

CAPITAL LEASE FUNDING INC  
Form 10-Q  
August 11, 2005

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

**FORM 10-Q**

**(Mark One)**

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

**For the quarterly period ended June 30, 2005**

**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**

**Capital Lease Funding, Inc.**

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

**Maryland**

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

**52-2414533**

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

**110 Maiden Lane, New York, NY**

**(Address of Principal Executive Offices)**

**10005**

**(ZIP Code)**

**Registrant's Telephone Number, Including Area Code:**

**(212) 217-6300**

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of August 11, 2005, there were 27,868,480 shares of common stock of Capital Lease Funding, Inc., \$0.01 par value per share, outstanding ("Common Stock").

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**Capital Lease Funding, Inc.**

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

Capital Lease Funding, Inc. and Subsidiaries  
Consolidated Balance Sheets  
As of June 30, 2005 (unaudited) and December 31, 2004  
*(in thousands)*

|   | As of<br>June 30,<br>2005<br>Unaudited | As of<br>December 31,<br>2004 |
|---|--|-------------------------------|
| Assets  |  |                               |
| Cash and cash equivalents   | \$ 55,826                              | \$ 30,721                     |
| Mortgage loans held for investment  | 237,977                                | 207,347                       |
| Real estate investments, net  | 391,607                                | 194,541                       |
| Real estate investments consolidated under FIN46  | 81,500                                 | 48,000                        |
| Securities available for sale   | 124,995                                | 87,756                        |
| Structuring fees receivable   | 4,150                                  | 4,426                         |
| Prepaid expenses and other assets   | 36,756                                 | 7,941                         |
| Amounts due from affiliates and members   | 79                                     | 81                            |
| Accrued rental income   | 1,928                                  | 507                           |
| Derivative assets   | -                                      | 42                            |
| Furniture, fixtures and equipment, net  | 360                                    | 340                           |
| Total Assets  | \$ 935,178                             | \$ 581,702                    |
| Liabilities and Stockholders' Equity:   |  |                               |
| Accounts payable and accrued expenses   | \$ 8,114                               | \$ 3,479                      |
| Deposits and escrows  | 2,993                                  | 10,725                        |
| Due to servicer and dealers   | -                                      | 4,357                         |
| Repurchase agreement obligations  | 45,744                                 | 133,831                       |
| Mortgages on real estate investments  | 265,314                                | 111,539                       |
| Mortgage on real estate investments consolidated under FIN46  | 50,887                                 | 4,815                         |
| Collateralized debt obligations   | 268,138                                | -                             |
| Derivative liabilities  | 3,451                                  | 7,355                         |
| Deferred rental revenue   | 850                                    | -                             |
| Intangible liabilities on real estate investments   | 11,525                                 | 7,028                         |
| Dividends payable   | 5,016                                  | 4,124                         |
| Total Liabilities   | 662,032                                | 287,253                       |
| Minority interest in real estate investments consolidated under FIN46   | 26,613                                 | 41,185                        |
| Commitments and contingencies   |  |                               |
| Stockholders' equity:   |  |                               |
| Preferred stock, \$.01 par value, 100,000,000 shares authorized, no shares issued and outstanding                                   | -                                      | -                             |
| Common stock, \$.01 par value, 500,000,000 shares authorized, 27,868,480 and 27,491,700 shares issued and outstanding, respectively | 279                                    | 275                           |
| Additional paid in capital  | 246,445                                | 251,786                       |
| Accumulated other comprehensive income (loss)   | (191)                                  | 1,203                         |

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|  |    |         |            |
|--|----|---------|------------|
| Retained earnings                          |    | –       | –          |
| Total Stockholders' Equity                 |    | 246,533 | 253,264    |
| Total Liabilities and Stockholders' Equity | \$ | 935,178 | \$ 581,702 |

See notes to consolidated financial statements

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Capital Lease Funding, Inc. and Subsidiaries  
Consolidated Statements of Operations  
(Unaudited)  
*(in thousands, except per share data)*

|   | For the three months<br>ended June 30, |               | For the six months<br>ended June 30, |                   |
|---|--|---------------|--------------------------------------|-------------------|
|   | 2005                                   | 2004          | 2005                                 | 2004              |
| <b>Revenues:</b>  |  |               |                                      |                   |
| Interest income from mortgage loans and securities                      | \$ 6,641                               | \$ 2,756      | \$ 12,748                            | \$ 4,678          |
| Gain on sales of mortgage loans and securities                          | 174                                    | -             | 237                                  | -                 |
| Rental revenue  | 7,124                                  | -             | 11,459                               | -                 |
| Property expense recoveries   | 1,356                                  | -             | 2,719                                | -                 |
| Other revenue   | 93                                     | 43            | 132                                  | 86                |
| <b>Total revenues</b>   | <b>15,388</b>                          | <b>2,799</b>  | <b>27,295</b>                        | <b>4,764</b>      |
| <b>Expenses:</b>  |  |               |                                      |                   |
| Interest expense  | 6,214                                  | -             | 9,756                                | 425               |
| Interest expense to affiliates  | -                                      | -             | -                                    | 231               |
| Property expenses   | 2,291                                  | -             | 4,074                                | -                 |
| Net loss on derivatives and short sales of securities                   | -                                      | -             | -                                    | 724               |
| Loss on securities  | 250                                    | -             | 250                                  | -                 |
| General and administrative expenses                                     | 2,414                                  | 1,989         | 4,967                                | 3,897             |
| General and administrative expenses-stock based compensation            | 467                                    | 334           | 922                                  | 3,167             |
| Depreciation and amortization expense on real property                  | 1,920                                  | -             | 3,188                                | -                 |
| Loan processing expenses  | 63                                     | 33            | 148                                  | 69                |
| <b>Total expenses</b>   | <b>13,619</b>                          | <b>2,356</b>  | <b>23,305</b>                        | <b>8,513</b>      |
| Income (loss) before minority interest                                  | 1,769                                  | 443           | 3,990                                | (3,749)           |
| Minority interest in consolidated entities                              | (215)                                  | -             | (215)                                | -                 |
| <b>Net income (loss)</b>  | <b>\$ 1,554</b>                        | <b>\$ 443</b> | <b>\$ 3,775</b>                      | <b>\$ (3,749)</b> |
| <b>Earnings per share</b>   |  |               |                                      |                   |
| Net income per share, basic and diluted                                 | \$ 0.06                                | \$ 0.02       | \$ 0.14                              | \$ (0.22)         |
| Weighted average number of common shares outstanding, basic and diluted | 27,868                                 | 27,488        | 27,698                               | 16,699            |
| Dividends declared per common share                                     | \$ 0.18                                | \$ -          | \$ 0.36                              | \$ -              |

See notes to consolidated financial statements



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

|   | Common<br>Stock<br>at Par | Additional<br>Paid-In<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Retained<br>Earnings | Total    |
|---|---------------------------|----------------------------------|---|----------------------|----------|
| Balance at December 31, 2004                                | \$ 275                    | \$ 251,786                       | \$ 1,203  | \$ -                 | 253,264  |
| Incentive stock plan compensation expense                   | -                         | 922                              | -   | -                    | 922      |
| Incentive stock plan grants issued                          | 4                         | (4)                              | -   | -                    | -        |
| Net income  | -                         | -                                | -   | 3,775                | 3,775    |
| Dividends declared  | -                         | (6,259)                          | -   | (3,775)              | (10,034) |
| Unrealized change in value of securities available for sale | -                         | -                                | 4,665   | -                    | 4,665    |
| Unrealized change in value of derivatives                   | -                         | -                                | 3,806   | -                    | 3,806    |
| Realized gains (losses) on derivatives, net of amortization | -                         | -                                | (9,865)   | -                    | (9,865)  |
| Balance at June 30, 2005                                    | \$ 279                    | \$ 246,445                       | \$ (191)  | \$ -                 | 246,533  |

See notes to consolidated financial statements



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

|   | For the six months<br>ended June 30, |            |
|---|--------------------------------------|------------|
|   | 2005                                 | 2004       |
| <b>Operating activities</b>   |                                      |            |
| Net income (loss)   | \$ 3,775                             | \$ (3,749) |
| Adjustments to reconcile net income to cash used in operating activities: |                                      |            |
| Depreciation and amortization   | 2,824                                | 41         |
| Amortization of stock based compensation                                  | 922                                  | 3,167      |
| Amortization of below market leases                                       | (212)                                | -          |
| Gain on sale of mortgage loans and securities                             | (237)                                | -          |
| Loss on derivatives and short sales of securities                         | -                                    | 724        |
| Accrued rental income   | (1,421)                              | -          |
| Deferred rental revenue   | 850                                  | -          |
| Amortization of discounts/premiums, and origination fees/costs            | (210)                                | (100)      |
| Amortization of debt issuance costs                                       | 475                                  | -          |
| Changes in operating assets and liabilities:                              |                                      |            |
| Funds used in hedging and risk management activities                      | -                                    | (1,827)    |
| Structuring fees receivable   | 276                                  | 532        |
| Prepaid expenses and other assets   | (9,858)                              | (1,382)    |
| Accounts payable and accrued expenses                                     | 4,581                                | (1,552)    |
| Deposits and escrows  | (7,732)                              | 1,142      |
| Due to servicer and dealer  | (4,359)                              | (38)       |
| Net cash used in operating activities                                     | (10,326)                             | (3,042)    |
| <b>Investing activities</b>   |                                      |            |
| Proceeds from sale of mortgage loans                                      | 2,310                                | -          |
| Principal advanced to borrowers   | (33,865)                             | (38,342)   |
| Principal received from borrowers   | 7,121                                | 5,357      |
| Loan origination costs  | 55                                   | (4)        |
| Purchase of securities available for sale                                 | (45,167)                             | (69,026)   |
| Sale of securities available for sale                                     | 5,787                                | 20,397     |
| Principal amortization on securities available for sale                   | 1,001                                | -          |
| Purchases of real estate investments                                      | (195,128)                            | -          |
| Deposits on potential equity investments                                  | (4,000)                              | -          |
| Return of deposit on equity investment                                    | 2,500                                | -          |
| Purchases of furniture, fixtures and equipment                            | (72)                                 | (31)       |
| Net cash used in investing activities                                     | (259,458)                            | (81,649)   |
| <b>Financing activities</b>   |                                      |            |
| Borrowing under repurchase agreements                                     | 123,538                              | -          |
| Repayments under repurchase agreements                                    | (211,626)                            | (28,765)   |
| Repayments under repurchase agreements to affiliates                      | -                                    | (59,322)   |
| Borrowings from mortgages on real estate investments                      | 154,309                              | -          |
| Repayments of mortgages on real estate investments                        | (534)                                | -          |
| Borrowings from collateralized debt obligations                           | 268,130                              | -          |
| Deferred financing costs  | (5,323)                              | (60)       |

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|  |               |               |
|--|---------------|---------------|
| Deposits and escrows on mortgage notes               | (14,269)      | –             |
| Funds used in hedging and risk management activities | (10,196)      | –             |
| Reverse merger                                       | –             | 14            |
| Net proceeds from equity offering                    | –             | 222,818       |
| Dividends paid                                       | (9,141)       | –             |
| Changes in amounts due from affiliates and members   | 1             | 30            |
| Net cash provided by financing activities            | 294,889       | 134,715       |
| <b>Net increase in cash</b>                          | <b>25,105</b> | <b>50,024</b> |
| Cash and cash equivalents at beginning of period     | 30,721        | 6,522         |
| Cash and cash equivalents at end of period           | \$ 55,826     | \$ 56,546     |

**Supplemental disclosure of cash flow information**

|                                 |          |      |
|---------------------------------|----------|------|
| Dividends declared but not paid | \$ 5,016 | \$ – |
|---------------------------------|----------|------|

**Supplemental disclosure of noncash operating, investing and financing information**

|   |           |          |
|---|-----------|----------|
| Prepaid expenses and other assets reclassified to public offering costs | \$ –      | \$ 1,040 |
| Unrealized gain (loss) on cash flow hedges                              | \$ 3,806  | \$ 2,554 |
| Securities reclassified to mortgage loans held for investment           | \$ 6,180  | \$ –     |
| Real estate investments consolidated under FIN46                        | \$ 81,500 | \$ –     |
| Real estate investments no longer consolidated under FIN46              | \$ 48,000 | \$ –     |
| Mortgage on real estate investments consolidated under FIN46            | \$ 50,887 | \$ –     |
| Mortgage on real estate investments no longer consolidated under FIN46  | \$ 4,815  | \$ –     |
| Depreciation on real estate investments consolidated under FIN46        | \$ 417    | \$ –     |

See notes to consolidated financial statements

Capital Lease Funding, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
(Dollar amounts in thousands)

June 30, 2005 (unaudited)

## 1. Organization

Capital Lease Funding, Inc. ("CLF, Inc." and collectively with its wholly-owned subsidiaries, the "Company") was incorporated in the State of Maryland during October 2003, and was formed for the purpose of continuing the existing business operations and acquiring the assets and liabilities of Caplease, LP ("LP" or the "Predecessor"). CLF, Inc. completed this acquisition through a reverse merger and its initial public offering during March 2004.

The Company invests in real estate mortgage loans, equity interests in real estate properties, real estate securities and other real estate assets. The Company's investments primarily consist of real estate related assets that are backed by commercial properties typically subject to long-term net leases from investment grade and near investment grade tenants.

The accompanying financial statements include the historical results of operations of the Predecessor prior to its acquisition by CLF, Inc. The Predecessor's principal activity was the origination and sale or securitization of commercial mortgage loans. Since 1995, the Predecessor was primarily engaged in the business of underwriting, originating and selling or securitizing mortgage loans to owners of real properties subject to long term leases to high credit quality tenants. These loans were typically secured by a first lien on the leased property and an assignment of the leases and all rents due under the leases.

In March 2004, CLF, Inc. sold 23 million shares of its common stock in an initial public offering at a price to the public of \$10.50 per share, for net proceeds of approximately \$222 million. CLF, Inc. had 27,868,480 shares of common stock outstanding at June 30, 2005.

CLF, Inc. is organized and conducts its operations to qualify as a real estate investment trust ("REIT") for federal income tax purposes. As such, it will generally not be subject to federal income tax on that portion of its income that is distributed to stockholders if it distributes at least 90% of its REIT taxable income to its stockholders by prescribed dates and complies with various other requirements. On March 22, 2005, CLF, Inc. declared a dividend of \$0.18 per common share, payable on April 15, 2005, to stockholders of record as of March 31, 2005. The dividend declared in March was paid on April 15, 2005. On June 15, 2005, CLF, Inc. declared a dividend of \$0.18 per common share, payable on July 15, 2005, to stockholders of record as of June 30, 2005. The dividend declared in June was paid on July 15, 2005.

The accompanying consolidated financial statements and related notes of the Company have been prepared in accordance with accounting principles generally accepted in the United States for interim financial reporting and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in the financial statements prepared under accounting principles generally accepted in the United States have been condensed or omitted. In the opinion of management, all adjustments considered necessary for a fair presentation of the Company's financial position, results of operations and cash flows have been included and are of a normal and recurring nature. The operating results presented for interim periods are not necessarily indicative of the results that may be expected for any other interim period or for the entire year. These financial statements should be read in conjunction with the Company's consolidated financial statements for the fiscal year ended December 31, 2004 and notes thereto, included in the Company's Form 10-K filed with the SEC on March

30, 2005.

## **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 Predecessor prior to March 24, 2004 and CLF, Inc. and its wholly-owned subsidiaries thereafter. Results of operations of properties acquired are included in the Consolidated Statement of Operations from the date of acquisition. All significant intercompany transactions, balances and accounts have been eliminated in consolidation.

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Capital Lease Funding, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
(Dollar amounts in thousands)

June 30, 2005 (unaudited)

*Investments in Mortgage Loans*

Mortgage loans are secured by an assignment of the long-term real property leases (the majority of whose tenants are investment grade) and mortgages on the underlying real estate. Mortgage loans held for investment are carried at cost (unpaid principal balance adjusted for unearned discount and deferred expenses), and are amortized using the effective interest method over the life of the loan.

*Purchase Accounting for Acquisition of Real Estate*

The fair value of rental real estate acquired subject to existing leases is allocated to the following based on fair values:

- the acquired tangible assets, consisting of land, building and improvements; and
- identified intangible assets and liabilities, consisting of the value of above-market and below-market leases, the value of in-place leases and the value of tenant relationships, based in each case on their fair values.

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.

Above-market and below-market lease values for acquired properties are recorded based on the present value (using a discount rate which reflects the risks associated with the leases acquired) of the differences between (i) the contractual amounts to be paid pursuant to each in-place lease and (ii) management's estimate of fair market lease rates for each corresponding in-place lease, 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. 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 fixed rate 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 an estimate of 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, legal and other related expenses. Characteristics considered by management in valuing tenant relationships include the nature and extent of the Company's existing business relationships with the tenant, growth prospects for developing new business with the tenant, the tenant's credit quality and expectations of lease renewals. The value of in-place leases is amortized to expense over the remaining initial terms of the respective leases. The value of tenant

relationship intangibles is amortized to expense over the anticipated life of the relationships.

Real estate taxes, insurance and interest expense on properties that are under development are capitalized in accordance with the Financial Accounting Standards Board (“FASB”) Statement of Financial Accounting Standards (“SFAS”) No. 34, *Capitalization of Interest Cost* and SFAS 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*.

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

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Capital Lease Funding, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
(Dollar amounts in thousands)

June 30, 2005 (unaudited)

*Securities Available for Sale*

Securities are classified as available-for-sale and are reported at fair value on the Company's balance sheet, with unrealized gains and losses included in other comprehensive income, and other than temporary impairments included in current earnings on the Statement of Operations, in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The Company has also adopted the disclosure requirements of EITF Issue No. 03-01 regarding disclosures to be made when held-to-maturity or available-for-sale investments are impaired at the balance sheet date but for which an "other than temporary" loss has not been recognized.

*Deferred Origination Fees and Costs*

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

*Revenue Recognition*

Interest income from mortgage loans (including mortgage loans with associated valuation reserves), 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.

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

Gains are recognized on the sale of mortgage loans and securities in accordance with the requirements of SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. As part of the Company's 10-year credit tenant loan program, the Company may from time to time bifurcate its mortgage loan investments into two notes, a real estate note and a corporate credit note. In these instances, the Company will generally sell the real estate note to a third party and retain the corporate credit note in portfolio. The Company computes gain on these sales by comparing the sales proceeds on the note sold to its cost basis. The Company computes its cost basis on the note sold by allocating the entire basis in the loan between the two notes based on the present value of expected cash flows on each note. In computing present values, management estimates a discount rate based on a benchmark rate plus a market spread based on the underlying credit. These estimates reflect market rates that management believes are reasonable. However, the use of different estimates could have an impact on the calculation of gain on sale revenue.

The Company may periodically receive breakup fees on contracts in connection with its investments in real estate. The Company recognizes revenues from contract breakup fees when the contractual conditions have occurred to

trigger the receipt of such a fee, when the amounts of such revenue can be reasonably determined, and when collection is probable.

*Income Taxes*

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



Capital Lease Funding, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
(Dollar amounts in thousands)

June 30, 2005 (unaudited)

*Earnings per Share*

In accordance with the Statement of Financial Accounting Standards No. 128 ("SFAS No. 128"), the Company presents both basic and diluted earnings per share ("EPS"). Basic EPS excludes dilution and is computed by dividing net income allocable to common shareholders 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 has no such securities or other contracts outstanding and, therefore, there is no difference between basic and diluted EPS results for the Company.

The following summarizes the Company's EPS computations for the three and six months ended June 30, 2005 and June 30, 2004 (in thousands, except per share amounts):

|   | For the three months<br>ended June 30, |         | For the six months<br>ended June 30, |            |
|---|--|---------|--------------------------------------|------------|
|   | 2005                                   | 2004    | 2005                                 | 2004       |
| Net income (loss)   | \$ 1,554                               | \$ 443  | \$ 3,775                             | \$ (3,749) |
| Weighted average number of common shares outstanding, basic and diluted           | 27,868                                 | 27,488  | 27,698                               | 16,699     |
| Earnings per share, basic and diluted   | \$ 0.06                                | \$ 0.02 | \$ 0.14                              | \$ (0.22)  |
| Non-vested shares included in weighted average number of shares outstanding above | 497                                    | 251     | 497                                  | 251        |

*Recently Issued Accounting Pronouncements*

On December 16, 2004, the FASB issued SFAS No. 153: *Exchanges of Non-monetary Assets – An Amendment of APB Opinion No. 29*. The amendments made by SFAS No. 153 are based on the principle that exchanges of non-monetary assets should be measured based on the fair value of the assets exchanged. Further, the amendments eliminate the narrow exception for non-monetary exchanges of similar productive assets and replace it with a broader exception for exchanges of non-monetary assets that do not have "commercial substance." SFAS No. 153 is effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 on June 15, 2005 did not have a material effect on the Company's consolidated financial statements.

On December 16, 2004, the FASB issued SFAS No. 123R: (Revised 2004) – *Share-Based Payment* ("SFAS No. 123R"). SFAS 123R replaces SFAS No. 123, which the Company adopted on January 1, 2003. SFAS No. 123R requires that the compensation cost relating to share-based payment transactions be recognized in financial statements and be measured based on the fair value of the equity or liability instruments issued. SFAS No. 123R is effective as of the first interim or annual reporting period that begins after December 31, 2005 (or as of January 1, 2006 for the Company). The Company does not believe that the adoption of SFAS No. 123R will have a material effect on the Company's consolidated financial statements.

*Reclassification*

Certain prior year amounts have been reclassified to conform to the current presentation.

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Capital Lease Funding, Inc. and Subsidiaries  
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### 3. 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.

### 4. Mortgage Loan Held for Investment

Mortgage loans held for investment at June 30, 2005 and December 31, 2004 consist predominantly of loans on properties subject to leases to investment grade companies with credit ratings generally ranging from AA to BB- from Standard & Poor's. These loans are summarized in the following table:

|                                | Jun 30, 2005<br>Unaudited | Dec 31, 2004 |
|--------------------------------|---------------------------|--------------|
| Principal                      | \$ 236,576                | \$ 206,735   |
| Premium (discount)             | 1,965                     | 1,158        |
| Carrying amount of mortgages   | 238,541                   | 207,893      |
| Deferred origination fees, net | (564)                     | (546)        |
| Total                          | \$ 237,977                | \$ 207,347   |

At June 30, 2005, the mortgage loans carried interest rates ranging from 5.36% to 10.00% and at December 31, 2004, the mortgage loans carried interest rates ranging from 4.71% to 10.00%. At June 30, 2005 and December 31, 2004, the weighted average effective interest rate on the mortgage loans, as measured against our cost basis, was 6.64% and 6.56%, respectively.

### 5. Real Estate Investments

Real estate held for investment and related intangible liabilities on real estate investments consisted of the following at June 30, 2005 and December 31, 2004:

|                                   | Jun 30, 2005<br>Unaudited | Dec 31, 2004 |
|-----------------------------------|---------------------------|--------------|
| Real estate investments, at cost: |                           |              |
| Land and improvements             | \$ 75,716                 | \$ 28,226    |
| Building and improvements         | 286,160                   | 154,078      |
| Intangible assets under SFAS 141  | 33,783                    | 13,518       |

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|  |    |         |    |         |
|--|----|---------|----|---------|
| Less: Accumulated depreciation and amortization        |    | (4,052) |    | (1,281) |
| Real estate investments, net                           | \$ | 391,607 | \$ | 194,541 |
| Intangible liabilities on real estate investments:     |    |         |    |         |
| Intangible liabilities under SFAS 141                  | \$ | 11,817  | \$ | 7,108   |
| Less: Accumulated amortization                         |    | (292)   |    | (80)    |
| Intangible liabilities on real estate investments, net | \$ | 11,525  | \$ | 7,028   |

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Capital Lease Funding, Inc. and Subsidiaries  
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Some leases provide for scheduled rent increases throughout the lease term. Such amounts are recognized on a straight-line basis over the terms of the leases. For the three and six months ended June 30, 2005, the Company recognized \$993 and \$1,421, respectively, of such revenue. At June 30, 2005, the balance of accrued rental income was \$1,928. At June 30, 2005, the balance of deferred rental income was \$850. Amortization of intangible assets on real estate investments totaled \$371 and \$678, respectively, for the three and six months ended June 30, 2005, and is included in "Depreciation and amortization expense" on the Company's Consolidated Statement of Operations. Amortization of intangible liabilities on real estate investments totaled \$113 and \$212, respectively, for the three and six months ended June 30, 2005, and is included in "Rental revenue" on the Company's Consolidated Statement of Operations.

Scheduled amortization on existing intangible assets and liabilities on real estate investments is as follows:

|                                   | Intangible<br>Assets | Intangible<br>Liabilities |
|-----------------------------------|----------------------|---------------------------|
| 6 months ending December 31, 2005 | \$ 1,368             | \$ 393                    |
| 2006                              | 2,736                | 787                       |
| 2007                              | 2,736                | 787                       |
| 2008                              | 2,736                | 787                       |
| 2009                              | 2,736                | 787                       |
| Thereafter                        | 20,498               | 7,984                     |
|                                   | \$ 32,810            | \$ 11,525                 |

The Company's analysis of intangible assets and liabilities acquired in connection with the acquisition of real estate properties is preliminary.

During the three months ended June 30, 2005, the Company completed the following real estate acquisitions:

| Month<br>Acquired | Tenant or Guarantor  | Location                | Acquisition<br>Cost     | Lease<br>Expires | Net Rentable<br>Square Feet |
|-------------------|--|-------------------------|-------------------------|------------------|-----------------------------|
| May               | ITT Industries, Inc.   | Herndon, Virginia       | \$46,100 <sup>(1)</sup> | 2019             | 167,285                     |
| May               | Lowe's Companies, Inc./ Michaels Stores, Inc. <sup>(2)</sup> | Aliso Viejo, California | \$52,860                | 2024/2015        | 180,854                     |
| June              | Capital One Financial Corp.                                  | Plano, Texas            | \$27,900                | 2015             | 159,000                     |
| June              | Omnicom Group, Inc.  | Irving, Texas           | \$18,100                | 2013             | 101,120                     |

<sup>(1)</sup> Does not include our contingent obligation to fund tenant improvements of approximately \$9,500.

<sup>(2)</sup> Approximately 4% of the property is leased to one other tenant.

Capital Lease Funding, Inc. and Subsidiaries  
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**6. Securities Available for Sale and Structuring Fees Receivable**

Securities available for sale at June 30, 2005 and at December 31, 2004 consisted of the following:

|   | Jun 30, 2005<br>Unaudited | Dec 31, 2004     |
|---|---------------------------|------------------|
| BSCMS 1999 CLF1, Class E (rated BB) Face amount                 | \$ 3,326                  | \$ 3,326         |
| BSCMS 1999 CLF1, Class F (rated B-) Face amount                 | 2,494                     | 2,494            |
| CALFS 1997-CTL1, Class D (rated BBB) Face amount                | 6,000                     | 3,000            |
| CMLBC 2001-CMLB-1 Class E (rated BBB+) Face amount              | 9,526                     | 9,526            |
| CMLBC 2001-CMLB-1 Class G (rated BBB-) Face amount              | 9,526                     | 9,526            |
| CMLBC 2001-CMLB-1, Class H (rated BB-) Face amount              | 11,907                    | 11,907           |
| CMLBC 2001-CMLB-1, Class J (rated B-) Face amount               | 7,144                     | 7,144            |
| CMLBC 2001-CMLB-1, Class K (not rated) Face amount              | 4,766                     | 4,766            |
| NLFC 1999 LTL1, Class D (rated BBB) Face amount                 | 5,000                     | 5,000            |
| NLFC-99LTL 1, Class E (rated BB-) Face amount                   | 11,082                    | 11,081           |
| NLFC-99LTL 1, Class X/IO (rated AAA) Cost basis                 | 8,935                     | 9,908            |
| Yahoo, Inc 6.65% Certificates (tenant rated BBB-) Face amount   | 31,995                    | 16,999           |
| WBCMT 2004-C15 180D (rated B+) Face amount                      | 15,000                    | -                |
| WBCMT 2004-C15 180E (rated B) Face amount                       | 8,000                     | -                |
| CVS Pass Through Certificates (tenant rated A-) Face amount (1) | -                         | 6,180            |
| BACMS 2002-2, Class V-1 (tenant rated BBB) Face amount          | 377                       | 361              |
| BACMS 2002-2, Class V-2 (tenant rated BBB-) Face amount         | 577                       | 553              |
| Unearned discount   | (25,534)                  | (24,224)         |
| Cost basis  | 110,121                   | 77,547           |
| Unrealized appreciation on securities held for sale             | 14,874                    | 10,209           |
| <b>Total</b>  | <b>\$ 124,995</b>         | <b>\$ 87,756</b> |

(1) These securities were reclassified to mortgage loan investments during March 2005, when the underlying mortgage loan trust was dissolved.

During the three months ended June 30, 2005, the Company recorded a \$250 loss on its investment in the BSCMS 1999 CLF1, Class F bonds, due to management's determination that an other-than-temporary decline in the fair value of the bond had occurred. The Company's remaining carrying value of \$750 on this bond is approximately equal to management's estimate of its current fair value.

Unrealized gains and losses on securities available for sale at June 30, 2005 and December 31, 2004, included as a component of other comprehensive income consisted of the following:

| Jun 30, 2005<br>Unaudited | Dec 31, 2004 |
|---------------------------|--------------|
|---------------------------|--------------|

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|  |        |        |
|--|--------|--------|
| Unrealized gains on securities available for sale  | 14,934 | 10,266 |
| Unrealized losses on securities available for sale | (60)   | (57)   |

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Capital Lease Funding, Inc. and Subsidiaries  
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At June 30, 2005 and December 31, 2004, the effective interest rate (yield to maturity on cost basis) on securities available for sale was approximately 8.8% and 9.9%, respectively.

The following summarizes sales of securities during the three and six months ended June 30, 2005 and June 30, 2004:

|                           | For the three months<br>ended June 30, |      | For the six months<br>ended June 30, |           |
|---------------------------|--|------|--------------------------------------|-----------|
|                           | 2005                                   | 2004 | 2005                                 | 2004      |
| Net proceeds<br>from sale | \$ 5,787                               | \$ — | \$ 5,787                             | \$ 20,397 |
| Net gain (loss)           | 174                                    | —    | 174                                  | —         |

Structuring fees receivable of \$4,150 and \$4,426 at June 30, 2005 and December 31, 2004, respectively, were earned by the Company in conjunction with the structuring and subsequent sale of certain net lease loans. Such fees are payable to the Company monthly without interest through March 2020 and, accordingly, have been discounted based on imputed interest rates estimated by management to approximate market. Structuring fees receivable are shown at their amortized cost.

### 7. Prepaid Expenses and Other Assets

Prepaid expenses and other assets as of June 30, 2005 and December 31, 2004 consisted of the following:

|   | Jun 30, 2005<br>Unaudited | Dec 31, 2004 |
|---|---------------------------|--------------|
| Mortgage note escrows & deposits              | \$ 16,619                 | \$ 2,350     |
| Deferred financing costs                      | 5,530                     | 343          |
| Deposits on acquisitions & pending financings | 558                       | 500          |
| Accrued interest receivable                   | 1,331                     | 1,128        |
| Funds collected by servicers                  | 11,291                    | 2,467        |
| Other   | 1,427                     | 1,153        |
| Total   | \$ 36,756                 | \$ 7,941     |

### 8. Repurchase Agreements

As of June 30, 2005, the Company had a repurchase agreement in place for short-term liquidity requirements with Wachovia Bank, N.A. On March 1, 2005, the Company's repurchase agreement with Bank of America expired unused.

Amounts related to the Company's credit facilities as of June 30, 2005 and December 31, 2004 are as follows:

June 30, 2005

December 31, 2004



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|                        | Unaudited        |                  |                  |                   |                   |
|------------------------|------------------|------------------|------------------|-------------------|-------------------|
|                        | Wachovia         | Total            | BofA             | Wachovia          | Total             |
| <i>Collateral face</i> |                  |                  |                  |                   |                   |
| Mortgage loans         | \$ 13,549        | \$ 13,549        | \$ 22,800        | \$ 136,477        | \$ 159,277        |
| CMBS                   | 43,354           | 43,354           | –                | 41,130            | 41,130            |
| <b>Total</b>           | <b>\$ 56,903</b> | <b>\$ 56,903</b> | <b>\$ 22,800</b> | <b>\$ 177,607</b> | <b>\$ 200,407</b> |
| <i>Financing</i>       |                  |                  |                  |                   |                   |
| Mortgage loans         | \$ 11,738        | \$ 11,738        | –                | \$ 102,288        | \$ 102,288        |
| CMBS                   | 34,006           | 34,006           | –                | 31,543            | 31,543            |
| <b>Total</b>           | <b>\$ 45,744</b> | <b>\$ 45,744</b> | <b>–</b>         | <b>\$ 133,831</b> | <b>\$ 133,831</b> |

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Weighted average interest rates on the Company's credit facilities for the six months ended June 30, 2005 and 2004 are as follows:

|   | Jun 30,<br>2005 | Jun 30,<br>2004 |
|---|-----------------|-----------------|
|   | Unaudited       | Unaudited       |
| Bank of America-mortgage loan repurchase agreements | N/A             | 2.59%           |
| Bank of America-CMBS repurchase agreements          | N/A             | 1.90%           |
| Wachovia-mortgage loan repurchase agreements        | 3.41%           | 2.10%           |
| Wachovia-CMBS repurchase agreements                 | 3.57%           | 3.10%           |

As of June 30, 2005 and 2004, the 1-month LIBOR rate was 3.34% and 1.37%, respectively. As of June 30, 2005, the Company was in compliance with the terms of the repurchase agreement with its warehouse lender.

The Company's credit facility with Wachovia Bank matures in September 2005. The Company does not anticipate any issues with renewing this facility. In addition, the Company has a strong history of negotiating credit facilities with lenders, and management is confident that it can find replacement or additional credit facilities if the need arises.

### 9. Risk Management Transactions

Prior to CLF, Inc.'s conversion to a REIT on March 24, 2004, the Company used risk management transactions consisting of U.S. Treasury and Agency lock transactions ("Locks") to hedge the interest rate risk associated with owning fixed rate mortgage loan assets financed by floating rate debt. Subsequent to REIT conversion, the Company changed the way it hedges to comply with the REIT tax requirements and began using forward starting interest rate swaps to hedge the variability of changes in the interest-related cash outflows on forecasted future borrowings. As of June 30, 2005, the Company was hedging its exposure to such variability through December 2015. In accordance with SFAS 133, the Locks and interest rate swaps, to the extent that they have been designated and qualify as part of a hedging relationship, are treated as fair value hedges and cash flow hedges, respectively, for accounting purposes.

Interest rate swaps are agreements between two parties to exchange, at particular intervals, payment streams calculated on a specified notional amount. The interest rate swaps that the Company has entered into are single currency interest rate swaps and, as such, do not require the exchange of a notional amount.

Amounts related to open positions as of June 30, 2005 and December 31, 2004, are as follows:

|               |                   |
|---------------|-------------------|
| June 30, 2005 | December 31, 2004 |
| Unaudited     |                   |

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| <i>Description</i>  | Notional<br>Amount | Fair value | Notional<br>Amount | Fair value |
|---------------------|--------------------|------------|--------------------|------------|
| Interest rate swaps | \$ 120,456         | \$ (3,451) | \$ 228,182         | \$ (7,312) |

At June 30, 2005 and December 31, 2004, the Company had hedged the following future borrowings:

|                                      | Jun 30, 2005<br>Unaudited | Dec 31, 2004 |
|--------------------------------------|---------------------------|--------------|
| Future borrowings (principal amount) | \$ 120,456                | \$ 228,182   |

At June 30, 2005 and December 31, 2004, derivatives with a fair value of \$(3,451) and \$(7,355) respectively, were included in derivative liabilities on the Company's balance sheet. At June 30, 2005 and December 31, 2004, derivatives with a fair value of \$0 and \$42, respectively, were included in derivative assets on the Company's balance sheet. For the six months ended June 30, 2005 and 2004, the Company had net realized losses of \$10,196 and net realized gains of \$912, respectively, related to cash flow hedges. The net realized losses and gains are included in Other Comprehensive Income and will be reclassified and amortized as part of interest expense on the Company's Consolidated Statement of Operations over the expected term of the Company's related debt issuances. The change in net unrealized gains and losses of \$3,806 in the six months ended June 30, 2005 period for derivatives designated as cash flow hedges is separately disclosed in the statement of changes in stockholders' equity.

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We recognized no expense due to hedge ineffectiveness for the three months ended June 30, 2005 and 2004. For the three months ended June 30, 2005 and 2004, the Company reclassified \$241 and \$0, respectively, from accumulated other comprehensive loss into interest expense related to the underlying debt issuances. For the six months ended June 30, 2005 and 2004, the Company reclassified \$331 and \$0, respectively, from accumulated other comprehensive loss into interest expense related to the underlying debt issuances.

### 10. Long-Term Debt

Our long-term debt consists of the following:

- mortgage notes on real estate investments; and
- collateralized debt obligations.

#### *Mortgages Notes on Real Estate Investments*

Mortgage notes payable collateralized by the respective properties (aggregating \$352,208 at June 30, 2005 and \$153,690 at December 31, 2004) and assignment of leases are as follows:

| Property Level Debt - Fixed Rate   | Jun 30, 2005      |                       | Dec 31, 2004      |                   | Coupon | Effective Rate <sup>(1)</sup> | Maturity |
|------------------------------------|-------------------|-----------------------|-------------------|-------------------|--------|-------------------------------|----------|
|                                    | Face Unaudited    | Carry Value Unaudited | Face              | Carry Value       |        |                               |          |
| Choice, Silver Spring, MD          | \$ 32,416         | 32,416                | \$ 32,625         | \$ 32,625         | 5.30%  | 5.34%                         | May-13   |
| Omnicom Group, Inc., Irving, TX    | 13,575            | 13,575                | –                 | –                 | 5.24%  | 5.30%                         | May-13   |
| Capital One, Plano, TX             | 20,925            | 20,925                | –                 | –                 | 5.24%  | 5.29%                         | May-13   |
| AON Corporation, Glenview, IL      | 64,800            | 64,800                | 64,800            | 64,800            | 5.23%  | 5.75%                         | Nov-14   |
| Cadbury Schweppes, Whippany, NJ    | 36,000            | 36,000                | –                 | –                 | 5.26%  | 5.34%                         | Mar-15   |
| ITT, Herndon, VA                   | 41,700            | 41,700                | –                 | –                 | 5.33%  | 5.47%                         | Jun-15   |
| Lowes Corporation, Aliso Viejo, CA | 42,125            | 42,125                | –                 | –                 | 5.10%  | 5.36%                         | Jul-15   |
| GSA, Ponce, PR                     | 7,530             | 7,906                 | 7,735             | 8,117             | 7.30%  | 6.47%                         | Apr-16   |
| Walgreen Co., Pennsauken, NJ       | 2,105             | 2,279                 | 2,162             | 2,347             | 7.65%  | 6.04%                         | Oct-16   |
| Walgreen Co., Portsmouth, VA       | 3,358             | 3,588                 | 3,410             | 3,650             | 7.20%  | 6.18%                         | Jul-18   |
| <b>Total</b>                       | <b>\$ 264,534</b> | <b>\$ 265,314</b>     | <b>\$ 110,732</b> | <b>\$ 111,539</b> |        |                               |          |

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

*Collateralized Debt Obligations*

On March 10, 2005, the Company issued to third party investors two classes (Classes A and B) of investment grade collateralized debt obligations, or CDOs, through a newly formed wholly-owned subsidiary, Caplease CDO, 2005-1, Ltd., or Caplease CDO-1. Caplease CDO-1 issued three additional classes of investment grade notes (Classes C, D and E) that were purchased by the Company through another newly-formed wholly-owned subsidiary. The Company also purchased all equity interests in Caplease CDO-1, including preferred shares with a principal amount of \$15,000. The Company consolidates Caplease CDO-1 into its financial statements.

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The notes have a stated maturity in January 2040, but are expected to mature in January 2015, when the notes become subject to an auction call procedure. The Company's effective blending financing rate (inclusive of original issue discount, debt issuance and hedge costs) on the Class A and Class B notes (the classes the Company did not retain) is approximately 5.66%.

Scheduled principal amortization and balloon payments for mortgage notes payable and collateralized debt obligations for the next five years and thereafter are as follows:

|                                   | Scheduled<br>Amortization | Balloon<br>Payments | Total             |
|-----------------------------------|---------------------------|---------------------|-------------------|
| 6 months ending December 31, 2005 | \$ 559                    | \$ -                | \$ 559            |
| 2006                              | 1,652                     | -                   | 1,652             |
| 2007                              | 2,297                     | -                   | 2,297             |
| 2008                              | 4,091                     | -                   | 4,091             |
| 2009                              | 4,826                     | -                   | 4,826             |
| Thereafter                        | 115,980                   | 404,047             | 520,027           |
| <b>Total</b>                      | <b>\$ 129,405</b>         | <b>\$ 404,047</b>   | <b>\$ 533,452</b> |

### 11. Commitments and Contingencies

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

The Company's acquisition cost of \$46,100 for the real property it acquired in Herndon, Virginia (see Note 5), does not include its obligation under the lease to pay for tenant improvements to the real property of approximately \$9,500. When the Company arranged long-term financing on this property, it funded a reserve account with its lender for the full amount of this obligation. The Company expects these funds will be disbursed in full as improvements are completed.

The Company is obligated under a letter of credit with respect to one of its 1999 securitization transactions (BSCMS 1999-CLF1). The maximum potential amount of future required payments under the letter of credit is \$2,850. The letter of credit expires on February 18, 2009. The trustee may draw the letter of credit if there are realized losses on the mortgage loans that would create a shortfall in the interest or principal on any investment grade certificate. The letter of credit may be withdrawn when the ratings of the investment grade certificates are no longer dependent upon the credit support provided by the letter of credit. During February 2005, one of the mortgage loans on a property net leased to Winn-Dixie defaulted, as a result of the bankruptcy of Winn-Dixie. However, management does not expect any draw on the letter of credit as a result of this mortgage default, or otherwise. Letter of credit fees included in interest expense were \$26 and \$25 for the three months ended June 30, 2005 and 2004, respectively, and \$53 and \$50 for the six months ended June 30, 2005 and 2004, respectively.

The Company had outstanding commitments to fund loans of approximately \$2,000 related to certain of its development or joint-venture loans as of June 30, 2005. As of June 30, 2005, advances of \$1,300 had been made

against these commitments.

## 12. Stock Based Compensation

The Company adopted an incentive stock compensation plan for its employees during March 2004 in connection with its initial public offering. The shares issued under the stock plan are accounted for under Statement of Financial Accounting Standards No. 123 ("SFAS No. 123"), "*Accounting for Stock Based Compensation*." The Company accounts for stock based compensation using the intrinsic value method proscribed by Accounting Principles Board Opinion No. 25, "*Accounting for Stock Issued to Employees*," ("APB25") and related interpretations. APB25 requires compensation cost to be measured as the fair value of the Company's stock less the amount, if any, that the employee is required to pay. The Company measures compensation costs for share awards under the stock plan as of the grant date and expenses such amounts against earnings, either at the grant date (if no vesting period exists) or ratably over the requisite service period. The Company has not awarded any options, stock appreciation rights or other stock based compensation under the stock plan.

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During March 2005, CLF, Inc. granted 383,500 shares of common stock to employees and directors. None of these shares were vested on the date of the award. During the three months ended June 30, 2005, 4,000 of these shares were forfeited as a result of an employee termination. An aggregate of 179,500 shares are scheduled to vest in three equal installments beginning on the first anniversary of the grant date. These shares will generally be forfeited, however, if the recipient ceases either to be employed by the Company or to remain a member of CLF, Inc.'s Board prior to the vesting date.

An aggregate of 200,000 shares are scheduled to vest over three years if a combination of objective and subjective performance criteria, to be determined by the CLF, Inc. Compensation Committee, are attained. On June 30, 2005, the CLF, Inc. Compensation Committee determined the performance criteria for 66,667 of these 200,000 shares.

For the three and six months ended June 30, 2005, compensation expense of \$155 and \$168, respectively, was recorded in the Company's Consolidated Statement of Operations under "General and administrative-stock based compensation expense" related to the March 2005 awards.

During March 2004, CLF, Inc. granted 383,766 shares of common stock to employees and directors, simultaneous with the completion of its initial public equity offering. The following table summarizes the vesting schedule of these shares.

|                                     |           |
|-------------------------------------|-----------|
| Shares vested upon grant            | 129,580   |
| Shares forfeited during 2004        | 3,630*    |
| Shares vested on March 24, 2005     | 125,276   |
| Shares forfeited during 2005        | 2,720     |
| Shares vested on May 1, 2005        | 8,833     |
| Unvested shares as of June 30, 2005 | 113,727** |
| Total                               | 383,766   |

\* During 2004, CLF, Inc. granted 3,630 shares to a new employee. These shares will vest over a three-year period from the date of initial grant.

\*\* All shares are scheduled to vest on March 24, 2006.

The following summarizes the expense the Company recorded in its Consolidated Statement of Operations during the three and six months ended June 30, 2005 and June 30, 2004, for the March 2004 awards:

|  | For the three months<br>ended June 30, |        | For the six months<br>ended June 30, |          |
|--|--|--------|--------------------------------------|----------|
|  | 2005                                   | 2004   | 2005                                 | 2004     |
| General and administrative expenses-<br>stock based compensation | \$ 467                                 | \$ 334 | \$ 922                               | \$ 3,167 |

On November 17, 2003, CLF, Inc. sold 139,134 shares to certain current and former employees of the Predecessor for \$0.10 per share. The Company recorded no compensation expense in connection with the issuance of the 139,134



shares, since the fair value of the stock on the date of sale was equal to the \$0.10 per share purchase price. Upon completion of CLF, Inc.'s initial public offering on March 24, 2004, the difference between the public offering price per share of \$10.50 and the price at which these individuals purchased the shares was recognized as a \$1,447 expense (a component of General and administrative-stock based compensation expense) in the Company's Consolidated Statement of Operations.

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June 30, 2005 (unaudited)

### 13. Rental Income

The Company is the lessor to tenants under operating leases with expiration dates ranging from 2010 to 2024 (not including incidental leases). The minimum rental amounts due under the leases are generally subject to scheduled fixed increases. The leases generally also require that the tenants pay for or reimburse the Company for the occupancy and operating costs of the properties, or in certain cases reimburse the Company for increases in certain operating costs and real estate taxes above their base year costs. Approximate future minimum rents to be received over the next five years and thereafter for non-cancelable operating leases in effect at June 30, 2005, are as follows (in thousands):

|                                   |            |
|-----------------------------------|------------|
| 6 months ending December 31, 2005 | \$ 12,639  |
| 2006                              | 29,134     |
| 2007                              | 30,881     |
| 2008                              | 31,432     |
| 2009                              | 31,289     |
| Thereafter                        | 265,035    |
| Total                             | \$ 400,410 |

### 14. Pro Forma Condensed Consolidated Income Statements

The accompanying unaudited Pro Forma Condensed Consolidated Income Statements are presented as if, at January 1, 2004, the Company acquired all real properties purchased during 2005 and 2004. 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.

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 January 1, 2004, nor do they purport to represent the Company's future results of operations.

|   | For the three months<br>ended June 30, |           | For the six months<br>ended June 30, |           |
|---|--|-----------|--------------------------------------|-----------|
|   | 2005                                   | 2004      | 2005                                 | 2004      |
| Total revenues  | \$ 17,996                              | \$ 11,936 | \$ 33,470                            | \$ 23,038 |
| Income (loss) from continuing operations                                    | \$ 1,764                               | \$ 2,249  | \$ 4,553                             | \$ (136)  |
| Income (loss) per basic and diluted common share from continuing operations | \$ 0.06                                | \$ 0.08   | \$ 0.16                              | \$ (0.01) |

### 15. Segment Reporting

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

Selected results of operations for the three months ended June 30, 2005 and June 30, 2004 are as follows:

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Capital Lease Funding, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
(Dollar amounts in thousands)

June 30, 2005 (unaudited)

|                                       | Corporate /<br>Unallocated |           | Operating Net Lease<br>Real Estate |           | Lending<br>Investments |           |
|---------------------------------------|----------------------------|-----------|------------------------------------|-----------|------------------------|-----------|
|                                       | 6/30/2005                  | 6/30/2004 | 6/30/2005                          | 6/30/2004 | 6/30/2005              | 6/30/2004 |
| Total revenues                        | \$ 310                     | \$ 278    | \$ 8,487                           | \$ -      | \$ 6,591               | \$ 2,521  |
| Total expenses &<br>minority interest | 2,879                      | 2,308     | 7,274                              | -         | 3,681                  | 48        |
| Net income (loss)                     | (2,569)                    | (2,030)   | 1,213                              | -         | 2,910                  | 2,473     |
| Total assets                          | 56,715                     | 57,755    | 496,887                            | 100       | 381,576                | 203,050   |

Selected results of operations for the six months ended June 30, 2005 and June 30, 2004 are as follows:

|                                       | Corporate /<br>Unallocated |           | Operating Net Lease<br>Real Estate |           | Lending<br>Investments |           |
|---------------------------------------|----------------------------|-----------|------------------------------------|-----------|------------------------|-----------|
|                                       | 6/30/2005                  | 6/30/2004 | 6/30/2005                          | 6/30/2004 | 6/30/2005              | 6/30/2004 |
| Total revenues                        | \$ 482                     | \$ 365    | \$ 14,236                          | \$ -      | \$ 12,577              | \$ 4,399  |
| Total expenses &<br>minority interest | 5,889                      | 7,048     | 11,804                             | -         | 5,827                  | 1,465     |
| Net income (loss)                     | (5,407)                    | (6,683)   | 2,432                              | -         | 6,750                  | 2,934     |
| Total assets                          | 56,715                     | 57,755    | 496,887                            | 100       | 381,576                | 203,050   |

### 16. Other Comprehensive Income (Loss)

The components of other comprehensive income (loss) for the three and six months ended June 30, 2005 and 2004, are as follows (also see Notes 6 and 9):

|  | For the three months<br>ended June 30, |          | For the six months<br>ended June 30, |            |
|--|--|----------|--------------------------------------|------------|
|  | 2005                                   | 2004     | 2005                                 | 2004       |
| Net income (loss)  | \$ 1,554                               | \$ 443   | \$ 3,775                             | \$ (3,749) |
| Unrealized change in value on<br>securities available for sale | 3,556                                  | (1,624)  | 4,665                                | (1,303)    |
| Unrealized gain (loss) on derivatives                          | (3,695)                                | 2,974    | 3,806                                | 2,554      |
| Realized gain (loss) on derivatives                            | (541)                                  | -        | (9,865)                              | 912        |
| Other comprehensive income (loss)                              | \$ 874                                 | \$ 1,793 | \$ 2,381                             | \$ (1,586) |

### 17. Variable Interest Entities

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

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

Capital Lease Funding, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
(Dollar amounts in thousands)

June 30, 2005 (unaudited)

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

Based on the provisions of FIN 46, we have concluded that whenever we agree to purchase a real estate property and pay the seller a deposit that is not refundable at our option, a VIE is created as our deposit puts us, rather than the equity owners, in a first loss position. For each VIE created, we are required to compute expected losses and residual returns based on the probability of future cash flows as outlined in FIN 46. If we are deemed to be the primary beneficiary of the VIE we will consolidate it on our balance sheet and statement of operations.

On March 3, 2005, we entered into a purchase and sale agreement to acquire a Class A office building in North Bethesda, Maryland for \$83.5 million. We paid a deposit of \$2.0 million into escrow, and we were granted the right to conduct a due diligence review of the property during a due diligence period scheduled to expire on March 31, 2005. Subsequent to our initial contract date, we and the seller agreed to amend the purchase and sale agreement to reduce the purchase price to \$81.5 million and extend our due diligence period until April 13, 2005. During our due diligence period, we had the right to terminate the agreement for any reason or for no reason and to an immediate return of our deposit.

On April 13, 2005, our due diligence period expired and we paid into escrow an additional \$2.0 million deposit. If we default in our obligations under the agreement, the seller will be entitled to our deposit as liquidated damages. The acquisition is scheduled to close no later than September 2005.

We were required under FIN 46 to consolidate this acquisition at June 30, 2005. Our deposit represents our maximum exposure to loss. The fair value of the property, representing the purchase price we agreed to pay, was reported on our balance sheet as "Real estate investments consolidated under FIN 46." Mortgage debt of the entity owning the property was \$50.9 million at June 30, 2005, and was reported on our balance sheet as "Mortgage on real estate investments consolidated under FIN 46." The net balance of the assets and liabilities consolidated under FIN 46 for this VIE is reported on our balance sheet as "Minority interest in real estate investments consolidated under FIN 46." Creditors of the VIE have no recourse against our Company.

As part of our developer loan program, we fund loans to an entity that owns an undeveloped property. These loans are used to finance pre-construction costs related to the property, such as due diligence costs and land acquisition contract deposits, rather than costs to build on the property. We have funded five such loans as of June 30, 2005, with an aggregate unpaid principal amount of approximately \$1.3 million as of that date. We have determined that our borrowers are VIEs under FIN 46. However, because part of our collateral for these loans is a personal guarantee from each entity's equity owner, we are not considered the primary beneficiary of these entities and, therefore, we are not required to consolidate them under FIN 46.

During 2004, we also funded a long-term credit tenant loan to an entity owning a property leased to Home Depot USA, Inc. in Westminster, Colorado. Our carry value on this loan was approximately \$8.6 million as of June 30, 2005. In connection with funding the loan, we acquired the right to participate in any gain upon sale of the underlying property. The borrower entity similarly meets the criteria for a VIE under FIN 46, because the equity owners of the entity are required to share 25% of their expected residual returns with us. However, because we are not the primary beneficiary, we are not required to consolidate it.

### **18. Subsequent Events**

During July 2005, the Company entered into a series of purchase and sale agreements to acquire a portfolio of five real properties, each of which is net leased entirely to the United States Government. The aggregate purchase price for all five properties is \$97.5 million, and consists of approximately \$36.3 million of debt on the properties to be assumed by the Company. The purchase of the properties is subject to various customary closing conditions.

## **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. Where appropriate, the following discussion includes analysis of our predecessor entity.*

### **General**

We are a net lease company focused on investing in commercial real estate assets that are leased typically on a long-term basis primarily to high credit quality corporate, government and not-for-profit tenants. These assets include mortgage loans and mortgage backed net lease securities (debt) and direct investments in real estate (equity). We began our business in 1995 through private equity capital. In March 2004, we completed an initial public offering and our common stock began trading on the New York Stock Exchange under the symbol "LSE." We intend to elect to be taxed as a REIT for federal income tax purposes.

Prior to our initial public offering in March 2004, we operated primarily as a first mortgage lender using a gain on sale business model, where we sold the loans without retaining any interest in them after origination, either through securitization or whole-loan sales. Our mortgage loans have included traditional long-term credit tenant first mortgage loans (typically 15 to 25 years), 10-year credit tenant loans and a few development type loans and recapitalized loans. Prior to our initial public offering, we derived our revenues primarily from interest payments on the loans we originated prior to sale and from the sale of those loans to third parties. Our borrowings were on a short-term basis, and the interest expense on those borrowings was tied to short-term floating interest rates, which are typically lower than long-term fixed-rates.

Upon completion of our initial public offering in March 2004, we changed our strategy from that of a gain on sale originator of net lease loans, to a long-term holder of debt, equity and mezzanine net lease assets for portfolio investment, though we do still engage in some gain on sale activities. An important component of our portfolio investment strategy is to borrow, or leverage, against our assets in order to enable us to originate a larger portfolio of assets and to enhance our returns on invested equity capital. This strategy entails financing our mostly fixed rate net lease investments by using our existing warehouse facilities on a reasonably short term basis and, as soon as practicable thereafter, financing the majority of these assets on a secured long-term fixed rate basis, both through collateralized debt obligations, or CDOs, and through traditional first mortgage debt obtained from third party lenders, and other mechanisms. We typically employ hedging strategies to mitigate interest rate risk until our fixed rate assets are financed with long-term debt mechanisms. We expect our leverage to average 70% to 85% of our assets in portfolio. All of our financing transactions are now and we expect that they will continue to be, held on balance sheet. We believe that the combination of assets backed by long-term leases with high quality tenants coupled with long-term fixed rate financing will produce stable risk-adjusted returns on our equity base.

In connection with our initial public offering, we raised net proceeds after all related expenses of approximately \$221.8 million in addition to the existing book equity of approximately \$34.0 million at the time of the initial public offering. As of June 30, 2005, we had invested those proceeds into approximately \$747.2 million of net lease assets (net of intangible liabilities on real estate investments) and continue to leverage our existing portfolio utilizing our existing floating rate warehouse credit facilities, fixed rate first mortgage debt, and collateralized debt obligations.

### **Summary of Closed Transactions in Second Quarter 2005**

The following highlights our closed transactions during the second quarter ended June 30, 2005:



We added net assets to our portfolio of approximately \$176 million, including four real property acquisitions for an aggregate purchase price of approximately \$146.2 million, the origination of mortgage and development loans aggregating \$24.5 million and the net purchases of CMBS securities of \$8.3 million.

- We financed the four real property acquisitions we made during the quarter with fixed rate debt aggregating \$132.9 million, including \$118.3 million of mortgage loans and \$14.6 million of corporate credit notes we made to our operating partnership, Caplease, LP. The corporate credit notes represent intercompany debt, and are eliminated from our financial statements in consolidation.

## **Business Environment**

The markets have been and remain extremely competitive across all of our business segments. We continue to see significant amounts of investment capital pursuing transactions across the real estate spectrum which has put downward pressure on yields and spreads on both property acquisitions and our origination of mortgage loans for our portfolio. This pressure has been most pronounced in the lending investments segment of our business where it continues to be challenging to originate loans with yield and risk characteristics that fit within our targets.

## **Winn-Dixie Bankruptcy**

We continue to monitor our exposure to the Winn-Dixie bankruptcy. As described in detail in our 2004 Form 10-K, we are exposed to five Winn-Dixie stores, 14 Winn-Dixie warehouse/distribution and/or manufacturing facilities and the Winn-Dixie headquarters building. Our exposure is through securities we own from our past securitizations which own mortgage loan assets secured by Winn-Dixie properties or, in one case, a pass-through certificate issued by another securitization trust which owns mortgage loan assets secured by Winn-Dixie properties.

Through our BSCMS 1999-CLF1 investment, we are exposed to two of the five stores discussed above, one in Rainsville, Alabama, and the second in Columbus, Mississippi. As described in our 2004 Form 10-K, Winn-Dixie has rejected the lease on the Rainsville store, and the loan on the property is in default and has an unpaid principal balance of \$3.8 million.

On June 21, 2005, Winn-Dixie announced its plans to sell or close 326 stores and some additional warehouse, distribution and/or manufacturing facilities, including the Columbus store. The loan on this property has an unpaid principal balance of \$4.1 million and remains current. On July 1, 2005, Winn-Dixie also announced it has reached a preliminary agreement to sell 79 stores, including the Columbus store, to purchasers who intend to continue operating the stores. Winn-Dixie has announced that BI-LO has agreed to acquire and plans to continue operating the Columbus store.

The other three stores to which we have exposure were not included in the 326 stores Winn-Dixie plans to sell or close and continue to be operated by Winn-Dixie. We cannot, however, assure you that Winn-Dixie will not reject the leases on these stores and the other properties we have exposure to in the future.

As a result of Winn-Dixie announcements described above and other factors, such as the risk the Columbus store sale is not completed or recoveries on the Rainsville store are less than expected, we determined to take an additional \$0.25 million write-down on our most junior class investment (Class F) in the BSCMS transaction as of June 30, 2005. This write-down is in addition to the \$0.25 million write-down we took at December 31, 2004. We received a fair value mark from a third party on this investment at June 30, 2005 that supports the write-downs we have taken. Management believes that the decline in market value is an other-than-temporary decline, which requires that we recognize the loss currently in our Consolidated Statement of Operations.

Our ultimate losses as a result of the Winn-Dixie bankruptcy will depend upon various factors beyond our control, including the liquidation value of the underlying properties and the unpaid principal amount of the related loans, the costs to foreclose and sell the properties, and the availability of other collateral or reserves to absorb the losses on the properties. While we believe based on the information we currently have, that we have been reasonable in making assumptions and estimating our losses as a result of our Winn-Dixie exposure, our assumptions and estimates may be inaccurate and, therefore, we cannot assure you that we will not need to take additional losses or reserves or that our losses as a result of the Winn-Dixie bankruptcy will not be greater than our current estimates.

## **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, 2004 in Management's Discussion and Analysis of Financial Condition and Results of Operations. There have been no significant changes to those policies during 2005 other than the addition of Stock Based Compensation as a critical accounting policy, as described below.

*Stock Based Compensation.* During March 2005, we awarded 200,000 shares of common stock to our executive officers with vesting subject to attainment of performance criteria. We expect that in the future we will award additional shares to our executive officers and/or other employees with vesting of those shares subject to attainment of performance criteria. Under SFAS No. 123 and SFAS No. 123R (revised 2004), *Share-Based Payment*, we are and will be required to estimate the probability of vesting of these shares quarterly and recognize expense (generally equal to the fair market value of the shares awarded on the grant date) for any shares deemed probable to vest over the period the employee is required to perform services to receive the shares. We base our estimates of probability on an assessment of our actual results against the relevant performance criteria. These estimates may change over time as our actual results against the criteria are re-assessed. Changes in these estimates could have a material impact on the expense we recognize.

## Property Acquisitions

During the second quarter 2005, we completed the following property acquisitions:

| Tenant or Guarantor  | Location                   | Ratings<br>(S&P/<br>Moody's) <sup>(1)</sup> | Net<br>Rentable<br>Square<br>Feet | Property<br>Type   | Purchase<br>Date | Lease<br>Maturity         | Purchase<br>Price<br><i>(in<br/>thousands)</i> |
|--|----------------------------|---|-----------------------------------|--------------------|------------------|---------------------------|--|
| ITT Industries, Inc.   | Herndon,<br>Virginia       | BBB+/Baa1                                   | 167,285                           | Office<br>Building | May 23,<br>2005  | March 2019<br>August 2024 | \$46,081 <sup>(2)</sup>                        |
| Lowe's Companies, Inc.<br>and Michaels Stores, Inc. <sup>(3)</sup> | Aliso Viejo,<br>California | A+/A2 and<br>BB+/Ba1                        | 180,854                           | Retail Stores      | May 31,<br>2005  | February<br>2015          | 52,860   |
| Capital One Financial<br>Corp.                                     | Plano, Texas               | BBB-/Baa3                                   | 159,000                           | Office<br>Building | June 23,<br>2005 | February<br>2015          | 27,900   |
| Omnicom Group, Inc.  | Irving, Texas              | A-/Baa1                                     | 101,120                           | Office<br>Building | June 23,<br>2005 | May 2013                  | 18,100   |

<sup>(1)</sup> Ratings represent publicly available long-term corporate credit ratings or long-term senior unsecured debt ratings as of June 30, 2005.

<sup>(2)</sup> Does not include our contingent obligation to fund tenant improvements of approximately \$9.5 million.

<sup>(3)</sup> Approximately 4% of the property is leased to one other tenant.

## Business Segments

We conduct our business through two operating segments:

- lending investments (including our loan business as well as our investments in structured interests and structuring fees receivable); and
- operating net lease real estate (including our property acquisition business).

Segment data for the three months ended June 30, 2005 and 2004 are as follows:

|                                       | Corporate /<br>Unallocated |           | Operating Net Lease<br>Real Estate |           | Lending<br>Investments |           |
|---------------------------------------|----------------------------|-----------|------------------------------------|-----------|------------------------|-----------|
|                                       | 6/30/2005                  | 6/30/2004 | 6/30/2005                          | 6/30/2004 | 6/30/2005              | 6/30/2004 |
| Total revenues                        | \$ 310                     | \$ 278    | \$ 8,487                           | \$ —      | \$ 6,591               | \$ 2,521  |
| Total expenses &<br>minority interest | 2,879                      | 2,308     | 7,274                              | —         | 3,681                  | 48        |
| Net income (loss)                     | (2,569)                    | (2,030)   | 1,213                              | —         | 2,910                  | 2,473     |
| Total assets                          | 56,715                     | 57,755    | 496,887                            | 100       | 381,576                | 203,050   |

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Segment data for the six months ended June 30, 2005 and 2004 are as follows:

|                                       | Corporate /<br>Unallocated |           | Operating Net Lease<br>Real Estate |           | Lending<br>Investments |           |
|---------------------------------------|----------------------------|-----------|------------------------------------|-----------|------------------------|-----------|
|                                       | 6/30/2005                  | 6/30/2004 | 6/30/2005                          | 6/30/2004 | 6/30/2005              | 6/30/2004 |
| Total revenues                        | \$ 482                     | \$ 365    | \$ 14,236                          | \$ -      | \$ 12,577              | \$ 4,399  |
| Total expenses &<br>minority interest | 5,889                      | 7,048     | 11,804                             | -         | 5,827                  | 1,465     |
| Net income (loss)                     | (5,407)                    | (6,683)   | 2,432                              | -         | 6,750                  | 2,934     |
| Total assets                          | 56,715                     | 57,755    | 496,887                            | 100       | 381,576                | 203,050   |

A discussion of the comparison of segment performance is not included herein as we were under a gain on sale (rather than portfolio) business model prior to our initial public offering and we had no real property acquisitions prior to June 30, 2004.

## **Results of Operations**

During the three and six months ended June 30, 2005, we continued to execute on our business plan as a long-term holder of debt, equity and mezzanine investments in net lease assets. Our focus during the second quarter of 2005 was on: (i) closing the long-term mortgage loans and the net lease property acquisitions in our pipeline, (ii) closing long-term financings on the real property acquisitions we closed during the quarter, (iii) continuing to leverage our net lease portfolio, and (iv) continuing to implement our marketing plan to communicate to the market our expanded capabilities.

### **Comparison of the Quarter Ended June 30, 2005 to the Quarter Ended June 30, 2004**

The following discussion compares our operating results for the quarter ended June 30, 2005 to the comparable period in 2004.

#### *Revenue*

Total revenue increased \$12.6 million, or 450%, to \$15.4 million. The increase was primarily attributable to increases in interest income from mortgage loans and securities and increases in rental revenue, including property operating expense recoveries.

Interest income increased \$3.9 million, or 141%, to \$6.6 million. The increase was due to larger overall asset investments, including both mortgage loans and CMBS investments.

Rental income and property expense recoveries, in the aggregate, increased from \$0 to \$8.5 million, as we did not own any investments in real estate during the comparable period in 2004. Rental income for the 2005 period includes \$1.8 million of revenue from assets not yet owned but consolidated under FIN 46.

Gain on sales of mortgage loans and securities increased from \$0 to \$0.2 million. We sold an investment in CMBS during the 2005 period that resulted in the gain on sale activity for that period.

#### *Expenses*

Total expenses increased \$11.3 million, or 478%, to \$13.6 million. The increase in expenses was primarily attributable to higher levels of interest expense, general and administrative expenses, stock based compensation expense, property expenses, loss on securities and depreciation and amortization expense on real property.

Interest expense increased from \$0 to \$6.2 million. The expense in the 2005 period included \$1.7 million of interest expense related to property mortgages originated or assumed in 2004 and 2005, \$3.6 million related to collateralized debt obligations issued in 2005, and interest expense on our borrowings under our secured warehouse line of credit (repurchase agreement obligations) of \$0.3 million. 2005 results also include interest expense of \$0.6 million from assets not yet owned but consolidated under FIN 46. For the 2004 period, we had no borrowings outstanding. After the completion of our initial public offering in March 2004, we repaid all of the amounts outstanding under our credit facilities. We began borrowing under these facilities again during August 2004.

Property expenses increased from \$0 to \$2.3 million. We did not own any investments in real estate during the comparable period in 2004. Property expenses for the 2005 period include \$0.6 million of expense from assets not yet

owned but consolidated under FIN 46.

Loss on securities increased from \$0 to \$0.3 million. We wrote down the carrying value of one of our CMBS investments to reflect the decline in its market value below our carrying cost, primarily as a result of the exposure it has to Winn-Dixie, as discussed earlier.

General and administrative expense increased \$0.4 million, or 21%, from \$2.0 million to \$2.4 million, due primarily to increased expenses associated with operating as a public company, including increased professional fees of \$0.3 million related to our compliance with the Sarbanes-Oxley Act of 2002.

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General and administrative expense-stock based compensation increased \$0.1 million, or 40%, to \$0.5 million, due to additional expense related to stock awards granted during 2005.

Depreciation and amortization expense on real property increased \$1.9 million, as we did not own any real property investments during the comparable period in 2004. Depreciation and amortization expense for the 2005 period includes \$0.4 million of expense from assets not yet owned but consolidated under FIN 46.

Minority interest in consolidated entities is (\$0.2) million as a result of the assets not yet owned but consolidated under FIN 46 as discussed above.

#### *Net income*

Net income increased from \$0.4 million to \$1.6 million, as a result of the factors discussed above.

### **Comparison of the Six Months Ended June 30, 2005 to the Six Months Ended June 30, 2004**

The following discussion compares our operating results for the six months ended June 30, 2005 to the comparable period in 2004.

#### *Revenue*

Total revenue increased \$22.5 million, or 473%, to \$27.3 million. The increase was primarily attributable to increases in interest income from mortgage loans and securities and increases in rental revenue, including property operating expense recoveries.

Interest income increased \$8.1 million, or 173%, to \$12.7 million. The increase was due to larger overall asset investments, including both mortgage loans and CMBS investments.

Rental income and property expense recoveries, in the aggregate, increased from \$0 to \$14.2 million, as we did not own any investments in real estate during the comparable period in 2004. Rental income for the 2005 period includes \$1.8 million of revenue from assets not yet owned but consolidated under FIN 46.

Gain on sales of mortgage loans and securities increased from \$0 to \$0.2 million. We sold an investment in CMBS during the 2005 period that resulted in the gain on sale activity for that period.

#### *Expenses*

Total expenses increased \$14.8 million, or 174%, to \$23.3 million. The increase in expenses was primarily attributable to higher levels of interest expense, property expenses, loss on securities, general and administrative expenses, and depreciation and amortization expense on real property, offset in part by reductions in both stock based compensation expense and net losses on derivatives and short sales of securities.

Interest expense, including interest expense to affiliates, increased \$9.1 million, or 1,387%, from \$0.7 million to \$9.8 million. There was no interest expense to affiliates in the 2005 period. The increase in 2005 included \$2.9 million of interest expense related to property mortgages originated or assumed in 2004 and 2005, and \$4.4 million related to collateralized debt obligations issued in 2005. In addition, interest expense on our borrowings under our secured warehouse lines of credit (repurchase agreement obligations), increased \$1.2 million, or 176%, from \$0.6 million to \$1.8 million. This was the result of increased average borrowing levels in 2005. After the completion of our initial public offering in March 2004, we repaid all of the amounts outstanding under our credit facilities. We began borrowing under these facilities again during August 2004. 2005 results also include interest expense of \$0.6 million



from assets not yet owned but consolidated under FIN 46.

Property expenses increased from \$0 to \$4.1 million. We did not own any investments in real estate during the comparable period in 2004. Property expenses for the 2005 period include \$0.6 million of expenses from assets not yet owned but consolidated under FIN 46.

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Loss on derivatives and short sales of securities decreased \$0.7 million, from \$0.7 million to \$0. This was primarily the result of our use of fair value hedges of our assets, along with derivatives and short sales of securities that did not qualify for hedge accounting treatment, prior to our initial public offering, and the use of cash flow hedges against our expected future borrowings since our initial public offering. Under SFAS 133, we were required to expense the cost of carrying our open fair value hedge positions against current earnings. The cost of carrying open cash hedge positions is amortized as part of interest expense over the term of the related debt issuance.

Loss on securities increased from \$0 to \$0.3 million. We wrote down the carrying value of one of our CMBS investments to reflect the decline in its market value below our carrying cost, primarily as a result of the exposure it has to Winn-Dixie, as discussed earlier.

General and administrative expense increased \$1.1 million, or 27%, from \$3.9 million to \$5.0 million, due primarily to increased expenses of \$0.7 million associated with operating as a public company, including increased professional fees of \$0.3 million related to our compliance with the Sarbanes-Oxley Act of 2002, and \$0.2 million of increased compensation expense. General and administrative expense for the 2005 period also included approximately \$0.1 million of accrued severance expense.

General and administrative expense-stock based compensation decreased \$2.2 million, or 71%, to \$0.9 million. The expense recognized during the 2004 period included \$1.4 million of expense from stock grants which were vested at the initial public offering date and \$1.4 million of expense from shares issued in November 2003 at a discount to the initial public offering price.

Depreciation and amortization expense on real property increased from \$0 to \$3.2 million, as we did not own any real property investments during the comparable period in 2004. Depreciation and amortization expense for the 2005 period includes \$0.4 million of expense from assets not yet owned but consolidated under FIN 46.

Minority interest in consolidated entities is (\$0.2) million as a result of the assets not yet owned but consolidated under FIN 46 as discussed above.

#### *Net income (loss)*

Net income (loss) increased from \$(3.7) million to \$3.8 million, as a result of the factors discussed above.

#### **Funds from Operations**

Funds from operations (“FFO”) is a non-GAAP financial measure. We believe FFO is a useful additional measure of our performance because it facilitates an understanding of the operating performance of the Company 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 a 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 the Company’s 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, the Company’s 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 (computed in accordance with GAAP) excluding gains (or losses) from sales of property, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures.



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The following table reconciles our net income to FFO for the three and six months ended June 30, 2005 and June 30, 2004.

|  | For the three months<br>ended June 30, |         | For the six months<br>ended June 30, |            |
|--|--|---------|--------------------------------------|------------|
|  | 2005                                   | 2004    | 2005                                 | 2004       |
| Net income (loss)  | \$ 1,554                               | \$ 443  | \$ 3,775                             | \$ (3,749) |
| Adjustments:   |  |         |                                      |            |
| Add: Depreciation and amortization<br>expense on real property             | 1,920                                  | —       | 3,188                                | —          |
| Funds from operations  | \$ 3,474                               | \$ 443  | \$ 6,963                             | \$ (3,749) |
| Weighted average number of common<br>shares outstanding, basic and diluted | 27,868                                 | 27,488  | 27,698                               | 16,699     |
| Funds from operations per share  | \$ 0.12                                | \$ 0.02 | \$ 0.25                              | \$ (0.22)  |
| Gain on sale of mortgage loans and<br>securities                           | \$ 174                                 | —       | \$ 237                               | —          |
| Depreciation on real estate<br>investments consolidated under FIN<br>46    | \$ 417                                 | —       | \$ 417                               | —          |

### Liquidity and Capital Resources

As of June 30, 2005, we had \$55.8 million in available cash and cash equivalents. As a REIT, we are required to distribute at least 90% of our taxable income to our stockholders on an annual basis, and we intend to distribute all or substantially all of our REIT taxable income in order to comply with the distribution requirements of the Code and to avoid federal income tax and the nondeductible excise tax. We declared a dividend of \$0.18 per share during the quarter ended June 30, 2005 that we paid during July 2005.

We believe that our working capital and cash provided by operations are sufficient to fund our operations and pay our distributions necessary to enable us to continue to qualify as a REIT. However, our strategy contemplates additional net lease investments, and we believe we will reach our targeted leverage level of 70% to 85% of our assets in portfolio in the next one to four months, at which point we will need to raise additional debt or equity capital, or both, in order to continue to implement our strategy. We filed a shelf registration statement to register additional debt and equity securities in April 2005. We may issue publicly or privately debt or equity securities, or both, to satisfy our liquidity needs. We expect to raise capital in the third or fourth quarter of 2005, although the precise timing will be impacted by our investment activities for the remainder of 2005 and market conditions. Our ability to raise capital is influenced by market conditions, and we cannot assure you conditions for raising capital will be favorable for us at any time.

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

We expect to meet our short-term liquidity requirements generally through our available cash and cash equivalents, cash provided by operations, as well as through secured credit facilities.

We had \$45.7 million outstanding as of June 30, 2005 under our Wachovia credit facility, which borrowings were secured by commercial mortgage loans and corporate credit notes with an aggregate principal balance of \$13.5 million, and CMBS with a fair value of \$43.4 million. As of June 30, 2005, we had \$204.3 million available under our

Wachovia credit facility. Our credit facility with Wachovia Bank matures in September 2005. Our Bank of America facility expired unused on March 1, 2005.

As of June 30, 2005, we were in compliance with the terms of the agreement with Wachovia Bank. We do not currently anticipate any difficulty in maintaining compliance with these terms in future periods. We believe our relationship with Wachovia Bank is excellent. However, because our secured credit facility with Wachovia Bank is uncommitted and is generally terminable at will by the lender, we cannot make any assurance that this facility will continue to be available to us.

We are currently in negotiations to extend our existing credit facility with Wachovia Bank and to enter into a new \$100 million short-term bridge facility with Wachovia Bank. If we reach agreement with Wachovia on the new facility, we expect it will enable us to finance our real property acquisitions for a period of up to 90 days while we arrange permanent financing. We expect the new facility will have a one year term, and will be co-terminus with our existing credit facility. We will pay interest on our borrowings at prevailing short-term interest rates. We expect the new facility will be a secured fully recourse lending arrangement. We also expect the new facility will require us to comply with financial covenants of maximum leverage and minimum net worth.

We expect the bridge facility will facilitate our ability to leverage our portfolio while also providing us with flexibility in the timing of our next debt or equity capital raise.

Our negotiations with Wachovia Bank are continuing and there can be no assurance that any such agreement will be concluded.

*Long-Term Liquidity and Financing.*

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

We finance our investments through short-term financing arrangements and, as soon as practicable thereafter, we obtain long-term financing for these investments, generally on a secured basis. Long-term financing can be in the form of traditional mortgage debt, CDOs or other debt mechanisms. As of June 30, 2005, we have financed an aggregate of \$352.2 million of assets in portfolio on a long-term basis through the issuance or assumption of long-term mortgage debt of \$265.3 million and collateralized debt obligations of \$268.1 million. We expect our leverage to average 70% to 85% of our assets in portfolio.

*Long-Term Mortgage Financings.*

During the quarter ended June 30, 2005, we obtained long-term financing on the four real property acquisitions we completed during the quarter. We incurred aggregate debt of \$132.9 million, including \$118.3 million of mortgage notes and \$14.6 million of corporate credit notes we made to our operating partnership, Caplease, LP. The corporate credit notes represent intercompany debt, and are eliminated from our financial statements in consolidation.

The mortgage notes we issued during the second quarter 2005 are summarized in the following table:

| Property                                      | Face Amount of Mortgage Note (in thousands) | Interest Rate | Maturity Date | Balloon at Maturity (in thousands) |
|---|---|---------------|---------------|------------------------------------|
| ITT Industries, Inc.                          | \$41,700                                    | 5.33%         | June 2015     | \$36,500                           |
| Lowe's Companies, Inc./ Michaels Stores, Inc. | 42,125                                      | 5.10%         | July 2015     | 38,970                             |
| Capital One Financial Corp.                   | 20,925                                      | 5.24%         | May 2013      | 18,500                             |
| Omnicom Group, Inc.                           | 13,575                                      | 5.24%         | May 2013      | 12,000                             |

Debt service on the notes is payable monthly. During an "interest-only" period ranging from 24 months to 60 months, only interest is payable on the mortgage notes. We generally may not prepay the notes, but we have the right to defease the notes after a lockout period if certain conditions are satisfied.

The notes are generally non-recourse to us but are secured by a mortgage on the property and an assignment of the underlying lease and rents on the property. The notes generally include non-recourse exceptions for certain losses, damages or expenses to the lender, including those incurred as a result of the following:

- waste to the mortgaged property or damage to the mortgaged property as a result of our intentional misconduct or gross negligence;
- the existence of hazardous substances or radon on the mortgaged property or the failure to comply with environmental laws or regulations with respect to the mortgaged property; and

- a fraud, willful misconduct or material misrepresentation committed by us or any person authorized to act on our behalf or the failure of us or anyone authorized to make statements on our behalf to disclose a material fact.

The notes become fully recourse if we fail to comply with covenants prohibiting us from transferring or further encumbering the mortgaged property or requiring us to take (or refrain from taking) various actions in order to preserve the borrower's status as a single-purpose entity.

Each note is subject to customary events of default, including the failure to pay principal and/or interest on the note, our failure to comply with our obligations under the loan documents (subject to our right to remedy defaults that may be cured) or the determination that any representation or warranty made in the loan documents is false or misleading in any material respect. Upon such event of default, each note will, at the option of the payee, become immediately due and payable.

#### *CDO Financing.*

We issued our first CDO on March 10, 2005. Our first CDO financing was effected through the issuance of multi-class notes and preferred shares by our newly formed wholly-owned subsidiary Caplease CDO 2005-1, Ltd. The multi-class notes were co-issued by another newly formed wholly-owned subsidiary, Caplease CDO 2005-1 Corp. The subsidiaries issued 5 classes of investment-grade notes with an aggregate principal amount of \$285.0 million and preferred shares with a principal amount of \$15.0 million. We retained \$31.5 million in principal amount of the securities offered, comprised of the entire principal amount of the three most junior note classes and the preferred shares.

The notes have a stated maturity in January 2040, but are expected to mature in January 2015, when the notes become subject to an auction call procedure. Our effective blended financing rate (inclusive of original issue discount, debt issuance and hedge costs) on the Class A and Class B notes (the classes we did not retain) is approximately 5.66%.

#### **Statement of Cash Flows**

We used \$10.3 million of cash in operating activities in the six months ended June 30, 2005, compared to \$3.0 million used in the six months ended June 30, 2004. Our net cash used in operating activities reflects adjustments for non-cash items of expenses for amortization of stock-based compensation (\$0.9 million and \$3.2 million in the six months ended June 30, 2005 and 2004, respectively) and depreciation and amortization (\$2.8 million and approximately \$0, in the six months ended June 30, 2005 and 2004, respectively). The cash used in 2005 was driven primarily by increases in prepaid expenses and other assets and decreases in deposits and escrows and amounts due to servicers and dealers, partially offset by greater net income (net of non-cash items discussed above) and an increase in accounts payable and accrued expenses. As part of our CDO issuance, we transferred a number of loan deposits and other escrows to the CDO trustee. The cash used in 2004 primarily reflects funds used in hedging and risk management activities, decreases in accounts payable and increases in prepaid expenses and other assets, partially offset by an increase in deposits and escrows.

Investing activities used \$259.5 million during the six months ended June 30, 2005, which primarily resulted from net investments in real estate of \$195.1 million, net advances to borrowers of \$26.7 million and net investments in CMBS of \$39.4 million. Investing activities used \$81.7 million during the six months ended June 30, 2004, which resulted primarily from investments in mortgage loans of \$33.0 million and net investments in CMBS and corporate bonds of \$48.7 million.

Cash provided by financing activities during the six months ended June 30, 2005 was \$294.9 million, which primarily resulted from borrowings under collateralized debt obligations of \$268.1 million, borrowings under mortgages on real estate investments, net of repayments, deposits and escrows, of \$139.5 million, partially offset by net repayments on repurchase agreements of \$88.1 million, funds used in hedging and risk management activities of \$10.2 million and dividends paid of \$9.1 million. Cash provided by financing activities during the six months ended June 30, 2004 was \$134.7 million, reflecting net proceeds from our initial public offering of \$222.8 million (before prepaid offering expenses of approximately \$1.0 million) and repayments of our repurchase agreements of \$88.1 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.



**Derivative and Other Risk Management Transactions**

In connection with our lending and other investment activities, we enter into derivative and other risk management transactions in order to hedge the value of our future debt obligations from changes in underlying interest rates during the period between origination and permanent financing of our loans and other net lease assets. Historically, we have done so primarily by entering into Treasury and agency lock transactions and short sales of U.S. government and agency obligations. In accordance with SFAS 133, these lock transactions and short sales, to the extent that they have been designated and qualify as part of a hedging relationship, are treated as fair value hedges for accounting purposes. The cost to carry our open fair value hedges appears on our Consolidated Statement of Operations as part of gain or loss on derivatives and short sales of securities.

Since our initial public offering, our derivative and other risk management activities have consisted primarily of interest rate swaps, and we expect they will continue to consist primarily of interest rate swaps in the future. In accordance with SFAS 133, the interest rate swaps, to the extent that they have been designated and qualify as part of a hedging relationship, are treated as cash flow hedges for accounting purposes. Consistent with SFAS No. 133, open cash flow hedges are marked to fair value at each reporting date, with a corresponding offset to Other Comprehensive Income (a component of Stockholders' Equity). The cost to carry our open cash flow hedges and any gain or loss we realize upon closing the cash flow hedge is amortized as part of interest expense over the term of the related debt issuance.

For the six months ended June 30, 2005 and 2004, the Company had net realized losses of \$10,196 and net realized gains of \$912, respectively, related to cash flow hedges. The net realized losses and gains are included in Other Comprehensive Income and will be reclassified and amortized as part of interest expense on the Company's Consolidated Statement of Operations over the expected term of the Company's related debt issuances. The change in net unrealized gains and losses of \$3,806 in the six months ended June 30, 2005 period for derivatives designated as cash flow hedges is separately disclosed in the statement of changes in stockholders' equity.

In general, we expect to hedge our liabilities against changes in underlying interest rates until the related assets have been financed on a long-term basis. Some assets, including development loans and structured securities, may not be hedged at all. We do not use derivative and other risk management transactions for trading or speculative purposes and we only enter into contracts or hedging arrangements with major financial institutions.

We settle our derivative and other risk management transactions in cash. Therefore, upon settlement, we will pay or receive cash for the net amount due. These amounts could be material and could have a material impact (positive or negative) on our liquidity. We seek to settle these transactions simultaneous with the closing of our financing transaction for the related hedged asset to mitigate the possible adverse impact on our liquidity.

#### **CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

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

- our ability to invest in additional net lease assets in a timely manner or on acceptable terms;
- our ability to obtain long-term financing for our asset investments at the spread levels we project when we invest in the asset;
- adverse changes in the financial condition of the tenants underlying our net lease investments;
- increases in our financing costs and/or our general and administrative costs;

- changes in our industry, the industries of our tenants, interest rates or the general economy;
  - the success of our hedging strategy;
  - our ability to raise additional capital to invest in net lease assets;
- our ability to complete pending net lease real property acquisitions and/or other net lease investments in a timely manner or at all;
  - impairments in the value of the collateral underlying our investments; and
    - the degree and nature of our competition.

In addition, we may be required to defer revenue recognition on real properties we acquire if the property is under construction or is not yet ready for occupancy.

These risks and uncertainties should be considered in evaluating any forward-looking statement we may make from time to time. Any forward-looking statement speaks only as of its date. All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are qualified by the cautionary statements in this section. We undertake no obligation to update or publicly release any revisions to forward-looking statements to reflect events, circumstances or changes in expectations after the date made.

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

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

#### *Interest Rate Exposure*

Substantially all of our assets have exposures to long-term interest rate movements, primarily the yields on long-term U.S. Treasuries. This includes our mortgage loans and real estate securities. Our hedge and other risk management transactions will also have exposures to movements in interest rates. Changes in the general level of interest rates can affect our net interest income, which is the difference between the interest income earned on interest-bearing assets and the interest expense incurred in connection with our interest-bearing liabilities. Changes in interest rates can also affect our net income from any investments that we make in net leased real estate, which is the difference between the rental income earned and the interest expense on the liabilities associated with the properties. Changes in the level of interest rates may also affect, among other things, our ability to originate or acquire mortgage loans and securities, real estate properties, and the value of our mortgage loans and other assets.

#### *Credit Spread Curve Exposure*

Our mortgage loans and real estate securities are subject to spread risk. The majority of these assets are fixed-rate assets, which are valued based on a market credit spread over the rate payable on fixed-rate U.S. Treasuries of like maturity. In other words, their value is dependent on the yield demanded on such assets by the market based on their credit relative to U.S. Treasuries. Changes in the general credit markets can lead to changes in the required yield on these assets, which would result in a higher or lower value for our mortgage loans and real estate securities. If the required market yields increase as a result of these general credit-market changes, the value of our fixed-rate assets would decline relative to U.S. Treasuries. Conversely, if the required market yields decrease as a result of these general credit-market changes, the value of our fixed-rate assets would increase relative to U.S. Treasuries. These changes in the market value of our fixed-rate asset portfolio may affect the equity on our balance sheet or our results of operations directly through provisions for losses on mortgage loans or through unrealized losses on available-for-sale securities. These value changes may also affect our ability to borrow and access capital.

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 fixed-rate assets. This would have similar effects on the fair value of our fixed-rate assets, our financial position and results of operations, as would a change in general credit spreads.

*Tenant Credit Rating Exposure*

Our mortgage loans and real estate securities are subject to risks due to credit rating changes of the tenants under the related net lease obligations. The credit quality of a particular net lease asset is highly dependent on the credit rating of the related tenant obligor of the net lease. Deterioration in the tenant's credit rating can lead to changes in the required yield on the related asset, which would result in a lower value for our net lease assets. This would have similar effects on the fair value of our fixed-rate assets, our financial position and results of operations, as would a change in general credit spreads. In addition, precipitous declines in the credit rating of a particular tenant prior to our obtaining long-term financing may significantly impede or eliminate our ability to finance the asset. We manage this risk by maintaining diversity among our credits and assessing our aggregate exposure to ratings classes, in particular lower rated classes.

*Equity Price Risk Exposure*

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

*Fair Value*

For certain of our financial instruments, fair values are not readily available since there are no active trading markets as characterized by current exchanges between willing parties. Accordingly, we derive or estimate fair values using various valuation techniques, such as computing the present value of estimated future cash flows using discount rates commensurate with the risks involved. However, the determination of estimated cash flows may be subjective and imprecise. Changes in assumptions or estimation methodologies can have a material affect on these estimated fair values. The fair values indicated below are indicative of the interest rate and credit spread environment as of June 30, 2005, and may not take into consideration the effects of subsequent interest rate, credit spread fluctuations, or changes in the ratings of the tenants under related net leases.

The following summarizes certain data regarding our interest rate sensitive instruments as of June 30, 2005:

|  | <b>Carrying<br/>Amount</b> | <b>Notional<br/>Amount</b> | <b>Weighted<br/>Average<br/>Effective<br/>Interest Rate</b> | <b>Maturity<br/>Date</b> | <b>Fair Value</b> |
|--|----------------------------|----------------------------|---|--------------------------|-------------------|
| <i>(dollars in thousands)</i>          |                            |                            |   |                          |                   |
| <b>Assets:</b>                         |                            |                            |   |                          |                   |
| Mortgage loans held for investment (1) | \$ 237,977                 | \$ 236,576                 | 6.64%   | Various                  | \$ 254,780        |
| Securities available for sale-CMBS (2) | 124,995                    | 135,655                    | 8.78%   | 2009-2028                | 124,995           |
| Structuring fees receivable (2)        | 4,150                      | N/A                        | 8.24%   | 2010-2020                | 4,150             |
| <b>Liabilities:</b>                    |                            |                            |   |                          |                   |
| Repurchase agreements (3)              | 45,744                     | 45,744                     | 4.42%   | Short term               | 45,744            |
| Mortgage notes payable (4)             | 265,314                    | 264,534                    | 5.33%   | 2013-2018                | 269,919           |
| Collateralized debt obligations (4)    | 268,138                    | 268,500                    | 5.66%   | 2015                     | 271,752           |
| Derivative liabilities (5)             | 3,451                      | 120,456                    | N/A   | N/A                      | 3,451             |

(1) With the exception of one loan, this portfolio of mortgage loans bears interest at fixed rates. We have estimated the fair value of this portfolio of loans based on sales of loans with similar credit and structural characteristics where available, and management's estimate of fair values where comparable sales information is not available. The maturity dates for the mortgage loans range from 2006 through 2033.

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

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

Scheduled maturities of interest rate sensitive instruments as of June 30, 2005 are as follows:

|                                    | <b>Expected Maturity Dates</b>  |             |             |             |             |                   |
|------------------------------------|---|-------------|-------------|-------------|-------------|-------------------|
|                                    | <b>2005</b>   | <b>2006</b> | <b>2007</b> | <b>2008</b> | <b>2009</b> | <b>thereafter</b> |
|                                    | <i>(in thousands, notional amounts where appropriate, otherwise carrying amounts)</i> |             |             |             |             |                   |
| Mortgage loans held for investment | \$ 4,230  | \$ 19,560   | \$ 14,098   | \$ 5,304    | \$ 14,380   | \$ 179,004        |
| Securities available for sale-CMBS | 394   | 797         | 868         | 952         | 24,007      | 108,637           |
| Structuring fees receivable        | 287   | 609         | 659         | 713         | 772         | 1,110             |
| Repurchase agreements              | 45,744  | —           | —           | —           | —           | —                 |
| Mortgage notes payable             | 543   | 1,621       | 2,267       | 4,062       | 4,787       | 251,254           |
| Collateralized debt obligations    | —   | —           | —           | —           | —           | 268,500           |
| Derivative liabilities             | 3,451   | —           | —           | —           | —           | —                 |

The expected maturity dates shown for mortgage loans, securities available for sale and structuring fees receivable are based on the contractual terms of the underlying assets. These assets, based on our current operating strategy, are held for investment. Our liabilities with respect to repurchase agreements are short-term in nature and, accordingly, are listed in the current period. The material assumptions used to determine fair value are included in footnotes 1 through 5 in the immediately preceding table.

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

We maintain disclosure controls and procedures 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.

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.

There has been no change in our internal control over financial reporting during the quarter covered by this report 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. The Company is not a party to any material litigation or legal proceedings, or to the best of its knowledge, any threatened litigation or legal proceedings, which, in the opinion of management would have a material adverse effect on its results of operations or financial condition.

### **Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities**



None.

**Item 3. Defaults Upon Senior Securities**

None.

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

Our annual meeting of stockholders was held in New York, New York on June 15, 2005. 23,287,914 shares of common stock, representing 83.5% of our outstanding shares, were represented in person or by proxy.

The seven directors listed below were elected to a one-year term expiring in 2006.

|                      | Number of Shares |          |
|----------------------|------------------|----------|
|                      | For              | Withheld |
| Lewis S. Ranieri     | 23,212,366       | 75,548   |
| Paul H. McDowell     | 23,211,866       | 76,048   |
| William R. Pollert   | 23,211,866       | 76,048   |
| Michael E. Gagliardi | 23,237,996       | 49,918   |
| Stanley Kreitman     | 22,746,034       | 541,880  |
| Jeffrey F. Rogatz    | 23,156,234       | 131,680  |
| Howard A. Silver     | 23,063,740       | 224,174  |

**Item 5. Other Information**

None.

**Item 6. Exhibits**

**a. Exhibits**

- 10.1 Second Amendment to Purchase and Sale Agreement, dated as of April 15, 2005, by and between Caplease, LP and Aliso Commons at Town Center, LLC
- 31.1 Certification of the Registrant's Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Registrant's Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of the Registrant's Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of the Registrant's Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002



**SIGNATURES**

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

**CAPITAL LEASE FUNDING, INC.**

*Registrant*

Date: August 11, 2005

/s/ Paul H. McDowell  
Paul H. McDowell  
*Chief Executive Officer*

Date: August 11, 2005

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