

CAPITAL LEASE FUNDING INC  
Form 10-Q  
November 06, 2006

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SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

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.)

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

10018  
(ZIP Code)

Registrant's Telephone Number, Including Area Code:

(212) 217-6300

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of November 6, 2006, there were 33,925,929 shares of common stock of Capital Lease Funding, Inc., \$0.01 par value per share, outstanding (“Common Stock”).



**Capital Lease Funding, Inc.****Index to Form 10-Q**

|  | Page      |
|--|-----------|
| <b>PART I. FINANCIAL INFORMATION</b>   | <b>2</b>  |
| Item 1. Financial Statements   | 2         |
| Consolidated Balance Sheets as of September 30, 2006 (unaudited) and December 31, 2005                             | 2         |
| Consolidated Income Statements (unaudited) for the Three and Nine Months Ended September 30, 2006 and 2005         | 3         |
| Consolidated Statement of Changes in Stockholders' Equity (unaudited) for the Nine Months Ended September 30, 2006 | 4         |
| Consolidated Statements of Cash Flows (unaudited) for the Three and Nine Months Ended September 30, 2006 and 2005  | 5         |
| Notes to Consolidated Financial Statements (unaudited)   | 7         |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations                      | 28        |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk   | 36        |
| Item 4. Controls and Procedures  | 39        |
| <b>PART II. OTHER INFORMATION</b>  | <b>39</b> |
| Item 1. Legal Proceedings  | 39        |
| Item 1A. Risk Factors  | 39        |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds  | 41        |
| Item 3. Defaults Upon Senior Securities  | 41        |
| Item 4. Submission of Matters to a Vote of Security Holders  | 41        |
| Item 5. Other Information  | 41        |
| Item 6. Exhibits   | 41        |
| Signatures   | 42        |

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

Capital Lease Funding, Inc. and Subsidiaries  
Consolidated Balance Sheets  
As of September 30, 2006 (unaudited) and December 31, 2005

| (Amounts in thousands, except share and per share amounts)  | As Of<br>September 30,<br>2006 | As Of<br>December 31,<br>2005 |
|---|--------------------------------|-------------------------------|
| <b>Assets</b>   |                                |                               |
| Real estate investments, net  | \$ 964,260                     | \$ 764,930                    |
| Mortgage and other real estate loans held for investment  | 275,041                        | 297,551                       |
| Securities available for sale   | 172,135                        | 137,409                       |
| Cash and cash equivalents   | 2,271                          | 19,316                        |
| Assets held for sale  | 2,942                          | 2,942                         |
| Structuring fees receivable   | 3,410                          | 3,862                         |
| Other assets  | 72,136                         | 60,478                        |
| <b>Total Assets</b>   | <b>\$ 1,492,195</b>            | <b>\$ 1,286,488</b>           |
| <b>Liabilities and Stockholders' Equity</b>   |                                |                               |
| Accounts payable, accrued expenses and other liabilities  | \$ 15,396                      | \$ 14,890                     |
| Repurchase agreement and other short-term financing obligations   | 140,699                        | 129,965                       |
| Mortgages on real estate investments  | 696,662                        | 551,844                       |
| Collateralized debt obligations   | 268,182                        | 268,156                       |
| Other long-term debt  | 30,930                         | 30,930                        |
| Intangible liabilities on real estate investments   | 17,809                         | 14,419                        |
| Dividends payable   | 7,549                          | 6,253                         |
| <b>Total liabilities</b>  | <b>1,177,227</b>               | <b>1,016,457</b>              |
| Minority interest   | 2,902                          | -                             |
| Commitments and contingencies   |                                |                               |
| Stockholders' equity:   |                                |                               |
| Preferred stock, \$0.01 par value, 100,000,000 shares authorized, Series A cumulative redeemable preferred, liquidation preference \$25.00 per share, 1,400,000 shares issued and outstanding | 33,657                         | 33,657                        |
| Common stock, \$0.01 par value, 500,000,000 shares authorized, 33,925,929 and 27,868,480 shares issued and outstanding, respectively  | 339                            | 279                           |
| Additional paid in capital  | 280,788                        | 237,843                       |
| Accumulated other comprehensive loss  | (2,718)                        | (1,748)                       |
| <b>Total Stockholders' Equity</b>   | <b>312,066</b>                 | <b>270,031</b>                |
| <b>Total Liabilities and Stockholders' Equity</b>   | <b>\$ 1,492,195</b>            | <b>\$ 1,286,488</b>           |

See notes to consolidated financial statements.

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Capital Lease Funding, Inc. and Subsidiaries  
Consolidated Income Statements  
(Unaudited)

| (Amounts in thousands, except per share amounts)                         | For the Three Months<br>Ended September 30 |                 | For the Nine Months<br>Ended September 30 |                 |
|--|--|-----------------|---|-----------------|
|  | 2006                                       | 2005            | 2006                                      | 2005            |
| <b>Revenues:</b>   |  |                 |   |                 |
| Rental revenue   | \$ 20,238                                  | \$ 11,979       | \$ 57,114                                 | \$ 23,438       |
| Interest income from mortgage and other real estate loans and securities | 7,985                                      | 7,376           | 23,944                                    | 20,123          |
| Property expense recoveries  | 2,237                                      | 1,473           | 6,276                                     | 4,193           |
| Gains on sale of mortgage loans and securities                           | –  | 210             | 645                                       | 447             |
| Other revenue  | 487  | 147             | 1,571                                     | 279             |
| <b>Total revenues</b>  | <b>30,947</b>                              | <b>21,185</b>   | <b>89,550</b>                             | <b>48,480</b>   |
| <b>Expenses:</b>   |  |                 |   |                 |
| Interest expense   | 16,099                                     | 9,798           | 45,851                                    | 19,554          |
| Property expenses  | 3,765                                      | 2,994           | 11,092                                    | 7,068           |
| Loss on securities   | 240  | 2,122           | 240                                       | 2,372           |
| General and administrative expenses                                      | 2,199                                      | 2,538           | 6,979                                     | 7,504           |
| General and administrative expenses-stock based compensation             | 552  | 647             | 1,766                                     | 1,569           |
| Depreciation and amortization expense on real property                   | 6,580                                      | 3,596           | 18,396                                    | 6,785           |
| Loan processing expenses   | 66   | 33              | 198                                       | 181             |
| Loss (gain) on derivatives   | 2  | –               | (127)                                     | –               |
| <b>Total expenses</b>  | <b>29,503</b>                              | <b>21,728</b>   | <b>84,395</b>                             | <b>45,033</b>   |
| Income (loss) before minority interest and taxes                         | 1,444                                      | (543)           | 5,155                                     | 3,447           |
| Minority interest in consolidated entities                               | (6)  | 270             | (7)                                       | 55              |
| Income (loss) from continuing operations                                 | 1,438                                      | (273)           | 5,148                                     | 3,502           |
| Income from discontinued operations                                      | 49   | –               | 146                                       | –               |
| Net income (loss)  | 1,487                                      | (273)           | 5,294                                     | 3,502           |
| Dividends allocable to preferred shares                                  | (711)                                      | –               | (2,133)                                   | –               |
| <b>Net income (loss) allocable to common stockholders</b>                | <b>\$ 776</b>                              | <b>\$ (273)</b> | <b>\$ 3,161</b>                           | <b>\$ 3,502</b> |
| <b>Earnings per share:</b>   |  |                 |   |                 |
| Net income (loss) per common share, basic and diluted                    | \$ 0.02                                    | \$ (0.01)       | \$ 0.10                                   | \$ 0.13         |
| Weighted average number of common shares outstanding, basic              | 33,919                                     | 27,868          | 31,252                                    | 27,755          |
| Weighted average number of common shares outstanding, diluted            | 33,921                                     | 27,868          | 31,252                                    | 27,755          |
| Dividends declared per common share                                      | \$ 0.20                                    | \$ 0.18         | \$ 0.60                                   | \$ 0.54         |
| Dividends declared per preferred share                                   | \$ 0.50781                                 | \$ –            | \$ 1.52344                                | \$ –            |

See notes to consolidated financial statements.



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

|   | Preferred<br>Stock | Common<br>Stock<br>at Par | Additional<br>Paid-In<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Retained<br>Earnings | Total    | Comprehensive<br>Income<br>(Loss) |
|---|--------------------|---------------------------|----------------------------------|---|----------------------|----------|-----------------------------------|
| Balance at December 31, 2005                                      | \$ 33,657          | \$ 279                    | \$ 237,843                       | \$ (1,748)  | -\$                  | 270,031  | \$ 2,179                          |
| Incentive stock plan<br>compensation expense                      | -                  | -                         | 1,766                            | -   | -                    | 1,766    |                                   |
| Incentive stock plan grants<br>issued & forfeited                 | -                  | 3                         | (3)                              | -   | -                    | -        |                                   |
| Net income  | -                  | -                         | -                                | -   | 5,294                | 5,294    | 5,294                             |
| Issuance of common stock  | -                  | 57                        | 57,225                           | -   | -                    | 57,282   |                                   |
| Dividends declared-preferred                                      | -                  | -                         | -                                | -   | (2,133)              | (2,133)  |                                   |
| Dividends declared-common   | -                  | -                         | (16,043)                         | -   | (3,161)              | (19,204) |                                   |
| Unrealized change in value of<br>securities<br>available for sale | -                  | -                         | -                                | (1,136)   | -                    | (1,136)  | (1,136)                           |
| Unrealized change in value of<br>derivatives                      | -                  | -                         | -                                | (765)   | -                    | (765)    | (765)                             |
| Realized gains (losses) on<br>derivatives,<br>net of amortization | -                  | -                         | -                                | 931   | -                    | 931      | 931                               |
| Balance at September 30, 2006                                     | \$ 33,657          | \$ 339                    | \$ 280,788                       | \$ (2,718)  | -\$                  | 312,066  | \$ 4,324                          |

See notes to consolidated financial statements.

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

|   | For the Nine Months<br>Ended September 30, |           |
|---|--|-----------|
|   | 2006                                       | 2005      |
| <b>Operating activities</b>   |  |           |
| Net income  | \$ 5,294                                   | \$ 3,502  |
| Adjustments to reconcile net income to cash provided by (used in) operating activities: |  |           |
| Depreciation and amortization   | 18,578                                     | 5,934     |
| Amortization of stock based compensation  | 1,766                                      | 1,569     |
| Amortization of above and below market leases   | (500)                                      | (408)     |
| Minority interest in consolidated entities  | 7  | -         |
| Gains on sale of mortgage loans and securities  | (645)                                      | (447)     |
| Loss on securities available for sale   | 240  | 2,372     |
| (Gain) loss on derivatives  | (127)                                      | -         |
| Straight-lining of rents  | (6,914)                                    | (2,852)   |
| Amortization of discounts/premiums, and origination fees/costs                          | (396)                                      | (404)     |
| Amortization of debt issuance costs and FMV of debt assumed                             | 1,178                                      | 795       |
| Changes in operating assets and liabilities:  |  |           |
| Structuring fees receivable   | 452  | 418       |
| Other assets  | (4,130)                                    | (24,662)  |
| Accounts payable, accrued expenses and other liabilities                                | 708  | 7,630     |
| Deposits and escrows  | (1,913)                                    | (6,966)   |
| Amounts due to servicer   | -  | (4,359)   |
| Net cash provided by (used in) operating activities                                     | 13,598                                     | (17,878)  |
| <b>Investing activities</b>   |  |           |
| Proceeds from sale of mortgage and other real estate loans                              | 78,645                                     | 12,131    |
| Additions to mortgage and other real estate loans                                       | (121,509)                                  | (67,608)  |
| Principal received from borrowers   | 65,805                                     | 9,271     |
| Origination costs on lending investments  | 203  | 78        |
| Purchase of securities available for sale   | (36,792)                                   | (46,168)  |
| Sale of securities available for sale   | -  | 5,787     |
| Principal amortization on securities available for sale                                 | 1,098                                      | 1,320     |
| Purchases of real estate investments  | (202,648)                                  | (432,155) |
| Real estate improvements, additions and construction in progress                        | (8,188)                                    | (1,692)   |
| Deposits on potential equity investments  | (12,360)                                   | (9,100)   |
| Return of deposit on equity investment  | 4,700                                      | 11,600    |
| Purchases of furniture, fixtures, equipment and leasehold improvements                  | (1,747)                                    | (82)      |
| Net cash used in investing activities   | (232,793)                                  | (516,618) |
| <b>Financing activities</b>   |  |           |
| Borrowing under repurchase agreement and other short-term financing obligations         | 131,109                                    | 184,980   |
| Repayment of repurchase agreement and other short-term financing obligations            | (120,376)                                  | (234,357) |
| Borrowings from mortgages on real estate investments                                    | 146,285                                    | 328,627   |



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|  |                 |                 |
|--|-----------------|-----------------|
| Repayments of mortgages on real estate investments                 | (1,186)         | (786)           |
| Borrowings from collateralized debt obligations                    | –               | 268,130         |
| Debt issuance costs  | (590)           | (5,895)         |
| Escrows held with mortgage lender                                  | 9,495           | –               |
| Funds provided by (used in) hedging and risk management activities | 186             | (11,206)        |
| Common stock issued, net of offering costs                         | 57,282          | –               |
| Cash distributions to minority limited partners                    | (53)            | –               |
| Dividends paid on common and preferred stock                       | (20,094)        | (14,158)        |
| Changes in amounts due from affiliates and members                 | 92              | (23)            |
| Net cash provided by financing activities                          | 202,150         | 515,312         |
| <b>Net decrease in cash and cash equivalents</b>                   | <b>(17,045)</b> | <b>(19,184)</b> |
| Cash and cash equivalents at beginning of period                   | 19,316          | 30,721          |
| Cash and cash equivalents at end of period                         | \$ 2,271        | \$ 11,537       |

See notes to consolidated financial statements.

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

For the Nine Months  
Ended September 30,  
2006                      2005

**Supplemental disclosure of cash flow information**

|   |    |        |    |        |
|---|----|--------|----|--------|
| Cash paid for interest expense (excluding capitalized interest) | \$ | 43,306 | \$ | 12,954 |
| Cash paid for capitalized interest                              | \$ | -      | \$ | 1,347  |
| Distributions declared but not paid                             | \$ | 53     | \$ | -      |
| Dividends declared but not paid                                 | \$ | 7,496  | \$ | 5,016  |

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

|  |    |         |    |         |
|--|----|---------|----|---------|
| Unrealized gain (loss) on cash flow hedges                             | \$ | (765)   | \$ | 7,467   |
| Unrealized gain (loss) on available-for-sale securities                | \$ | (1,136) | \$ | 672     |
| Value of in-place leases and above-market leases acquired              | \$ | 19,567  | \$ | 53,038  |
| Value of below-market leases acquired                                  | \$ | 4,259   | \$ | 8,631   |
| Securities reclassified to mortgage loans held for investment          | \$ | -       | \$ | 6,932   |
| Mortgage notes payable assumed on properties acquired                  | \$ | -       | \$ | 41,276  |
| Operating partnership units issued in connection with an investment    | \$ | 3,000   | \$ | -       |
| Real estate investments consolidated under FIN46                       | \$ | -       | \$ | 81,500  |
| Real estate investments no longer consolidated under FIN46             | \$ | -       | \$ | 129,500 |
| Mortgage on real estate investments consolidated under FIN46           | \$ | -       | \$ | 50,887  |
| Mortgage on real estate investments no longer consolidated under FIN46 | \$ | -       | \$ | 55,702  |
| Depreciation on real estate investments consolidated under FIN46       | \$ | -       | \$ | 935     |

See notes to consolidated financial statements.

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

September 30, 2006 (unaudited)

## 1. Organization

Capital Lease Funding, Inc. (“CLF, Inc.” and collectively with its majority-owned subsidiaries, the “Company”) is a diversified real estate investment trust, or REIT, that invests primarily in single tenant commercial real estate assets subject to long-term leases to primarily investment grade tenants. The Company focuses on properties that are subject to a net lease, which the Company defines as a lease that requires the tenant (rather than the landlord) to pay for, or pay for and perform, all or substantially all aspects of the property and its operations during the lease term.

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

CLF, Inc. 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. Since 1995, Caplease, LP was primarily engaged in the business of underwriting, originating and selling or securitizing mortgage loans made to owners of commercial real properties subject to long term net leases to high credit quality tenants. CLF, Inc. completed the acquisition of Caplease, LP through a reverse merger and its initial public offering during March 2004. CLF, Inc. is the indirect sole general partner of, and owns approximately 98.5% of the common equity of, Caplease, LP.

In March 2004, CLF, Inc. sold 23,000,000 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 \$222,000. In October 2005, CLF, Inc. sold 1,400,000 shares of its 8.125% Series A cumulative redeemable preferred stock in a public offering at a price to the public of \$25.00 per share, for net proceeds of approximately \$33,657. In May 2006, CLF, Inc. issued 5,747,000 shares of common stock in a public offering at a price to the public of \$10.55 per share, for net proceeds of approximately \$57,282. As of September 30, 2006, CLF, Inc. had 33,925,929 shares of common stock and 1,400,000 shares of 8.125% Series A cumulative redeemable preferred stock outstanding.

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

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, 2005 and notes thereto, included in the Company’s Form 10-K filed with the SEC on March 16, 2006.

## **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 CLF, Inc. and its majority-owned subsidiaries and other entities consolidated under FIN 46 (see Note 20). Results of operations of properties acquired are included in the Consolidated Income Statements from the date of acquisition. All significant intercompany transactions, balances and accounts have been eliminated in consolidation.

7

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

September 30, 2006 (unaudited)

*Investments in Mortgage Loans*

Mortgage loans comprise the vast majority of the Company's loan portfolio. Mortgage loans are secured by an assignment of the long-term real property leases (the majority of whose tenants carry credit ratings of BBB- or better, commonly referred to as 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.

The Company periodically evaluates each of its loans held for investment for possible impairment. Impairment is indicated when it is deemed probable that the Company will be unable to collect all amounts due according to the contractual terms of the asset. Upon determination of impairment, the Company must establish a specific valuation allowance with a corresponding charge to earnings. Significant judgment is required both in determining impairment and in estimating the resulting loss allowance. In determining impairment and any loan loss allowance, the Company will be required to evaluate its assets, historical and industry loss experience, economic conditions and trends, collateral values and quality, and other relevant factors. As of September 30, 2006, the Company had no loss allowances on any of the loans in its portfolio.

*Purchase Accounting for Acquisition of Real Estate*

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

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

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

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

Other intangible assets acquired include in-place leases and tenant relationships which are valued 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 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. Through September 30, 2006, the Company has assigned no value to tenant relationships on any of its acquisitions.

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

September 30, 2006 (unaudited)

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

Real estate taxes, insurance and interest expense on properties that are under construction 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 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.

*Securities Available for Sale*

Securities are classified as available-for-sale and are reported at fair value on the Company's consolidated balance sheets, with unrealized gains and losses included in other comprehensive income, and any other-than-temporary impairments included in current earnings on the Income Statement, in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been below cost, (2) the financial condition and near-term prospects of the underlying credit and (3) the intent and ability of the Company to retain its investment in the underlying credit for a period of time sufficient to allow for anticipated recovery in fair value. The Company had losses on securities charged to the Income Statement of \$240 during the three and nine months ended September 30, 2006. The Company had losses on securities charged to the Income Statement of \$2,122 during the three months ended September 30, 2005, and \$2,372 during the nine months ended September 30, 2005.

*Deferred Origination Fees and Costs*

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

*Revenue Recognition*

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

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

Gains are recognized on the sale of loans and securities in accordance with the requirements of SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The Company may from time to time split 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 credit of the underlying tenant. 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.



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

September 30, 2006 (unaudited)

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.

*Impairment of Long-Lived Assets*

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company reviews its investment in long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company acquired its first real property in the third quarter of 2004. The Company recognized no impairment losses on long-lived assets during the three and nine months ended September 30, 2006 and September 30, 2005.

*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 continue to operate in a manner consistent with and it has elected to be treated as a REIT for tax purposes. From time to time, the Company may conduct a portion of its business through a taxable REIT subsidiary ("TRS"), and the income from the activities of the TRS is subject to federal and state taxation at the applicable corporate rates.

*Earnings per Share*

In accordance with 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 EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock, where such exercise or conversion would result in a lower EPS amount. For the 2006 periods, the Company's computation of diluted EPS included 6,000 shares which the Company agreed in September 2006 to issue to an employee if a service condition is satisfied on January 2, 2007.

The following summarizes the Company's EPS computations for the three and nine months ended September 30, 2006 and September 30, 2005 (in thousands, except per share amounts):

|   | <u>For the three months</u><br><u>ended September 30,</u> |          | <u>For the nine months</u><br><u>ended September 30,</u> |          |
|---|---|----------|--|----------|
|   | 2006  | 2005     | 2006   | 2005     |
| Net income allocable to common stockholders                 | \$ 776  | \$ (273) | \$ 3,161   | \$ 3,502 |
| Weighted average number of common shares outstanding, basic | 33,919  | 27,868   | 31,252   | 27,755   |
| Weighted average number of common shares                    | 33,921  | 27,868   | 31,252   | 27,755   |

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|  |    |      |    |        |    |      |
|--|----|------|----|--------|----|------|
| outstanding, diluted   |    |      |    |        |    |      |
| Earnings per share, basic<br>and diluted   | \$ | 0.02 | \$ | (0.01) | \$ | 0.13 |
| Non-vested shares included<br>in weighted average<br>number of shares<br>outstanding above |    | 583  |    | 496    |    | 583  |
|  |    |      |    |        |    | 496  |

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

September 30, 2006 (unaudited)

*Recently Issued Accounting Pronouncements*

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. The Company adopted SFAS No. 123R as of January 1, 2006. The adoption of SFAS No. 123R did not have a material effect on the Company’s consolidated financial statements. See Note 15.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections — A Replacement of APB Opinion No. 20 and SFAS No. 3*. SFAS No. 154 changes the requirements for the accounting and reporting of a change in accounting principle by requiring retrospective application to prior periods’ financial statements of the change in accounting principle, unless it is impracticable to do so. SFAS No. 154 also requires that a change in depreciation or amortization for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company’s adoption of SFAS No. 154 on January 1, 2006 did not have a material effect on the Company’s consolidated financial statements.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109* (“FIN 48”). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company’s financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on description, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company believes that the adoption of this standard on January 1, 2007 will not have a material effect on its consolidated financial statements.

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

*Reclassification*

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

**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 and Other Real Estate Loans Held for Investment**

Mortgage and other real estate loans held for investment at September 30, 2006 and December 31, 2005, are summarized in the following table. These investments consist predominantly of mortgage loans on properties subject to leases to investment grade tenants. As of September 30, 2006, the weighted average credit rating of the underlying tenants was BBB+ from Standard & Poor's. As of September 30, 2006, none of the Company's loans held for investment were delinquent or in default.

11

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

September 30, 2006 (unaudited)

|                                | Sep 30, 2006<br>Unaudited | Dec 31,<br>2005   |
|--------------------------------|---------------------------|-------------------|
| Principal                      | \$ 274,184                | \$ 296,479        |
| Premium                        | 1,836                     | 1,898             |
| Carrying amount of loans       | 276,020                   | 298,377           |
| Deferred origination fees, net | (979)                     | (826)             |
| <b>Total</b>                   | <b>\$ 275,041</b>         | <b>\$ 297,551</b> |

From time to time, the Company makes mezzanine loan and other investments. These investments are typically shorter-term in nature and are often subordinate to other financing on the property. As of September 30, 2006, these investments aggregated \$10,965, and are included in the table above.

As described in the Company's Form 10-Q for the quarter ended June 30, 2006, the Company started a modest franchise lending business during June 2006, and loans made under this program have been classified as mezzanine loans by the Company. As of September 30, 2006, the Company had advanced \$5,169 to a borrower under a \$12,000 revolving credit agreement that expires in September 2009. The borrower uses funds advanced by the Company to support capital contributions to a joint venture that makes franchise loans to franchisees of YUM! Brands, Inc. restaurant concepts such as Taco Bell, Kentucky Fried Chicken and Pizza Hut. During the three months ended September 30, 2006, the Company also made a \$6,648 bridge loan to an affiliated entity of the credit agreement borrower to support a franchise loan made outside the joint venture. The Company's loan is secured by an assignment of the franchise loan, as well as a pledge of all of the equity in the franchise lender. The Company earns interest on the bridge loan at the rate of ten percent per annum. As of September 30, 2006, there was \$4,648 of principal outstanding under the bridge loan, all of which is scheduled to mature during the fourth quarter of 2006.

At September 30, 2006, the Company's mortgage and other real estate loans carried interest rates ranging from 5.28% to 10.00%, and at December 31, 2005, the Company's mortgage and other real estate loans carried interest rates ranging from 5.28% to 14.29%. At September 30, 2006 and December 31, 2005, the weighted average effective interest rate on the mortgage and other real estate loans, as measured against the Company's cost basis, was 6.77% and 6.86%, respectively.

## 5. Real Estate Investments

Real estate held for investment and related intangible liabilities on real estate investments consisted of the following at September 30, 2006 and December 31, 2005:

|   | Sep 30, 2006<br>Unaudited | Dec 31,<br>2005 |
|---|---------------------------|-----------------|
| Real estate investments, at cost:               |                           |                 |
| Land  | \$ 156,556                | \$ 136,566      |
| Building and improvements                       | 735,786                   | 557,248         |
| Intangible assets under SFAS 141                | 102,429                   | 82,862          |
| Less: Accumulated depreciation and amortization | (30,511)                  | (11,746)        |

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|  |            |            |
|--|------------|------------|
| Real estate investments, net                           | \$ 964,260 | \$ 764,930 |
| Intangible liabilities on real estate investments:     |            |            |
| Intangible liabilities under SFAS 141                  | 19,468     | 15,210     |
| Less: Accumulated amortization                         | (1,659)    | (791)      |
| Intangible liabilities on real estate investments, net | \$ 17,809  | \$ 14,419  |

Acquisition costs capitalized as part of buildings and improvements were \$123 and \$1,482 for the three and nine months ended September 30, 2006.

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

September 30, 2006 (unaudited)

Amounts for accrued rental income and deferred rental income as of September 30, 2006 and December 31, 2005, were as follows:

|                        | Sep 30, 2006<br>Unaudited | Dec 31,<br>2005 |
|------------------------|---------------------------|-----------------|
| Accrued Rental Income  | \$ 13,277                 | \$ 6,708        |
| Deferred Rental Income | 275                       | 620             |

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

Amortization of intangible assets and liabilities for the three and nine months ended September 30, 2006 and September 30, 2005, was as follows:

|   | <u>For the three months</u><br><u>ended September 30,</u> |        | <u>For the nine months</u><br><u>ended September 30,</u> |          |
|---|---|--------|--|----------|
|   | 2006  | 2005   | 2006   | 2005     |
| Amortization of in-place leases (included in depreciation and amortization expense) | \$ 2,045  | \$ 896 | \$ 5,794   | \$ 1,573 |
| Amortization of above-market leases (included as a reduction of rental revenue)     | 130   | 34     | 368  | 34       |
| Amortization of below-market leases (included as a component of rental revenue)     | 303   | 231    | 868  | 443      |

As of September 30, 2006, the Company's weighted average amortization period on intangible assets was 12.2 years, and the weighted average amortization period on intangible liabilities was 20.6 years.

Scheduled amortization on existing intangible assets and liabilities on real estate investments as of September 30, 2006 is as follows:

|            |            |
|------------|------------|
| Intangible | Intangible |
|------------|------------|

|                              | Assets    | Liabilities |
|------------------------------|-----------|-------------|
| 3 Months Ending December 31, |           |             |
| 2006                         | \$ 2,183  | \$ 304      |
| 2007                         | 8,733     | 1,216       |
| 2008                         | 8,733     | 1,216       |
| 2009                         | 8,733     | 1,216       |
| 2010                         | 8,733     | 1,216       |
| Thereafter                   | 55,804    | 12,641      |
|                              | \$ 92,919 | \$ 17,809   |

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

As of September 30, 2006, all of the Company's owned properties were pledged as collateral for the related long-term financings of those assets, with the exception of the Cott Corporation asset described below which is not yet financed. The Company owns and finances each property through a separate single purpose entity, or SPE, with each property and the related lease or leases on the property generally representing the sole assets of the SPE.



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

September 30, 2006 (unaudited)

During the three months ended September 30, 2006, the Company completed the following real estate acquisition:

| Month Acquired | Tenant or Guarantor | Location    | Purchase Price | Lease Expires | Net Rentable Square Feet |
|----------------|---------------------|-------------|----------------|---------------|--------------------------|
| July           | Cott Corporation    | Reading, PA | \$ 5,350       | June 2017     | 120,000                  |

## 6. Discontinued Operations

During the fourth quarter of 2005, the Company acquired a portfolio of three office properties from Allstate Insurance Company in a sale/leaseback transaction. The smallest of the three buildings is an approximately 19,500 square foot office building located in Pittsburgh, Pennsylvania. Because of the small size of this property, management concluded, prior to completing the acquisition, to resell the property promptly following its acquisition. The Company intends to resell the property as soon as practicable.

In accordance with SFAS No. 144, the Company reported the carrying value of the Allstate Pittsburgh property as assets held for sale on the September 30, 2006 and December 31, 2005 Consolidated Balance Sheets, and the revenues from the property as income from discontinued operations on the Consolidated Income Statement for the nine months ended September 30, 2006 and for the year ended December 31, 2005. Revenue and net income for the Allstate Pittsburgh property were \$146 and \$146, respectively, for the nine months ended September 30, 2006. Based on initial pricing expectations, the Company expects to recognize a gain on the sale of the property and, therefore, no impairment loss on the property has been recognized.

## 7. Securities Available for Sale and Structuring Fees Receivable

Securities available for sale at June 30, 2006 and at December 31, 2005, consisted of the following:

|  | Sep 30, 2006<br>Unaudited | Dec 31, 2005 |
|--|---------------------------|--------------|
| BSCMS 1999 CLF1, Class E (rated B+) Face Amount                  | \$ 3,326                  | \$ 3,326     |
| BSCMS 1999 CLF1, Class F (rated CCC) Face Amount                 | 2,494                     | 2,494        |
| CALFS 1997-CTL1, Class D (rated BB+) Face Amount                 | 6,000                     | 6,000        |
| CMLBC 2001-CMLB-1, Class E (rated BBB+) Face Amount              | 9,526                     | 9,526        |
| CMLBC 2001-CMLB-1, Class G (rated BB+) Face Amount               | 9,526                     | 9,526        |
| CMLBC 2001-CMLB-1, Class H (rated B+) Face Amount                | 11,907                    | 11,907       |
| CMLBC 2001-CMLB-1, Class J (rated D) Face Amount                 | 6,383                     | 6,383        |
| NLFC 1999-LTL-1, Class D (rated BBB) Face Amount                 | 5,000                     | 5,000        |
| NLFC 1999-LTL-1, Class E (rated BB) Face Amount                  | 11,081                    | 11,081       |
| NLFC 1999-LTL-1, Class X (IO) (rated AAA) Carry Value            | 7,775                     | 8,434        |
| WBCMT 2004-C15 180D (rated B+) Face Amount                       | 15,000                    | 15,000       |
| WBCMT 2004-C15 180E (rated B) Face Amount                        | 8,000                     | 8,000        |
| BACMS 2002-2, Class V-1 (7-Eleven, Inc.) (rated BBB) Face Amount | 419                       | 393          |
|  | 641                       | 602          |

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|   |            |            |
|---|------------|------------|
| BACMS 2002-2, Class V-2 (Sterling Jew elers) (rated BBB-) Face Amount |            |            |
| CVS Corporation (rated BBB+) Face Amount                              | 19,720     | 20,000     |
| Koninklijke Ahold, N.V. 7.82% Jan 2020 (rated BB+) Face Amount        | 8,980      | -          |
| Koninklijke Ahold, N.V. 7.9% May 2026 (rated BB+) Face Amount         | 23,498     | -          |
| Yahoo, Inc. (rated BBB-) Face Amount                                  | 31,975     | 31,990     |
| Other marketable securities (rated NA) Face Amount                    | 2,310      | -          |
| Unearned Discount   | (19,938)   | (21,901)   |
| Cost Basis  | 163,623    | 127,761    |
| Net unrealized appreciation on securities held for sale               | 8,512      | 9,648      |
| Total   | \$ 172,135 | \$ 137,409 |

All Standard & Poor's ratings in the above table are as of September 30, 2006.

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

September 30, 2006 (unaudited)

During the three and nine months ended September 30, 2006, the Company recorded an other-than-temporary decline in the fair value of its BSCMS 1999 CLF1, Class F bond, as a result of remaining exposure to the Winn-Dixie bankruptcy. The Company recorded a loss of \$240, thereby reducing its carry value of the bond to \$300. The Company's estimated loss and remaining carry value reflect (i) the fact that the Company has not received an interest payment on the bond since June 2006, (ii) the Company's estimates of the expected recovery value to the trust of a property acquired as a result of foreclosure on a defaulted Winn-Dixie mortgage loan and (iii) the Company's estimates of the extent to which it will be able to recover its losses from an expense reserve account maintained by the trust.

The Company recorded other-than-temporary declines in the fair value of two classes of CMLBC 2001 CMLB-1 bonds and one class of BSCMS 1999 CLF1 bonds during the three and nine months ended September 30, 2005. During the three months ended September 30, 2005, the Company wrote off its entire investment in the CMLBC 2001 CMLB-1, Class K bonds (\$1,092), and \$910 of its carry value on the CMLBC 2001 CMLB-1, Class J bonds. These losses resulted primarily from the sale by the CMLBC trust of \$22.4 million of Winn-Dixie certificates within the trust. During the nine months ended September 30, 2005, the Company also recorded a \$369 other-than-temporary decline in the fair value of its BSCMS 1999 CLF1, Class F bonds, including \$119 in the three months ended September 30, 2005, and \$250 in the three months ended June 30, 2005.

Unrealized gains and losses on securities available for sale at September 30, 2006 and December 31, 2005, included as a component of other comprehensive income, consisted of the following:

|  | Sep 30,<br>2006<br>Unaudited | Dec 31,<br>2005 |
|--|------------------------------|-----------------|
| Unrealized gains on securities available for sale  | \$ 9,280                     | \$ 10,002       |
| Unrealized losses on securities available for sale | (768)                        | (354)           |

The unrealized losses on the Company's securities are primarily the result of market factors, rather than credit impairment, and the Company believes the securities' carrying values are fully recoverable over their expected holding period.

The following table summarizes the Company's securities in an unrealized loss position as of September 30, 2006.

|   | Aggregate<br>Fair Value | Aggregate<br>Unrealized<br>Loss | Number<br>of<br>Securities |
|---|-------------------------|---------------------------------|----------------------------|
| In unrealized loss position less than 12 months | \$ 50,490               | \$ 388                          | 3                          |
| In unrealized loss position 12 or more months   | 22,261                  | 381                             | 3                          |

One of the securities with an unrealized loss in the "12 or more months" category is a zero coupon bond whose value increases over time as maturity approaches. The Company expects the market value of this security to increase to an

amount in excess of the Company's carry value by December 31, 2006. The fair value on each of the other two securities has declined primarily due to interest rate increases, rather than credit impairment, and the Company believes that in each case the security's carrying value is fully recoverable over its expected holding period.

At September 30, 2006 and December 31, 2005, the effective interest rate (yield to maturity on adjusted cost basis) on securities available for sale was approximately 7.9% and 8.2%, respectively.

The following summarizes the Company's sales of securities during the three and nine months ended September 30, 2006 and September 30, 2005:

15

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

September 30, 2006 (unaudited)

|                        | <u>For the three months</u> |      | <u>For the nine months</u> |          |
|------------------------|-----------------------------|------|----------------------------|----------|
|                        | <u>ended September 30,</u>  |      | <u>ended September 30,</u> |          |
|                        | 2006                        | 2005 | 2006                       | 2005     |
| Net proceeds from sale | \$ -                        | \$ - | \$ -                       | \$ 5,787 |
| Net gain               | -                           | -    | -                          | 174      |

Structuring fees receivable of \$3,410 and \$3,862 at September 30, 2006 and December 31, 2005, 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.

## 8. Other Assets

Other assets as of September 30, 2006 and December 31, 2005, consisted of the following:

|   | Sep 30, 2006 | Dec 31, 2005 |
|---|--------------|--------------|
|   | Unaudited    |              |
| Receivables and accrued interest                            | \$ 7,657     | \$ 6,515     |
| Prepaid expenses and deposits                               | 9,505        | 2,077        |
| Reserve accounts  | 9,899        | 8,131        |
| Escrow held with mortgage lender                            | 12           | 9,507        |
| Funds with CDO trustee pending distribution or reinvestment | 18,095       | 16,638       |
| Amounts held by servicer                                    | 1,477        | 1,483        |
| Derivative assets   | 2,375        | 1,082        |
| Accrued rental income                                       | 13,277       | 6,708        |
| Debt issuance costs, net                                    | 7,004        | 6,975        |
| Other   | 2,835        | 1,362        |
| Total   | \$ 72,136    | \$ 60,478    |

## 9. Repurchase Agreements and Other Short-Term Financing Arrangements

As of September 30, 2006, the Company had a \$250,000 repurchase agreement and a \$100,000 real property acquisition facility in place for short-term liquidity requirements with Wachovia Bank, N.A. and its affiliate. The Company's repurchase agreement and real property acquisition facility were renewed in August 2006, and are now scheduled to expire in August 2007.

The Company's short-term borrowing arrangements are secured by the assets financed and are fully recourse to its other assets.

Amounts related to the Company's repurchase agreement as of September 30, 2006 and December 31, 2005, are as follows:



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

September 30, 2006 (unaudited)

|                               | Sep 30,<br>2006<br>Unaudited | Dec 31,<br>2005   |
|-------------------------------|------------------------------|-------------------|
| <i>Collateral carry value</i> |                              |                   |
| Loans                         | \$ 150,055                   | \$ 116,881        |
| Securities                    | 42,980                       | 43,785            |
| <b>Total</b>                  | <b>\$ 193,035</b>            | <b>\$ 160,666</b> |
| <i>Borrowings</i>             |                              |                   |
| Loans                         | \$ 105,523                   | \$ 94,341         |
| Securities                    | 35,176                       | 35,624            |
| <b>Total</b>                  | <b>\$ 140,699</b>            | <b>\$ 129,965</b> |

The Company pays interest on amounts borrowed under its repurchase agreement with Wachovia Bank at prevailing short-term rates (30-day London Interbank Offered Rate (“LIBOR”)) plus a pricing spread (determined based upon the class and credit rating of the asset financed). Weighted average interest rates on the Company’s repurchase agreements for the nine months ended September 30, 2006 and September 30, 2005, are as follows:

|  | Sep 30, 2006<br>Unaudited | Sep 30, 2005<br>Unaudited |
|--|---------------------------|---------------------------|
| Wachovia-mortgage loan repurchase agreements | 5.92%                     | 3.65%                     |
| Wachovia-CMBS repurchase agreements          | 5.62%                     | 3.94%                     |

As of September 30, 2006 and September 30, 2005, the 30-day LIBOR rate was 5.32% and 3.86%, respectively.

The Company is required to pay interest on any borrowings on the real property acquisition facility at prevailing short-term rates (30-day LIBOR) plus a pricing spread (ranging from 95 to 225 basis points). As of September 30, 2006, the Company had no borrowings outstanding on the real property acquisition facility.

The Company is required to comply with the following financial covenants under its short-term financing agreements: minimum liquidity, minimum tangible net worth and maximum leverage. As of September 30, 2006, the Company was in compliance with the terms of its short-term financing agreements.

## 10. Risk Management Transactions

The Company’s objectives in using derivatives include adding stability to interest expense and managing its exposure to interest rate movements. The Company uses forward starting interest rate swaps to hedge the variability of changes in the interest-related cash outflows on forecasted future borrowings. As of September 30, 2006, the Company was hedging its exposure to such variability through October 2016. 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.

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 September 30, 2006 and December 31, 2005, were as follows:

17

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

September 30, 2006 (unaudited)

| <i>Description</i>  | September 30, 2006<br>Unaudited |               | December 31, 2005  |               |
|---------------------|---------------------------------|---------------|--------------------|---------------|
|                     | Notional<br>Amount              | Fair<br>value | Notional<br>Amount | Fair<br>value |
| Interest rate swaps | \$ 224,201                      | \$ (97)       | \$ 125,881         | \$ 784        |

At September 30, 2006 and December 31, 2005, the Company had hedged the following future borrowings:

|                                      | Sep 30, 2006<br>Unaudited | Dec 31, 2005 |
|--------------------------------------|---------------------------|--------------|
| Future borrowings (principal amount) | \$ 224,201                | \$ 125,881   |

At September 30, 2006 and December 31, 2005, derivatives with a fair value of \$2,472 and \$298, respectively, were included in accounts payable, accrued expenses and other liabilities on the Company's Consolidated Balance Sheet. At September 30, 2006 and December 31, 2005, derivatives with a fair value of \$2,375 and \$1,082, respectively, were included in other assets on the Company's Consolidated Balance Sheet.

Net realized gains and losses on qualifying cash flow hedges are included in other comprehensive income and will be reclassified and amortized as part of interest expense on the Company's Consolidated Income Statement over the expected term of the Company's related debt issuances. For the three months ended September 30, 2006 and September 30, 2005, the Company had net realized gains and (losses) of \$163 and \$(1,010), respectively, related to cash flow hedges. For the three months ended September 30, 2006 and September 30, 2005, the Company reclassified \$296 and \$262, respectively, from accumulated other comprehensive loss into interest expense related to the underlying debt issuances.

For the nine months ended September 30, 2006 and September 30, 2005, the Company had net realized gains and (losses) of \$186 and \$(11,206), respectively, related to cash flow hedges. For the nine months ended September 30, 2006 and September 30, 2005, the Company reclassified \$873 and \$593, respectively, from accumulated other comprehensive loss into interest expense related to the underlying debt issuances.

Within the next twelve months, the Company estimates that \$1,222 of net losses currently held within Accumulated Other Comprehensive Income will be reclassified to earnings as additional interest expense.

The change in net unrealized gains and (losses) of \$(765) and \$7,467 in the nine months ended September 30, 2006 and September 30, 2005, respectively, for derivatives designated as cash flow hedges is separately disclosed in the Company's Consolidated Statement of Changes in Stockholders' Equity.

The Company had net expense due to hedge ineffectiveness of \$2 and \$0 for the three months ended September 30, 2006 and September 30, 2005, respectively, and net income of \$127 and \$0 for the nine months ended September 30, 2006 and September 30, 2005, respectively. These amounts are included in loss (gain) on derivatives on the Consolidated Income Statements.

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

### **11. Long-Term Debt**

Our long-term debt consists of the following:

- mortgage notes on real estate investments;
- collateralized debt obligations; and
- debt related to trust preferred securities.

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

September 30, 2006 (unaudited)

*Mortgages Notes on Real Estate Investments*

The Company has financed most of its owned real properties with third party mortgage debt. The Company's mortgage notes payable are as follows:

| Property Level Debt -<br>Fixed Rate                               | September 30, 2006 |                             | December 31, 2005 |                | Coupon | Effective<br>Rate (1) | Maturity |
|---|--------------------|-----------------------------|-------------------|----------------|--------|-----------------------|----------|
|   | Face<br>Unaudited  | Carry<br>Value<br>Unaudited | Face              | Carry<br>Value |        |                       |          |
| Choice Hotels<br>International, Inc., Silver<br>Spring, MD        | \$ 31,802          | \$ 31,802                   | \$ 32,199         | \$ 32,199      | 5.30%  | 5.34%                 | May-13   |
| Omnicom Group, Inc.,<br>Irving, TX                                | 13,575             | 13,575                      | 13,575            | 13,575         | 5.24%  | 5.30%                 | May-13   |
| Capital One Financial<br>Corporation, Plano, TX                   | 20,925             | 20,925                      | 20,925            | 20,925         | 5.24%  | 5.29%                 | May-13   |
| Aon Corporation,<br>Glenview, IL                                  | 64,800             | 64,800                      | 64,800            | 64,800         | 5.23%  | 5.75%                 | Nov-14   |
| Cadbury Schweppes<br>Holdings (US),<br>Whippany, NJ               | 35,748             | 35,748                      | 36,000            | 36,000         | 5.26%  | 5.34%                 | Mar-15   |
| ITT Industries, Inc.,<br>Herndon, VA                              | 41,700             | 41,700                      | 41,700            | 41,700         | 5.33%  | 5.48%                 | Jun-15   |
| Lowes Companies, Inc.,<br>Aliso Viejo, CA                         | 42,125             | 42,125                      | 42,125            | 42,125         | 5.10%  | 5.37%                 | Jul-15   |
| Abbott Laboratories,<br>Waukegan, IL                              | 15,244             | 15,244                      | 15,244            | 15,244         | 5.11%  | 5.16%                 | Aug-15   |
| United States<br>Government (NIH), N.<br>Bethesda, MD             | 65,188             | 65,188                      | 65,188            | 65,188         | 5.32%  | 5.56%                 | Sep-15   |
| United States<br>Government (SSA),<br>Austin, TX                  | 5,391              | 5,391                       | 5,391             | 5,391          | 5.23%  | 5.46%                 | Sep-15   |
| United States<br>Government (DEA),<br>Birmingham, AL              | 11,280             | 11,280                      | 11,280            | 11,280         | 5.23%  | 5.42%                 | Sep-15   |
| United States<br>Government (FBI),<br>Birmingham, AL              | 18,800             | 18,800                      | 18,800            | 18,800         | 5.23%  | 5.31%                 | Sep-15   |
| Tiffany & Co.,<br>Parsippany, NJ                                  | 58,400             | 58,400                      | 58,400            | 58,400         | 5.33%  | 5.34%                 | Oct-15   |
| Farmers New World Life<br>Insurance Company,<br>Mercer Island, WA | 30,200             | 30,200                      | 30,200            | 30,200         | 5.69%  | 5.72%                 | Jan-16   |

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|  |            |            |            |            |       |       |        |
|--|------------|------------|------------|------------|-------|-------|--------|
| Allstate Insurance Company, Charlotte, NC                            | 20,209     | 20,209     | 20,209     | 20,209     | 5.68% | 5.71% | Jan-16 |
| Allstate Insurance Company, Roanoke, VA                              | 21,516     | 21,516     | 21,516     | 21,516     | 5.68% | 5.76% | Jan-16 |
| TJX Companies, Inc., Philadelphia, PA                                | 71,700     | 71,700     | -          | -          | 5.57% | 5.59% | Mar-16 |
| United States Government (Department of Veterans Affairs), Ponce, PR | 6,984      | 7,300      | 7,317      | 7,670      | 7.30% | 6.41% | Apr-16 |
| Pearson Plc., Lawrence, KS   | 16,025     | 16,025     | -          | -          | 5.84% | 5.95% | May-16 |
| Koninklijke Ahold, N.V., Levittown, PA                               | 14,836     | 14,836     | -          | -          | 6.05% | 6.11% | Jul-16 |
| AMVESCAP PLC, Denver, CO   | 43,700     | 43,700     | -          | -          | 6.03% | 6.07% | Jul-16 |
| Walgreen Co., Pennsauken, NJ   | 1,952      | 2,097      | 2,046      | 2,208      | 7.65% | 6.04% | Oct-16 |
| Walgreen Co., Portsmouth, VA   | 3,220      | 3,426      | 3,304      | 3,525      | 7.20% | 6.18% | Jul-18 |
| United States Government (EPA), Kansas City, KS                      | 21,395     | 24,982     | 21,395     | 25,151     | 7.57% | 5.74% | Oct-22 |
| United States Government (OSHA), Sandy, UT                           | 14,668     | 15,693     | 14,670     | 15,738     | 6.28% | 5.52% | Jan-24 |
| Total  | \$ 691,383 | \$ 696,662 | \$ 546,284 | \$ 551,844 |       |       |        |

(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.

The mortgage notes are non-recourse (subject to customary exceptions) and are secured by the respective properties and an assignment of the relevant leases on the properties. The Company's book value before accumulated depreciation and amortization on owned properties encumbered with mortgage debt aggregated \$989,300 at September 30, 2006, and \$776,676 at December 31, 2005.

#### *Collateralized Debt Obligations*

In March 2005, the Company completed its first collateralized debt obligation, or CDO. The CDO was an entirely fixed rate financing. The Company aggregated approximately \$300,000 of assets into the pool, and created \$285,000 face amount of multi-class notes and \$15,000 of preferred equity through the CDO trust. The net amount of the debt the Company issued was \$268,130, inclusive of a \$370 discount to face, as the Company retained the three most junior note classes aggregating a face amount of \$16,500 and the full \$15,000 of preferred equity. Each of the five note classes of the CDO was rated investment grade. During the first five years of the CDO term, the Company expects to reinvest principal repayments on the underlying assets into qualifying replacement collateral. The CDO notes have a stated maturity in January 2040, but are expected to mature in January 2015 when they become subject to an auction call procedure. The Company's effective blended financing rate (inclusive of original issue discount and debt issuance and hedge costs) on its CDO is approximately 5.67%. The CDO debt is non-recourse to the Company but is secured by the assets in the pool. The following table summarizes the assets in the Company's portfolio posted as CDO collateral as of September 30, 2006.



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

September 30, 2006 (unaudited)

|                                       | Carry Value |
|---------------------------------------|-------------|
| Long-Term Mortgage Loans              | \$ 156,942  |
| Corporate Credit Notes                | 11,793      |
| CMBS and Other Real Estate Securities | 68,188      |
| Total                                 | \$ 236,923  |

The table does not include approximately \$48,285 of intercompany mortgage notes that are eliminated from the Company's balance sheet in consolidation.

*Trust Preferred Securities*

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

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

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

Scheduled principal amortization and balloon payments for long-term debt as of September 30, 2006 for the next five years and thereafter are as follows:

|                   | Scheduled<br>Amortization | Balloon<br>Payments | Total    |
|-------------------|---------------------------|---------------------|----------|
| 3 Months Ending   |                           |                     |          |
| December 31, 2006 | \$ 1,267                  | \$ -                | \$ 1,267 |
| 2007              | 4,783                     | -                   | 4,783    |
| 2008              | 7,121                     | -                   | 7,121    |

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|            |            |            |            |
|------------|------------|------------|------------|
| 2009       | 8,822      | -          | 8,822      |
| 2010       | 33,487     | -          | 33,487     |
| Thereafter | 153,116    | 787,178    | 940,293    |
|            | \$ 208,596 | \$ 787,178 | \$ 995,773 |

20

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

September 30, 2006 (unaudited)

## 12. Minority Interests

As of September 30, 2006, Caplease, LP had issued and outstanding 263,157 common units of limited partnership to a minority interest holder. All of these units were issued in connection with the acquisition of a net lease property acquired in June 2006 (see the Company's Form 10-Q for the quarter ended June 30, 2006 for more detail). Beginning on June 13, 2008, the units of limited partnership are redeemable by the holder, at its option, on the basis of one unit for either one share of CLF, Inc. common stock or cash equal to the fair market value of a share of common stock at the time of the redemption. The units of limited partnership do not have a liquidation preference.

Cash distributions by Caplease, LP will be paid in the following priority: first, to the minority interest holder until such holder receives the amount it would have received if the holder's units of limited partnership interest were converted to an equal number of shares of CLF, Inc. common stock, and then, to CLF, Inc. Simultaneous with CLF, Inc.'s payment of a cash dividend of \$0.20 per share of common stock on each of July 17, 2006 and October 16, 2006 (see Note 14 below), the minority interest holder was paid a cash dividend of \$0.20 per limited partnership unit.

Net income has been allocated to the minority interest holder on an "as converted" basis. In other words, the limited partnership units are treated as converted to shares of CLF, Inc. common stock, and the minority interest holder is allocated a percentage of the Company's net income based on its percentage of as converted common shares outstanding. In addition, a weighted average is used for units outstanding for less than a full period.

## 13. 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.

As an owner of commercial real estate, the Company is subject to potential environmental costs. At September 30, 2006, the Company was not aware of any environmental concerns that would have a material adverse effect on the Company's financial position or results of operations.

During the third quarter of 2005, the Company obtained long-term financing on two of its owned real properties (the United States Government/DEA Property and the United States Government/SSA Property) and simultaneously issued two letters of credit in the aggregate of \$16,671 to its mortgage lender to provide additional collateral while the buildings on the property were under construction. Each letter of credit was issued for the full amount the Company borrowed from the lender on the property (\$11,280 letter of credit in the case of the DEA Property and \$5,391 letter of credit in the case of the SSA Property). Construction of the buildings on each property was substantially completed in the first quarter of 2006, the letter of credit on the DEA Property was cancelled in March 2006, and the letter of credit on the SSA Property was cancelled in April 2006.

During May 2005, the Company acquired a real property in Herndon, Virginia net leased to ITT Industries, Inc., and agreed under the tenant's lease to fund expected improvements to the real property of approximately \$9,500. During May 2005, the Company arranged long-term financing on this property and it funded a reserve account with its lender for the full amount of this obligation. As of September 30, 2006, all of these funds have been disbursed to the tenant.

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 in the securitization on a property net leased to Winn-Dixie defaulted, in connection with the bankruptcy of Winn-Dixie. However, management does not expect any draw on the letter of credit as a result of this mortgage default, or otherwise. Letter of credit fees included in interest expense were \$26 and \$26 for the three months ended September 30, 2006 and September 30, 2005, respectively, and \$76 and \$77 for the nine months ended September 30, 2006 and September 30, 2005, respectively.

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

September 30, 2006 (unaudited)

As described at Note 4 above, the Company had outstanding commitments to fund loans of approximately \$12,000 related to its credit agreement to support YUM! Brands, Inc. franchise loans as of September 30, 2006. As of September 30, 2006, advances of \$5,169 had been made against these commitments.

The Company entered into an office lease in April 2006 for its new corporate offices at 1065 Avenue of the Americas, New York, New York. The term of the lease is for seven years and five months with a base rent of \$699 per year for the first four years (after a five month rent free period) and \$753 per year for the remainder of the term.

#### **14. Stockholders' Equity**

##### *Stock Issuances*

CLF, Inc.'s authorized capital stock consists of 500,000,000 shares of common stock, \$0.01 per share, and 100,000,000 shares of preferred stock, \$0.01 per share. As of September 30, 2006, CLF, Inc. had issued and outstanding 33,925,929 shares of common stock, and 1,400,000 shares of 8.125% Series A cumulative redeemable preferred stock.

During May 2006, CLF, Inc. issued 5,747,000 shares of common stock in a public offering at a price to the public of \$10.55 per share, for net proceeds of approximately \$57,282. During the nine months ended September 30, 2006, CLF, Inc. issued 316,450 shares of common stock to its executive officers, other employees and directors pursuant to the Company's stock incentive plan (net of forfeitures of 5,000 shares). As of September 30, 2006, the Company had awarded 1,070,995 shares of common stock under the stock plan, all in the form of stock awards to executive officers, other employees and directors of the Company (see Note 15 below).

##### *Dividends*

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

On January 17, 2006, CLF, Inc. paid a dividend of \$0.20 per share to its common stockholders. The dividend was declared on December 6, 2005, to common stockholders of record as of December 30, 2005.

On January 17, 2006, CLF, Inc. paid a dividend of \$0.48524 per share to its Series A preferred stockholders. The dividend was declared on December 6, 2005, to Series A preferred stockholders of record as of December 30, 2005.

On April 17, 2006, CLF, Inc. paid a dividend of \$0.20 per share to its common stockholders. The dividend was declared on March 14, 2006, to common stockholders of record as of March 31, 2006.

On April 17, 2006, CLF, Inc. paid a dividend of \$0.5078125 per share to its Series A preferred stockholders. The dividend was declared on March 14, 2006, to Series A preferred stockholders of record as of March 31, 2006.

On July 17, 2006, CLF, Inc. paid a dividend of \$0.20 per share to its common stockholders. The dividend was declared on June 14, 2006, to common stockholders of record as of June 30, 2006.

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On July 17, 2006, CLF, Inc. paid a dividend of \$0.5078125 per share to its Series A preferred stockholders. The dividend was declared on June 14, 2006, to Series A preferred stockholders of record as of June 30, 2006.

On October 16, 2006, CLF, Inc. paid a dividend of \$0.20 per share to its common stockholders. The dividend was declared on September 13, 2006, to common stockholders of record as of September 29, 2006.

On October 16, 2006, CLF, Inc. paid a dividend of \$0.5078125 per share to its Series A preferred stockholders. The dividend was declared on September 13, 2006, to Series A preferred stockholders of record as of September 29, 2006.

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

September 30, 2006 (unaudited)

## 15. Stock Based Compensation

The Company adopted a stock incentive plan for its employees and directors during March 2004 in connection with its initial public offering. 2,323,000 shares of common stock are authorized for issuance under the stock plan, inclusive of 1,250,000 shares approved by the Company's stockholders at the Company's annual stockholder meeting held on June 14, 2006. As of September 30, 2006, the Company had awarded 1,070,995 shares of common stock under the stock plan, all in the form of stock awards to executive officers, other employees and directors of the Company. The Company has also agreed to award an employee 6,000 shares of common stock under the stock plan if a service condition is satisfied as of January 2, 2007. The Company has not awarded any options, stock appreciation rights or other stock based compensation under the stock plan.

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

Because the Company has historically valued compensation cost for stock awards at fair value under SFAS No. 123, the adoption of SFAS No. 123R did not have a material effect on the Company.

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

The adoption of SFAS No. 123R had no impact on the Company's income from continuing operations, net income, earnings per share (basic and diluted), cash flows from operations or cash flows from financing activities.

A summary of the Company's activity under the stock plan during the nine months ended September 30, 2006, is presented below:

|   | Number<br>of<br>Shares     |
|---|----------------------------|
| Stock Awards at January 1, 2006                       | 760,546                    |
| Granted During Nine Months Ended September 30, 2006   | 327,450 <sup>(1) (2)</sup> |
| Forfeited During Nine Months Ended September 30, 2006 | (11,001)                   |
| Stock Awards at September 30, 2006                    | 1,076,995                  |

- <sup>(1)</sup> Shares are scheduled to vest between March 2007 and September 2009, but will generally be forfeited if the recipient either terminates his employment with the Company or ceases to be a member of CLF, Inc.'s Board of Directors at any time prior to the vesting date. Vesting of an aggregate of 133,500 shares is also subject to satisfaction of objective and subjective performance criteria, to be determined by CLF, Inc.'s Compensation Committee.

- (2) Includes 6,000 shares the Company has agreed to issue on January 2, 2007 if an employee satisfies a service condition. Pursuant to SFAS 123R, the grant date for these shares occurred in September 2006 when the Company agreed to issue the shares.

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

September 30, 2006 (unaudited)

A summary of the status of unvested shares as of and for the nine months ended September 30, 2006, is presented below:

|                                 | Shares    | Weighted<br>Average<br>Fair<br>Value |
|---------------------------------|-----------|--------------------------------------|
| Nonvested at January 1, 2006    | 495,654   | \$ 10.83(1)                          |
| Granted                         | 327,450   | 11.05(2) (3)                         |
| Vested                          | (228,998) | 10.72                                |
| Forfeited                       | (11,001)  | 11.02                                |
| Nonvested at September 30, 2006 | 583,105   | 10.98                                |

- (1) Includes weighted average fair value on 433,430 of the 495,654 shares awarded and remaining unvested as of January 1, 2006. Performance criteria on the remaining 62,224 shares have not yet been determined, and therefore, as required under SFAS 123R, the applicable grant date for these shares has not yet occurred and the fair value has not yet been determined.
- (2) Includes weighted average fair value on 223,450 of the 312,450 shares awarded during the year. Performance criteria on the remaining 89,000 shares have not yet been determined, and therefore, as required under SFAS 123R, the applicable grant date for these shares has not yet occurred and the fair value has not yet been determined.
- (3) Includes 6,000 shares the Company has agreed to issue on January 2, 2007 if an employee satisfies a service condition. Pursuant to SFAS 123R, the grant date for these shares occurred in September 2006 when the Company agreed to issue the shares.

As of September 30, 2006, \$3,615 of deferred compensation expense was included in the Company's Consolidated Balance Sheet as a component of additional paid in capital. This amount is expected to be charged to the Company's Consolidated Income Statement over the remaining vesting period (through September 2009). The amount of deferred compensation expense for awards of 62,224 shares made in 2005 and 89,000 shares made in 2006 has not yet been measured and included as a component of additional paid in capital because the grant date (as defined under SFAS 123R) has not yet occurred.

The following summarizes the expense the Company recorded in its Consolidated Income Statement during the three and nine months ended September 30, 2006 and September 30, 2005, for awards under the stock plan:

|   | <u>For the three months</u><br><u>ended September 30,</u> |        | <u>For the nine months</u><br><u>ended September 30,</u> |          |
|---|---|--------|--|----------|
|   | 2006  | 2005   | 2006   | 2005     |
| General and administrative expenses- stock based compensation | \$ 552  | \$ 647 | \$ 1,766   | \$ 1,569 |

## 16. Other Comprehensive Income

Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances, excluding those resulting from investments by and distributions to owners. For the Company's purposes, comprehensive income represents net income, as presented in the Company's Consolidated Income Statements, adjusted for unrealized gains or losses on securities available for sale, unrealized gains or losses on derivatives designated as cash flow hedges, and realized gains and losses on derivatives designated as cash flow hedges (net of amortization of those realized gains and losses into interest expense). The Company's comprehensive income is summarized in the last column on the Consolidated Statement of Changes in Stockholders' Equity.

SFAS No. 130, Reporting Comprehensive Income, divides comprehensive income into "net income" and "other comprehensive income." Other comprehensive income is defined as revenues, expenses, gains and losses that under generally accepted accounting principles are included in comprehensive income but excluded from net income. Other comprehensive income is also summarized on the Company's Consolidated Statement of Changes in Stockholders' Equity (fourth column). The following table summarizes the Company's accumulated other comprehensive income (loss) as reported on the Consolidated Statement of Changes in Stockholders' Equity.

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

September 30, 2006 (unaudited)

|                                      | Sep 30, 2006<br>Unaudited | Dec 31,<br>2005 |
|--------------------------------------|---------------------------|-----------------|
| Net unrealized gains on securities   | \$ 8,512                  | \$ 9,648        |
| Net unrealized gains on derivatives  | (97)                      | 784             |
| Net realized losses on derivatives   | (11,133)                  | (12,180)        |
| Accumulated other comprehensive loss | \$ (2,718)                | \$ (1,748)      |

### 17. Rental Income

The Company is the lessor to tenants under operating leases with expiration dates ranging from 2007 to 2026 (not including incidental leases). The minimum rental amounts due under the leases are generally subject to scheduled fixed increases. The leases generally also require that the tenants pay for or reimburse the Company for the occupancy and operating costs of the properties, or in certain cases reimburse the Company for increases in certain operating costs and real estate taxes above their base year costs. Approximate future minimum rents to be received over the next five years and thereafter for non-cancelable operating leases in effect at September 30, 2006, are as follows:

|                                   |            |
|-----------------------------------|------------|
| 3 Months Ending December 31, 2006 | \$ 18,241  |
| 2007                              | 73,907     |
| 2008                              | 74,715     |
| 2009                              | 73,007     |
| 2010                              | 70,985     |
| Thereafter                        | 630,861    |
|                                   | \$ 941,716 |

### 18. Pro Forma Condensed Consolidated Income Statements

The accompanying unaudited Pro Forma Condensed Consolidated Income Statements are presented as if, at January 1, 2005, the Company acquired all real properties purchased during 2006 and 2005. 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 the dates indicated above, nor do they purport to represent our future results of operations.

|   | <u>For the three months</u><br><u>ended September 30,</u> |           | <u>For the nine months</u><br><u>ended September 30,</u> |           |
|---|---|-----------|--|-----------|
|   | 2006  | 2005      | 2006   | 2005      |
| Total revenues                              | \$ 30,902   | \$ 29,191 | \$ 93,330  | \$ 82,964 |
| Income from continuing operations           | \$ 1,419  | \$ 136    | \$ 4,851   | \$ 5,142  |
| Net income allocable to common stockholders | \$ 757  | \$ 136    | \$ 2,864   | \$ 5,142  |
|   | \$ 0.04   | \$ 0.00   | \$ 0.16  | \$ 0.19   |



Income per basic and diluted common  
share from  
continuing operations

|  |    |      |    |      |    |      |    |      |
|--|----|------|----|------|----|------|----|------|
| Net income per basic and diluted<br>common share | \$ | 0.02 | \$ | 0.00 | \$ | 0.09 | \$ | 0.19 |
|--|----|------|----|------|----|------|----|------|

25

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

September 30, 2006 (unaudited)

**19. Segment Reporting**

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

Selected results of operations for the three months ended September 30, 2006 and September 30, 2005, are as follows:

|  | Corporate /<br>Unallocated |           | Operating Net Lease<br>Real Estate |           | Lending<br>Investments |           |
|--|----------------------------|-----------|------------------------------------|-----------|------------------------|-----------|
|  | 9/30/2006                  | 9/30/2005 | 9/30/2006                          | 9/30/2005 | 9/30/2006              | 9/30/2005 |
| Total revenues                                 | \$ 122                     | \$ 278    | \$ 22,516                          | \$ 13,491 | \$ 8,309               | \$ 7,416  |
| Total expenses &<br>minority interest          | 3,380                      | 3,185     | 21,178                             | 12,318    | 4,951                  | 5,955     |
| Income (loss) from<br>continuing<br>operations | (3,257)                    | (2,907)   | 1,338                              | 1,172     | 3,357                  | 1,461     |
| Total assets                                   | 35,201                     | 26,253    | 1,004,385                          | 698,847   | 452,610                | 385,191   |

Selected results of operations for the nine months ended September 30, 2006 and September 30, 2005, are as follows:

|  | Corporate /<br>Unallocated |           | Operating Net Lease<br>Real Estate |           | Lending<br>Investments |           |
|--|----------------------------|-----------|------------------------------------|-----------|------------------------|-----------|
|  | 9/30/2006                  | 9/30/2005 | 9/30/2006                          | 9/30/2005 | 9/30/2006              | 9/30/2005 |
| Total revenues                                 | \$ 588                     | \$ 761    | \$ 63,569                          | \$ 27,727 | \$ 25,393              | \$ 19,992 |
| Total expenses &<br>minority interest          | 10,620                     | 9,074     | 59,281                             | 24,122    | 14,502                 | 11,781    |
| Income (loss) from<br>continuing<br>operations | (10,032)                   | (8,314)   | 4,288                              | 3,605     | 10,892                 | 8,211     |
| Total assets                                   | 35,201                     | 26,253    | 1,004,385                          | 698,847   | 452,610                | 385,191   |

**20. Variable Interest Entities**

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

the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties;

- equity holders either (a) lack direct or indirect ability to make decisions about the entity, (b) are not obligated to absorb expected losses of the entity or (c) do not have the right to receive expected residual returns of the entity if they occur; or
- equity holders have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest.

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

As part of the Company's developer loan program, the Company funds loans to an entity that owns an undeveloped property. These loans are used to finance pre-construction costs related to the property, such as due diligence costs and land acquisition contract deposits, rather than costs to build on the property. The Company has funded two such loans as of September 30, 2006, with an aggregate unpaid principal amount of approximately \$1,148 as of that date. The Company has determined that its borrowers are VIEs under FIN 46. Each loan is secured, in part, by a personal guarantee by the borrowing entity's owner. The Company has concluded it is not the primary beneficiary of the VIE (and, therefore, the Company has not consolidated the VIE under FIN 46). The Company's maximum exposure to loss as a result of its involvement with these VIEs is the amount funded on the loans.

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

September 30, 2006 (unaudited)

As of December 31, 2005, the Company had invested \$36,395 in an office building in Wilmington, Delaware, net leased to Hercules Incorporated, including a \$27,700 mezzanine loan and a \$8,695 preferred equity investment. As of December 31, 2005, the Company determined that its borrower was a VIE under FIN 46, but the Company did not consolidate the borrower because the Company concluded it was not the primary beneficiary of the VIE. During March 2006, the property was recapitalized and the Company's mezzanine loan and preferred equity investment were retired. The Company participated in the recapitalization by making a first mortgage loan on the property (which was simultaneously resold in a gain on sale transaction) and a corporate credit note investment secured by the property. Upon completion of the recapitalization, the Company's aggregate investment in the property was \$20,000, and the Company concluded its borrower was not a VIE under FIN 46.

During June 2006, the Company entered into a revolving credit agreement with a third party borrower pursuant to which the Company agreed to provide up to \$12,000 to support the borrower's capital contributions to a joint venture that provides franchise loans to franchisees of YUM! Brands, Inc. restaurant concepts such as Taco Bell, Kentucky Fried Chicken and Pizza Hut. The Company is generally required to make advances simultaneous with the borrower's capital contributions to the joint venture to fund the underlying franchise loans. As of September 30, 2006, the Company had advanced \$5,169 under the agreement. The Company has determined that the borrower is a VIE under FIN 46. The Company's advances are secured by a pledge of the borrower's 50% membership interest in the joint venture and a limited guaranty by one of the principals of the borrower. The Company has determined it is not the primary beneficiary of the VIE (and, therefore, the Company has not consolidated the VIE under FIN 46). The Company's maximum exposure to loss as a result of this investment is the amount advanced under the credit agreement.

## **21. Subsequent Events**

During the third and fourth quarter of 2006, the Company entered into separate purchase and sale agreements to acquire seven additional real properties, for an aggregate purchase price of \$198,148. The weighted average remaining lease term on the seven properties is approximately ten years and the weighted average credit rating of the underlying tenants or lease guarantors from Standard & Poor's ("S&P") is BBB+ (based on actual S&P rating as of November 6, 2006 or equivalent S&P rating if rated only by Moody's). As of November 6, 2006, two of these transactions have closed for a purchase price of \$41,417. The remaining transactions are scheduled to close in the fourth quarter of 2006. The properties under contract are subject to customary closing conditions and, therefore, the Company provides no assurance as to the timing or certainty of the closing of these transactions.

## 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 diversified REIT that invests primarily in single tenant commercial real estate assets subject to long-term leases to primarily investment grade tenants. We focus on properties that are subject to a net lease, which we define as a lease that requires the tenant (rather than the landlord) to pay for, or pay for and perform, all or substantially all aspects of the property and its operations during the lease term.

We invest at all levels of the capital structure of net lease properties, including equity investments in real estate (owned real properties), debt investments (mortgage loans and net lease mortgage backed securities) and mezzanine investments secured by net leased real estate collateral.

The principal sources of our revenues are rental income on our owned real properties and interest income from our debt investments. The principal sources of our expenses are interest expense on our assets financed, depreciation expense on our real properties, general and administrative expenses and property expenses (net of expense recoveries). While our focus is on net leased properties, we also have made and expect to continue to make owned property investments where we have exposure to property expenses when we determine we can sufficiently underwrite that exposure and isolate a predictable cash flow.

We rely on leverage to allow us to invest in a greater number of assets and enhance our asset returns. We seek to finance our assets on a long-term basis with fixed-rate debt of a like maturity. Through September 30, 2006, our long-term financings have been in the form of traditional third party mortgage financings (on most of our owned real properties) and our first CDO (completed in March 2005). We have short-term floating rate borrowing arrangements in place to facilitate our investment activity while we arrange long-term financing. We employ a hedging strategy to mitigate our exposure to changes in interest rates while our assets are financed under our short-term borrowing arrangements. We expect our leverage to average 70% to 85% of our assets in portfolio. Including the trust preferred debt we issued in December 2005 (see table below), our overall portfolio leverage as of September 30, 2006 was approximately 80.2%.

Our primary business objective is to generate stable, long-term and attractive returns based on the spread between the yields generated by our assets and the cost of financing our portfolio.

We rely primarily on equity and debt capital to fund our portfolio growth. The following is a summary of our capital raising activities beginning with our initial public offering in March 2004 and through September 30, 2006.

| Month/Year    | Securities Issued  | Price   | Net Proceeds    |
|---------------|--|---------|-----------------|
| March 2004    | 23.0 million shares of common stock  | \$10.50 | \$221.8 million |
| October 2005  | 14.0 million shares of 8.125% Series A cumulative redeemable preferred stock | \$25.00 | \$33.7 million  |
| December 2005 | \$30.9 million of junior subordinated notes                                  | N/A     | \$29.9 million  |
| May 2006      | 5.747 million shares of common stock   | \$10.55 | \$57.3 million  |

**Summary of Investment and Financing Activity in Third Quarter 2006**

During the quarter ended September 30, 2006, we added assets of \$53.4 million to our portfolio, including \$34.5 million of real estate securities backed by mortgage loans on properties net leased to Koninklijke Ahold, N.V. and one real property acquisition for an aggregate purchase price of \$5.4 million. We did not add any new long-term financings during the quarter ended September 30, 2006. We did make significant progress in preparing for our second CDO, which we expect to complete in the first quarter of 2007.

## Business Environment

Our ability to grow our portfolio is subject to a variety of factors beyond our control, including competitive conditions in the commercial real estate markets and interest rate levels. As we have reported in prior quarters, we saw through the first half of the third quarter of 2006, a trend of spread compression as interest rates trended upwards and the market for commercial real estate remained very strong. During the second half of the third quarter and the early part of the fourth quarter, we have started to see a positive reversal in this trend in our property acquisition business, as interest rates have fallen and spreads have begun to widen. While asset spreads have not returned to the levels we were seeing in 2004 and most of 2005, we are cautiously optimistic about our ability to grow our portfolio within our target return ranges for the remainder of 2006. Spread compression and competition from conduit lenders, however, continue to make it challenging for us to originate loans with yield and risk characteristics that fit within our targets.

## 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, 2005 in Management's Discussion and Analysis of Financial Condition and Results of Operations. There have been no significant changes to those policies during the first, second or third quarters of 2006.

## Property Acquisitions

During the three months ended September 30, 2006, we completed the following property acquisition (dollar amounts in thousands):

| Month Acquired | Tenant or Guarantor | Location    | Purchase Price | Lease Expires | Net Rentable Square Feet |
|----------------|---------------------|-------------|----------------|---------------|--------------------------|
| July           | Cott Corporation    | Reading, PA | \$ 5,350       | June 2017     | 120,000                  |

## Business Segments

We conduct our business through two operating segments:

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

Selected results of operations for the three months ended September 30, 2006 and September 30, 2005, are as follows (dollar amounts in thousands):

|  | Corporate / Unallocated |           | Operating Net Lease Real Estate |           | Lending Investments |           |
|--|-------------------------|-----------|---------------------------------|-----------|---------------------|-----------|
|  | 9/30/2006               | 9/30/2005 | 9/30/2006                       | 9/30/2005 | 9/30/2006           | 9/30/2005 |
| Total revenues                           | \$ 122                  | \$ 278    | \$ 22,516                       | \$ 13,491 | \$ 8,309            | \$ 7,416  |
| Total expenses & minority interest       | 3,380                   | 3,185     | 21,178                          | 12,318    | 4,951               | 5,955     |
| Income (loss) from continuing operations | (3,257)                 | (2,907)   | 1,338                           | 1,172     | 3,357               | 1,461     |
| Total assets                             | 35,201                  | 26,253    | 1,004,385                       | 698,847   | 452,610             | 385,191   |





Selected results of operations for the nine months ended September 30, 2006 and September 30, 2005, are as follows (dollar amounts in thousands):

|  | Corporate /<br>Unallocated |           | Operating Net Lease<br>Real Estate |           | Lending<br>Investments |           |
|--|----------------------------|-----------|------------------------------------|-----------|------------------------|-----------|
|  | 9/30/2006                  | 9/30/2005 | 9/30/2006                          | 9/30/2005 | 9/30/2006              | 9/30/2005 |
| Total revenues                                 | \$ 588                     | \$ 761    | \$ 63,569                          | \$ 27,727 | \$ 25,393              | \$ 19,992 |
| Total expenses &<br>minority interest          | 10,620                     | 9,074     | 59,281                             | 24,122    | 14,502                 | 11,781    |
| Income (loss) from<br>continuing<br>operations | (10,032)                   | (8,314)   | 4,288                              | 3,605     | 10,892                 | 8,211     |
| Total assets                                   | 35,201                     | 26,253    | 1,004,385                          | 698,847   | 452,610                | 385,191   |

### Results of Operations

During the third quarter of 2006, we continued to execute on our business plan as a long-term holder of equity, debt and mezzanine investments primarily in net lease assets.

### Comparison of the Quarter Ended September 30, 2006 to the Quarter Ended September 30, 2005

The following discussion compares our operating results for the quarter ended September 30, 2006 to the comparable period in 2005.

Total revenue increased \$9.8 million, or 46%, to \$30.9 million. The increase was primarily attributable to increases in rental revenue and property expense recoveries and increases in interest income and other revenue.

Rental revenue and property expense recoveries, in the aggregate, increased \$9.0 million, or 67%, to \$22.5 million. The increase was due to a substantial increase in the underlying property investments from the prior year period. Rental revenue for the 2005 period included \$1.7 million of revenue from assets not yet owed but consolidated under FIN 46.

Interest income increased \$0.6 million, or 8%, to \$8.0 million. The increase was due to larger overall asset investments, including both mortgage loans and CMBS investments.

We had no gains on sale of mortgage loans or securities, compared to \$0.2 million gain on the sale of a loan in the 2005 period.

Other revenue increased \$0.3 million to \$0.5 million, primarily reflecting income we received from loans that paid off in the 2006 period.

#### *Expenses.*

Total expenses increased \$7.8 million, or 36%, to \$29.5 million. The increase in expenses was primarily attributable to higher levels of interest expense, depreciation and amortization expense on real property and property expenses, offset in part by lower loss on securities and lower general and administrative expenses.

Interest expense increased \$6.3 million, or 64%, from \$9.8 million to \$16.1 million. Interest expense for the 2005 period included \$1.1 million of expense from assets not yet owned but consolidated under FIN 46. The increase in 2006 primarily consisted of \$5.5 million of additional interest expense on property mortgages originated or assumed

in 2005 and 2006, and \$0.6 of interest expense on the trust preferred debt we issued in December 2005. In addition, interest expense on our borrowings under our repurchase agreement increased \$1.3 million, from \$0.7 million to \$2.0 million, primarily as a result of higher borrowing levels and interest rates in 2006.

Depreciation and amortization expense on real property increased \$3.0 million, or 83%, from \$3.6 million to \$6.6 million, due to the significant increase in property investments compared with the prior year period. Depreciation and amortization expense for the 2005 period included \$0.5 million of expense from assets not yet owned but consolidated under FIN 46.

Property expenses increased \$0.8 million, or 26%, to \$3.8 million. The net amount of property expenses we incurred (net of expense recoveries) during the 2006 period was \$1.5 million. Property expenses for the 2005 period included \$0.3 million of expense from assets not yet owned but consolidated under FIN 46. The growth in property expenses reflects the growth of our portfolio as well as our purchase of properties with greater overall exposure to property expenses under the lease provisions, primarily with respect to leases with the United States Government. While our investment focus continues to be on net lease properties, we expect to continue to make owned property investments where we have exposure to property expenses when we determine we can sufficiently underwrite that exposure and isolate a predictable cash flow.

General and administrative expense decreased \$0.3 million, or 13%, to \$2.2 million, due primarily to slightly lower performance based employee compensation, Sarbanes-Oxley related professional fees and liability insurance.

General and administrative expense-stock based compensation decreased \$0.1 million, or 15%, to \$0.6 million. The decrease was due to marginally lower expected vesting of outstanding stock grants compared with the prior year period.

During the 2005 period, we had a \$2.1 million loss on the write down of one of our security investments. We had a \$0.2 million write-down on one of our security investments in the 2006 period. The losses in both periods relate to exposure to the Winn-Dixie bankruptcy and are discussed at footnote 7 of the financial statements included in this Form 10-Q filing.

*Minority Interest.*

Minority interest of \$(0.3) million in the 2005 period reflects the impact of assets not yet owned but consolidated under FIN 46.

*Net income (loss).*

Net income (loss) increased from \$(0.3) million to \$1.5 million, as a result of the factors discussed above. Net income allocable to common stockholders was \$0.8 million in the third quarter of 2006, reflecting dividends to preferred stockholders of \$0.7 million.

**Comparison of the Nine Months Ended September 30, 2006 to the Nine Months Ended September 30, 2005**

The following discussion compares our operating results for the nine months ended September 30, 2006 to the comparable period in 2005.

*Revenue.*

Total revenue increased \$41.1 million, or 85%, to \$89.6 million. The increase was attributable to increases in rental revenue and property expense recoveries and increases in interest income, other revenue and gain on sale of mortgage loans.

Rental revenue and property expense recoveries, in the aggregate, increased \$35.8 million, or 129%, to \$63.4 million. The increase was due to a substantial increase in the underlying property investments from the prior year period. Rental revenue for the 2005 period included \$3.5 million of revenue from assets not yet owed but consolidated under FIN 46.

Interest income increased \$3.8 million, or 19%, to \$23.9 million. The increase was due to larger overall asset investments, including both mortgage loans and CMBS investments.

Other revenue increased \$1.3 million to \$1.6 million, primarily reflecting income we received on loans that were paid off in the 2006 period.

Gain on sale of mortgage loans and securities increased \$0.2 million, to \$0.6 million, reflecting a gain we earned on the origination and sale of a mortgage loan in the first quarter of 2006.

*Expenses.*

Total expenses increased \$39.4 million, or 87%, to \$84.4 million. The increase in expenses was primarily attributable to higher levels of interest expense, depreciation and amortization expense on real property, property expenses and stock based compensation expense, offset in part by lower loss on securities and lower general and administrative expenses.

Interest expense increased \$26.3 million, or 134%, from \$19.6 million to \$45.9 million. Interest expense for the 2005 period included \$1.7 million of expense from assets not yet owned but consolidated under FIN 46. The increase in 2006 primarily consisted of \$19.2 million of additional interest expense on property mortgages originated or assumed in 2005 and 2006, \$3.0 million of additional interest expense on our collateralized debt obligations issued in March 2005, and \$1.9 of interest expense on the trust preferred debt we issued in December 2005. In addition, interest expense on our borrowings under our repurchase agreement and other short-term financing obligations increased \$4.0 million, or 161%, from \$2.5 million to \$6.6 million, primarily as a result of higher borrowing levels and interest rates in 2006.

Depreciation and amortization expense on real property increased \$11.6 million, due to the significant increase in property investments compared with the prior year period. Depreciation and amortization expense for the 2005 period included \$0.9 million of expense from assets not yet owned but consolidated under FIN 46.

Property expenses increased \$4.0 million, or 57%, to \$11.1 million. The net amount of property expenses we incurred (net of expense recoveries) during the 2006 period was \$4.8 million. Property expenses for the 2005 period included \$0.9 million of expense from assets not yet owned but consolidated under FIN 46. The growth in property expenses reflects the growth of our portfolio as well as our purchase of properties with greater overall exposure to property expenses under the lease provisions, primarily with respect to leases with the United States Government. While our investment focus continues to be on net lease properties, we expect to continue to make owned property investments where we have exposure to property expenses when we determine we can sufficiently underwrite that exposure and isolate a predictable cash flow.

General and administrative expense decreased \$0.5 million, or 7%, to \$7.0 million, due primarily to slightly lower Sarbanes-Oxley related professional fees, performance based employee compensation and liability insurance. General and administrative expense for the 2005 period included approximately \$0.1 million of accrued severance expense.

General and administrative expense-stock based compensation increased \$0.2 million, or 13%, to \$1.8 million. The increase was due to marginally higher expected vesting of outstanding stock grants compared with the prior year period.

During the 2005 period, we had \$2.4 million of losses on our security investments. We had a \$0.2 million write-down on one of our security investments in the 2006 period. The losses in both periods relate to exposure to the Winn-Dixie bankruptcy and are discussed at footnote 7 of the financial statements included in this Form 10-Q filing.

#### *Minority Interest.*

Minority interest of \$(0.1) million in the 2005 period reflects the impact of assets not yet owned but consolidated under FIN 46.

#### *Net income.*

Net income increased from \$3.5 million to \$5.3 million, as a result of the factors discussed above. Net income allocable to common stockholders was \$3.2 million in the 2006 period, reflecting dividends to preferred stockholders of \$2.1 million.

### **Funds from Operations**

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

We calculate FFO consistent with the National Association of Real Estate Investment Trusts (“NAREIT”) definition, or 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.

The following table reconciles our net income to FFO for the three and nine months ended September 30, 2006 and September 30, 2005.

32

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| (in thousands, except per share amounts)                                   | For the Three Months<br>Ended September 30 |          | For the Nine Months<br>Ended September 30 |           |
|--|--|----------|---|-----------|
|  | 2006                                       | 2005     | 2006                                      | 2005      |
| Net income (loss) allocable to common stockholders                         | \$ 776                                     | \$ (273) | \$ 3,161                                  | \$ 3,502  |
| Adjustments:   |  |          |   |           |
| Add: Minority interest-OP units  | 6  | -        | 7   | -         |
| Add: Depreciation and amortization expense on real property                | 6,580                                      | 3,596    | 18,396                                    | 6,785     |
| Funds from operations  | \$ 7,362                                   | \$ 3,323 | \$ 21,564                                 | \$ 10,287 |
| Weighted average number of common shares outstanding, diluted              | 33,921                                     | 27,868   | 31,252                                    | 27,755    |
| Weighted average number of OP units outstanding                            | 263  | -        | 105                                       | -         |
| Weighted average number of common shares and OP units outstanding, diluted | 34,184                                     | 27,868   | 31,357                                    | 27,755    |
| Funds from operations per share  | \$ 0.22                                    | \$ 0.12  | \$ 0.69                                   | \$ 0.37   |
| Gains on sale of mortgage loans and securities                             | \$ -                                       | \$ 210   | \$ 645                                    | \$ 447    |
| Depreciation on real estate investments consolidated under FIN46           | \$ -                                       | \$ 518   | \$ -                                      | \$ 935    |

### Liquidity and Capital Resources

As of September 30, 2006, we had \$2.3 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 Internal Revenue Code and to avoid federal income tax and the nondeductible excise tax. We declared a dividend of \$0.20 per share of common stock during each of the quarters ended March 31, 2006, June 30, 2006 and September 30, 2006. We also declared a dividend of \$0.5078125 per share of 8.125% series A cumulative redeemable preferred stock during each of the quarters ended March 31, 2006, June 30, 2006 and September 30, 2006.

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, therefore, as we approach or reach our targeted leverage level from time to time, we will need to raise additional capital. We expect our leverage to average 70% to 85% of our assets in portfolio. As of September 30, 2006, we had an effective shelf registration statement under which we can offer an aggregate of \$204.4 million of common stock, preferred stock and/or senior or subordinated debt securities from time to time.

We raised additional equity capital through a public offering of common stock that closed in May 2006. We issued 5,747,000 shares of common stock in a public offering at a price to the public of \$10.55 per share, and raised net proceeds of approximately \$57.3 million, after the underwriting discount and offering expenses. The shares were issued pursuant to our shelf registration statement. We used \$52.9 million of the proceeds from the offering to reduce our short-term borrowings, and the balance to fund additional net lease investments.

We expect to raise additional capital to enable us to continue to implement our growth strategy, although the precise timing of our next capital raise will be impacted by our pace of investment activity and market conditions. Our ability to raise capital is influenced by market conditions, and we cannot assure you 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 our short-term borrowing arrangements. Our short-term borrowing arrangements are comprised of a repurchase agreement with Wachovia Bank (aggregate borrowing capacity of \$250.0 million) and a real property acquisition facility with Wachovia Bank and one of its affiliates (two loan agreements with aggregate borrowing capacity of \$100.0 million). These arrangements are uncommitted, meaning the lenders may decline to advance on any asset we seek to finance.

We had \$140.7 million outstanding as of September 30, 2006 under our Wachovia repurchase agreement, which borrowings were secured by loan investments with an aggregate carry value of \$150.1 million, and securities with a carry value of \$43.0 million. We had no borrowings outstanding as of September 30, 2006 under our real property acquisition facility. Our short-term borrowing arrangements are co-terminus, and they were renewed in August 2006, and are now scheduled to expire in August 2007.



Our short-term borrowing arrangements allow us to finance our assets on a short-term basis while we arrange long-term financing. We pay interest at prevailing short-term interest rates plus a spread. These borrowing arrangements are secured by the assets financed and are fully recourse to our other assets. Our lender also has the right to initiate a margin call if our assets financed decline in value (including as a result of a tenant downgrade). We are required to comply with various covenants under these arrangements, including financial covenants of minimum liquidity, minimum consolidated net worth and maximum leverage.

As of September 30, 2006, we were in compliance with the terms of our short-term borrowing arrangements. 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 short-term borrowing arrangements are uncommitted, we cannot make any assurance that these facilities will continue to be available to us.

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

We expect to meet our long-term liquidity requirements generally through cash provided by operations, long-term fixed-rate financings on our net lease asset investments and issuances of debt and equity capital. As discussed in further detail above, we issued common stock in a public offering in May 2006.

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, non-recourse basis. Through September 30, 2006, our long-term financings have been in the form of traditional third party mortgage financings (on most of our owned real properties) and our first CDO (completed in March 2005). As of September 30, 2006, we have financed on a long-term basis an aggregate of approximately \$1.20 billion of assets in portfolio with third party mortgage debt of \$696.7 million and collateralized debt obligations of \$268.2 million. We also issued \$30.0 million of trust preferred debt in December 2005. We expect our leverage to average 70% to 85% of our assets in portfolio. Including the December 2005 trust preferred debt, our overall portfolio leverage as of September 30, 2006 was approximately 80.2%.

#### *Long-Term Mortgage Financings.*

We did not add any new third party mortgage debt during the quarter ended September 30, 2006.

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

#### *CDO Financing.*

In March 2005, we completed our first CDO. Our CDO was an entirely fixed rate financing. We aggregated approximately \$300 million of assets into the pool, and we created \$285 million face amount of multi-class notes and \$15 million of preferred equity through the CDO trust. The net amount of the debt we issued was \$268.1 million, inclusive of a \$0.4 million discount to face, as we retained the three most junior note classes aggregating a face amount of \$16.5 million and the full \$15 million of preferred equity. Each of the five note classes of the CDO was rated investment grade. During the first five years of the CDO term, we expect to reinvest principal repayments on the underlying assets into qualifying replacement collateral. The CDO notes are expected to mature in January 2015. Our effective blended financing rate (inclusive of original issue discount and debt issuance and hedge costs) on our CDO is approximately 5.67%. Our CDO debt is non-recourse to us but is secured by the assets in the pool.

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

**Statement of Cash Flows**

Operating activities provided \$13.6 million of cash during the nine months ended September 30, 2006, primarily driven by net income as adjusted by various non-cash gains and charges of \$18.5 million, partially offset by increases in other assets of \$4.1 million and decreases in deposits and escrows of \$1.9 million. Operating activities used \$17.9 million of cash during the nine months ended September 30, 2005, primarily driven by increases in other assets of \$24.7 million, decreases in deposits and escrows of \$7.0 million and amounts due to servicer of \$4.4 million, partially offset by net income as adjusted by various non-cash gains and charges of \$10.1 million and an increase in accounts payable, accrued expenses and other liabilities of \$7.6 million.

Investing activities used \$232.8 million during the nine months ended September 30, 2006, which primarily resulted from net investments in real estate of \$218.5 million, net investments in mortgage and other real estate loans of \$55.7 million, and net investments in securities available for sale of \$35.7 million and purchases of furniture, fixtures and equipment and leasehold improvements of \$1.7 million, partially offset by sales of mortgage loans of \$78.6 million. Investing activities used \$516.6 million during the nine months ended September 30, 2005, which resulted primarily from net investments in real estate of \$431.3 million, net investments in mortgage loans of \$46.2 and net securities investments of \$39.1 million.

Cash provided by financing activities during the nine months ended September 30, 2006 was \$202.2 million, which primarily resulted from net borrowings from mortgages on real estate investments of \$145.1 million, proceeds from our common stock offering of \$57.3 million, net borrowings under repurchase agreements and other short-term financing obligations of \$10.7 million and reductions in escrows held with mortgage lender of \$9.5 million, partially offset by dividends and distributions paid of \$20.1 million. Cash provided by financing activities during the nine months ended September 30, 2005 was \$515.3 million, which primarily resulted from net borrowings from mortgages on real estate investments of \$327.8 million and borrowings under collateralized debt obligations of \$268.1 million, partially offset by net repayments on repurchase agreements of \$49.4 million, dividends paid of \$14.2 million and funds used in hedging and risk management activities of \$11.2 million.

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

#### **Derivative and Other Risk Management Transactions**

Since our initial public offering, we have entered 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 closing and obtaining long-term financing of our net lease assets. Our derivative and other risk management activities during this period have consisted primarily of interest rate swaps, and we expect they will continue to consist primarily of interest rate swaps in the future. 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.

Net realized gains and losses on our qualifying cash flow hedges are included in other comprehensive income and will be reclassified and amortized as part of interest expense on our Consolidated Income Statement over the expected term of the related debt issuances. For the three months ended September 30, 2006 and September 30, 2005, we had net realized gains and (losses) of \$163,000 and \$(1.0) million, respectively, related to cash flow hedges. For the three months ended September 30, 2006 and September 30, 2005, we reclassified \$0.3 million and \$0.3 million, respectively, from accumulated other comprehensive loss into interest expense related to the underlying debt issuances.

For the nine months ended September 30, 2006 and September 30, 2005, we had net realized gains and (losses) of \$186,000 and \$(11.2) million, respectively, related to cash flow hedges. For the nine months ended September 30, 2006 and September 30, 2005, we reclassified \$0.9 million and \$0.6 million, respectively, from accumulated other comprehensive loss into interest expense related to the underlying debt issuances.

Within the next twelve months, we estimate that \$1.2 million of net losses currently held within Accumulated Other Comprehensive Income will be reclassified to earnings as additional interest expense.

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 change in net unrealized gains and (losses) of \$(0.8) million and \$7.5 million in the nine months ended September 30, 2006 and

September 30, 2005, respectively, for derivatives designated as cash flow hedges is separately disclosed in the Company's statement of changes in stockholders' equity.

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.

35

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

- our ability to close the net lease investments we currently have under due diligence on acceptable terms;
- our ability to make additional investments in a timely manner or on acceptable terms;
- our ability to obtain long-term financing for our asset investments 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, our general and administrative costs and/or our property expenses;
- changes in our industry, the industries of our tenants, interest rates or the general economy;
- the success of our hedging strategy;
- our ability to raise additional capital;
- impairments in the value of the collateral underlying our investments; and
- the degree and nature of our competition.

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 acts of war or terrorism), monetary and tax policy, general economic conditions and a variety of other associated risks.

36

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### *Interest Rate Exposure*

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

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

Furthermore, shifts in the U.S. Treasury yield curve, which represents the market's expectations of future interest rates, would also affect the yield required on our fixed-rate assets. This would have similar effects on the fair value of our loans and real estate securities, our financial position and results of operations, as would a change in general credit spreads (described below).

### *Credit Spread Curve Exposure*

Our 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 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 loans or on available-for-sale securities. These value changes may also affect our ability to borrow and access capital.

### *Tenant Credit Rating Exposure*

Substantially all of our portfolio assets 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. With respect to our loans and securities, 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 (see discussion of credit spread curve exposure above). 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 net lease asset. We manage these risks by maintaining diversity among our credits and assessing our aggregate exposure to ratings classes, in particular lower rated classes. We also seek to lock or procure long-term financing on our assets as promptly as practicable after we commit to invest.

### *Equity Price Risk Exposure*

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

*Fair Value*

For certain of our financial instruments, fair values are not readily available since there are no active trading markets as characterized by current exchanges between willing parties. Accordingly, we derive or estimate fair values using various valuation techniques, such as computing the present value of estimated future cash flows using discount rates commensurate with the risks involved. However, the determination of estimated cash flows may be subjective and imprecise. Changes in assumptions or estimation methodologies can have a material affect on these estimated fair values. The fair values indicated below are indicative of the interest rate and credit spread environment as of September 30, 2006, and may not take into consideration the effects of subsequent interest rate or 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:

|   | Carrying<br>Amount | Notional<br>Amount | Weighted<br>Average<br>Effective<br>Interest Rate<br><i>(dollars in<br/>thousands)</i> | Maturity Date | Fair Value |
|---|--------------------|--------------------|--|---------------|------------|
| <b>Assets:</b>  |                    |                    |  |               |            |
| Mortgage and other real estate loans held for investment (1)        | \$ 276,020         | \$ 274,184         | 6.77%  | Various       | \$ 280,478 |
| Securities available for sale -                                     |                    |                    |  |               |            |
| CMBS (2)  | 169,713            | 181,252            | 7.90%  | 2009-2028     | 169,713    |
| Structuring fees receivable   | 3,410              | N/A                | 7.99%  | 2010-2020     | 3,410      |
| Derivative assets (3)   | 2,375              | 128,760            | N/A  | N/A           | 2,375      |
| <b>Liabilities</b>  |                    |                    |  |               |            |
| Repurchase agreement and other short-term financing obligations (4) | 140,699            | 140,699            | 6.20%  | Short-term    | 140,699    |
| Mortgage notes payable (5)  | 696,662            | 691,383            | 5.58%  | 2013-2024     | 687,866    |
| Collateralized debt obligations (5)                                 | 268,182            | 268,500            | 5.67%  | 2015          | 256,190    |
| Other long-term debt (6)  | 30,930             | 30,930             | 8.30%  | 2016          | 30,244     |
| Derivative liabilities (3)  | 2,472              | 95,440             | N/A  | N/A           | 2,472      |

- (1) This portfolio of loans bears interest at fixed rates. We have estimated the fair value of this portfolio of loans based on sales of loans with similar credit and structural characteristics where available, and management's estimate of fair values where comparable sales information is not available. The maturity dates for the loans range from 2006 through 2033.
- (2) Securities available for sale represent subordinate interests in securitizations (CMBS), as well as pass-through certificates representing our pro rata investments in a pool of mortgage loans. 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) These instruments represent hedging and risk management transactions involving interest rate swaps. They have been valued by reference to market quotations.
- (4) Our repurchase agreement and other short-term financing obligations 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.
- (5) We estimate the fair value of mortgage notes on real estate investments 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. The maturity date of the collateralized debt obligations reflects our expected maturity date in January 2015 and is used to compute the related fair value and weighted average effective interest rate.
- (6) We estimate the fair value of our other long-term debt using a discounted cash flow analysis, based upon management's estimates of market interest rates. The maturity date of our other long-term debt reflects our expected maturity date in January 2016 and is used to compute the related fair value and weighted average effective interest rate.

Scheduled maturities of interest rate sensitive instruments as of September 30, 2006 are as follows:

|   | <b>Expected Maturity Dates</b>  |             |             |             |             |                   |
|---|---|-------------|-------------|-------------|-------------|-------------------|
|   | <b>2006</b>   | <b>2007</b> | <b>2008</b> | <b>2009</b> | <b>2010</b> | <b>Thereafter</b> |
|   | <i>(in thousands, notional amounts where appropriate, otherwise carrying amounts)</i> |             |             |             |             |                   |
| Mortgage and other real estate loans                            | \$ 6,031  | \$ 10,923   | \$ 5,955    | \$ 14,281   | \$ 11,374   | \$ 225,620        |
| Securities available for sale - CMBS                            | 420   | 1,803       | 2,203       | 25,129      | 2,366       | 149,331           |
| Structuring fees receivable                                     | 157   | 659         | 713         | 772         | 768         | 341               |
| Derivative assets   | 2,375   | -           | -           | -           | -           | -                 |
| Mortgages on real estate investments                            | 1,276   | 4,819       | 7,160       | 8,862       | 10,695      | 663,850           |
| Repurchase agreement and other short-term financing obligations | 140,699   | -           | -           | -           | -           | -                 |
| Collateralized debt obligations                                 | (9)   | (36)        | (38)        | (41)        | 22,792      | 245,514           |
| Other long-term debt  | -   | -           | -           | -           | -           | 30,930            |
| Derivative liabilities  | 2,472   | -           | -           | -           | -           | -                 |

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

The expected maturity dates shown for loan investments, 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 our repurchase agreement and other short-term financing obligations 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 6 in the immediately preceding table.

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

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

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

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

##### *Changes in Internal Controls*

There has been no change in our internal control over financial reporting during the quarter ended September 30, 2006, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II.**

**OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A.**

**Risk Factors**

The following risk factors amend and restate those risk factors with the same caption headings included in our Form 10-K for the year ended December 31, 2005 and our Form 10-Q for the quarters ended March 31, 2006 and June 30, 2006.

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

We are subject to the following tenant credit concentrations as of September 30, 2006:

- approximately \$192.1 million, or 13.6%, of our assets in portfolio involve properties leased to the United States Government;
- approximately \$91.6 million, or 6.5%, of our assets in portfolio involve properties leased to, or leases guaranteed by, TJX Companies, Inc.;
- approximately \$87.8 million, or 6.2%, of our assets in portfolio involve properties leased to, or leases guaranteed by, Lowe's Companies Inc.;
- approximately \$82.0 million, or 5.8%, of our assets in portfolio involve properties leased to, or leases guaranteed by, Aon Corporation;
- approximately \$77.8 million, or 5.5%, of our assets in portfolio involve properties leased to, or leases guaranteed by, Koninklijke Ahold, N.V.; and
- approximately \$75.7 million, or 5.3%, of our assets in portfolio involve properties leased to, or leases guaranteed by, Tiffany & Co.

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

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

We are subject to the following industry concentrations as of September 30, 2006:

- approximately \$175.8 million, or 12.4%, of our assets in portfolio involve properties leased to, or leases guaranteed by, companies in the insurance industry (e.g., Aon Corporation, Allstate Insurance Company, Farmers New World Life Insurance Company);
- approximately \$139.3 million, or 9.8%, of our assets in portfolio involve properties leased to, or leases guaranteed by, companies in the retail department stores industry (e.g., TJX Companies, Inc. and Kohl's Corporation);
- approximately \$104.7 million, or 7.4%, of our assets in portfolio involve properties leased to, or leases guaranteed by, companies in the retail home improvements industry (e.g., Lowe's Companies, Inc. and Home Depot USA, Inc.); and
- approximately \$89.1 million, or 6.3%, of our assets in portfolio involve properties leased to, or leases guaranteed by, companies in the retail drug industry (e.g., CVS Corporation, Walgreen Co.).

Any downturn in one or more of these industries or in any other industry in which we may have a significant credit concentration in the future could have a material adverse effect on our cash flows and operating results.

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

We are subject to the following geographic concentrations as of September 30, 2006:

- approximately \$182.0 million, or 12.9%, of our assets in portfolio are investments in properties located in the Chicago, Illinois metropolitan area;
- approximately \$180.1 million, or 12.7%, of our assets in portfolio are investments in properties located in the Washington, D.C. metropolitan area;
- approximately \$146.9 million, or 10.4%, of our assets in portfolio are investments in properties located in the New York City and Northern New Jersey area; and
- approximately \$136.1 million, or 9.6%, of our assets in portfolio are investments in properties located in the Philadelphia, Pennsylvania metropolitan area.

An economic downturn or other adverse events or conditions such as terrorist attacks or natural disasters in one or more of these areas, or any other area where we may have a significant credit concentration in the future, could have a material adverse effect on our financial condition and operating results.

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

We invest in net lease assets where the underlying tenant's credit rating is below investment grade (approximately \$171.6 million, or 12.1%, of our assets in portfolio as of September 30, 2006). These investments will have a greater risk of default and bankruptcy than investments on properties net leased exclusively to investment grade tenants.

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

As of September 30, 2006, our CMBS investments included \$92.5 million of below investment grade bond classes (approximately 6.5% of our assets in portfolio as of September 30, 2006). Generally, these classes represent subordinate classes of the securitization pool, meaning that we hold the "first loss" position or a near "first loss" position in the event of losses on the assets within the pool. We may not be able to recover our investment in these subordinated CMBS classes. In addition, the value of these subordinated investments may be adversely affected by decreases in the value of the underlying collateral, increases in market rates for similar collateral pools or economic downturns, and we may be required under GAAP to record an impairment loss on our investment if any of these developments occur.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

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

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

| <b>a.</b> | <b>Exhibits</b>   |
|-----------|---|
| 12.1      | Computation of ratio of earnings to fixed charges and preferred stock dividends   |
| 31.1      | Certification of the Registrant's Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2      | Certification of the Registrant's Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1      | Certification of the Registrant's Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |

- 32.2 Certification of the Registrant's Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**SIGNATURES**

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

**CAPITAL LEASE FUNDING, INC.**

*Registrant*

Date: November 6, 2006

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

Date: November 6, 2006

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