations during the nine months ended September 30, 2012. The Company had \$48 of other-than-temporary impairment losses on securities charged to the Statement of Operations during the nine months ended September 30, 2011.

#### Deferred Fees and Costs

In connection with its leasing efforts, the Company may incur primarily two types of costs: (i) allowances paid to the tenant or on its behalf for the construction of leasehold improvements, or tenant improvement allowances, and (ii) commissions paid to leasing brokers, or leasing commissions. Tenant improvement allowances are initially capitalized as part of "Construction in progress" and then transferred to "Building and improvements" at completion and depreciated on a straight-line basis over periods not exceeding 40 years. Leasing commissions are capitalized as "Deferred leasing costs" and amortized on a straight-line basis over the term of the related lease.

In accordance with applicable accounting guidance, the Company defers the recognition of fees and expenses associated with the origination of its loans held for investment. These items include lender fee income, rate lock income, direct loan origination costs, certain legal expenses, insurance costs, rating agency fees and certain other expenses. Deferred fees and costs are recognized as an adjustment to the effective yield over the life of the related asset.

The Company also defers the recognition of expenses associated with the issuance of its debt obligations. These items include placement fees, lender fees, legal expenses, broker fees and certain other expenses. Deferred debt issuance costs are recognized as an adjustment to the effective financing rate over the term of the related debt obligation. Upon the retirement of the related debt obligation, any unamortized debt issuance costs are charged off as a component of gain or loss on extinguishment of debt.

Costs incurred in connection with debt obligations that have been modified or restructured are subject to the provisions of FASB ASC 470-50, Debt -- Modification and Extinguishment. If the terms of the modified debt instrument are deemed to be substantially different (i.e., a 10 percent or greater difference in the present value of cash flows between instruments), the original debt is deemed extinguished and all unamortized financing costs associated with the extinguished debt are charged to earnings in the current period. If the cash flows are deemed to be not substantially different, the original debt is deemed modified and the unamortized financing costs and any additional costs between the borrower and lender in connection with the modification are capitalized and amortized into interest expense over the remaining term of the related debt instrument, and other related costs of the modification are expensed.

### Risk Management Transactions

The Company may enter into risk management transactions as part of its overall portfolio financing strategy. These transactions are intended to manage the Company's exposure to changes in interest rates associated with its expected future debt issuances. The Company is not currently a party to any risk management transactions. It has been party to risk management transactions in the past and these transactions impact the Company's current results through amortization of the effective portion under GAAP of the realized gains and losses on these transactions into interest expense on the Company's Consolidated Statement of Operations. See Note 11.

### Cash and Cash Equivalents

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

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except per share amounts; totals may not add due to rounding)

September 30, 2012 (unaudited)

### Revenue Recognition

The Company recognizes rental revenue on real estate on a straight-line basis over the non-cancelable term of the lease. The excess of straight-line rents over base rents under the lease is included in "Accrued rental income" on the Company's Consolidated Balance Sheet and any excess of base rents over the straight-line amount is included as "Deferred rental income" on the Company's Consolidated Balance Sheet. The Company's leases also generally require the tenants to pay directly or reimburse the Company for occupancy and operating costs of the properties, or in certain cases reimburse the Company for increases in certain operating costs and real estate taxes above their base year costs. The Company recognizes such income in the period the related expenses are incurred.

Interest income from loans, securities, and structuring fees receivable is recognized on the accrual basis of accounting. Interest income from securities (including interest-only strips) is recognized over the life of the investment using the effective interest method. The cost basis of interest-only strips is adjusted to reflect any prepayments from underlying assets, using the initial yield-to-maturity at the purchase date. The Company has adopted the cost-recovery method, in which all receipts are applied to reduce the Company's cost basis, on a limited number of its securities investments.

On occasion, the Company may consider a loan to be non-performing and place the loan on non-accrual status when there is sufficient doubt as to the ultimate ability to collect interest on the loan. While on non-accrual status, the loan is accounted for on either a cash basis, in which case interest income is recognized only upon actual receipt, or on a cost-recovery basis based upon management's judgment as to the collectibility of the investment.

### Income Taxes

CapLease has made an election to qualify, and believes it is operating so as to qualify, as a REIT for federal income tax purposes. As such, it will generally not be subject to federal income tax on that portion of its taxable income that is distributed to stockholders if it distributes at least 90% of its taxable income to its stockholders by prescribed dates and complies with various other requirements. From time to time, the Company may conduct a portion of its business through a taxable REIT subsidiary ("TRS"), and the income from the activities of the TRS is subject to federal and state taxation at the applicable corporate rates.

### Earnings per Share

As required by GAAP, the Company presents both basic and diluted earnings per share ("EPS"). Basic EPS excludes dilution and is computed by dividing net income (loss) allocable to common stockholders by the weighted average number of shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock, where such exercise or conversion would result in a lower EPS amount. The Company's computation of diluted earnings per share does not include shares of common stock that may be issued in the future upon conversion of the convertible senior notes issued in October 2007, as the impact would not be dilutive. The number of weighted average common shares not included was 3,093,759 for each of the three and nine months ended September 30, 2012, and 3,093,759 for each of the three and nine months ended September 30, 2011.



## CapLease, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except per share amounts; totals may not add due to rounding)

September 30, 2012 (unaudited)

The following summarizes the Company's EPS computations for the three and nine months ended September 30, 2012 and September 30, 2011 (in thousands, except per share amounts):

	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Net loss allocable to common stockholders	\$ (1,252 )	\$ (14,797 )	\$ (9,689 )	\$ (22,787 )
Weighted average number of common shares outstanding, basic and diluted	66,767	67,615	66,616	64,238
Loss per share, basic and diluted	\$ (0.02 )	\$ (0.22 )	\$ (0.15 )	\$ (0.35 )
Non-vested shares included in weighted average number of shares outstanding above	1,520	1,617	1,520	1,617

## Recently Issued Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board ("FASB") issued new accounting guidance ASU 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs, which amends various sections of Accounting Standards Codification ("ASC") 820 and changes the wording used to describe the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements in order to improve consistency in the application and description of fair value between U.S. GAAP and International Financial Reporting Standards ("IFRS"). ASU 2011-04 clarifies how the concepts of highest and best use and valuation premise in a fair value measurement are relevant only when measuring the fair value of nonfinancial assets and are not relevant when measuring the fair value of financial assets or of liabilities. In addition, the guidance expanded the disclosures for the unobservable inputs for Level 3 fair value measurements, requiring quantitative information to be disclosed related to (1) the valuation processes used, (2) the sensitivity of the fair value measurement to changes in unobservable inputs and the interrelationships between those unobservable inputs, and (3) use of a nonfinancial asset in a way that differs from the asset's highest and best use. The revised guidance is effective for interim and annual periods beginning after December 15, 2011 and early application by public entities is prohibited. ASU 2011-04 is to be applied prospectively. The Company's adoption of this ASU for the reporting period ended March 31, 2012, as required, did not have a material effect on the Company's consolidated financial statements.

In June 2011, the FASB issued new accounting guidance ASU 2011-05, Presentation of Comprehensive Income, which amends various sections of ASC 220 and allows an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in ASU 2011-05 do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net



income. ASU 2011-05 should be applied retrospectively. For public entities, the amendments in ASU 2011-05 are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company elected early adoption of this ASU for the reporting period ended December 31, 2011, as permitted by the ASU. The Company's adoption of this ASU did not have a material effect on the Company's consolidated financial statements.

In December 2011, the FASB issued new accounting guidance ASU 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standard Update No. 2011-05, which amends various sections of ASC 220-10. The amended sections indefinitely defer the effective date of the presentation of reclassification adjustments out of accumulated other comprehensive income on the components of net income and other comprehensive income, which ASU 2011-05 would require. All other requirements of ASU 2011-05 are unaffected by this new guidance. For public entities, the amendments in ASU 2011-12 are effective concurrent with ASU 2011-05, for fiscal years and interim periods within those years, beginning after December 15, 2011. The Company elected to adopt this ASU for the reporting period ended December 31, 2011, as it is required to be adopted concurrently with ASU 2011-05. The Company's adoption of this ASU did not have a material effect on the Company's consolidated financial statements.

## CapLease, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except per share amounts; totals may not add due to rounding)

September 30, 2012 (unaudited)

In December 2011, the FASB issued new accounting guidance ASU No. 2011-11, Balance Sheet (ASC Topic 210): Disclosures about Offsetting Assets and Liabilities. ASU No. 2011-11 creates new disclosure requirements about the nature of an entity's rights of setoff and related arrangements associated with its financial instruments and derivative instruments. The changes to the ASC as a result of this update are effective for periods beginning on or after January 1, 2013 (January 1, 2013 for the Company) and must be shown retrospectively for all comparative periods presented. This guidance requires new disclosures only, and will have no impact on the Company's consolidated financial statements.

In December 2011, the FASB issued new accounting guidance ASU No. 2011-10, Derecognition of in Substance Real Estate – a Scope Clarification, which amends ASC Topic 360, Property, Plant and Equipment. ASU No. 2011-10 states that when an investor ceases to have a controlling financial interest in an entity that is in-substance real estate as a result of a default on the entity's nonrecourse debt, the investor should apply the guidance under ASC Subtopic 360-20, Property, Plant and Equipment – Real Estate Sales to determine whether to derecognize the entity's assets (including real estate) and liabilities (including the nonrecourse debt). The changes to the ASC as a result of this update are effective prospectively for deconsolidation events occurring during fiscal years, and interim periods within those years, beginning on or after June 15, 2012 (January 1, 2013 for the Company). Adoption of this guidance will not impact the Company's consolidated financial statements.

In July 2012, the FASB issued new accounting guidance ASU 2012-02, Intangibles – Goodwill and Other (Topic 250): Testing Indefinite-Lived Intangible Assets for Impairment, which amends various sections of ASC 350. The amendments update guidance with respect to annual impairment testing of indefinite-lived intangible assets. The standards update is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, and early adoption is permitted. Adoption of this guidance is not expected to impact the Company's consolidated financial statements.

## Reclassifications

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

## 3. Real Estate Investments

Real estate held for investment and related intangible liabilities consisted of the following at September 30, 2012 and December 31, 2011:

	Sep 30, 2012 Unaudited	Dec 31, 2011
Real estate investments:		
Land	\$ 209,909	\$ 203,184
Building and improvements	1,348,495	1,304,655
Construction in progress, land	5,742	2,345
Construction in progress, building and improvements	30,466	6,277

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Intangible assets	162,719	165,963
Less: Accumulated depreciation and amortization	(300,047 )	(280,898 )
Real estate investments, net	\$ 1,457,284	\$ 1,401,526
<b>Intangible liabilities on real estate investments:</b>		
Intangible liabilities	\$ 47,908	\$ 47,908
Less: Accumulated amortization	(14,329 )	(12,689 )
Intangible liabilities on real estate investments, net	\$ 33,579	\$ 35,219

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except per share amounts; totals may not add due to rounding)

September 30, 2012 (unaudited)

“Construction in progress, building and improvements” in the above table includes \$443 of capitalized interest on development properties.

Except for the Vitamin Shoppe Industries development project described below, the Company did not make any real estate acquisitions during the quarter ended September 30, 2012. In addition to the Vitamin Shoppe development project, the Company also continued to fund the construction of the office building for Cimarex Energy Co. described below during the quarter ended September 30, 2012.

The Company sold one owned property investment (the vacant Johnston, Rhode Island property) during the nine months ended September 30, 2012. See Note 6.

#### Lease Extensions

During March 2012, the Company entered into a five year lease extension for the 1,045,153 square foot warehouse property located in Breinigsville, Pennsylvania and leased to a subsidiary of Nestlé Holdings, Inc. The lease extension commences January 1, 2013 and the rental rate is \$4.40 per square foot increasing 3% per annum.

During April 2012, the Company entered into a five year lease extension for the 751,021 square foot warehouse property located in Lathrop, California with the current subtenant at the property, Del Monte Corporation. The lease extension commences January 1, 2013 and the rental rate is \$3.32 per square foot increasing 2.5% per annum.

The Company has entered into two separate leases with the United States Government with respect to the approximately 191,000 square feet of space occupied by the National Institutes of Health at the office building located in North Bethesda, Maryland. Both leases were scheduled to mature in May 2012, but the tenant has remained in occupancy and has requested a lease extension for all such space for an additional 18 months (until November 30, 2013). The primary lease is administered by the General Services Administration (on behalf of the Government) and relates to approximately 164,000 square feet. Such lease has now been extended until November 30, 2013. The other lease is being administered by the National Institutes of Health and relates to approximately 27,000 square feet of space. That lease has now been extended until December 31, 2012, and the Company has been advised that the National Institutes of Health is in the process of obtaining approval of the General Services Administration to the full 18 month lease extension until November 30, 2013.

#### Development Activities

During August 2012, the Company agreed to construct a distribution warehouse on a build-to-suit basis for Vitamin Shoppe Industries, Inc. with an estimated total investment of \$21,698. Construction activity and funding of the project commenced during the third quarter of 2012. The Company will fund all of the project costs from cash on hand and other sources of available liquidity.

During July 2011, the Company entered into a joint venture that is developing a 17 story office building primarily on a build-to-suit basis for Cimarex Energy Co. with an estimated total investment of \$55,000. Construction activity and funding of the project commenced during the third quarter of 2011. The Company is obligated to fund and has funded

approximately one-half of the costs of the project, with the other half of the project costs to be funded by Bank of Oklahoma (BOK) pursuant to a loan agreement it has entered into with the joint venture entity. As of September 30, 2012, BOK had advanced \$6,240 to the joint venture pursuant to the loan agreement. See Note 9. The Company owns a 99% ownership interest in and consolidates the joint venture for financial accounting purposes.

## CapLease, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except per share amounts; totals may not add due to rounding)

September 30, 2012 (unaudited)

The table below details the Company's investment in the above development projects as of September 30, 2012. The information included in the table below represents management's estimates and expectations at September 30, 2012 which are subject to change. The Company's disclosures regarding certain projections or estimates of completion dates may not reflect actual results.

Location	Tenant	Property Type	Approximate Square Feet	Lease Term (years)	Investment through 9/30/12	Estimated Remaining Investment	Estimated Total Investment	Estimated Completion Date
Ashland, Virginia	Vitamin Shoppe Industries, Inc.	Warehouse	312,000	15 (1)	\$ 4,478	\$ 17,226	\$ 21,698	Q2 2013
Tulsa, Oklahoma	Cimarex Energy Co.	Office Building	324,000	12 (2)	\$ 34,350	\$ 21,072 (3)	\$ 55,000 (4)	Q1 2013

- (1) The lease is in force and rent and the 15 year lease term will commence upon substantial completion of the building and the satisfaction of certain other conditions.
- (2) The lease is in force and rent will commence as building floors are completed and delivered to the tenant and the 12 year lease term will commence upon completion and delivery of all building floors to the tenant.
- (3) The Company has entered into a construction/term loan with BOK pursuant to which BOK will fund the remaining investment. Upon completion of construction, up to \$31,000 is expected to have been funded from borrowings under the loan agreement with BOK. See Note 9.
- (4) Interest and fees the Company will earn during the construction period are expected to reduce the total investment to \$53,000.

The amount of the "Investment" as of September 30, 2012, includes capitalized interest of \$443, including imputed interest on equity funded by the Company in accordance with GAAP of \$6 for the Vitamin Shoppe property and \$422 for the Cimarex property. The "Estimated Remaining Investment" and "Estimated Total Investment" are based on project budgets and/or purchase prices and therefore do not include any amounts of imputed interest under GAAP.

## Straight-Line Rent Adjustment

As described under "Revenue Recognition" in Note 2 above, the Company recognizes rental revenue from its owned properties on a straight-line basis as required by relevant accounting guidance. The impact of the straight-line rent adjustment on rental revenue is recorded on the Company's Consolidated Balance Sheet through accrued rental income and deferred rental income. Amounts for accrued rental income and deferred rental income as of September 30, 2012 and December 31, 2011, were as follows:

Sep 30, 2012	Dec 31, 2011
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	Unaudited	
Accrued Rental Income	\$ 34,575	\$ 41,387
Deferred Rental Income	4,451	2

Accrued rental income is included in “Other assets” on the Company’s Consolidated Balance Sheet. See Note 8.  
Deferred rental income is included in “Accounts payable and other liabilities” on the Company’s Consolidated Balance Sheet. See Note 10.

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September 30, 2012 (unaudited)

### Depreciation and Amortization Expense

Depreciation expense and amortization of intangible assets and liabilities on real estate investments for the three and nine months ended September 30, 2012 and September 30, 2011, were as follows:

	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Depreciation on real estate (included in depreciation and amortization expense)	\$8,574	\$7,965	\$24,930	\$23,427
Amortization of in-place leases (included in depreciation and amortization expense)	3,479	3,592	10,653	10,785
Amortization of above-market leases (included as a reduction of rental revenue)	319	361	1,027	1,082
Amortization of below-market leases (included as an increase to rental revenue)	547	547	1,640	1,640

As of September 30, 2012, the Company's weighted average amortization period on intangible assets was 7.7 years, and the weighted average amortization period on intangible liabilities was 25.3 years.

Scheduled amortization on existing intangible assets and liabilities on real estate investments as of September 30, 2012, was as follows:

	Intangible Assets	Intangible Liabilities
2012	\$3,798	\$547
2013	10,133	2,051
2014	9,776	1,954
2015	9,116	1,678
2016	7,530	1,614
Thereafter	22,743	25,736
Total	\$63,096	\$33,579

### Owned Property Investment and Financing Strategy

All of the Company's owned properties are subject to financing and have been pledged as collateral to the Company's lender that has provided the applicable financing. Many of these properties are owned and financed on a long-term basis with fixed rate, non-recourse debt. Each property is owned through a separate and distinct special purpose entity, or SPE, with the property and the related lease or leases on the property generally representing the sole assets of the SPE and the sole collateral available to the Company's lender in the event the Company defaults on the debt that finances the property. Also see Note 9. Certain of the Company's owned properties are pledged to Wells Fargo Bank, N.A., as lender under the June 2012 revolving credit agreement described at Note 9, to secure the Company's



borrowings from time to time outstanding thereunder. These properties are otherwise unencumbered and the related debt can be repaid and the lender's lien released at any time without payment of a penalty or premium to the lender.

## CapLease, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except per share amounts; totals may not add due to rounding)

September 30, 2012 (unaudited)

## 4. Loans Held for Investment

Loans held for investment at September 30, 2012 and December 31, 2011, are summarized in the following table. These investments consist predominantly of mortgage loans on properties subject to leases to investment grade tenants. As of September 30, 2012, the weighted average credit rating of the underlying tenants was BBB from Standard & Poor's. As of September 30, 2012, none of the Company's loans held for investment were on non-accrual status or past due 90 days or more.

	Sep 30, 2012 Unaudited	Dec 31, 2011
Principal	\$32,960	\$37,622
Discount	(3,829 )	(3,913 )
Cost basis	29,131	33,709
Allowance for loan losses	(500 )	(500 )
Carrying amount of loans	28,631	33,209
Deferred origination fees, net	(62 )	(70 )
Total	\$28,569	\$33,139

As of each of September 30, 2012 and December 31, 2011, the Company's loan investments carried interest rates ranging from 5.28% to 9.32%. At September 30, 2012 and December 31, 2011, the weighted average effective interest rate on the Company's loan investments, as measured against its cost basis, was 7.0% and 7.3%, respectively.

The Company's loan portfolio is comprised primarily of fully amortizing or nearly fully amortizing first mortgage loans on commercial real estate leased to a single tenant. Payments of debt service on the Company's loans is, in substantially all cases, funded directly by rent payments typically paid into a lockbox account by the underlying tenant. Therefore, the Company's monitoring of the credit quality of its loans held for investment is focused primarily on an analysis of the tenant, including review of tenant credit ratings (including changes in ratings) and other measures of tenant credit quality, trends in the tenant's industry and general economic conditions, and an analysis of measures of collateral coverage, such as an estimate of the loan's loan-to-value (LTV) ratio (principal amount outstanding divided by estimated value of the property) and its remaining term until maturity.

The following table is a summary of the Company's loans held for investment by credit category with the credit ratings of the underlying tenants presented as of each applicable balance sheet date:

Credit rating (1)	Carry Value	
	9/30/12 (unaudited)	12/31/11
Investment grade rating of A- or A3 and above	\$5,320	\$16,664
Investment grade rating of below A- or A3	19,959	9,239
Non-investment grade rating	3,852	7,806
General loan loss reserve	(500 )	(500 )
	\$28,631	\$33,209

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

As of September 30, 2012, the Company has a general loan loss reserve of \$500, reflecting management's estimate of losses that have probably occurred in its mortgage loan portfolio. The loan loss reserve was established at December 31, 2008, and to date the Company has not had any actual losses charged against the allowance.

During the nine months ended September 30, 2012, the Company received net proceeds of \$709 in satisfaction of the outstanding balance of its loan to a franchise lending joint venture. The amount received is included in "Gain on investments, net" in the Company's Consolidated Statement of Operations. The Company previously recorded aggregate losses of \$1,432 related to this investment, including \$444 during the quarter ended June 30, 2009 and \$988 during the quarter ended June 30, 2011.

## CapLease, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except per share amounts; totals may not add due to rounding)

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## 5. Commercial Mortgage-Backed Securities

As of September 30, 2012, the Company classifies all of its commercial mortgage-backed securities as “available for sale” for financial accounting purposes and carries those securities on the Consolidated Balance Sheet at fair value with the net unrealized gains or losses included in Accumulated Other Comprehensive Income (Loss), a component of Stockholders’ Equity on the Company’s Consolidated Balance Sheet.

A detailed schedule of the Company’s securities investments at September 30, 2012 follows:

Description	Face Amount (1)		Cost Basis		Fair Value	
	Sep 30, 2012 Unaudited	Dec 31, 2011	Sep 30, 2012 Unaudited	Dec 31, 2011	Sep 30, 2012 Unaudited	Dec 31, 2011
Certificated Mortgage Loan (with Alcatel-Lucent USA Inc. as tenant in Highlands Ranch, CO) (rated B)	\$23,487	\$24,527	\$23,741	\$24,818	\$21,422	\$20,648
Certificated Mortgage Loan (with CVS Corporation as tenant / multi-property) (rated BBB+)	16,382	16,867	16,382	16,867	18,586	17,410
Certificated Mortgage Loan (with Koninklijke Ahold, N.V. as tenant / multi-property) (rated BBB)	6,546	7,489	6,616	7,578	7,497	8,395
BACM 2006-4, Class H (rated D)	4,000	4,000	–	–	40	800
BACMS 2002-2, Class V-1 (7-Eleven, Inc.) (rated AA-)	699	656	606	555	607	555
BACMS 2002-2, Class V-2 (Sterling Jewelers) (not rated)	1,067	1,001	905	828	908	828
CALFS 1997-CTL1, Class D (rated B-)	2,704	3,000	2,704	3,000	2,481	1,200
CMLBC 2001-CMLB-1, Class H (rated B-)	11,907	11,907	7,276	7,139	4,167	2,639
CMLBC 2001-CMLB-1, Class J (rated D)	6,383	6,383	461	756	766	672
NLFC 1999-LTL-1, Class X (IO) (rated AAA)	3,584	3,916	3,584	3,916	3,429	2,533
CapLease CDO 2005-1, Class A (rated BBB+)	–	2,661	–	2,326	–	2,345
CapLease CDO 2005-1, Class B (rated BBB-)	–	2,000	–	1,400	–	1,410
<b>Total</b>	<b>\$76,760</b>	<b>\$84,405</b>	<b>\$62,274</b>	<b>\$69,181</b>	<b>\$59,904</b>	<b>\$59,435</b>

(1) Reflects face amount, or, in the case of the NLFC 1999-LTL-1 Class X (IO) bond, amortized cost.

All credit ratings in the above table are as of September 30, 2012.

The Company evaluated each of its securities for other-than-temporary impairment at September 30, 2012, and determined that no other-than-temporary impairment charges on its securities were appropriate.

Unrealized gains and losses on securities at September 30, 2012 and December 31, 2011, included as a component of Other Comprehensive Income (Loss) on the Company's Consolidated Balance Sheet, consisted of the following, and did not include any other-than-temporary impairment charges:

	Sep 30, 2012 Unaudited	Dec 31, 2011
Unrealized gains on securities available for sale	\$3,433	\$2,189
Unrealized losses on securities available for sale	(5,803 )	(11,936 )

The following table summarizes the Company's securities in an unrealized loss position as of September 30, 2012.

	Aggregate Fair Value	Aggregate Unrealized Loss	Number of Securities
In unrealized loss position less than 12 consecutive months	\$3,429	\$ 155	1
In unrealized loss position 12 or more consecutive months	\$28,071	\$ 5,649	3

Credit ratings on the 3 securities in a continuous unrealized loss position for more than 12 months as of September 30, 2012, range from B to B- with a weighted average of B and those securities have a weighted average maturity of approximately 6.2 years. The Company believes that none of the unrealized losses on investment securities are other-than-temporary because management expects the Company will receive all contractual principal and interest related to these investments. In addition, the Company did not have the intent to sell the securities or believe it would be required to sell them as of September 30, 2012.

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At September 30, 2012 and December 31, 2011, the weighted average effective interest rate (yield to maturity on adjusted cost basis) on securities was approximately 8.3% and 8.4%, respectively.

6. Assets Sold and Discontinued Operations

Nine Months Ended September 30, 2012

The Company sold the following investments during the nine months ended September 30, 2012.

During July, the Company sold two securities investments. The \$2,379 face amount of Class A bonds and \$2,000 face amount of Class B bonds in the CapLease 2005 CDO transaction were sold for total sales proceeds of \$3,744, and the Company recognized a gain on investment during the quarter ended September 30, 2012 of \$300. The gain is included as a component of "Gain on investments, net" in the Company's Consolidated Statement of Operations. The aggregate carrying amount of the securities sold was \$3,444 as of June 30, 2012.

During June, the Company sold the vacant Johnston, Rhode Island property to the former tenant at the building. As part of the sale, the Company also settled its litigation with the former tenant regarding its end-of-lease surrender obligations. The Company sold the property for a cash purchase price of \$9,750, before transaction expenses. The Company recognized a loss on such sale during the nine months ended September 30, 2012, of \$15,229. The loss is included as a component of discontinued operations under the caption "Gain (loss) on investments" on the Company's Consolidated Statement of Operations. The operating results of the sold property have been reclassified as a component of discontinued operations for all periods presented.

Nine Months Ended September 30, 2011

The Company sold the following investments during the nine months ended September 30, 2011.

During September 2011, the Company sold the assets and liabilities comprising its March 2005 CDO. For legal and accounting purposes, the sale resulted in the transfer by the Company of the various assets in the CDO trust along with the transfer of the obligation to pay debt service on the various CDO note classes. By virtue of the sale, the Company disposed of 44 loans held for investment with an aggregate carry value of \$151,317 as of June 30, 2011, and all or a portion of 12 securities available for sale with an aggregate carry value of \$46,203 and cost basis of \$59,087 as of June 30, 2011. The CDO sale generated cash proceeds net of debt repaid and excluding accrued interest of approximately \$30,217, and a net gain of \$3,910, before the charge-off of various deferred CDO costs totaling \$3,698, including deferred realized losses on cash flow hedges of \$2,333 and deferred issuance costs of \$1,240. The net gain of \$3,910 is included as a component of "Gain on investments, net" on the Company's Consolidated Statement of Operations, and the \$3,698 charge-off is included as "Gain (loss) on extinguishment of debt, net" on the Company's Consolidated Statement of Operations.

The Company sold two small owned property investments during the quarter ended September 30, 2011. During August 2011, the Company sold a retail property located in Pennsauken, New Jersey leased to Walgreen Co. for net cash proceeds of \$3,830 and recognized a gain of \$603. During September 2011, the Company sold another retail

property located in Simi Valley, California leased to McDonald's USA, LLC for net cash proceeds of \$2,000 and recognized a gain of \$822. The foregoing gains are included as a component of discontinued operations under the caption "Gain (loss) on investments" on the Company's Consolidated Statement of Operations. The operating results of the two sold properties have been reclassified as a component of discontinued operations for all periods presented.

During May 2011, the Company sold two long-term mortgage loans each backed by a single retail store leased to Home Depot USA, Inc., one store located in Chelsea, Massachusetts and the other located in Tullytown, Pennsylvania. The loans had an aggregate carry value of \$16,002, and generated sales proceeds of \$16,935. The Company's net gain on sale of the loans after estimated expenses of \$271 was \$662, and is included as a component of "Gain on investments, net" on the Company's Consolidated Statement of Operations.

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During May 2011, the Company sold one of its commercial mortgage-backed securities investments (WBCMT 2006-C27, Class C). The total of \$11,000 face amount of securities were sold at a dollar price of \$79.50 per \$100 of face amount, and the Company recognized a loss on investment during the nine months ended September 30, 2011 of \$2,397. The loss is included as a component of "Gain on investments, net" in the Company's Consolidated Statement of Operations. The aggregate carrying amount of the securities was \$11,142 as of March 31, 2011.

During February 2011, the Company sold two commercial mortgage-backed securities investments, both of which were secured by portions of the mortgage financing on the office building located at 180 Maiden Lane, New York, New York (WBCMT 2004-C15, Class 180ML-D and Class 180ML-E). The total of \$23,000 face amount of securities were sold at a dollar price of \$98 per \$100 of face amount, and the Company recognized a loss on investment during the nine months ended September 30, 2011 of \$490. The loss is included as a component of "Gain on investments, net" in the Company's Consolidated Statement of Operations. The aggregate carrying amount of these securities was \$22,236 as of December 31, 2010.

#### Discontinued Operations

Income (loss) from discontinued operations for the three and nine months ended September 30, 2012, is comprised of the operating results of the Company's former Johnston, Rhode Island office property which was sold during June 2012. Income (loss) from discontinued operations for the three and nine months ended September 30, 2011, is comprised of the operating results of the following assets that were sold during subsequent periods or during the nine months ended September 30, 2011.

- the Company's former Johnston, Rhode Island office property;
- the Company's former Hartford, Connecticut office property that was transferred to the lender in full satisfaction of the mortgage debt during December 2011;
- the Company's former Pennsauken, New Jersey retail property which was sold during August 2011; and
- the Company's former Simi Valley, California retail property which was sold during September 2011.

#### 7. Fair Value

The Company is required to disclose fair value information about all of its financial instruments (as defined under prevailing accounting guidance), whether or not these instruments are measured at fair value on the Company's Consolidated Balance Sheet. Under such guidance, substantially all of the Company's assets and liabilities other than its owned property investments are classified as financial instruments.

The Company estimates that the fair values of cash and cash equivalents, other assets, accounts payable and other liabilities, and dividends and distributions payable approximate their carrying values due to the short-term maturities of these items.



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The carrying amounts, notional or face amounts and estimated fair values of the Company's other financial instruments (as defined under GAAP) at September 30, 2012 and December 31, 2011, are as follows:

	Carrying Amount		Notional Amount		Estimated Fair Value	
	9/30/2012	12/31/2011	9/30/2012	12/31/2011	9/30/2012	12/31/2011
<b>Assets:</b>	<b>(unaudited)</b>		<b>(unaudited)</b>		<b>(unaudited)</b>	
Loans held for investment	\$28,631	\$33,209	\$32,960	\$37,622	\$32,792	\$35,120
Commercial mortgage-backed securities	59,904	59,435	76,760	84,405	59,904	59,435
<b>Liabilities:</b>						
Mortgages on real estate investments	\$986,629	\$972,924	\$985,261	\$969,004	\$1,053,701	\$1,002,247
Credit agreements	48,097	70,668	48,097	70,668	48,097	70,668
Secured term loan	76,100	88,142	76,100	88,142	73,684	78,302
Convertible senior notes	35,007	34,522	35,009	35,009	35,009	34,997
Other long-term debt	30,930	30,930	30,930	30,930	30,535	29,421

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The fair values indicated above are indicative of the interest rate and credit spread environment as of September 30, 2012 and December 31, 2011, respectively, and may not take into consideration the effects of subsequent interest rate, credit spread fluctuations, or changes in the ratings of the underlying tenants on the related leases. The methodologies used and key assumptions made to estimate fair values are as follows:

**Loans held for investment**—The fair value of the Company's fixed-rate loan portfolio is estimated with a discounted cash flow analysis, utilizing scheduled cash flows and discount rates estimated by management to approximate those that a willing buyer and seller might use.

**Commercial mortgage-backed securities**—The fair values of the securities reflect management's best estimate and require a considerable amount of judgment and assumptions. Management evaluates a variety of inputs and then estimates fair value based on those inputs. The primary inputs evaluated by management are broker quotations, collateral values, subordination levels, and liquidity of the security.

**Credit agreements**—Management believes that the stated interest rate (which floats based on short-term interest rates) approximates market rates (when compared to similar credit facilities with similar credit risk). As such, the fair value of these obligations is estimated to be equal to the outstanding principal amount.

**Mortgages on real estate investments and secured term loan** —The fair value of mortgages payable on real estate investments and the secured term loan is estimated using a discounted cash flow analysis, based on management's estimates of market interest rates. For mortgages where the Company has an early prepayment right, management also considers the prepayment amount to evaluate the fair value.

**Convertible senior notes** —The carry value of convertible senior notes reflects the impact of accounting guidance for the notes adopted as of January 1, 2009. See Note 9. The fair value is estimated using a discounted cash flow analysis, based on management's estimates of market interest rates, and indications of market yields, where available.

**Other long-term debt**—The fair value of the Company's other long-term debt is estimated using a discounted cash flow analysis, based on management's estimates of market interest rates.

On January 1, 2008, the Company adopted accounting guidance (codified at FASB ASC 820) that defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. The guidance does not impose any new requirements around which assets and liabilities are to be measured at fair value, and instead applies to asset and liability balances required or permitted to be measured at fair value under existing accounting pronouncements.

The guidance applies principally to the Company's securities investments, all of which are classified as available for sale for accounting purposes and, as such, are measured at fair value on a recurring basis on the Company's financial statements.

FASB ASC 820 establishes a valuation hierarchy based on the transparency of inputs used in the valuation of an asset or liability. Classification is based on the lowest level of inputs that is significant to the fair value measurement. The

valuation hierarchy contains three levels:

- Level 1 – Quoted prices are available in active markets for identical assets or liabilities at the reporting date. As of September 30, 2012, the Company has not classified any of its securities as Level 1.
- Level 2 – Pricing inputs other than quoted prices included within Level 1 that are observable for substantially the full term of the asset or liability. Level 2 assets include quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities that are not active; and inputs other than quoted prices that are observable, such as models or other valuation methodologies. As of September 30, 2012, the Company has classified two certificated mortgage loans (one with CVS Corporation as underlying tenant and the other with Koninklijke Ahold, N.V. as underlying tenant), as well as its sole remaining generic commercial mortgage-backed security investment (BACM 2006-4, Class H), as Level 2.

## CapLease, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

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September 30, 2012 (unaudited)

•Level 3 – Inputs reflect management’s best estimate of what market participants would use in pricing the asset or liability at the measurement date. These valuations require a considerable amount of judgment and assumptions. As of September 30, 2012, the Company has classified all of its securities that are backed primarily by single tenant loan collateral, other than the CVS and Ahold backed certificated loans discussed above, as Level 3. The valuation technique utilized by management is a discounted cash flow analysis. Management evaluates a variety of inputs to estimate the applicable discount rate. The primary inputs evaluated by management in estimating the discount rate are broker quotations (observable), collateral values (observable), subordination levels (observable), and liquidity of the security (unobservable). These inputs are the factors employed by management and to its knowledge other parties in determining where to price actual transactions. The Company’s securities available for sale that are classified as Level 3 are unique in that in most cases the Company owns the entire bond class. As a result, the broker quotes obtained by the Company reflect expected pricing rather than actual trades and may also reflect transactions in inactive markets. Therefore, the Company believes Level 3 is the appropriate classification in the fair value hierarchy for the Company’s available for sale securities.

The table below presents the fair value of the Company’s securities as of September 30, 2012, aggregated by the level in the fair value hierarchy within which those measurements fall.

	Quoted Prices in Active Markets for Identical Assets and Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at September 30,2012
<b>Assets</b>				
Securities available for sale	\$–	\$26,123	\$ 33,781	\$59,904

A 50 basis point (or 0.50%) change in the discount rate utilized to estimate fair value would result in a change in the fair value of securities that are classified as Level 3 of approximately \$673 as of September 30, 2012.

The following table summarizes the change in the fair value for Level 3 items for the three and nine months ended September 30, 2012 and September 30, 2011:

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Securities available for sale				
Beginning balance	\$37,246	\$74,647	\$32,829	\$13,797
Gains (losses) included in net income (loss):				
Included in interest income	72	100	228	259

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Gains (losses) included in other comprehensive income	544	253	6,713	120
Purchases, sales, issuances and settlements (net)	(4,081 )	(45,188 )	(5,989 )	(52,870 )
Transfers in (out) of Level 3	–	4,903	–	73,409
Ending balance	\$33,781	\$34,715	\$33,781	\$34,715

The transfers into Level 3 during the 2011 periods related to the Company’s reclassification of certain securities investments from the “held to maturity” to the “available for sale” classification for financial reporting purposes.

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## 8. Other Assets

Other assets as of September 30, 2012 and December 31, 2011, consisted of the following:

	Sep 30, 2012 Unaudited	Dec 31, 2011
Receivables and accrued interest	\$8,113	\$8,317
Prepaid expenses and deposits	1,899	1,381
Mortgage lender reserve accounts	31,781	17,393
Restricted cash	116	440
Amounts held by servicer	478	431
Accrued rental income	34,575	41,387
Debt issuance costs, net	5,865	3,889
Deferred leasing costs, net	4,790	1,483
Investment in statutory trust	930	930
Other	471	712
<b>Total</b>	<b>\$89,018</b>	<b>\$76,363</b>

Mortgage lender reserve accounts represent cash on deposit with the lender on the Company's owned properties to fund future debt service or other future property related costs such as taxes and insurance, repairs and maintenance, tenant improvement allowance and other re-tenanting costs.

## 9. Debt Obligations

### Credit Agreements

#### June 2012 Credit Agreement

During June 2012, the Company entered into a senior secured revolving credit agreement with Wells Fargo Bank, N.A. The agreement authorizes the Company to borrow up to \$100,000 from time to time from Wells Fargo Bank. This new credit agreement is the Company's primary short-term borrowing facility.

The agreement is for a three year term scheduled to mature on June 28, 2015, although the Company has an option to extend the term for one additional year subject to the payment of an extension fee and the satisfaction of certain other routine conditions. The Company is obligated to pay interest on its borrowings pursuant to the agreement at a floating rate of LIBOR plus 275 basis points. The Company may select a one month, three month or six month interest period for its LIBOR-based borrowings.

The current collateral pool consists of 16 real properties: the 11 Kroger grocery stores the Company owns located in Georgia, Tennessee and Kentucky, the two multi-tenant properties the Company owns in Omaha, Nebraska, the property the Company owns in Columbus, Ohio leased to Abbott Laboratories, the property the Company owns in Bloomington, Indiana leased to Baxter International, Inc., and the property the Company owns in Louisville, Kentucky leased to Michelin North America, Inc. Advance rates on these properties are generally equal to 60% or

65%, depending on the property, of the lender's as-is appraised value. The Company is authorized to add additional real estate properties to the collateral pool over time subject to the lender's approval of the property, and the Company expects to do so as it adds additional real estate properties and as mortgage debt matures on properties the Company currently owns. The Company is also authorized to remove assets provided it repays any associated borrowings at par.

The Company's borrowings are a recourse obligation, and CapLease has guaranteed all obligations of its various subsidiaries that act as borrowers under the agreement and own the real property that comprises the initial collateral pool.

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The Company made various customary representations and warranties and affirmative and negative covenants pursuant to the credit agreement, and agreed to various customary events of defaults. The Company also agreed to various financial covenants which it will be required to be in compliance with during the term of the credit agreement. The principal financial covenants are as follows:

- **Maximum Leverage:** The Company's total indebtedness divided by the capitalized value of its portfolio based on an 8.0% capitalization rate may not exceed 77% initially and declining to 70% over the agreement term.
- **Minimum Fixed Charge Coverage:** The Company's adjusted EBITDA (as defined in the credit agreement) divided by its fixed charges (basically interest expense, principal payments, net of principal received, and preferred dividends) may not be less than 100% initially increasing to 105% over the agreement term. For this purpose, EBITDA excludes non-recurring gains and losses and stock-based compensation and is adjusted to remove the impact of straight-line rents.
- **Minimum Debt Yield:** The Company's total net operating income (as defined in the credit agreement) divided by total liabilities may not be less than 9% initially increasing to 9.75% over the agreement term. For this purpose, total net operating income includes interest income on the Company's loans and securities and rental revenues are adjusted to remove the impact of straight-line rents.
- **Minimum Interest Coverage Ratio:** The Company's adjusted EBITDA divided by interest expense may not be less than 140% initially increasing to 150% over the agreement term.
- **Minimum Tangible Net Worth:** The Company's tangible net worth (basically stockholders' equity before accumulated depreciation and amortization) may not be less than 85% of such tangible net worth as of June 29, 2012 plus 80% of net proceeds of any future equity issuances.
- **Maximum Dividends:** Cash dividends to CapLease shareholders may not exceed the greater of (i) the amount required to maintain REIT status and avoid the payment of income or excise tax and (ii) 95% of adjusted funds from operations (as defined in the credit agreement). For this purpose, funds from operations excludes non-recurring gains and losses.

As of September 30, 2012, the Company was in compliance with the above financial covenants.

#### July 2010 Credit Agreement

During July 2010, the Company entered into an amended and restated senior secured revolving credit agreement with Wells Fargo Bank, N.A. In connection with the closing of the June 2012 credit agreement described above, the Company repaid \$51,353 of principal amount of borrowings under the July 2010 credit agreement, released the Kroger properties and Omaha properties from the collateral securing its borrowings under the July 2010 credit agreement, and reduced the size of the July 2010 credit agreement to \$12,000 (from \$140,000).



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As of September 30, 2012, this recourse borrowing facility authorized the Company to borrow up to \$12,000, with interest payable on the Company's borrowings at one-month LIBOR plus 275 basis points. The Company's borrowings were scheduled to mature during July 2013.

As of September 30, 2012, the Company was in compliance with all of the financial covenants and other obligations under the July 2010 credit agreement.

During October 2012, the Company utilized the proceeds from a new \$10,000 term loan from KeyBank National Association, to repay in full and terminate the July 2010 credit agreement with Wells Fargo Bank, N.A. See Note 20.

## CapLease, Inc. and Subsidiaries

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September 30, 2012 (unaudited)

Borrowings and collateral carry values related to the Company's credit agreements in place as of September 30, 2012 and December 31, 2011, were as follows:

	At September 30, 2012		At December 31, 2011	
	Borrowings (unaudited)	Collateral Carry Value (unaudited)	Borrowings	Collateral Carry Value
July 2010 Credit Agreement				
Loans held for investment	\$ 1,478	\$ 4,108	\$ 1,552	\$ 4,111
Intercompany mortgage loans on CapLease properties	7,538	14,474	66,887	94,020
Commercial mortgage-backed securities	1,025	3,429	2,230	2,533
Owned property	–	–	–	25,494
June 2012 Credit Agreement				
Owned properties	38,056	134,539	–	–
Total	\$ 48,097	\$ 156,550	\$ 70,669	\$ 126,158

For the three and nine months ended September 30, 2012 and September 30, 2011, the following interest rates applied with respect to the Company's borrowings under the credit agreements:

	For the three months ended September 30, 2012		For the nine months ended September 30, 2011	
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Weighted average effective financing rate	4.9	% 3.5	% 4.2	% 3.5
One-Month LIBOR rate	0.24	% 0.20	% 0.25	% 0.23

## CapLease, Inc. and Subsidiaries

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## Mortgage Notes on Real Estate Investments

The Company has financed many of its owned real properties with traditional first mortgage debt provided primarily through the commercial mortgage-backed securitization market. The Company's mortgage notes payable are summarized in the following table:

Property Description	Sep 30, 2012		Dec 31, 2011		Coupon	Effective Financing Rate (1)	Maturity Date
	Face Amount of Debt (unaudited)	Carry Value of Debt (unaudited)	Face Amount of Debt	Carry Value of Debt			
Abbott Laboratories, Columbus, OH	\$-	\$ -	\$5,080	\$5,080	5.40	% 6.1	% N/A
Abbott Laboratories, Waukegan, IL	14,155	14,155	14,440	14,440	5.11	% 5.2	% Aug 2015
Aetna Life Insurance Company, Fresno, CA	16,043	16,043	16,043	16,043	5.63	% 5.7	% Dec 2016
Allstate Insurance Company, Charlotte, NC	19,231	19,231	19,445	19,445	5.68	% 5.7	% Jan 2016
Allstate Insurance Company, Roanoke, VA	20,474	20,474	20,702	20,702	5.68	% 5.8	% Jan 2016
AMEC plc, Houston, TX	16,029	16,358	16,175	16,569	5.85	% 5.3	% Apr 2016
Aon Corporation, Glenview, IL	57,981	57,981	59,274	59,274	5.23	% 5.8	% Nov 2014
AT&T Services, Inc./MetroPCS Communications, Inc., Richardson, TX	20,625	20,625	-	-	4.60	% 4.8	% Jun 2022
Baxter International, Inc., Bloomington, IN	-	-	4,407	4,407	5.40	% 6.1	% N/A
Bunge North America, Inc., Fort Worth, TX	6,262	6,262	6,262	6,262	5.45	% 5.6	% May 2017
Cadbury Holdings Limited, Whippany, NJ	32,031	32,031	32,559	32,559	5.26	% 5.3	% Mar 2015
Cadbury Holdings Limited, Whippany, NJ	1,355	1,355	1,727	1,727	5.26	% 6.5	% Mar 2015
Capital One Financial Corporation, Plano, TX	18,915	18,915	19,344	19,344	5.24	% 5.3	% May 2013
Choice Hotels International, Inc., Silver Spring, MD	25,585	25,585	26,708	26,708	5.30	% 5.3	% May 2013
	6,240	6,240	-	-			Floats

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	LIBOR+300bps (4% floor)							
Cimarex Energy Company (Development Property), Tulsa, OK								Jul 2018
Cooper Tire & Rubber Company, Franklin, IN	17,442	17,442	17,690	17,690	5.54	%	5.8	% May 2021
County of Yolo, California, Woodland, CA	10,332	10,332	10,332	10,332	5.68	%	5.8	% Feb 2017
Crozer-Keystone Health System, Ridley Park, PA	2,741	2,741	2,964	2,964	5.40	%	6.0	% Apr 2019
CVS Corporation, Randolph, MA	7,359	7,359	7,601	7,601	5.40	%	6.4	% Jan 2014
Exelis, Inc. (formerly ITT Corporation), Herndon, VA	39,214	39,214	39,764	39,764	5.33	%	5.4	% Jun 2015
Exelis, Inc. (formerly ITT Corporation), Herndon, VA	2,429	2,429	2,995	2,995	5.33	%	6.4	% Jun 2015
Farmers Group, Inc., Simi Valley, CA	25,620	25,620	25,620	25,620	5.81	%	5.9	% Jan 2017
Farmers New World Life Insurance Company, Mercer Island, WA	29,630	29,630	29,889	29,889	5.69	%	5.7	% Jan 2016
General Motors Financial Company, Inc., Arlington, TX	26,269	26,078	26,672	26,454	5.28	%	5.5	% Sep 2017
Invesco Holding Co. Ltd., Denver, CO	43,700	43,700	43,700	43,700	6.03	%	6.1	% Jul 2016
Johnson Controls, Inc., Largo, FL	16,200	16,200	16,200	16,200	5.48	%	5.5	% Jan 2017
Koninklijke Ahold, N.V., Levittown, PA	13,649	13,649	13,820	13,820	6.05	%	6.1	% Jul 2016
Lowes Companies, Inc., Aliso Viejo, CA	40,841	40,841	41,299	41,299	5.10	%	5.4	% Jul 2015
Lowes Companies, Inc., New Orleans, LA	8,399	9,020	8,599	9,258	5.57	%	4.8	% Aug 2030
Lowes Companies, Inc., New Orleans, LA	7,517	7,925	7,702	8,135	5.32	%	4.7	% Aug 2030
Lowes Companies, Inc., New Orleans, LA	423	467	433	479	5.93	%	4.8	% Aug 2030
Nestle Holdings, Inc., Breinigsville, PA; Fort Wayne, IN; and Lathrop, CA	106,000	106,000	117,000	117,000	6.32	%	6.8	% Feb 2014
Omnicom Group, Inc., Irving, TX	12,229	12,229	12,472	12,472	5.24	%	5.3	% May 2013
Pearson Plc., Lawrence, KS	15,460	15,460	15,616	15,616	5.84	%	6.0	% May 2016
Praxair, Inc., The Woodlands, TX	22,440	22,440	–	–	3.70	%	3.9	% Aug 2022
Tiffany & Co., Parsippany, NJ	56,870	56,870	57,482	57,482	5.33	%	5.3	% Oct 2015
Time Warner Cable Enterprises LLC, Milwaukee, WI	17,500	17,500	17,500	17,500	5.55	%	5.6	% Dec 2016
	2,055	2,055	2,473	2,473	5.83	%	6.8	%

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Time Warner Cable Enterprises LLC, Milwaukee, WI									Dec 2015
Time Warner Cable Enterprises LLC, Milwaukee, WI	2,047	2,047	2,208	2,208	6.18	%	6.8	%	Dec 2016
TJX Companies, Inc., Philadelphia, PA	68,309	68,309	68,847	68,847	5.57	%	5.6	%	Mar 2016
T-Mobile USA, Inc., Nashville, TN	10,495	10,495	10,606	10,606	5.59	%	5.7	%	Dec 2016
United States Government (DEA), Birmingham, AL	10,795	10,795	10,922	10,922	5.23	%	5.4	%	Sep 2015
United States Government (EPA), Kansas City, KS	18,462	18,462	–	–	3.23	%	3.8	%	Mar 2023
United States Government (EPA), Kansas City, KS	–	–	18,395	20,806	7.57	%	5.3	%	N/A
United States Government (FBI), Albany, NY	10,137	10,137	10,137	10,137	5.50	%	5.7	%	Nov 2016
United States Government (FBI), Birmingham, AL	18,020	18,020	18,233	18,233	5.23	%	5.3	%	Sep 2015
United States Government (NIH), N. Bethesda, MD	56,700	56,700	57,908	57,908	5.32	%	5.6	%	Sep 2015
United States Government (SSA), Austin, TX	5,156	5,156	5,217	5,217	5.23	%	5.5	%	Sep 2015
United States Government (VA), Ponce, PR	3,546	3,614	4,062	4,154	7.30	%	6.4	%	Apr 2016
Walgreen Co., Portsmouth, VA	2,351	2,440	2,481	2,584	7.20	%	6.2	%	Jul 2018
	\$985,261	\$ 986,629	\$969,004	\$972,924					

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

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During October 2007, the lender on the Nestlé properties split the debt on these properties into a \$106,000 senior first mortgage note and an \$11,000 junior first mortgage note. During the nine months ended September 30, 2012, the Company repurchased the \$11,000 junior first mortgage note from a private investor. The Company repurchased the \$11,000 note for a purchase price (including transaction costs) of \$2,000. The Company recognized a gain of \$9,000 on the repurchase which is included in “Gain on extinguishment of debt, net” in the Company’s Consolidated Statement of Operations.

During August 2012, the Company extended the \$106,000 senior note on the Nestlé properties for up to five years inclusive of one 18-month extension option and two one year extension options. The face amount of the note and the note coupon of 6.32% were not modified by the extension. Pursuant to the extension option provisions of the note, the Company may not extend the loan maturity date beyond August 2015 unless it has fully leased the Fort Wayne, Indiana property. The extension option rights if exercised also require the Company to make the following principal payments on the note:

- \$7,500 during the first extension option term;
- \$7,500 during the second extension option term; and
- \$5,000 during the third extension option term.

Since the terms of the extended loan are deemed for financial accounting purposes to be not substantially different to the original loan, the Company accounts for the extension as a modification on its financial statements. See “Deferred Fees and Costs” under Note 2 above. Total transaction costs incurred in connection with the extension were \$1,626, including \$710 of fees paid to the lender to obtain the extension and expenses paid on the lender’s behalf which were added to debt issuance costs for the loan and increase the Company’s effective financing rate of the loan. The remaining \$916 of advisory costs related to the extension were charged to earnings in the current period and have been included in “Other expenses” in the Company’s Consolidated Statement of Operations.

During the nine months ended September 30, 2012, the Company repaid at par the outstanding mortgage debt on the properties owned in Columbus, Ohio (leased to Abbott Laboratories) and Bloomington, Indiana (leased to Baxter International, Inc.), and refinanced the mortgage debt on the property owned in Kansas City, Kansas (leased to the United States Government (EPA)). These transactions resulted in net gain on debt extinguishment of \$2,012, including primarily gain of \$2,392 on the reversal of the remaining unamortized balance of the fair value adjustment on the debt repaid on the EPA property, and losses of \$196 from the charge-off of deferred hedge and other costs associated with the debt repaid on all three properties. The net gain of \$2,012 is included as a component of “Gain on extinguishment of debt, net” in the Company’s Consolidated Statement of Operations. The Columbus, Ohio and Bloomington, Indiana properties were later pledged as part of the collateral securing the June 2012 revolving credit agreement with Wells Fargo Bank. See the discussion of this revolving credit agreement above in this Note 2.

The mortgage notes in the above table are non-recourse to the Company subject to limited non-recourse exceptions and are secured by the respective properties and an assignment of the relevant leases on the properties. See Note 3 regarding the separate and distinct nature of the Company’s SPEs. The Company’s book value before accumulated

depreciation and amortization on owned properties encumbered with mortgage debt aggregated \$1,582,405 at September 30, 2012, and \$1,483,528 at December 31, 2011.

The Company has classified the loan agreement related to the Tulsa, Oklahoma development project for Cimarex Energy Co. as a component of "Mortgages on real estate investments" on the Company's Consolidated Balance Sheet. The Company entered into the loan agreement with Bank of Oklahoma during July 2011, to provide construction financing of approximately one-half of the project costs related to the development of the property. See Note 3. Pursuant to the agreement, Bank of Oklahoma has agreed to fund up to \$24,000 of project costs beginning after the Company has funded an aggregate of \$24,000 to the project. During the quarter ended September 30, 2012, the Company fully funded its \$24,000 commitment and began drawing on the loan from Bank of Oklahoma. During the construction period, interest only will be payable by the Company to the lender each month at a rate equal to the prevailing one month LIBOR rate plus 300 basis points (subject to a 4.00% floor). As of September 30, 2012, the Company had drawn \$6,240 under the loan agreement with Bank of Oklahoma. For the three and nine months ended September 30, 2012, the weighted average effective financing rate on the loan agreement with Bank of Oklahoma was 4.0% and 4.0%, respectively.

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Upon completion of the project, the construction loan will automatically convert to a term loan of up to \$31,000 bearing interest at a rate equal to the prevailing one month LIBOR rate plus 275 basis points and maturing in July 2018. During the term loan period, in addition to monthly payments of interest, principal will also be payable by the Company to the lender based on a 25-year amortization period. Subject to customary non-recourse exceptions, the lender's recourse in the event of a default of the loan is limited to the property and the other assets of the Company's joint venture entity that owns the property.

## Secured Term Loan

During December 2007, the Company completed a secured term loan with KBC Bank, N.V. The Company transferred a pool of assets into a wholly-owned special purpose entity, called CapLease 2007-STL LLC, and issued debt to the lender secured by the assets in the pool. The Company retained all of the equity in the special purpose entity and, therefore, is entitled to all residual cash after the payment of scheduled principal and interest on the debt. The lender's debt is structured to be senior to the Company's equity. For example, all principal payments on the assets transferred to the SPE will be paid to the lender until the secured term loan is repaid in full. The Company is in a first loss position in the event of a payment default or loss on any of the SPE assets.

The interest coupon on the loan is fixed at 5.81% annually until the loan matures in January 2018. The Company's effective financing rate on the loan is approximately 6.0% annually (inclusive of hedge and closing costs). The loan is non-recourse to the Company, subject to limited non-recourse exceptions.

Amounts related to the secured term loan as of September 30, 2012, were as follows:

	Borrowings	Collateral Carry Value
Loans held for investment	\$16,073	\$25,023
Intercompany mortgage loans on CapLease properties	19,141	30,317
Commercial mortgage-backed securities	40,886	50,026
Total	\$76,100	\$105,366

## Convertible Senior Notes

During October 2007, CapLease issued \$75,000 principal amount of 7.50% convertible senior notes due 2027. The notes represent general unsecured recourse obligations of CapLease and rank equally in right of payment with all of its other existing and future obligations that are unsecured and unsubordinated. The notes are jointly and severally, fully and unconditionally guaranteed, on a senior unsecured basis by four of CapLease's subsidiaries, Caplease, LP, Caplease Debt Funding, LP, Caplease Services Corp. and Caplease Credit LLC.

As of September 30, 2012, CapLease had \$35,009 principal amount of convertible senior notes outstanding, as a result of repurchases aggregating \$39,991 principal amount of notes during the years ended December 31, 2008, December 31, 2009 and December 31, 2010. On October 1, 2012, CapLease repurchased another \$15,799 principal amount of



notes pursuant to the put right in the notes that allowed the holders to tender some or all of their notes back to CapLease during a 20 business day period that expired on September 27, 2012. The cash purchase price for the notes tendered was 100% of the principal amount of notes tendered. The October 2012 put right has now expired and the note holders' next put right will be on October 1, 2017. Beginning on October 5, 2012, CapLease has the right to redeem the notes in whole or in part, for cash at any time or from time to time. The redemption price will be 100% of the principal amount of the notes to be redeemed, plus any accrued and unpaid interest.

The notes bear interest at an annual fixed rate of 7.50% and are scheduled to mature on October 1, 2027, unless earlier converted, redeemed or repurchased. As of September 30, 2012, the Company's effective financing rate on the notes, which includes the effect of the commissions and other expenses associated with the issuance of the notes, was approximately 8.1%.

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## Notes to Consolidated Financial Statements

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For financial accounting purposes and because the notes may be converted into equity in the future, the Company is required to bifurcate the proceeds from the issuance of the notes between a liability component and an equity component and record interest expense on the liability component at the Company's estimated nonconvertible debt borrowing rate on the date of issue. The liability component is initially recorded at a discount from the principal amount of the notes and is subsequently accreted back to the principal amount over the expected useful life of the notes as interest expense at the estimated nonconvertible debt borrowing rate is recorded. The Company's estimated nonconvertible debt borrowing rate for financial accounting purposes was 10.2% and 10.2%, respectively, at September 30, 2012 and December 31, 2011.

The carry value of the equity component of the convertible senior notes was \$6,189 at each of September 30, 2012 and December 31, 2011, and is included as a component of "Additional paid in capital" on the Company's Consolidated Balance Sheet.

The Company recorded interest expense on the convertible senior notes for the three and nine months ended September 30, 2012 and September 30, 2011 as follows:

	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Interest expense paid or accrued at stated interest rate of 7.5%	\$657	\$657	\$1,963	\$1,969
Convertible senior notes issuance costs expensed as a component of interest expense	59	51	172	152
Interest expense at the nonconvertible debt incremental borrowing rate of 2.5%	164	149	485	439
Total convertible senior notes interest expense	\$880	\$857	\$2,620	\$2,560

The liability component of the convertible senior notes comprised the following amounts at September 30, 2012 and December 31, 2011:

	Sep 30, 2012 (Unaudited)	Dec 31, 2011
Convertible notes - principal	\$ 35,009	\$ 35,009
Unamortized debt discount	(2 )	(487 )
Convertible senior notes - net	\$ 35,007	\$ 34,522

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

The initial conversion rate for each \$1 principal amount of notes is 88.3704 shares of CapLease's common stock, which is equivalent to an initial conversion price of approximately \$11.32 per share. As of September 30, 2012, the if-converted value of the convertible senior notes does not exceed the principal amount of the notes. The initial conversion rate will be adjusted for certain events, including in the event CapLease makes any quarterly cash dividend in excess of \$0.20 per share.

#### Trust Preferred Securities

In December 2005, the Operating Partnership issued \$30,000 in aggregate principal amount of fixed/floating rate preferred securities through its wholly-owned subsidiary, Caplease Statutory Trust I. The trust preferred securities represent an unsecured subordinated recourse debt obligation of the Company and require quarterly interest payments calculated at a fixed interest rate equal to 7.68% per annum through January 30, 2016, and subsequently at a variable interest rate equal to LIBOR plus 2.60% per annum. The securities must be redeemed on January 30, 2036, and may be redeemed, in whole or in part, at par, at the Company's option, at any time. The Company's effective financing rate on the trust preferred securities, inclusive of deferred issuance costs, is approximately 8.3% per annum.

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September 30, 2012 (unaudited)

#### Scheduled Principal Payments on Debt Obligations

Scheduled principal amortization and balloon payments for all of the Company's outstanding debt obligations as of September 30, 2012, for the next five years and thereafter are as follows:

	Scheduled Amortization	Balloon Payments	Total
3 months ending December 31, 2012	\$ 9,302	\$35,009	\$44,311
2013	34,643	62,385	97,029
2014	31,141	166,379	197,520
2015	25,746	293,755	319,501
2016	18,116	303,544	321,660
Thereafter	44,350	151,028	195,377
<b>Total</b>	<b>\$ 163,297</b>	<b>\$1,012,100</b>	<b>\$1,175,397</b>

#### 10. Accounts Payable and Other Liabilities

Accounts payable and other liabilities as of September 30, 2012 and December 31, 2011 consisted of the following:

	Sep 30, 2012 Unaudited	Dec 31, 2011
Accounts payable and other liabilities	\$9,779	\$3,781
Accrued interest	5,232	5,014
Accrued expenses	4,313	4,689
Deferred rental income	4,451	2
Unearned rental income	4,280	3,885
<b>Total</b>	<b>\$28,055</b>	<b>\$17,371</b>

#### 11. Risk Management Transactions

As part of its financing strategy, the Company may use interest rate swap transactions to manage its exposure to interest rate fluctuations on assets not yet financed with long-term fixed rate debt. During the first nine months of 2012 and all of 2011, the Company had no open interest rate swap positions.

As of September 30, 2012, the Company had \$1,283 of net realized losses on derivatives deferred on the Company's Consolidated Balance Sheet as a component of Accumulated Other Comprehensive Income (Loss) related to prior interest rate swaps for certain of the Company's long-term debt issuances. Within the next twelve months, the Company estimates that \$543 of realized losses on derivatives will be reclassified to the Company's Consolidated Statements of Operations as additional interest expense.

The Company classifies the cash flows from derivatives as a financing activity on the Consolidated Statements of Cash Flows.

## 12. Commitments and Contingencies

The Company is committed to fund up to \$24,000 of project costs related to the Tulsa, Oklahoma development project described at Note 3 above. As of September 30, 2012, the Company had fully-funded this commitment. The Company is also committed to fund \$21,698 of project costs related to the Ashland, Virginia development project described at Note 3 above. As of September 30, 2012, the Company had funded \$3,078 of such commitment.

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The Company is involved from time to time in litigation arising in the ordinary course of business. The Company is not currently involved in any matter which management believes will have a material adverse effect on the Company's business, results of operations or financial condition. However, periodic settlements and/or professional or other fees and expenses related to any matter could have an adverse impact on our results of operations in the quarterly or annual period in which they are recognized.

As an owner of commercial real estate, the Company is subject to potential environmental costs. At September 30, 2012, the Company was not aware of any environmental concerns that would have a material adverse effect on the Company's business, results of operations or financial condition.

### 13. Stockholders' Equity

#### Authorized Capital Stock

CapLease's authorized capital stock consists of 500,000,000 shares of common stock, par value \$0.01 per share, and 100,000,000 shares of preferred stock, par value \$0.01 per share. As of September 30, 2012, CapLease had issued and outstanding 66,766,965 shares of common stock, 3,401,107 shares of 8.125% Series A cumulative redeemable preferred stock and 2,140,913 shares of 8.375% Series B cumulative redeemable preferred stock.

#### Terms of Series A Preferred Stock

The Series A preferred stock ranks, with respect to the payment of dividends and the distribution of assets in the event of CapLease's liquidation, dissolution or winding up, senior to CapLease's common stock and junior to all of the Company's existing and future indebtedness. The Series A preferred stock ranks pari passu with CapLease's 8.375% Series B cumulative redeemable preferred stock and any other future equity securities that CapLease may later authorize or issue that by their terms are on a parity with the Series A preferred stock.

Investors in the Series A preferred stock are entitled to receive cumulative cash distributions at a rate of 8.125% per annum of the \$25.00 liquidation preference per share (equivalent to \$2.03125 per annum per share). The annual dividend rate will increase to 9.125% if the Series A preferred stock is delisted from the New York Stock Exchange following a change of control of CapLease. Dividends on the Series A preferred stock are payable quarterly in arrears on or about the 15th day of January, April, July and October of each year.

If CapLease liquidates, dissolves or wind ups its operations, the Series A preferred stock holders will have the right to receive \$25.00 per share, plus all accrued and unpaid dividends (whether or not declared) to the date of payment. Holders of Series A preferred stock will be entitled to receive this liquidating distribution before CapLease distributes any assets to holders of its common stock or any other shares of stock that rank junior to the Series A preferred stock. The rights of holders of Series A preferred stock to receive their liquidation preference will be subject to the proportionate rights of each parity stock, including the Series B preferred stock, and preferential rights of the holders of any series of shares that are senior to the Series B preferred stock.

The Series A preferred stock does not have any stated maturity date and is not subject to any sinking fund or mandatory redemption provisions. CapLease may redeem the Series A preferred stock for cash at its option, in whole or from time to time in part, at a redemption price of \$25.00 per share, plus accrued and unpaid dividends (whether or not declared) to the redemption date.

Holders of Series A preferred stock generally have no voting rights. However, Series A preferred stock holders will have limited voting rights if CapLease fails to pay dividends on the Series A preferred stock for six or more quarterly periods (whether or not consecutive), or if CapLease issues shares of capital stock senior to the Series A preferred stock or makes changes to the terms of the Series A preferred stock that would be materially adverse to the rights of holders of Series A preferred stock.

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The Series A preferred stock is not convertible into or exchangeable for CapLease's common stock or any of the Company's other securities or property.

#### Terms of Series B Preferred Stock

The Series B preferred stock ranks, with respect to the payment of dividends and the distribution of assets in the event of CapLease's liquidation, dissolution or winding up, senior to CapLease's common stock and junior to all of the Company's existing and future indebtedness. The Series B preferred stock ranks pari passu with CapLease's 8.125% Series A cumulative redeemable preferred stock and any other future equity securities that CapLease may later authorize or issue that by their terms are on a parity with the Series B preferred stock.

Investors in the Series B preferred stock are entitled to receive cumulative cash distributions at a rate of 8.375% per annum of the \$25.00 liquidation preference per share (equivalent to \$2.09375 per annum per share). Dividends of the Series B preferred stock are payable quarterly in arrears on or about the 15th day of January, April, July and October of each year, and commenced on July 16, 2012.

If CapLease liquidates, dissolves or wind ups its operations, the Series B preferred stock holders will have the right to receive \$25.00 per share, plus all accrued and unpaid dividends (whether or not declared) to the date of payment. Holders of Series B preferred stock will be entitled to receive this liquidating distribution before CapLease distributes any assets to holders of its common stock or any other shares of stock that rank junior to the Series B preferred stock. The rights of holders of Series B preferred stock to receive their liquidation preference will be subject to the proportionate rights of each parity stock, including the Series A preferred stock, and preferential rights of the holders of any series of shares that are senior to the Series B preferred stock.

The Series B preferred stock does not have any stated maturity date and is not subject to any sinking fund or mandatory redemption provisions. CapLease may not redeem the Series B preferred stock prior to April 19, 2017, except upon a "Change of Control" (as defined below) and in limited circumstances related to CapLease's continuing qualification as a REIT. At any time on and after April 19, 2017, CapLease may, at its option, redeem the Series B preferred stock, in whole or from time to time in part, by paying \$25.00 per share, plus any accumulated and unpaid dividends to, but not including, the date of redemption.

Upon the occurrence of a Change of Control and subject to CapLease's special optional redemption right described below, each holder of Series B preferred stock will have the right to convert some or all of the shares of Series B preferred stock held by such holder (the "Change of Control Conversion Right") into a number of shares of CapLease's common stock per share of Series B preferred stock to be converted equal to the lesser of:

- the quotient obtained by dividing (1) the sum of the \$25.00 liquidation preference plus the amount of any accumulated and unpaid dividends to the conversion date by (2) the Common Stock Price (as defined below); and
- 11.9904 (the "Share Cap"), subject to certain adjustments.



The Share Cap is subject to pro rata adjustments for any share splits (including those effected pursuant to a distribution of shares of CapLease's Common Stock), subdivisions or combinations with respect to CapLease's common stock.

Upon such a conversion, the holders will be limited to a maximum number of shares of CapLease's common stock equal to the Share Cap multiplied by the number of shares of Series B preferred stock converted. If the Common Stock Price is less than \$2.085 (which is 50% of the per-share closing sale price of CapLease's common stock on April 16, 2012), subject to adjustment, the holders will receive a maximum of 11.9904 shares of the common stock per share of Series B preferred stock, which may result in a holder receiving value that is less than the liquidation preference of the Series B preferred stock.

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In addition to the optional redemption right after April 19, 2017 described above, CapLease has a special optional redemption right in connection with a Change of Control and holders of the Series B preferred stock will not have the Change of Control Conversion Right if CapLease elects to redeem the Series B preferred stock in connection with the Change of Control. CapLease may, at its option, redeem the Series B preferred stock, in whole or in part upon the occurrence of a Change of Control, by paying \$25.00 per share, plus any accumulated and unpaid dividends to, but not including, the date of redemption.

A “Change of Control” occurs when the following have occurred and are continuing:

- the acquisition by any person, including any syndicate or group deemed to be a “person” under Section 13(d)(3) of the Securities Exchange Act of 1934, as amended, of beneficial ownership, directly or indirectly, through a purchase, merger or other acquisition transaction or series of purchases, mergers or other acquisition transactions of shares of CapLease entitling that person to exercise more than 50% of the total voting power of all shares of CapLease entitled to vote generally in elections of directors (except that such person will be deemed to have beneficial ownership of all securities that such person has the right to acquire, whether such right is currently exercisable or is exercisable only upon the occurrence of a subsequent condition); and
- following the closing of any transaction referred to in the bullet point above, neither CapLease nor the acquiring or surviving entity has a class of common securities (or American Depositary Receipts representing such securities) listed on the New York Stock Exchange (the “NYSE”), the NYSE Amex Equities (the “NYSE Amex”) or the NASDAQ Stock Market (“NASDAQ”), or listed or quoted on an exchange or quotation system that is a successor to the NYSE, the NYSE Amex or NASDAQ.

The “Common Stock Price” will be: (1) the amount of cash consideration per share of CapLease’s common stock, if the consideration to be received in the Change of Control by the holders of such common stock is solely cash; and (2) the average of the closing prices for the common stock on the NYSE for the ten consecutive trading days immediately preceding, but not including, the effective date of the Change of Control, if the consideration to be received in the Change of Control by the holders of CapLease’s common stock is other than solely cash.

Holders of Series B preferred stock generally have no voting rights. However, Series B preferred stock holders will have limited voting rights if CapLease fails to pay dividends on the Series B preferred stock for six or more quarterly periods (whether or not consecutive), or if CapLease issues shares of capital stock senior to the Series B preferred stock or makes changes to the terms of the Series B preferred stock that would be materially adverse to the rights of holders of Series B preferred stock.

#### Stock Issuances During Periods Presented

During April 2012, CapLease issued and sold in an underwritten public offering 2,000,000 shares of 8.375% Series B cumulative redeemable preferred stock. The Company received aggregate net proceeds in the offering of \$48,317, after deducting underwriting discounts and commissions and offering expenses.

During April 2011, CapLease issued 10,000,000 shares of common stock in a public offering at a price to the public of \$5.60 per share. During May 2011, CapLease issued an additional 150,000 shares of common stock as part of such public offering, as a result of the underwriters partially exercising the over-allotment option. Inclusive of the over-allotment option, the Company raised net proceeds of \$54,040, after the underwriting discount and offering expenses.

During the nine months ended September 30, 2012, the Company added Cantor Fitzgerald & Co. as an additional sales agent under its “at the market offering” program. The Company now has three separate sales agents for its “at the market offering” program: Cantor Fitzgerald & Co., Brinson Patrick Securities Corporation and Merrill Lynch, Pierce Fenner & Smith Incorporated. Under the sales agreement with Cantor Fitzgerald, CapLease is authorized to issue and sell, from time to time, up to 9,000,000 shares of common stock, 1,000,000 shares of Series A preferred stock, and 1,000,000 shares of Series B preferred stock through or to Cantor Fitzgerald. During the three and nine months ended September 30, 2012, CapLease issued an aggregate of 196,207 shares of Series A preferred stock and 140,913 shares of Series B preferred stock through its “at the market offering” program with Cantor Fitzgerald, at an average price of \$25.13 per share of Series A preferred stock and \$26.06 per share of Series B preferred stock, and for aggregate net proceeds of \$8,431, including accrued dividends of \$117. During the nine months ended September 30, 2011, CapLease issued an aggregate of 14,200 shares of common stock through its “at the market offering” program with Merrill Lynch, Pierce Fenner & Smith Incorporated, at an average price of \$6.00 per share of common stock, and aggregate net proceeds of \$84.

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September 30, 2012 (unaudited)

During the nine months ended September 30, 2012, CapLease did not issue any shares of common stock through its dividend reinvestment and stock purchase plan. During the nine months ended September 30, 2011, CapLease issued 27,697 shares of common stock through its dividend reinvestment and stock purchase plan, at a price of \$5.72 per share of common stock, and aggregate net proceeds of \$158.

During March 2012, CapLease issued 497,700 shares of common stock to its executive officers, other employees and directors pursuant to the Company's stock incentive plan. During March 2011, CapLease issued 392,500 shares of common stock to its executive officers, other employees and directors pursuant to the Company's stock incentive plan. As of September 30, 2012, the Company had awarded 4,243,005 shares of common stock under the stock plan, all in the form of stock awards to executive officers, other employees and directors of the Company (see Note 14 below).

## Share Repurchase Program

During August 2011, the Company announced that CapLease's Board of Directors has approved a share repurchase program authorizing the Company to repurchase in the aggregate up to \$20,000 of its outstanding common stock. The program permits the Company to purchase shares through a variety of methods, including in the open market or through privately negotiated transactions, in accordance with applicable securities laws. It does not obligate the Company to make any repurchases at any specific time or situation. The timing and extent to which the Company repurchases its shares will depend upon a variety of factors, including market conditions, the Company's liquidity, and regulatory requirements.

The Company did not make any share repurchases through the program during the nine months ended September 30, 2012. During the year ended December 31, 2011, the Company repurchased an aggregate of 1,769,250 shares of common stock at an average price of \$3.79 per share, utilizing an aggregate of \$6,736 of cash on hand. As of September 30, 2012, the Company had remaining authorization to repurchase up to \$13,264 through the above program.

## Dividends

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

Quarter Ended	Record Date	Payment Date	Dividend Per Share	Total Amount
12/31/2010	12/31/2010	1/18/2011	\$ 0.065	\$ 3,736
3/31/2011	3/31/2011	4/15/2011	0.065	3,764
6/30/2011	6/30/2011	7/15/2011	0.065	4,424
9/30/2011	9/30/2011	10/17/2011	0.065	4,321
12/31/2011	12/30/2011	1/17/2012	0.065	4,308
3/31/2012	4/2/2012	4/16/2012	0.065	4,340
6/30/2012	6/29/2012	7/16/2012	0.065	4,340
9/30/2012	9/28/2012	10/15/2012	0.070	4,674



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September 30, 2012 (unaudited)

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

Quarter Ended	Record Date	Payment Date	Dividend Per Share	Total Amount
12/31/2010	12/31/2010	1/18/2011	\$ 0.5078125	\$ 1,627
3/31/2011	3/31/2011	4/15/2011	0.5078125	1,627
6/30/2011	6/30/2011	7/15/2011	0.5078125	1,627
9/30/2011	9/30/2011	10/17/2011	0.5078125	1,627
12/31/2011	12/30/2011	1/17/2012	0.5078125	1,627
3/31/2012	4/2/2012	4/16/2012	0.5078125	1,627
6/30/2012	6/29/2012	7/16/2012	0.5078125	1,627
9/30/2012	9/28/2012	10/15/2012	0.5078125	1,727

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

Quarter Ended	Record Date	Payment Date	Dividend Per Share	Total Amount
6/30/2012	6/29/2012	7/16/2012	\$ 0.5001740	\$ 1,000
9/30/2012	9/28/2012	10/15/2012	0.5234375	1,121

#### 14. Stock Based Compensation

The Company adopted a stock incentive plan for its employees and directors during March 2004 in connection with its initial public offering. 5,123,000 shares of common stock are authorized for issuance under the stock plan. As of September 30, 2012, the Company had awarded 4,243,005 shares of common stock under the stock plan, all in the form of restricted stock awards to executive officers, other employees and directors of the Company. The Company has not awarded any options, stock appreciation rights or other stock based compensation under the stock plan.

A summary of the Company's activity under the stock plan from January 1, 2011 through the nine months ended September 30, 2012, is presented below:

	Number of Shares
Stock Awards at January 1, 2011	3,369,955
Granted During the Year Ended December 31, 2011	392,500 (1 )
Forfeited During the Year Ended December 31, 2011	(10,880 )
Stock Awards at January 1, 2012	3,751,575
Granted During the Period Ended September 30, 2012	497,700 (2 )

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Forfeited During the Period Ended September 30, 2012	(6,270 )
Stock Awards at September 30, 2012	4,243,005

- (1) Shares are scheduled to vest between March 2012 and March 2014, but will generally be forfeited if the recipient either terminates his employment with the Company or ceases to be a member of CapLease's Board of Directors at any time prior to the vesting date. Vesting of an aggregate of 196,425 shares is also subject to satisfaction of objective and subjective performance criteria, to be determined by CapLease's Compensation Committee.
- (2) Shares are scheduled to vest between March 2013 and March 2015, but will generally be forfeited if the recipient either terminates his employment with the Company or ceases to be a member of CapLease's Board of Directors at any time prior to the vesting date. Vesting of an aggregate of 262,725 shares is also subject to satisfaction of objective and subjective performance criteria, to be determined by CapLease's Compensation Committee.

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September 30, 2012 (unaudited)

A summary of the status of unvested shares from January 1, 2011 through the nine months ended September 30, 2012, is presented below:

	Shares Awarded Under Plan	Shares Priced Under GAAP	Weighted Average Fair Value
Nonvested at January 1, 2011	1,739,367	1,122,282	\$ 4.62
Current period awards	392,500	261,550	5.80
Prior period awards	N/A	223,635	5.80
Vested	(514,970 ) <sup>(1)</sup>	(514,970 )	5.14
Forfeited	(10,880 )	(10,880 )	3.43
Nonvested at January 1, 2012	1,606,017	1,081,617	4.91
Current period awards	497,700	322,550	4.08
Prior period awards	N/A	257,760	4.08
Vested	(577,757 ) <sup>(2)</sup>	(577,757 )	5.26
Forfeited	(6,270 )	(6,270 )	5.80
Nonvested at September 30, 2012	1,519,690	1,077,900	4.26

(1) Includes 247,191 shares vested as a result of performance criteria being satisfied.

(2) Includes 231,288 shares vested as a result of performance criteria being satisfied.

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

The Company has made certain of the restricted stock awards with vesting dependent upon satisfaction of performance criteria to be determined in the future. For such awards, applicable accounting guidance provides that despite the award having been granted, it is not valued for financial accounting purposes and expense related thereto does not commence until performance criteria have been established. "Prior period awards" in the above table represent restricted share awards made in a prior period but which have been valued for financial accounting purposes in the current period when the CapLease Compensation Committee determined the performance criteria.

As of September 30, 2012, \$3,022 of unvested shares (fair value at the grant dates) is expected to be charged to the Company's Consolidated Statement of Operations ratably over the remaining vesting period (through March 2015) assuming vesting criteria are satisfied. In addition, as of September 30, 2012, the Company has not yet commenced expense accrual related to the following number of share awards because the applicable performance criteria have not yet been determined: 104,715 restricted shares made in 2009, 96,450 restricted shares made in 2010, 65,475 restricted shares made in 2011 and 175,150 restricted shares made in 2012.

#### 15. Other Comprehensive Income (Loss)

Comprehensive income (loss) is defined under GAAP as the change in equity of a business enterprise during a period from transactions and other events and circumstances, excluding those resulting from investments by and distributions



to owners, and is presented in the Company's Consolidated Statements of Comprehensive Income (Loss). For the Company's purposes, comprehensive income (loss) represents net income (loss) before non-controlling interest in consolidated subsidiaries, as presented in the Company's Consolidated Statements of Operations, adjusted for unrealized gains or losses on securities available for sale and amortization of unrealized losses on securities previously classified as available for sale, and amortization of realized losses on derivatives reclassified into interest expense.

## CapLease, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

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September 30, 2012 (unaudited)

GAAP also divides comprehensive income (loss) into “net income (loss)” and “other comprehensive income (loss).” Other comprehensive income (loss) is defined as revenues, expenses, gains and losses that under GAAP are included in comprehensive income (loss) but excluded from net income (loss). Other comprehensive income (loss) is a component of Stockholders’ Equity and is shown on the Company’s Consolidated Statements of Changes in Equity (fourth column). The following table summarizes the Company’s Accumulated Other Comprehensive Income (Loss) as reported on the Consolidated Statements of Changes in Equity.

	Sep 30, 2012 (Unaudited)	Dec 31, 2011
Net unrealized losses on securities available for sale	\$(2,370 )	\$(9,747 )
Net realized losses on derivatives	(1,283 )	(1,304 )
Accumulated other comprehensive loss	\$(3,653 )	\$(11,051 )

## 16. Non-Controlling Interests

During June 2006, CapLease’s Operating Partnership issued 263,157 units of limited partnership to an unaffiliated third party. All of these units were issued as partial consideration for the Company’s acquisition of a real property in June 2006 from the third party. During June 2008, the units of limited partnership became redeemable by the holder, at its option, on the basis of one unit for either one share of CapLease common stock or cash equal to the fair market value of a share of common stock at the time of the redemption. The units of limited partnership do not have a liquidation preference. During September 2008, the holder redeemed 107,131 units for the same number of shares of CapLease common stock. As of September 30, 2012, the Operating Partnership had issued and outstanding 156,026 units of limited partnership.

Cash distributions by the Operating Partnership are paid in the following priority: first, to the non-controlling interest holders until such holders receive the amount they would have received if the holders’ units of limited partnership interest were converted to an equal number of shares of CapLease common stock, and then, to CapLease. As a result, since July 2006, at the same time CapLease has paid a cash dividend to its common stockholders, the non-controlling interest holders have been paid a cash dividend of the same amount per limited partnership unit.

## 17. Rental Income

The Company is the landlord to tenants under operating leases with expiration dates ranging from 2012 to 2030. The minimum rental amounts due under the leases are generally subject to scheduled fixed increases. The leases generally also require that the tenants pay for or reimburse the Company for the occupancy and operating costs of the properties, or in certain cases reimburse the Company for increases in certain operating costs and real estate taxes above their base year costs. Approximate future minimum rents to be received over the next five years and thereafter for non-cancelable operating leases in effect at September 30, 2012, are as follows:

3 months ending December 31, 2012	\$29,050
2013	123,853
2014	115,874

2015	113,487
2016	104,068
Thereafter	346,915
Total	\$833,246

18. Pro Forma Condensed Consolidated Income Statements

The accompanying unaudited Pro Forma Condensed Consolidated Income Statements are presented as if, at January 1, 2011, the Company acquired all real properties purchased during the nine months ended September 30, 2012 and that meet the classification of a business for financial accounting purposes. Earnings per share are presented using the weighted average shares outstanding during the relevant periods. In management's opinion, all adjustments necessary to reflect the effects of the above transactions have been made.

## CapLease, Inc. and Subsidiaries

## Notes to Consolidated Financial Statements

(Dollar amounts in thousands, except per share amounts; totals may not add due to rounding)

September 30, 2012 (unaudited)

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

	For the three months ended September 30,		For the nine months ended September 30,	
	2012	2011	2012	2011
Total revenues	\$41,818	\$43,945	\$125,673	\$132,599
Income (loss) from continuing operations	1,131	945	14,546	(897 )
Net loss allocable to common stockholders	(1,601 )	(14,066 )	(8,844 )	(20,605 )
Income (loss) per basic and diluted common share from continuing operations	(0.02 )	(0.01 )	0.12	(0.09 )
Net loss per basic and diluted common share	(0.02 )	(0.21 )	(0.13 )	(0.32 )

## 19. Segment Reporting

FASB ASC 280 establishes the manner in which public businesses report information about operating segments in annual and interim financial reports issued to stockholders. FASB ASC 280 defines a segment as a component of an enterprise about which separate financial information is available and that is evaluated regularly to allocate resources and assess performance. The Company conducts its business through two segments: operating real estate (including its investments in owned properties) and debt investments (including its loan investments as well as its investments in securities). For segment reporting purposes, the Company does not allocate interest income on short-term investments or general and administrative expenses.

Selected results of operations by segment for the three months ended September 30, 2012 and September 30, 2011, are as follows:

	Corporate / Unallocated		Operating Real Estate		Debt Investments	
	Sep 30, 2012	Sep 30, 2011	Sep 30, 2012	Sep 30, 2011	Sep 30, 2012	Sep 30, 2011
Total revenues	\$71	\$184	\$39,841	\$36,081	\$1,880	\$4,599
Total expenses	5,074	4,849	34,660	33,073	878	2,892
Other gain (loss)	—	—	—	(1,234 )	300	1,398
Income (loss) from continuing operations	(5,004 )	(4,665 )	5,181	1,774	1,302	3,104
Total assets	49,756	100,674	1,536,042	1,449,730	89,170	96,441

Selected results of operations by segment for the nine months ended September 30, 2012 and September 30, 2011, are as follows:

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	Corporate / Unallocated		Operating Real Estate		Debt Investments	
	Sep 30, 2012	Sep 30, 2011	Sep 30, 2012	Sep 30, 2011	Sep 30, 2012	Sep 30, 2011
Total revenues	\$396	\$563	\$114,368	\$105,974	\$5,710	\$16,824
Total expenses	15,554	14,785	100,505	97,330	2,733	11,275
Other gain (loss)	–	–	11,012	(1,234 )	1,009	(1,815 )
Income (loss) from continuing operations	(15,159 )	(14,222 )	24,875	7,410	3,986	3,734
Total assets	49,756	100,674	1,536,042	1,449,730	89,170	96,441

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20. Subsequent Events

Issuances of 8.125% Series A Cumulative Redeemable Preferred Stock and 8.375% Series B Cumulative Redeemable Preferred Stock

During October 2012, CapLease issued an aggregate of 46,075 shares of Series A preferred stock and 635,160 shares of Series B preferred stock through its “at the market offering” program with Cantor Fitzgerald, at an average price of \$25.01 per share of Series A preferred stock and \$25.43 per share of Series B preferred stock, and for aggregate net proceeds of \$16,959. The Company expects to use the proceeds from the offering for general corporate purposes.

Repurchase of Convertible Senior Notes

On October 1, 2012, CapLease repurchased \$15,799 principal amount of notes pursuant to the note holder put right described at Note 9 above. Upon completion of the repurchase, CapLease had \$19,210 principal amount of convertible senior notes outstanding.

\$10,000 Senior Secured Credit Agreement with KeyBank National Association

On October 12, 2012, the Company entered into a senior secured credit agreement with KeyBank National Association, pursuant to which KeyBank made a \$10,000 term loan to the Company. The proceeds of the new term loan were utilized to repay in full and terminate the Company’s amended and restated senior secured credit agreement with Wells Fargo Bank, N.A., entered into in July 2010.

The new credit agreement with KeyBank is for a three year term scheduled to mature on October 12, 2015, although the Company has two successive options to extend the maturity date, in each case for one additional year, subject to the payment of an extension fee and the satisfaction of certain other routine conditions. The Company is obligated to pay interest on its borrowings pursuant to the agreement at a floating rate of LIBOR plus 300 basis points. The Company may select a one month, two month or three month interest period for our LIBOR-based borrowings.

The collateral pool consists principally of fully amortizing mortgage notes on various real properties owned by the Company. Debt service on those notes is funded directly by rent paid by the tenant, and is expected to fully amortize the outstanding principal balance of the KeyBank loan over the loan term.

Our borrowings are a recourse obligation of the Company, and CapLease, Inc. has guaranteed all obligations of its subsidiary that acts as borrower under the agreement and owns the notes that comprise the collateral pool.

The Company made various customary representations and warranties and affirmative and negative covenants pursuant to the credit agreement, and agreed to various customary events of defaults. The Company also agreed to various financial covenants which it will be required to be in compliance with during the term of the credit agreement. The financial covenants, as well as the representations and warranties, affirmative and negative covenants, and events of default, closely conform to those included in the senior secured credit agreement the Company entered into with Wells Fargo in June 2012.



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

The following discussion should be read in conjunction with the consolidated financial statements and the notes to those financial statements, included elsewhere in this filing. Except where otherwise indicated or where the context is clear, the portfolio statistics in Item 2 of this Form 10-Q represent or are calculated from our carry value for financial reporting purposes before depreciation and amortization. With respect to our loan portfolio, we have adjusted our carry value to exclude a \$0.5 million general loss reserve.

When we use the term "we," "us," "our" or "the Company" we mean CapLease, Inc. and its majority-owned subsidiaries. All interests in our properties are held through special purpose entities which are separate and distinct legal entities.

### Overview

We are a REIT that primarily owns and manages a diversified portfolio of single tenant commercial real estate properties 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 property operating expenses, such as utilities, real estate taxes, insurance and routine maintenance. We also have made and expect to continue to make investments in single tenant properties where the owner has exposure to property operating expenses when we determine we can sufficiently underwrite that exposure and isolate a predictable cash flow.

Our tenants are primarily large public companies or their significant operating subsidiaries and 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 S&P and 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, (iii) for which we have evaluated the creditworthiness of the tenant and estimated a credit rating that is consistent with an investment grade rating from S&P or Moody's, or (iv) are governmental entity branches or units of another investment grade rated governmental entity.

In addition to our portfolio of owned properties, we have a modest portfolio of first mortgage loans and other debt investments on single tenant properties. That debt portfolio was reduced significantly during 2011 as a result of our sale of the assets and associated liabilities comprising our CDO, as well as the individual sale of certain other loans and securities. The remaining debt portfolio will continue to decrease over time as principal payments are received on the investments. While the focus of our investment activity is expected to remain the ownership of real properties, we may continue to make debt investments from time to time on an opportunistic basis in the future.

As of September 30, 2012, we had an approximately \$1.8 billion investment portfolio, almost entirely comprised of owned properties.

We have invested in certain owned properties that are leased primarily but not exclusively by one tenant. We have also invested in certain owned properties which were previously leased by one tenant but as a result of lease non-renewals have now become multi-tenant properties. We expect these types of properties will continue to comprise a portion of our portfolio for the foreseeable future.

Our main 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 believe that our focus on assets leased to high credit quality tenants subject to long-term leases will provide us with a stable and predictable stream of cash flows that will support our business and the payment of dividends to our stockholders for the foreseeable future.



The principal sources of our revenues are rental income on our owned real properties and interest income from our debt investments (loans and securities). In order to grow our revenues, we will be primarily dependent on our ability to add new assets to our portfolio. We intend to continue to grow the portfolio but cannot provide any assurance as to whether, when and at what yields and other terms we will be able to do so.

As of September 30, 2012, the occupancy rate in our owned property portfolio was 99.2% with virtually all of the vacant space being in one of the two office buildings we own in Omaha, Nebraska. We cannot provide any assurance as to when and on what terms we will be able to re-let properties that are or may become vacant in our portfolio.

The principal sources of our expenses are interest expense on our assets financed, depreciation expense on our real properties, general and administrative expenses and property expenses (net of expense recoveries). Our credit agreements with Wells Fargo Bank and KeyBank (which replaced another Wells Fargo Bank facility during October), as well as the loan agreement with Bank of Oklahoma for the Tulsa, Oklahoma development project, are floating rate debt and, therefore, the interest expense we pay is expected to increase if interest rates, in particular LIBOR rates, increase.

The average remaining lease term on our owned properties is approximately 6 years, although we have some leases that are scheduled to mature over the next few years. We are subject to the risk that our tenants do not renew their leases at maturity and that we are unable to promptly re-let the property, or that the terms of renewal or re-letting may be less favorable to us than the current lease terms, any of which could result in a reduction in our revenues and an increase in our property operating costs.

We rely on leverage to allow us to invest in a greater number of assets and enhance our asset returns. Our overall portfolio leverage, expressed as a percentage of our total debt to our total assets before depreciation and amortization on owned properties and with other minor adjustments, was approximately 62% as of September 30, 2012. Our leverage ratios by segment as of September 30, 2012 were approximately 60% for the owned properties segment and 67% for the debt investments segment. See "Liquidity and Capital Resources—Leverage" below for information about our use of leverage ratios and how we compute them.

During 2012, we have continued to grow the portfolio with approximately \$110 million of real property acquisitions and new build-to-suit commitments through September 30, 2012, and we expect to continue to grow the portfolio during the remainder of 2012 and beyond. We expect our leverage level to continue to decrease over time, primarily as a result of scheduled principal amortization on our debt and lower or no leverage on new asset acquisitions.

We have financed many of our owned properties with long-term, fixed rate, non-recourse debt. Through non-recourse debt, we seek to limit the overall company exposure in the event we default on the debt to the amount we have invested in the asset or assets financed. We have also pledged certain of our owned properties to Wells Fargo Bank as lender under a recourse revolving credit agreement, in order to provide us with an immediate source of liquidity through borrowings thereunder. We had \$114.0 million of recourse debt obligations outstanding as of September 30, 2012.

We will be required to repay, refinance or extend our debt obligations at maturity, which we expect, although cannot provide any assurance, that we will be able to do. To the extent we are unable to refinance or extend debt obligations, we expect to utilize a combination of (i) cash on hand, (ii) borrowings under our June 2012 credit agreement with Wells Fargo Bank, (iii) cash from sales of assets which may include the collateral for the debt, and (iv) cash from future debt or equity capital raises, to fund any liquidity needed to satisfy these obligations. Our ability to refinance debt, sell assets and/or raise capital on favorable terms will be highly dependent upon prevailing market conditions.

#### Business Environment

The performance of our existing portfolio and our ability to add new assets will continue to be impacted by market conditions. Commercial real estate market conditions are improving, although various signs of weakness still persist reflecting the weak U.S. economy. For example, delinquency rates on commercial real estate loans remain at historic highs, which has impacted the amount and terms of credit available for new transactions. Further, overall transaction volumes remain lower compared to historic norms and interest rates remain at historic lows, which have driven significant competition for new investment opportunities. We cannot provide any assurance as to when and at what yields and other terms we will be able to continue to add new assets to our portfolio.

In addition, while rents and property values have been recovering in some markets, weakness and uncertainty persists, particularly in those markets hardest hit by the recent downturn. We have a series of leases maturing over the next several years and commercial real estate conditions in the relevant markets at lease maturity will have a significant impact on our ability to retain tenants or re-let vacant properties promptly and on favorable terms as leases mature.

We also have a series of non-recourse mortgages on our owned properties maturing over the next several years and lending for commercial real estate transactions remains conservative, which could impact our ability to sell properties and refinance maturing debt on favorable terms or at all.

Our ability to execute on our business plan, including to add new assets to our portfolio and support additional investments in our existing assets, will continue to be impacted by capital market conditions. The stock market in general and the market price of our common stock in particular continue to be volatile. We cannot make any assurance that capital markets will be favorable to us at any time.

### Upcoming Lease Maturities and Expected Tenant Rollovers

We have certain leases scheduled to mature during 2012 and 2013, including those described below.

Our lease with Nestlé Holdings, Inc. in Fort Wayne, Indiana is scheduled to mature in December 2012, and we do not expect that tenant to extend or renew the lease at that property. The building is an approximately 764,000 square foot distribution warehouse, and Nestlé is the sole tenant. We are currently marketing the Fort Wayne property for re-let at the conclusion of the Nestlé lease term. Our annual rental revenue in accordance with GAAP from the Nestlé-Fort Wayne lease is \$4.07 per square foot, and we estimate that current market rent for this property is \$2.55 to \$2.85 per square foot.

Our lease with Choice Hotels International, Inc. is scheduled to mature in May 2013, and we do not expect that tenant to extend or renew the lease. The approximately 224,000 square foot office building is located in Silver Spring, Maryland, and Choice occupies approximately 174,000 square feet. We are currently marketing the Choice space for re-let at the conclusion of the Choice lease term. Our annual rental revenue in accordance with GAAP from the Choice lease is \$22.64 per square foot, and we estimate that current market rent for this property is \$22 to \$27 per square foot.

Market rent is based upon various estimates and may not be indicative of actual results. Market rent does not include the cost of any tenant concessions such as free rent periods and tenant improvement allowances.

### Application of Critical Accounting Policies

A summary of our critical accounting policies is included in our Annual Report on Form 10-K for the year ended December 31, 2011 in Management's Discussion and Analysis of Financial Condition and Results of Operations. There have been no significant changes to those policies during 2012.

### Third Quarter 2012 Transaction Summary

The following summarizes our significant transactions during the three months ended September 30, 2012.

#### New Investment Transactions

- During August 2012, we agreed to construct a distribution warehouse on a build-to-suit basis for Vitamin Shoppe Industries, Inc. in Ashland, VA with an estimated total investment of \$21.7 million. The project is expected to be completed in the second quarter of 2013. The lease with Vitamin Shoppe Industries, Inc. is in force and rent and the 15 year lease term will commence upon substantial completion of the building and the satisfaction of certain other conditions. As of September 30, 2012, we have funded \$3.1 million of our expected commitment to the project. See Note 3 of the consolidated financial statements included in this Form 10-Q.
- We continued to fund construction of the 17-story office building primarily for Cimarex Energy Co. in Tulsa, OK. As of September 30, 2012, we have funded all of our \$24 million expected cash commitment for the \$55 million project. The Bank of Oklahoma has agreed and commenced to fund the remaining project costs and the project is on schedule for completion in the first quarter of 2013. See Note 3 of the consolidated financial statements included in this Form 10-Q.

### Financings

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During July, we obtained \$22.4 million of nonrecourse mortgage financing on the Woodlands, TX property we purchased for \$40.5 million during June and lease primarily to Praxair, Inc. The interest rate payable on the related note is 3.70%, and the note is scheduled to mature in August 2022. See “Liquidity and Capital Resources—Long-Term Mortgage Financings” below.

- During August, we obtained an up to five year extension of the mortgage debt on the three Nestlé warehouses located in Breinigsville, PA, Lathrop, CA and Fort Wayne, IN. The debt was scheduled to mature in August. The note face amount of \$106 million and coupon of 6.32% were not modified by the extension, and the only immediate capital required for the extension was \$3 million which was funded into a reserve with the lender for future re-tenanting costs at the Fort Wayne property. See “Liquidity and Capital Resources—Long-Term Liquidity” below.

#### Sales

- We continued to reduce the size of our securities portfolio through the sale of two small mortgaged-backed securities for total proceeds of \$3.7 million and net gain of \$0.3 million. See Note 6 of the consolidated financial statements included in this Form 10-Q.

### Capital Raising

- We raised net proceeds of \$8.4 million through the issuance of 196,207 shares of Series A preferred stock and 140,913 shares of Series B preferred stock through our “at the market offering” program. See Note 13 of the consolidated financial statements included in this Form 10 Q.

We also closed certain significant transactions after the close of the quarter ended September 30, 2012, and prior to the date of this filing. For a description of these transactions, see “Subsequent Events” at Note 20 included in the Consolidated Financial Statements included in this Form 10-Q.

### Property Acquisitions

Except for the Vitamin Shoppe development project described above, we did not make any real estate acquisitions during the quarter ended September 30, 2012.

### Business Segments

We conduct our business through two operating segments:

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

Selected results of operations by segment for the three months ended September 30, 2012 and September 30, 2011, are as follows (dollar amounts in thousands):

	Corporate / Unallocated		Operating Real Estate		Debt Investments	
	Sep 30, 2012	Sep 30, 2011	Sep 30, 2012	Sep 30, 2011	Sep 30, 2012	Sep 30, 2011
Total revenues	\$71	\$184	\$39,841	\$36,081	\$1,880	\$4,599
Total expenses	5,074	4,849	34,660	33,073	878	2,892
Other gain (loss)	–	–	–	(1,234 )	300	1,398
Income (loss) from continuing operations	(5,004 )	(4,665 )	5,181	1,774	1,302	3,104
Total assets	49,756	100,674	1,536,042	1,449,730	89,170	96,441

Selected results of operations by segment for the nine months ended September 30, 2012 and September 30, 2011, are as follows (dollar amounts in thousands):

	Corporate / Unallocated		Operating Real Estate		Debt Investments	
	Sep 30, 2012	Sep 30, 2011	Sep 30, 2012	Sep 30, 2011	Sep 30, 2012	Sep 30, 2011
Total revenues	\$396	\$563	\$114,368	\$105,974	\$5,710	\$16,824
Total expenses	15,554	14,785	100,505	97,330	2,733	11,275
Other gain (loss)	–	–	11,012	(1,234 )	1,009	(1,815 )
Income (loss) from continuing operations	(15,159 )	(14,222 )	24,875	7,410	3,986	3,734

Total assets	49,756	100,674	1,536,042	1,449,730	89,170	96,441
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Comparison of the Quarter Ended September 30, 2012 to the Quarter Ended September 30, 2011

The following discussion compares our operating results for the quarter ended September 30, 2012 to the comparable period in 2011.

Revenue.

Total revenue increased \$0.9 million, or 2%, to \$41.8 million. The increase was primarily attributable to an increase in rental revenue and tenant reimbursements, offset in part by a decrease in interest income.

Rental revenue and tenant reimbursements, in the aggregate, increased \$3.8 million, or 10%, to \$39.7 million, primarily reflecting the impact of new property acquisitions.

Interest income decreased \$2.9 million, or 60%, to \$1.9 million, primarily as a result of lower balances on debt investments, including as a result of the collateralized debt obligations (CDO) sale on September 1, 2011.

Expenses.

Total expenses decreased slightly to \$40.6 million, reflecting a decrease in interest expense almost fully offset by increases in other expenses, property expenses and depreciation and amortization expense.

Interest expense decreased \$2.4 million, or 13%, to \$16.7 million, from \$19.1 million. The decrease in the 2012 period resulted primarily from no interest expense on the CDO during the 2012 period due to the sale of the CDO on September 1, 2011. Adjusted to exclude the \$2.1 million of CDO interest expense in the 2011 period, interest expense decreased \$0.3 million, primarily driven by \$0.2 million of reduced interest expense on the secured term loan (driven by lower amounts borrowed) and \$0.1 million of reduced interest expense on the credit agreements (driven by lower amounts borrowed). Additional interest expense on new property mortgages of \$0.6 million was principally offset by \$0.4 million of capitalized interest expense on the Cimarex and Vitamin Shoppe development projects and principal pay-downs on existing loans. Our average balance outstanding and effective financing rate under the Wells Fargo Bank floating rate credit agreements was approximately \$46 million at 4.9% during the 2012 period (average one-month LIBOR of 0.24%), compared with approximately \$78 million at 3.5% during the 2011 period (average one-month LIBOR of 0.20%). Our effective financing rate was driven higher during the 2012 period primarily as a result of fees and other costs under the agreements.

Property expenses increased \$0.6 million, or 9%, to \$7.2 million, primarily reflecting the impact of new property acquisitions. The net amount of property expenses we incurred (net of tenant reimbursements) was \$2.7 million in the 2012 period, down from \$3.4 million in the 2011 period.

General and administrative expense increased \$0.2 million, or 8%, to \$2.8 million, primarily reflecting the impact of property acquisition costs on new property acquisitions.

General and administrative expense-stock based compensation was basically unchanged at \$0.8 million. The impact of a larger number of share awards and a shorter vesting period in the 2012 period were basically fully offset by the impact of a lower price used for expense amortization purposes in the 2012 period. As of September 30, 2012, \$3.0 million of unvested shares (fair value at the grant dates) is expected to be charged to our Consolidated Statement of Operations ratably over the remaining vesting period (through March 2015) assuming vesting criteria are satisfied. As of September 30, 2012, we have not yet commenced expense accrual related to the following number of share awards because the applicable performance criteria have not yet been determined: 104,715 restricted shares made in 2009, 96,450 restricted shares made in 2010, 65,475 restricted shares made in 2011 and 175,150 restricted shares made in 2012.

Depreciation and amortization expense on real property increased \$0.5 million, or 4%, to \$12.2 million, from \$11.7 million, primarily reflecting the impact of new property acquisitions.

Other expenses increased \$0.9 million and was basically comprised of advisory costs paid on the extension of the mortgage debt on the three properties leased to Nestlé.

Other gains (losses).



We had \$0.3 million of gain on investments during the 2012 period, which reflects the gain on sale of two securities investments during the 2012 period (see Note 6 of the consolidated financial statements included in this Form 10-Q). During the 2011 period, we had gain on investment of \$5.3 million, comprised of gain of \$3.9 million on sale of the CDO (before related loss on extinguishment of debt discussed below) and gain of \$1.4 million on two property sales (see Note 6 of the consolidated financial statements included in this Form 10-Q).

We had no provision for loss on property investment during the 2012 period. We had a provision for loss on property investment of \$14.1 million in the 2011 period. The amount in the 2011 period comprises a loss on the Hartford, Connecticut property where the lease with the tenant expired during October 2011 and the property was transferred to the lender in full satisfaction of the related mortgage debt during December 2011.

We had no gain or loss on extinguishment of debt during the 2012 period. We had \$3.7 million of losses on extinguishment of debt during the 2011 period, primarily representing the charge-off of deferred issuance costs and deferred realized losses on cash flow hedges in connection with the sale of our CDO during September 2011 (see Note 6 of the consolidated financial statements included in this Form 10-Q).

Net income (loss).

We had net income of \$1.5 million during the 2012 period, compared to net (loss) of \$(13.2) million during the 2011 period. The change between the periods was driven primarily by the \$14.1 million provision for loss on property investment during the 2011 period. Net (loss) allocable to common stockholders was \$(1.3) million during the third quarter of 2012, reflecting dividends to preferred stockholders of \$2.7 million.

Comparison of the Nine Months Ended September 30, 2012 to the Nine Months Ended September 30, 2011

The following discussion compares our operating results for the nine months ended September 30, 2012 to the comparable period in 2011.

Revenue.

Total revenue decreased \$2.9 million, or 2%, to \$120.5 million. The decrease was primarily attributable to a decrease in interest income, offset in part by an increase in rental revenue and tenant reimbursements.

Rental revenue and tenant reimbursements, in the aggregate, increased \$8.4 million, or 8%, to \$113.8 million, primarily reflecting the impact of new property acquisitions.

Interest income decreased \$11.4 million, or 65%, to \$6.0 million, primarily as a result of lower balances on debt investments, including as a result of the CDO sale on September 1, 2011.

Expenses.

Total expenses decreased \$4.6 million, or 4%, to \$118.8 million, primarily as a result of lower interest expense, offset in part by an increase in depreciation expense, property expenses, other expenses and general and administrative expenses.

Interest expense decreased \$8.5 million, or 14%, to \$50.7 million, from \$59.2 million. The decrease in the 2012 period resulted primarily from no interest expense on the CDO during the 2012 period due to the sale of the CDO on September 1, 2011. Adjusted to exclude the \$9.0 million of CDO interest expense in the 2011 period, interest expense increased \$0.4 million, primarily driven by \$1.4 million of additional interest expense on property mortgages, partially offset by \$0.7 million of reduced interest expense on the secured term loan and \$0.3 million of reduced interest expense on the Wells Fargo Bank credit agreements (in each case driven by lower amounts borrowed). The increase in interest expense on property mortgages was driven by new mortgages on recent property acquisitions of \$1.9 million offset in part by \$0.4 million of capitalized interest expense on the Cimarex and Vitamin Shoppe development projects and principal pay-downs on existing loans. Our average balance outstanding and effective financing rate under the Wells Fargo Bank floating rate credit agreements was approximately \$61 million at 4.2% during the 2012 period (average one-month LIBOR of 0.25%), compared with approximately \$89 million at 3.5% during the 2011 period (average one-month LIBOR of 0.23%). Our effective financing rate was driven higher during the 2012 period primarily as a result of fees and other costs under the agreements.

Property expenses increased \$1.1 million, or 6%, to \$20.2 million, primarily reflecting the impact of new property acquisitions. The net amount of property expenses we incurred (net of tenant reimbursements) was \$8.3 million in the 2012 period, compared to \$9.1 million in the 2011 period, primarily due to the timing of certain tenant reimbursements.

General and administrative expense increased \$0.6 million, or 7%, to \$8.6 million, primarily reflecting the impact of property acquisition costs on new property acquisitions.

General and administrative expense-stock based compensation increased \$0.2 million, or 8%, to \$2.4 million. The impact of a larger number of share awards and a shorter vesting period in the 2012 period were partially offset by the impact of a lower price used for expense amortization purposes in the 2012 period.

Depreciation and amortization expense on real property increased \$1.3 million, primarily reflecting the impact of new property acquisitions.

Other gains (losses).

We had net loss on investments of \$14.2 million in the 2012 period, comprised of \$0.3 million of gain on sale of two securities investments (see Note 6 of the consolidated financial statements included in this Form 10-Q), \$15.2 million of loss on sale of the Johnston, Rhode Island property (see Note 6 of the consolidated financial statements included in this Form 10-Q), offset in part by \$0.7 million of net proceeds from the franchise lending venture (see Note 4 of the consolidated financial statements included in this Form 10-Q). We had gain on investments, net, of \$2.1 million in the 2011 period. The amount in the 2011 period primarily includes gains of \$3.9 million on sale of the CDO (before related loss on extinguishment of debt discussed below) during the third quarter (see Note 6 of the consolidated financial statements included in this Form 10-Q), \$1.4 million on two property sales during the third quarter (see Note 6 of the consolidated financial statements included in this Form 10-Q), and \$0.7 million on the sale of two loans during the second quarter (see Note 6 of the consolidated financial statements included in this Form 10-Q), partially offset by losses of \$2.9 million on the sale of CMBS securities during the first and second quarter (see Note 6 of the consolidated financial statements included in this Form 10-Q) and \$1.0 million on the charge-off of a loan investment during the second quarter (see Note 4 of the consolidated financial statements included in this Form 10-Q).

We had no provision for loss on property investment during the 2012 period. We had a provision for loss on property investment of \$14.1 million in the 2011 period. The amount in the 2011 period comprises a loss on the Hartford, Connecticut property where the lease with the tenant expired during October 2011 and the property was transferred to the lender in full satisfaction of the related mortgage debt during December 2011.

We had \$11.0 million of gain on extinguishment of debt during the 2012 period, comprised of \$9.0 million of gain from the repurchase of the junior mortgage note of the Nestlé properties and \$2.0 million of gain primarily representing the reversal of the unamortized fair value adjustment on a mortgage debt obligation that was refinanced during the first quarter (with respect to both items, see Note 9 of the consolidated financial statements included in this Form 10-Q). We had \$3.7 million of losses on extinguishment of debt during the 2011 period, primarily representing the charge-off of deferred issuance costs and deferred realized losses on cash flow hedges in connection with the sale of our CDO during September 2011 (see Note 6 of the consolidated financial statements included in this Form 10-Q).

Net loss.

Net loss decreased \$15.0 million, to \$(2.9) million, from \$(17.9) million, primarily reflecting the impact of other gains and losses and discontinued operations during the respective periods. Net loss allocable to common stockholders was \$(9.7) million in the 2012 period, reflecting dividends to preferred stockholders of \$6.8 million.

#### Funds from Operations

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

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

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

The following table reconciles our net income (loss) allocable to common stockholders to FFO for the three and nine months ended September 30, 2012 and September 30, 2011.

(Amounts in thousands, except per share amounts)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Net loss allocable to common stockholders	\$ (1,252 )	\$ (14,797 )	\$ (9,689 )	\$ (22,787 )
Add (deduct):				
Non-controlling interest in consolidated subsidiaries	(5 )	(36 )	(23 )	(55 )
Depreciation and amortization expense on real property	12,166	11,676	35,878	34,538
Depreciation and amortization expense on discontinued operations	–	930	653	2,815
(Gain) loss on property sales	–	(1,426 )	15,229	(1,426 )
Provision for loss on property investment on discontinued operations	–	14,119	–	14,119
Funds from operations	\$ 10,909	\$ 10,466	\$ 42,048	\$ 27,204
Weighted average number of common shares outstanding, basic and diluted	66,767	67,615	66,616	64,238
Weighted average number of OP units outstanding	156	156	156	156
Weighted average number of common shares and OP units outstanding, diluted	66,923	67,771	66,772	64,394
Net loss per common share, basic and diluted	\$ (0.02 )	\$ (0.22 )	\$ (0.15 )	\$ (0.35 )
Funds from operations per share	\$ 0.16	\$ 0.15	\$ 0.63	\$ 0.42

## Liquidity and Capital Resources

### Short-Term Liquidity

We define our short-term liquidity as our ability to generate adequate amounts of cash to meet day-to-day operating expenses and material cash commitments over the next twelve months. Our primary sources of short-term liquidity are available cash and cash equivalents, borrowings under our June 2012 credit agreement with Wells Fargo Bank, cash provided by operations, and a portion of the cash proceeds from issuances of debt and equity capital. As of September 30, 2012, we had \$40.2 million in available cash and cash equivalents, and approximately \$36.3 million of additional borrowing capacity under our June 2012 credit agreement. As of November 8, 2012, we had \$24.7 million in available cash and cash equivalents, and approximately \$46.3 million of additional borrowing capacity under our June 2012 credit agreement. We believe that our sources of short-term liquidity will be sufficient to enable us to satisfy our short-term liquidity requirements, including the payment of our dividend.

As a REIT, we are required to distribute at least 90% of our taxable income to our stockholders on an annual basis, and we intend to distribute all or substantially all of our REIT taxable income in order to comply with the distribution

requirements of the Code and to avoid federal income tax and the nondeductible excise tax. We declared a cash dividend of \$0.07 per share of common stock during the quarter ended September 30, 2012, and \$0.065 per share of common stock during each of the quarters ended June 30, 2012 and March 31, 2012. We also declared a cash dividend of \$0.5078125 per share of 8.125% Series A cumulative redeemable preferred stock during each of the quarters ended September 30, 2012, June 30, 2012 and March 31, 2012. We issued a new series of 8.375% Series B cumulative redeemable preferred stock during April 2012, and declared a cash dividend of \$0.500174 per share of Series B preferred stock during the quarter ended June 30, 2012, and \$0.5234375 per share of Series B preferred stock during the quarter ended September 30, 2012. Our dividend policy is subject to revision at the discretion of our Board of Directors. All distributions will be made at the discretion of our Board of Directors and will depend on our cash available for distribution, our funds from operations, our maintenance of REIT status, market conditions and such other factors as our Board of Directors deems relevant.

We have certain debt obligations that are scheduled to mature or potentially come due over the next 12 months. Please see the next subsection below entitled “Long-Term Liquidity” for a discussion of our expectations regarding these obligations.

#### Long-Term Liquidity

We define our long-term liquidity as our ability to generate adequate amounts of cash to meet cash demands and commitments beyond the next 12 months, including balloon payments on our debt obligations and capital expenditures on our owned properties. Our primary sources of long-term liquidity are our cash and cash equivalents, borrowings under our June 2012 credit agreement with Wells Fargo Bank, cash provided by operations, cash from long-term financings on our asset investments and issuances of debt and equity capital. We may continue to selectively sell assets to allow us to generate additional long-term liquidity. We believe that our various sources of long-term liquidity will be sufficient to enable us to satisfy our long-term liquidity requirements.

Our primary long-term liquidity requirement is repayment of our debt obligations. We intend to manage our debt maturities by refinancing, repaying or extending the related debt at or prior to maturity. To the extent we are unable to refinance or extend debt obligations, we expect to utilize a combination of (i) cash on hand, (ii) borrowings under our June 2012 credit agreement with Wells Fargo Bank, (iii) cash from sales of assets which may include the collateral for the debt, and (iv) cash from future debt or equity capital raises, to fund any liquidity needed to satisfy these obligations. We believe we will be successful in either refinancing, repaying or extending our debt obligations at or prior to maturity, but we cannot provide any assurance we will be able to do so. Our ability to refinance debt, sell assets and/or raise capital on favorable terms will be highly dependent upon prevailing market conditions. See “Item 1A—Risk Factors—Our use of debt financing could have a material adverse effect on our financial condition.” in our most recent Annual Report on Form 10-K.

We have three non-recourse mortgage debt obligations that are scheduled to mature during 2013: (i) \$24.5 million of mortgage debt on the Choice Hotels property scheduled to mature in May 2013, (ii) \$18.5 million of mortgage debt on the Capital One property scheduled to mature in May 2013, and (iii) \$12 million of mortgage debt on the Omnicom property scheduled to mature in May 2013. See the schedule of mortgage note maturities included at Note 9 in our consolidated financial statements included in this Form 10-Q. The Choice and Omnicom leases also mature in May 2013, and the Capital One lease matures in February 2015. We have the right to extend the Capital One and Omnicom mortgages until February 2015. During the extension term, excess cash flow from the properties will be reserved and subject to lender control and the interest rate we pay the lender will increase by 250 basis points.

In connection with the maturity of these and other mortgage debt obligations, we intend to evaluate a variety of alternatives with respect to our investment in the subject property, including restructuring or refinancing the debt, utilizing cash on hand and other sources of liquidity to repay all or a portion of the mortgage debt, and selling the property. We believe we will be successful in refinancing, repaying or extending these obligations but we cannot provide any assurance we will be able to do so. If we are unable to do so, we could convey the property to the lender to satisfy in full our obligations under the non-recourse debt. Our mortgage debt obligations are non-recourse and not cross-defaulted with our other debt obligations, and therefore, we do not believe default of any of our mortgage debt obligations will threaten the viability of our Company, although it could result in us losing all or some of our remaining investment in the subject properties.

The three mortgage debt obligations described above are our only debt obligations scheduled to mature before 2014.

We have extended or repaid the two debt obligations that were scheduled to mature or potentially come due during 2012, comprised of a \$106 million of non-recourse mortgage note on our three Nestlé properties which note was scheduled to mature during August 2012, and \$35 million of recourse convertible senior notes which were subject to a note holder put right that expired during September 2012.

During August 2012, we extended the \$106 million note on the Nestlé properties for up to five years inclusive of one 18-month extension option and two one year extension options. The face amount of the note and the note coupon of 6.32% were not modified by the extension. We contributed \$3 million into a reserve with the lender for future re-tenanting costs at the Fort Wayne, Indiana property. Any amount remaining in the reserve after the property is re-leased and re-tenanting costs paid will be used to reduce the principal balance of the note. Pursuant to the extension option provisions of the note, we may not extend the loan maturity date beyond August 2015 unless we have fully leased the Fort Wayne, Indiana property. The extension option rights if exercised also require us to make the following principal payments on the note:

- \$7.5 million during the first extension option term;
- \$7.5 million during the second extension option term; and



- \$5 million during the third extension option term.

Pursuant to the loan modification, we agreed with the lender that any cash flow shortfalls from the properties after debt service during the loan term will be funded through an approximately \$5 million reserve previously deposited with the lender. We also agreed to pay substantially all excess cash flows from the properties to reduce the principal amount of the debt. We may prepay the loan at any time without payment of a penalty or premium to the lender.

With respect to the leases at the three Nestlé properties, we have entered into five year lease extensions at the Breinigsville, Pennsylvania and Lathrop, California properties (commencing January 1, 2013) (see Note 3 in the consolidated financial statements included in this Form 10-Q), and are currently marketing the Fort Wayne, Indiana property for re-let at the conclusion of Nestlé's lease term in December 2012.

The holders of the convertible senior notes had the right to put all or a portion of their notes to us for a 20 business day period that expired on September 27, 2012. An aggregate of \$15.8 million of notes were tendered to us, and were repurchased by us on October 1, 2012. Upon completion of the repurchase, \$19.2 million of convertible senior notes remain outstanding. The October 2012 put right has now expired and the note holders' next put right will be on October 1, 2017.

During October, we refinanced our July 2010 credit agreement with Wells Fargo Bank, which was scheduled to mature in July 2013, with a secured term loan from KeyBank National Association which is scheduled to mature in October 2015. See “Term Financings—Credit Agreements—KeyBank Credit Agreement” below.

As an owner of commercial real estate, we are required to make capital expenditures to maintain and upgrade our properties. We expect the majority of these expenditures will be made as the leases mature and we renew existing leases or find new tenants to occupy the property. Any estimates we make of expected capital expenditures are highly subjective and actual amounts we spend may differ materially and will be impacted by a variety of factors, including market conditions which are beyond our control. We may be required to incur additional debt, sell assets and/or raise capital to generate the liquidity needed to pay for capital expenditures on our properties, and our ability to do so on favorable terms will be highly dependent upon prevailing market conditions. Our ability to satisfy our long-term liquidity requirements could be materially adversely affected by capital expenditures we make on our owned properties.

#### Share Repurchase Program

During August 2011, our Board of Directors approved a share repurchase program authorizing us to repurchase in the aggregate up to \$20 million of our outstanding common stock. The program permits us to purchase shares through a variety of methods, including in the open market or through privately negotiated transactions, in accordance with applicable securities laws. It does not obligate us to make any repurchases at any specific time or situation. The timing and extent to which we repurchase our shares will depend upon a variety of factors, including market conditions, our liquidity, and regulatory requirements

We did not repurchase any shares of common stock during the nine months ended September 30, 2012, through the above program or otherwise. As of September 30, 2012, we had remaining authorization to repurchase up to approximately \$13.3 million through the above program.

#### Sources of Capital

**General.** We intend to continue to raise additional capital from time to time to enable us to continue to implement our growth strategy. Our ability to raise capital is influenced by market conditions, and we cannot assure you that conditions for raising capital will be favorable for us at any time.

**Shelf Registration Statement.** We have a shelf registration statement on Form S-3 (File No. 333-171408) on file and effective with the Securities and Exchange Commission which we expect to utilize to issue public equity or debt capital from time to time in the future. Pursuant to the shelf registration statement, we may issue and sell publicly preferred stock, common stock, and debt securities, or any combination of such securities, from time to time in one or more offerings, up to an aggregate amount of \$500 million. We utilized our shelf registration statement to issue preferred equity capital during April 2012. Specifically, on April 19, 2012, we issued 2,000,000 shares of 8.375% Series B cumulative redeemable preferred stock in a public offering at a price to the public of \$25.00 per share (see Note 13 of the consolidated financial statements included in this Form 10-Q). We raised net proceeds of \$48.3 million, after the underwriting discount and offering expenses. These proceeds were fully utilized as of July 31, 2012, with \$45.7 million used to fund purchases of or improvements to owned properties and \$2.6 million used to reduce outstanding indebtedness.

We also utilized our shelf registration statement to issue shares of 8.125% Series A cumulative redeemable preferred stock and 8.375% Series B cumulative redeemable preferred stock with Cantor Fitzgerald & Co. as our agent through the “at the market offering” program from July through October 2012. See “ATM Offering” below.

We also utilized our shelf registration statement to issue common equity capital during the second quarter of 2011. Specifically, on April 5, 2011, we issued 10,000,000 shares of common stock in a public offering at a price to the public of \$5.60 per share. Then, on May 4, 2011, we issued an additional 150,000 shares of common stock as part of such public offering, as a result of the underwriters partially exercising the over-allotment option. Inclusive of the over-allotment option, we raised net proceeds of \$54.0 million, after the underwriting discount and offering expenses. These proceeds were fully utilized as of March 31, 2012, with \$38.8 million used to fund purchases of or improvements to owned properties, \$8.5 million used to reduce outstanding indebtedness and \$6.7 million used to repurchase our common stock.

As of October 31, 2012, we had remaining availability of \$367 million under our shelf registration statement, and we may offer and sell any combination of common stock, preferred stock and/or senior or subordinated debt securities up to such amount from time to time. As of that date, the availability under our shelf registration statement included (i) an aggregate of 9,000,000 shares of common stock, 757,718 shares of Series A preferred stock and 223,927 shares of Series B preferred stock reserved for sale under the Cantor Fitzgerald sales agreement described below, (ii) an aggregate of 2,693,900 shares of common stock and 995,100 shares of Series A preferred stock reserved for sale under the Brinson Patrick sales agreement described below, and (iii) an aggregate of 8,982,700 shares of common stock reserved for sale under the Merrill Lynch sales agreement described below.

**ATM Offering.** We have implemented an “at the market offering” program (as defined in Rule 415 of the Securities Act of 1933, as amended), which may be utilized by us from time to time to sell shares of our common stock, Series A preferred stock and Series B preferred stock, and increase liquidity. We have three separate sales agents for our “at the market offering” program, Cantor Fitzgerald & Co., Brinson Patrick Securities Corporation and Merrill Lynch, Pierce Fenner & Smith Incorporated.

During the three and nine months ended September 30, 2012, we issued an aggregate of 196,207 shares of Series A preferred stock and 140,913 shares of Series B preferred stock through our “at the market offering” program with Cantor Fitzgerald, at an average price of \$25.13 per share of Series A preferred stock and \$26.06 per share of Series B preferred stock, and for aggregate net proceeds of \$8.4 million. In addition, during October 2012, we issued an aggregate of 46,075 shares of Series A preferred stock and 635,160 shares of Series B preferred stock through our “at the market offering” program with Cantor Fitzgerald, at an average price of \$25.01 per share of Series A preferred stock and \$25.43 per share of Series B preferred stock, and for aggregate net proceeds of \$16,959. We expect to use the proceeds from the offering for general corporate purposes. We are not currently selling shares through the program, although we reserve the right to resume doing so in our sole discretion at any time in the future.

Our sales agreement with Cantor Fitzgerald & Co. authorizes us to issue and sell, from time to time, up to 9,000,000 shares of common stock, 1,000,000 shares of Series A preferred stock, and 1,000,000 shares of Series B preferred stock through or to Cantor Fitzgerald, and Cantor Fitzgerald has agreed to use its commercially reasonable efforts to sell such shares during the term of the agreement and on the terms set forth therein. We may sell our common stock, Series A preferred stock and Series B preferred stock to Cantor Fitzgerald as principal for its own account at prices agreed upon at the time of sale. Through October 31, 2012, we have not sold any shares of common stock pursuant to our sales agreement with Cantor Fitzgerald. We have sold an aggregate of 242,282 shares of Series A preferred stock and 776,073 shares of Series B preferred stock through our sales agreement with Cantor Fitzgerald as of October 31, 2012. We are not obligated to sell any shares pursuant to the agreement and we may start and stop selling shares pursuant to the program at any time in our sole discretion. We must pay Cantor Fitzgerald a commission of up to 2.0% of the gross proceeds from the sales of shares pursuant to the agreement.

Our sales agreement with Brinson Patrick Securities Corporation permits us to issue and sell through Brinson Patrick, from time to time, shares of our common stock and Series A preferred stock, and Brinson Patrick has agreed to use its best efforts to sell such shares during the term of the agreement and on the terms set forth therein. Our Board of Directors authorized the sale of up to 5,000,000 shares of common stock and 1,000,000 shares of Series A preferred stock pursuant to the sales agreement with Brinson Patrick from time to time. Through October 31, 2012, we have sold 2,306,100 shares of common stock and 4,900 shares of Series A preferred stock pursuant to the agreement with Brinson Patrick. We are not obligated to sell any shares pursuant to the agreement and we may start and stop selling shares pursuant to the program at any time in our sole discretion. We must pay Brinson Patrick a commission of 1.5% of the gross sales price per share sold.

Our sales agreement with Merrill Lynch, Pierce Fenner & Smith Incorporated authorizes us to issue and sell, from time to time, up to 9,000,000 shares of common stock through or to Merrill Lynch, and Merrill Lynch has agreed to

use its commercially reasonable efforts to sell such shares during the term of the agreement and on the terms set forth therein. We may sell our common stock to Merrill Lynch as principal for its own account at prices agreed upon at the time of sale. Through October 31, 2012, we have sold a total of 17,300 shares of common stock pursuant to our sales agreement with Merrill Lynch. We are not obligated to sell any shares pursuant to the agreement and we may start and stop selling shares pursuant to the program at any time in our sole discretion. We must pay Merrill Lynch a commission of 2.0% of the gross sales price per share sold.

Dividend Reinvestment and Stock Purchase Plan. In March 2007, we implemented a dividend reinvestment and direct stock purchase plan, which may be utilized by us from time to time to sell shares of our common stock and increase liquidity.

We did not sell any shares of common stock through the plan during the nine months ended September 30, 2012, and are not currently issuing new shares through the plan, although we reserve the right to elect to do so in our sole discretion at any time in the future.

The plan allows interested stockholders to reinvest all or a portion of their cash dividends in shares of our common stock and to make monthly purchases of our common stock generally up to a maximum of \$10,000 (unless a higher amount is approved by us in our sole discretion). Shares purchased through the plan may be either (i) newly issued by us (which may be sold at a discount of up to 5% off of the average of the high and low sales prices on the applicable investment date) or (ii) purchased by the plan administrator in the open market, at our discretion. During the year ended December 31, 2011, we issued 27,697 shares of common stock through the plan at a price of \$5.72 per share. As of September 30, 2012, we have reserved an aggregate of 6,830,043 shares of common stock for future issuance pursuant to the dividend reinvestment and direct stock purchase plan.

### Leverage

We rely on leverage to allow us to invest in a greater number of assets and enhance our asset returns. Leverage also exposes us to a variety of risks which are discussed in more detail in our most recent Annual Report on Form 10-K under the heading "Risk Factors." In reviewing and analyzing our debt, we look at a variety of financial metrics such as our leverage ratios, weighted average and individual interest rates on the debt, weighted average and individual maturity dates and scheduled principal amortization and balloon balances due at maturity. We also evaluate a variety of subjective factors such as present and expected future market conditions.

Leverage ratios are a widely used financial measure by the real estate investment community, especially for REITs. We measure our leverage ratios by dividing total debt by total assets, as adjusted. We measure total assets, as adjusted, at historical cost before depreciation and amortization on owned properties. Therefore, our leverage ratios do not account for any fluctuations in value, up or down, that may have occurred since we acquired our owned properties. Other companies including other REITs may compute leverage ratios in a different manner and, therefore, our leverage ratios may not be comparable to similarly titled measures reported by other companies.

The following table sets forth the computation of our overall portfolio leverage ratio as of September 30, 2012 and December 31, 2011 (dollars in thousands).

	Sep 30, 2012	Dec 31, 2011
<b>Debt</b>	<b>unaudited</b>	
Mortgages on real estate investments	\$ 986,629	\$ 972,924
Credit agreements	48,097	70,668
Secured term loan	76,100	88,142
Convertible senior notes	35,007	34,522
Other long-term debt	30,930	30,930
<b>Total Debt</b>	<b>\$ 1,176,763</b>	<b>\$ 1,197,186</b>
<b>Assets</b>		
Total assets	\$ 1,674,967	\$ 1,641,623
Accumulated depreciation and amortization on owned properties	285,718	268,209
Intangible liabilities on real estate investments	(33,579 )	(35,219 )
Prepaid expenses and deposits	(1,899 )	(1,381 )
Accrued rental income	(34,575 )	(41,387 )
Deferred rental income	4,451	2

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Debt issuance costs, net	(5,865 )	(3,889 )
Other	(471 )	(712 )
Total Assets, as adjusted	\$ 1,888,747	\$ 1,827,247
Leverage (Total Debt/Total Assets, as adjusted)	62 %	66 %

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The following table sets forth the computation of our leverage ratios by segment as of September 30, 2012.

(in thousands)	Mortgage Debt	Secured Term Loan Debt	Credit Agreement Debt	Total Debt	Investment (1)	Leverage
Owned Properties	\$ 986,629	\$ 19,141	\$ 45,594	\$ 1,051,364	\$ 1,757,331	60 %
Debt Investments	–	56,959	2,503	59,462	89,035	67 %

(1) Represents our carry value for financial reporting purposes before depreciation and amortization on owned properties. The carry value of our debt investments has been adjusted to exclude a \$500 general loss reserve.

We expect our leverage level to continue to decrease over time, primarily as a result of scheduled principal amortization on our debt and lower or no leverage on new asset acquisitions.

We have financed many of our owned properties with long-term, fixed rate, non-recourse debt. We have also pledged certain of our owned properties to Wells Fargo Bank as lender under a recourse revolving credit agreement, in order to provide us with an immediate source of liquidity through borrowings thereunder. We may also hold certain owned properties unencumbered by debt in the future.

Through non-recourse debt, we seek to limit the overall company exposure in the event we default on the debt to the amount we have invested in the asset or assets financed. We seek to “match-fund” or substantially “match-fund” substantially all of our assets with conservative levels of long-term, fixed rate, non-recourse financing. By “match-funded” debt, we mean the maturity of the debt matches as closely as possible the lease maturity of the asset financed. As of September 30, 2012, we have financed on a long-term basis an aggregate of approximately \$1.66 billion of portfolio assets with non-recourse, first mortgage debt of \$986.6 million and a non-recourse, secured term loan of \$76.1 million.

#### Long-Term Mortgage Financings

We have financed many of our owned properties through traditional first mortgage financings provided primarily through the commercial mortgage-backed securitization market. We also have utilized the term financings described below including the CDO transaction we sold during September 2011, to add incremental leverage on many of our owned properties.

During the quarter ended September 30, 2012, we obtained mortgage financing on the Woodlands, TX property we acquired during June 2012. The principal economic terms of the fully amortizing note we made is summarized in the following table:

Property	Original Face Amount of Mortgage Note (in thousands)	Coupon	Maturity Date
Praxair, Inc., Woodlands, TX	\$ 22,440	3.70 %	August 2022

During the quarter ended September 30, 2012, we also began borrowing on the loan agreement from Bank of Oklahoma related to the Tulsa, Oklahoma development project for Cimarex Energy Co. (see Note 9 in the consolidated financial statements included in this Form 10-Q).



As of September 30, 2012, we had \$986.6 million of non-recourse first mortgage debt at a weighted average coupon of 5.43% and a weighted average effective financing rate of 5.6%.

With the exception of the construction financing we have with the Bank of Oklahoma on the Tulsa, Oklahoma development property, all of our mortgage financings are fixed rate financings. The notes typically mature over a long-term period of approximately ten years, and debt service is payable monthly. The notes are non-recourse to us subject to limited recourse exceptions and are secured by a mortgage on the property and an assignment of the underlying lease and rents on the property. The notes are frequently interest only for all or a portion of the note term, and in most cases require a balloon payment at maturity. As described above, we believe we will be able to refinance, repay or extend these obligations at or prior to maturity but cannot provide any assurance in that regard, and our ability to do so on favorable terms will be highly dependent upon prevailing market conditions. See “Business Environment” above and “Item 1A—Risk Factors” in our most recent Annual Report on Form 10-K.

## Term Financings

We have financed most of our loan and securities investments as well as a select number of our owned properties through the term financings described below. As noted above, we have also utilized term financings to add incremental leverage on our owned properties financed with mortgage debt.

**Secured Term Loan.** In December 2007, we completed a secured term loan with a European bank. We transferred a pool of assets into a wholly-owned special purpose entity, called CapLease 2007-STL LLC, and issued debt to the lender secured by the assets in the pool. We retained all of the equity in the special purpose entity, or SPE, and, therefore, are entitled to all residual cash after the payment of scheduled principal and interest on the debt. The lender's debt is structured to be senior to our equity. For example, all principal payments on the assets transferred to the SPE will be paid to the lender until the secured term loan is repaid in full. We are in a first loss position in the event of a payment default or loss on any of the SPE assets.

As of September 30, 2012, we had \$76.1 million of debt outstanding under the secured term loan, secured by assets with a carry value of \$105.4 million. The interest coupon on the loan is fixed at 5.81% annually until the loan matures in January 2018. Our effective financing rate on the loan is 6.0% annually (inclusive of hedge and closing costs). The loan is non-recourse to us, subject to limited non-recourse exceptions.

**CDO Financing.** During September 2011, we completed the sale of our March 2005 CDO. For legal and accounting purposes, the sale resulted in the transfer by us of the various assets in the CDO trust along with the transfer of the obligation to pay debt service on the various CDO note classes. The CDO sale generated cash proceeds net of debt repaid and excluding accrued interest of approximately \$30.2 million, and a net gain of \$3.9 million, before the charge-off of primarily deferred issuance costs and deferred realized gains on cash flow hedges totaling \$3.7 million.

**Credit Agreements.** We have two senior secured credit agreements in place which provide us with additional asset level financing on a recourse, floating rate basis. The first is with Wells Fargo Bank, N.A. and represents our primary short-term borrowing facility. The second is with KeyBank National Association and represents a term loan collateralized principally by fully amortizing mortgage notes on various real properties owned by us.

### Wells Fargo Credit Agreement.

During June 2012, we entered into a senior secured revolving credit agreement with Wells Fargo Bank, N.A. The agreement authorizes us to borrow up to \$100 million from time to time from Wells Fargo Bank.

The agreement is for a three year term scheduled to mature on June 28, 2015, although we have an option to extend the term for one additional year subject to the payment of an extension fee and the satisfaction of certain other routine conditions. We are obligated to pay interest on our borrowings pursuant to the agreement at a floating rate of LIBOR plus 275 basis points. We may select a one month, three month or six month interest period for our LIBOR-based borrowings.

The current collateral pool consists of 16 real properties: the 11 Kroger grocery stores we own located in Georgia, Tennessee and Kentucky, the two multi-tenant properties we own in Omaha, Nebraska, the property we own in Columbus, Ohio leased to Abbott Laboratories, the property we own in Bloomington, Indiana leased to Baxter International, Inc., and the property we own in Louisville, Kentucky leased to Michelin North America, Inc. Advance rates on these properties are generally equal to 60% or 65%, depending on the property, of the lender's as-is appraised value. We are authorized to add additional real estate properties to the collateral pool over time subject to the lender's approval of the property, and we expect to do so as we add additional real estate properties and as mortgage debt matures on properties we currently own. We are also authorized to remove assets provided we repay any associated

borrowings at par.

Our borrowings are a recourse obligation, and CapLease, Inc. has guaranteed all obligations of its various subsidiaries that act as borrowers under the agreement and own the real property that comprises the initial collateral pool.

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We made various customary representations and warranties and affirmative and negative covenants pursuant to the credit agreement, and agreed to various customary events of defaults. We also agreed to various financial covenants which we will be required to be in compliance with during the term of the credit agreement. The principal financial covenants are as follows:

- **Maximum Leverage:** Our total indebtedness divided by the capitalized value of our portfolio based on an 8.0% capitalization rate may not exceed 77% initially and declining to 70% over the agreement term.
- **Minimum Fixed Charge Coverage:** Our adjusted EBITDA (as defined in the credit agreement) divided by our fixed charges (basically interest expense, principal payments, net of principal received, and preferred dividends) may not be less than 100% initially increasing to 105% over the agreement term. For this purpose, EBITDA excludes non-recurring gains and losses and stock-based compensation and is adjusted to remove the impact of straight-line rents.
- **Minimum Debt Yield:** Our total net operating income (as defined in the credit agreement) divided by total liabilities may not be less than 9% initially increasing to 9.75% over the agreement term. For this purpose, total net operating income includes interest income on our loans and securities and rental revenues are adjusted to remove the impact of straight-line rents.
  - **Minimum Interest Coverage Ratio:** Our adjusted EBITDA divided by interest expense may not be less than 140% initially increasing to 150% over the agreement term.
- **Minimum Tangible Net Worth:** Our tangible net worth (basically stockholders' equity before accumulated depreciation and amortization) may not be less than 85% of such tangible net worth as of June 29, 2012 plus 80% of net proceeds of any future equity issuances.
- **Maximum Dividends:** Cash dividends to CapLease, Inc. shareholders may not exceed the greater of (i) the amount required to maintain REIT status and avoid the payment of income or excise tax and (ii) 95% of adjusted funds from operations (as defined in the credit agreement). For this purpose, funds from operations excludes non-recurring gains and losses.

As of September 30, 2012, we were in compliance with the above financial covenants.

As of September 30, 2012, we had \$38.1 million of borrowings under the agreement which were secured by various owned properties with an aggregate carry value of \$134.5 million.

#### KeyBank Credit Agreement.

On October 12, 2012, we entered into a senior secured credit agreement with KeyBank National Association, pursuant to which KeyBank made a \$10 million term loan to the Company. The proceeds of the new term loan were utilized to repay in full and terminate the Company's amended and restated senior secured credit agreement with Wells Fargo Bank, N.A., entered into in July 2010.

The new credit agreement with KeyBank is for a three year term scheduled to mature on October 12, 2015, although we have two successive options to extend the maturity date, in each case for one additional year, subject to the payment of an extension fee and the satisfaction of certain other routine conditions. We are obligated to pay interest on our borrowings pursuant to the agreement at a floating rate of LIBOR plus 300 basis points. We may select a one month, two month or three month interest period for our LIBOR-based borrowings.

The collateral pool consists principally of fully amortizing mortgage notes on various real properties owned by the Company. Debt service on those notes is funded directly by rent paid by the tenant, and is expected to fully amortize the outstanding principal balance of the KeyBank loan over the loan term.

Our borrowings are a recourse obligation of the Company, and CapLease, Inc. has guaranteed all obligations of its subsidiary that acts as borrower under the agreement and owns the notes that comprise the collateral pool.

We made various customary representations and warranties and affirmative and negative covenants pursuant to the credit agreement, and agreed to various customary events of defaults. We also agreed to various financial covenants which we will be required to be in compliance with during the term of the credit agreement. The financial covenants, as well as the representations and warranties, affirmative and negative covenants, and events of default, closely conform to those included in the senior secured credit agreement we entered into with Wells Fargo in June 2012.

## Statement of Cash Flows

Operating activities provided \$43.3 million of cash during the nine months ended September 30, 2012, primarily driven by net (loss) as adjusted by various non-cash income and expenses and other gains and losses of \$51.4 million and increases in accounts payable of \$6.2 million, partially offset by increases in other assets of \$14.4 million. Operating activities provided \$39.4 million of cash during the nine months ended September 30, 2011, primarily driven by net (loss) as adjusted by various non-cash income and expenses and other gains and losses of \$43.2 million, partially offset by increases in other assets of \$4.4 million.

We recognize rental income on our owned properties on a straight line basis in accordance with GAAP. As of September 30, 2012, this has resulted in us accruing \$30.1 million, net, of rental income in excess of actual rents due under the various leases. During the nine months ended September 30, 2012, actual rents due under the leases exceeded rents on a straight-line basis by \$11.3 million. We expect the impact of straight-lining of rents to fluctuate over time as contractual rents step up and actual rents due increase under the various leases and we purchase additional properties. Certain of our owned properties are also subject to rents which pay semi-annually, rather than monthly, and this also impacts the quarter-to-quarter changes due to straight-lining of rents.

Cash used in investing activities during the nine months ended September 30, 2012 was \$99.1 million, which primarily resulted from real estate purchases and improvements and construction in progress of \$117.9 million, and leasing commissions of \$3.6 million, partially offset by proceeds from sale of real estate of \$9.6 million and securities of \$3.7 million, principal received on loans of \$5.4 million and securities of \$3.7 million. Investing activities provided \$133.5 million of cash during the nine months ended September 30, 2011, which primarily resulted from proceeds from sale or prepayments of loan investments of \$86.9 million, proceeds from sale of securities of \$31.3 million, proceeds from sale of the CDO of \$22.3 million, proceeds from sale of real estate of \$5.2 million, and principal received from loans and securities of \$11.9 million, partially offset by real estate purchases and improvements and construction in progress of \$24.0 million.

Cash provided by financing activities during the nine months ended September 30, 2012 was \$24.8 million, which primarily resulted from preferred stock issued of \$56.6 million, partially offset by net repayments of principal on debt of \$9.5 million (including \$22.6 million of net repayments on the Wells Fargo Bank credit agreements and \$12.0 million of repayments on the secured term loan with KBC Bank, offset by \$25.1 million of net borrowings on property mortgages), dividends and distributions paid of \$18.8 million and debt issuance costs of \$3.5 million. Cash used in financing activities during the nine months ended September 30, 2011 was \$113.3 million, which primarily resulted from net repayments and repurchases of debt of \$143.8 million (including repayment and repurchases of CDO debt of \$106.9 million, repayments on the July 2010 Wells Fargo credit agreement of \$33.9 million, and repayments on the secured term loan with KBC Bank of \$10.5 million), dividends and distribution paid of \$16.8 million and common stock repurchased of \$6.1 million, partially offset by common stock issued of \$54.3 million.

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

### CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

We may from time to time make written or oral forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements contained in our filings with the Securities and Exchange Commission (“SEC”) and in our press releases and webcasts. Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts. In some cases, you can identify forward-looking statements by terms such as “anticipate,” “believe,” “could,” “estimate,” “expect,” “intend,”

“plan,” “potential,” “should,” “strategy,” “will” and other words of similar meaning. The forward-looking statements are based on our beliefs, assumptions and expectations of future performance, taking into account all information currently available to us. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to us or are within our control. If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. In connection with the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995, we are hereby identifying important factors that could cause actual results and outcomes to differ materially from those contained in any forward-looking statement made by or on our behalf. Such factors include, but are not limited to:

- our ability to renew leases as they expire or lease-up vacant space on favorable terms or at all;

- our ability to close new investment transactions that we have in our pipeline;
- our ability to make additional investments in a timely manner or on acceptable terms;
- current credit market conditions and our ability to obtain long-term financing for our asset investments in a timely manner and on terms that are consistent with those we project when we invest in the asset;
- access to capital markets and capital market conditions;
- adverse changes in the financial condition or credit ratings of the tenants underlying our investments;
- our ability to make scheduled payments on our debt obligations and to repay or refinance our debt obligations at maturity on favorable terms or at all;
- increases in our financing costs (including as a result of LIBOR rate increases), our general and administrative costs and/or our property expenses;
- changes in our industry, the industries of our tenants, interest rates or the general economy;
- impairments in the value of the collateral underlying our investments; and
- the degree and nature of our competition.

These risks and uncertainties should be considered in evaluating any forward-looking statement we may make from time to time. For a more detailed discussion of the risks affecting our business, any of which could cause our actual results to differ materially from those in the forward-looking statements, see our Annual Report on Form 10-K for the year ended December 31, 2011, including the section entitled “Risk Factors,” and any other reports or documents we file with the SEC from time to time. Any forward-looking statement speaks only as of its date. All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are qualified by the cautionary statements in this section. We undertake no obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in expectations after the date made.

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

Market risk refers to the risk of loss from adverse changes in the level of one or more market prices, rate indices or other market factors. We are exposed to market risk primarily from changes in interest rates, credit spreads, tenant credit ratings and equity prices. We may attempt to mitigate certain of these risks by entering into hedge and other risk management transactions during the short-term and fixed-rate financings for the long-term. We seek to obtain long-term fixed rate financing as soon as practicable after we make an asset investment. There can be no assurance, however, that such mitigation strategies will be completely or even partially successful. The level of our exposure to market risk is subject to factors beyond our control, including political risk (including terrorism), monetary and tax policy, general economic conditions and a variety of other associated risks.

#### Interest Rate Exposure

We are exposed to interest rate risk in various aspects of our business. The most significant ways we can be impacted by interest rates are as follows: increases in the level of interest rates may impact our ability to add new assets, as spreads on assets we are targeting may compress (unless there is a corresponding increase in asset returns). Declines in interest rates could result in greater demand for higher yielding assets and therefore increased competition for our



asset class.

Also, to the extent we finance assets in our portfolio on our floating rate borrowing facilities, our net income from these fixed rate assets will decrease as interest rates rise (particularly LIBOR rates) and our borrowing cost increases. Our Wells Fargo Bank and KeyBank credit agreements, as well as the loan agreement with Bank of Oklahoma for the Tulsa, Oklahoma development project, are currently our only floating rate borrowing facilities. Low market interest rates kept our borrowing cost on the our credit agreements low during 2011 and through the third quarter of 2012, although we cannot predict the level of market interest rates in the future. In addition, as interest rates rise, our anticipated cost to finance assets on a long-term fixed rate basis may rise, causing our expected spread on assets to be reduced. We may attempt to mitigate these risks by entering into risk management transactions that react in a manner that offsets our increased interest costs and by locking our long-term financing cost as soon as practicable after we commit to an asset. As a result of market conditions, we are not currently carrying an open interest rate hedge to manage our exposure to interest rate fluctuations for assets for which we may obtain long-term financing for in the future. Our decision to do so leaves us exposed to increases in long-term interest rates for those assets and, therefore, may make it more difficult or more costly to obtain long-term financing. As noted above, there can be no assurance that our mitigation strategies will be successful.

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

#### Credit Spread Curve Exposure

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

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

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

#### Tenant Credit Rating Exposure

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

#### Equity Price Risk Exposure

We may seek to raise capital by sale of our common stock. Our ability to do so is dependent upon the market price of our common stock and general market conditions. Any common stock sales we make may be dilutive to existing stockholders.

#### Fair Value

For certain of our financial instruments, fair values are not readily available since there are no active trading markets as characterized by current exchanges between willing parties. Accordingly, we derive or estimate fair values using various valuation techniques, such as computing the present value of estimated future cash flows using discount rates

commensurate with the risks involved. However, the determination of estimated cash flows may be subjective and imprecise. Changes in assumptions or estimation methodologies can have a material affect on these estimated fair values. The fair values indicated below are indicative of the interest rate and credit spread environment as of September 30, 2012, and may not take into consideration the effects of subsequent interest rate or credit spread fluctuations, or changes in the ratings of the underlying tenants.

The following summarizes certain data regarding our interest rate sensitive instruments as of September 30, 2012:

	Carrying Amount	Notional Amount	Weighted Average Effective Interest / Financing Rate		Maturity Date	Fair Value
(dollars in thousands)						
<b>Assets:</b>						
Loans held for investment (1)	\$28,631	\$32,960	7.0	%	Various	\$32,792
Commercial mortgage-backed securities (2)	59,904	76,760	8.3	%	2016-2028	59,904
<b>Liabilities</b>						
Mortgage notes payable (4)	\$986,629	\$985,261	5.6	%	2013-2030	\$1,053,701
Credit agreements (3)	48,097	48,097	4.9	%	2013-2015	48,097
Secured term loan (4)	76,100	76,100	6.0	%	2018	73,684
Convertible senior notes (5)	35,007	35,009	10.2	%	2012	35,009
Other long-term debt (6)	30,930	30,930	8.3	%	2016	30,535

(1) This portfolio of loans bears interest at fixed rates. We have estimated the fair value of this portfolio of loans with a discounted cash flow analysis, utilizing scheduled cash flows and discount rates estimated by management to approximate those that a willing buyer and seller might use. The maturity dates for the loans range from 2013 through 2033.

(2) Commercial mortgage-backed securities represent subordinate interests in securitizations, as well as pass-through certificates representing our pro rata investments in a pool of mortgage loans (collectively, CMBS). The notional values for the CMBS are shown at their respective face amounts. The fair values of CMBS reflect management's best estimate and require a considerable amount of judgment and assumptions. Management evaluates a variety of inputs and then estimates fair value based on those inputs. The primary inputs evaluated by management are broker quotations, collateral values, subordination levels, and liquidity of the security. For the CMBS, we expect to receive monthly interest coupon payments, and contractual principal payments as scheduled.

(3) Represents credit agreements as of September 30, 2012. Does not include new credit agreement we entered into with KeyBank National Association during October 2012 (see Note 23 in the consolidated financial statements included in this Form 10-Q). Our credit agreements bear interest at floating rates, and we believe that for similar financial instruments with comparable credit risks, the effective rates approximate market value. Accordingly, the carrying amounts outstanding are believed to approximate fair value.

(4) We estimate the fair value of mortgage notes on real estate investments and the secured term loan using a discounted cash flow analysis, based on our estimates of market interest rates. For mortgages where we have an early payment right, we also consider the prepayment amount to evaluate the fair value.

(5) The carry value and effective financing rate on the convertible senior notes reflect the impact of the accounting guidance applicable to the notes as of January 1, 2009. See Note 9 in our consolidated financial statements included in this Form 10-Q. We estimate the fair value of our convertible senior notes using a discounted cash flow analysis, based upon management's estimates of market interest rates, and indications of market yields, where

available. In computing the related fair value and weighted average effective interest rate, we have used a maturity date of October 2012, which represents the earliest note investor put right date as of September 30, 2012. Does not include impact of the repurchase of \$15.8 million principal amount of notes put to the Company on October 1, 2012. See Note 23 in the consolidated financial statements included in this Form 10-Q. The next note investor put right date is in October 2017.

(6) We estimate the fair value of our other long-term debt using a discounted cash flow analysis, based upon management's estimates of market interest rates. The maturity date of our other long-term debt reflects our expected maturity date in January 2016 and is used to compute the related fair value and weighted average effective interest rate.

Scheduled maturities of interest rate sensitive instruments as of September 30, 2012 are as follows:

	2012	2013	Expected Maturity Dates		2016	Thereafter
			2014	2015		
			(in thousands, notional amounts)			
Loans held for investment	\$1,631	\$3,498	\$1,108	\$1,029	\$918	\$24,776
Commercial mortgage-backed securities	391	3,675	4,174	4,779	8,894	54,846
Mortgages on real estate investments	4,785	73,573	184,670	269,583	278,214	174,437
Credit agreements	827	9,214	–	38,056	–	–
Secured term loan	3,690	14,242	12,851	11,862	12,516	20,940
Convertible senior notes	35,009	–	–	–	–	–
Other long-term debt	–	–	–	–	30,930	–

The above table includes regularly scheduled principal amortization and balloon payments due to maturity on our debt obligations. See Note 9 in our consolidated financial statements included in this Form 10-Q. The expected maturity dates shown for loans held for investment and commercial mortgage-backed securities are based on the contractual terms of the assets. The material assumptions used to determine fair value are included in footnotes 1 through 6 in the immediately preceding table.

#### Item 4. Controls and Procedures

##### Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined under Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

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

##### Changes in Internal Controls

There has been no change in our internal control over financial reporting during the quarter ended September 30, 2012, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

#### Item 1. Legal Proceedings

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

financial condition. However, periodic settlements and/or professional or other fees and expenses related to any matter could have an adverse impact on our results of operations in the quarterly or annual period in which they are recognized.

Item 1A. Risk Factors

See Item 1A of our Form 10-K for the fiscal year ended December 31, 2011 filed with the SEC on February 23, 2012.

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

During August 2011, our Board of Directors approved a share repurchase program authorizing us to repurchase in the aggregate up to \$20 million of our outstanding common stock. The program has no expiration date and permits us to purchase shares through a variety of methods, including in the open market or through privately negotiated transactions, in accordance with applicable securities laws. It does not obligate us to make any repurchases at any specific time or situation. The timing and extent to which we repurchase our shares will depend upon a variety of factors, including market conditions, our liquidity, and regulatory requirements.

We did not repurchase any shares of common stock during the three months ended September 30, 2012, through the above program or otherwise. As of September 30, 2012, we had remaining authorization to repurchase up to approximately \$13.3 million through the above program.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

- 10.1 Credit Agreement by and among Caplease Debt Funding, LP, as Borrower, the financial institutions party thereto and their assignees under Section 14.6, as Lenders, KeyBank National Association, as Administrative Agent, and KeyBank Capital Markets, as Sole Lead Arranger and Bookrunner, dated as of October 12, 2012 (incorporated by reference to the Registrant's Form 8-K filed October 16, 2012)
- 12.1 Computation of ratio of earnings to fixed charges and ratio of earnings to combined fixed charges and preferred stock dividends
- 31.1 Certification of the Registrant's Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Registrant's Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of the Registrant's Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of the Registrant's Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002



101.INS\*\* XBRL Instance

101.SCH\*\* XBRL Taxonomy Extension Schema

101.CAL\*\* XBRL Taxonomy Extension Calculation

101.DEF\*\* XBRL Taxonomy Extension Definition

101.LAB\*\* XBRL Taxonomy Extension Labels

101.PRE\*\* XBRL Taxonomy Extension Presentation

\*\*XBRL Information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CAPLEASE, INC.  
Registrant

Date: November 9, 2012

/s/ Paul H. McDowell  
Paul H. McDowell  
Chairman and Chief Executive Officer

Date: November 9, 2012

/s/ Shawn P. Seale  
Shawn P. Seale  
Senior Vice President, Chief Financial  
Officer  
and Treasurer