

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

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2012

OR

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

For the transition period from _____ to _____

Commission file number 001-32039

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

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

1065 Avenue of the Americas, New York, NY 10018
(Address of Principal Executive Offices) (ZIP Code)
Registrant's Telephone Number, Including Area Code: (212) 217-6300

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

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

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

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 May 9, 2012, there were 66,766,965 shares of common stock of CapLease, Inc., \$0.01 par value per share, outstanding ("Common Stock").

CapLease, Inc.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CapLease, Inc. and Subsidiaries

Consolidated Balance Sheets

As of March 31, 2012 (unaudited) and December 31, 2011

| (Amounts in thousands, except share and per share amounts) | As Of March 31, 2012 | As Of December 31, 2011 |
|--|----------------------------|-------------------------------|
| Assets | | |
| Real estate investments, net | \$ 1,395,058 | \$ 1,401,526 |
| Loans held for investment, net | 31,646 | 33,139 |
| Commercial mortgage-backed securities | 62,366 | 59,435 |
| Cash and cash equivalents | 57,356 | 71,160 |
| Other assets | 79,037 | 76,363 |
| Total Assets | \$ 1,625,463 | \$ 1,641,623 |
| Liabilities and Equity | | |
| Mortgages on real estate investments | \$ 957,407 | \$ 972,924 |
| Credit agreement | 68,399 | 70,668 |
| Secured term loan | 83,081 | 88,142 |
| Convertible senior notes | 34,678 | 34,522 |
| Other long-term debt | 30,930 | 30,930 |
| Total Debt Obligations | 1,174,495 | 1,197,186 |
| Intangible liabilities on real estate investments | 34,672 | 35,219 |
| Accounts payable and other liabilities | 22,371 | 17,371 |
| Dividends and distributions payable | 5,977 | 5,946 |
| Total Liabilities | 1,237,515 | 1,255,722 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |

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| | | |
|---|-------------|--------------|
| Preferred stock, \$0.01 par value, 100,000,000 shares authorized, Series A cumulative redeemable preferred, liquidation preference \$25.00 per share, 3,204,900 shares issued and outstanding | 73,880 | 73,880 |
| Common stock, \$0.01 par value, 500,000,000 shares authorized, 66,766,965 and 66,275,535 shares issued and outstanding, respectively | 668 | 663 |
| Additional paid in capital | 318,091 | 321,303 |
| Accumulated other comprehensive loss | (5,788) | (11,051) |
| Total Stockholders' Equity | 386,851 | 384,795 |
| Non-controlling interest in consolidated subsidiaries | 1,097 | 1,106 |
| Total Equity | 387,948 | 385,901 |
| Total Liabilities and Equity | \$1,625,463 | \$ 1,641,623 |

See notes to consolidated financial statements.

CapLease, Inc. and Subsidiaries

Consolidated Statements of Operations

(Unaudited)

| (Amounts in thousands, except per share amounts) | For the Three Months Ended March 31, | |
|--|---|-------------|
| | 2012 | 2011 |
| Revenues: | | |
| Rental revenue | \$ 32,982 | \$ 31,178 |
| Interest income from loans and securities | 2,013 | 6,428 |
| Tenant reimbursements | 3,832 | 3,353 |
| Other revenue | 159 | 283 |
| Total revenues | 38,986 | 41,242 |
| Expenses: | | |
| Interest expense | 16,978 | 20,035 |
| Property expenses | 6,791 | 6,900 |
| General and administrative expenses | 3,016 | 2,827 |
| General and administrative expenses-stock based compensation | 704 | 672 |
| Depreciation and amortization expense on real property | 12,144 | 11,717 |
| Other expenses | 16 | 66 |
| Total expenses | 39,649 | 42,217 |
| Other gains (losses): | | |
| Gain (loss) on investments, net | 709 | (490) |
| Gain on extinguishment of debt, net | 2,012 | — |
| Total other gains (losses) | 2,721 | (490) |
| Income (loss) from continuing operations | 2,058 | (1,465) |
| Loss from discontinued operations | — | (50) |
| Net income (loss) before non-controlling interest in consolidated subsidiaries | 2,058 | (1,515) |
| Non-controlling interest in consolidated subsidiaries | (1) | 9 |
| Net income (loss) | 2,057 | (1,506) |
| Dividends allocable to preferred shares | (1,627) | (1,627) |
| Net income (loss) allocable to common stockholders | \$ 430 | \$ (3,133) |
| Income (loss) per common share, basic and diluted: | | |
| Income (loss) from continuing operations | \$ 0.01 | \$ (0.05) |
| Income (loss) from discontinued operations | \$ — | \$ — |

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| | | |
|---|----------|------------|
| Net income (loss) per common share, basic and diluted | \$ 0.01 | \$ (0.05) |
| Weighted average number of common shares outstanding, basic and diluted | 66,313 | 57,537 |
| Dividends declared per common share | \$ 0.065 | \$ 0.065 |
| Dividends declared per preferred share | \$ 0.51 | \$ 0.51 |

See notes to consolidated financial statements.

CapLease, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income (Loss)

(Unaudited)

| (Amounts in thousands) | For the Three Months Ended March 31, | |
|---|---|-------------|
| | 2012 | 2011 |
| Net income (loss) before non-controlling interest in consolidated subsidiaries | \$ 2,058 | \$ (1,515) |
| Other comprehensive income: | | |
| Amortization of unrealized loss on securities previously classified as available for sale | – | 150 |
| Increase (decrease) in fair value of securities available for sale | 5,210 | 585 |
| Reclassification of derivative items into earnings | 53 | 150 |
| Other comprehensive income | 5,263 | 885 |
| Comprehensive income (loss) | 7,321 | (630) |
| Comprehensive (income) loss attributable to non-controlling interests | (17) | 2 |
| Comprehensive income (loss) attributable to CapLease, Inc. | \$ 7,304 | \$ (628) |

See notes to consolidated financial statements.

CapLease, Inc. and Subsidiaries

Consolidated Statement of Changes in Equity

(Unaudited)

(in thousands)

| | Stockholders' Equity | | | | Accumulated Other Comprehensive Income (Loss) | Retained Earnings | Non-controlling Interest | Total Equity |
|---|----------------------|---------------------------|----------------------------------|--|---|----------------------|-----------------------------|-----------------|
| | Preferred Stock | Common Stock at Par | Additional Paid-In Capital | | | | | |
| Balance at December 31, 2011 | \$73,880 | \$ 663 | \$ 321,303 | | \$ (11,051) | \$- | \$ 1,106 | \$385,901 |
| Incentive stock plan compensation expense | - | - | 704 | | - | - | - | 704 |
| Incentive stock plan grants issued and forfeited | - | 5 | (5) | | - | - | - | - |
| Net income | - | - | - | | - | 2,057 | - | 2,057 |
| Non-controlling interest in consolidated subsidiaries | - | - | - | | - | - | 1 | 1 |
| Dividends declared-preferred | - | - | - | | - | (1,627) | - | (1,627) |
| Dividends declared-common | - | - | (3,911) | | - | (430) | - | (4,341) |
| Distributions declared-operating partnership units | - | - | - | | - | - | (10) | (10) |
| Increase in fair value of securities available for sale | - | - | - | | 5,210 | - | - | 5,210 |
| Reclassification of derivative items into earnings | - | - | - | | 53 | - | - | 53 |
| Balance at March 31, 2012 | \$73,880 | \$ 668 | \$ 318,091 | | \$ (5,788) | \$- | \$ 1,097 | \$387,948 |

See notes to consolidated financial statements.

CapLease, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

(in thousands)

| | For the Three Months Ended March 31, | |
|---|---|-------------|
| | 2012 | 2011 |
| Operating activities | | |
| Net income (loss) | \$ 2,057 | \$ (1,506) |
| Adjustments to reconcile net loss to cash provided by operating activities: | | |
| Depreciation and amortization | 12,120 | 12,306 |
| Stock based compensation | 704 | 672 |
| Amortization of above and below market leases | (186) | 419 |
| (Gain) loss on investments, net | (709) | 490 |
| Gain on extinguishment of debt, net | (2,012) | – |
| Non-controlling interest in consolidated subsidiaries | 1 | (9) |
| Straight-lining of rents | 13,097 | 11,674 |
| Amortization of discounts/premiums, and origination fees/costs, net | (95) | (133) |
| Amortization of debt issuance costs, leasing commissions and fair market value of debt issued or assumed | 487 | 617 |
| Changes in operating assets and liabilities: | | |
| Other assets | (8,136) | (7,786) |
| Accounts payable and other liabilities | (1,398) | (1,746) |
| Net cash provided by operating activities | 15,930 | 14,998 |
| Investing activities | | |
| Principal received from borrowers | 2,241 | 3,021 |
| Proceeds from sale of securities | – | 22,540 |
| Repayments of commercial mortgage-backed securities | 2,334 | 2,321 |
| Real estate improvements, additions and construction in progress | (5,946) | (6,417) |
| Leasing commission costs | (1,279) | (60) |
| Purchases of furniture, fixtures, equipment and leasehold improvements | (6) | (2) |
| Net cash (used in) provided by investing activities | (2,656) | 21,403 |
| Financing activities | | |
| Borrowings from mortgages on real estate investments | 19,200 | 468 |
| Repayments of mortgages on real estate investments | (32,444) | (4,679) |
| Funds held by trustee of CDO pending distribution | – | (15,171) |
| Repayments of collateralized debt obligations | – | (2,416) |
| Repayments on credit agreement | (2,269) | (4,239) |
| Repayments on secured term loan | (5,061) | (4,446) |
| Debt issuance costs | (559) | – |
| Common stock issued, net of offering costs | – | 219 |
| Distributions to non-controlling interest | (10) | (10) |

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| | | |
|--|-----------|-----------|
| Dividends paid on common and preferred stock | (5,935) | (5,363) |
| Net cash used in financing activities | (27,078) | (35,637) |
| Net (decrease) increase in cash and cash equivalents | (13,804) | 764 |
| Cash and cash equivalents at beginning of period | 71,160 | 32,742 |
| Cash and cash equivalents at end of period | \$ 57,356 | \$ 33,506 |
| Supplemental disclosure of cash flow information | | |
| Cash paid for interest expense | \$ 16,307 | \$ 18,522 |
| Distributions declared but not paid | 10 | 10 |
| Dividends declared but not paid | 5,967 | 5,391 |

See notes to consolidated financial statements.

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

1. Organization and Business

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

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

The Company’s tenants are primarily large public companies or their significant operating subsidiaries and governmental entities with investment grade credit ratings, defined as a published senior unsecured credit rating of BBB-/Baa3 or above from one or both of Standard & Poor’s (“S&P”) and Moody’s Investors Service (“Moody’s”). The Company also implies an investment grade credit rating for tenants that are not publicly rated by S&P or Moody’s but (i) are 100% owned by an investment grade parent, (ii) for which it has obtained a private investment grade rating from either S&P or Moody’s, (iii) for which it has evaluated the creditworthiness of the tenant and estimated a credit rating that is consistent with an investment grade rating from S&P or Moody’s, or (iv) are governmental entity branches or units of another investment grade rated governmental entity.

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

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

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

2. Summary of Significant Accounting Policies

Basis of Presentation and Principles of Consolidation

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

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

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

Accounting for Real Estate

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

The Company reviews its owned real properties for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. The evaluation includes estimating and reviewing anticipated future undiscounted cash flows to be derived from the asset. If such cash flows are less than the asset's net carrying value, an impairment charge is recognized to earnings to the extent by which the asset's carrying value exceeds the estimated fair value. Estimating future cash flows is highly subjective and includes an evaluation of factors such as the anticipated cash flows from the property, which may include rent from current leases in place and projected future leases, estimated capital expenditures, and an estimate of proceeds to be realized upon sale of the property. The Company's estimates could differ materially from actual results. The Company has determined that the significant inputs used to evaluate its owned properties for impairment primarily rely on Level 3 inputs in accordance with the fair value measurement topic in the applicable accounting guidance as described in Note 7 below. The Company did not recognize any impairment losses on long-lived assets during either of the quarters ended March 31, 2012 or March 31, 2011.

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

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

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

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

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

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

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

Other intangible assets acquired include amounts for in-place lease values and tenant relationship values which are based on management's evaluation of the specific characteristics of each tenant's lease and the Company's overall relationship with the respective tenant. Factors considered by management in its analysis of in-place lease values include estimates of the dark value of the property, carrying costs during the hypothetical expected time it would take management to find a tenant to lease the space for the existing lease term (a "lease-up period") considering current market conditions, and costs to execute similar leases. Management estimates carrying costs, including such factors as real estate taxes, insurance and other operating expenses during the expected lease-up period, considering current market conditions and costs to execute similar leases. In estimating costs to execute similar leases, management considers leasing commissions and other related expenses. Characteristics considered by management in estimating the value of tenant relationships include the nature and extent of the Company's existing business relationships with the tenant, growth prospects for developing new business with the tenant, the tenant's credit quality and expectations of lease renewals. The value of in-place leases is amortized as a component of depreciation expense over the remaining initial terms of the respective leases. The value of tenant relationship intangibles, if any, is amortized as a component of depreciation expense over the anticipated life of the relationships. Through March 31, 2012, the Company has assigned no value to tenant relationships on any of its acquisitions.

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

Development Activities

Project costs and expenses associated with the development, construction and lease-up of a real estate project are capitalized as construction in progress. Once the development and construction of the building is substantially completed, the costs capitalized to construction in progress are transferred to (i) land and (ii) buildings and improvements.

Loan Investments

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

From time to time, the Company may determine to sell a loan in which case it must reclassify the asset as held for sale. Loans held for sale are carried at lower of cost or estimated fair value. The Company did not sell any of its loan investments during the quarters ended March 31, 2012 and March 31, 2011, and, as of March 31, 2012, the Company has not classified any of its loans as held for sale.

The Company evaluates its loan investments for possible impairment on a quarterly basis. The Company's impairment analysis includes both a general reserve component and an asset-specific component. The general reserve component covers performing loans and in accordance with relevant accounting guidance an allowance for loan losses is recorded when (i) available information as of each balance sheet date indicates that it is probable a loss has occurred in the portfolio and (ii) the amount of the loss can be reasonably estimated. Actual loan losses are then charged against the allowance when management believes that uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Significant judgment is required in determining reserve balances for the performing loan portfolio, including estimates of the likelihood of default and lease rejection given the credit characteristics of the tenant, and estimates of stressed collateral values and potential bankruptcy claim recoveries. These estimates are highly subjective and could differ materially from actual results. As of March 31, 2012, the Company has a general loan loss reserve of \$500. See Note 4.

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

The asset-specific component of the loan loss impairment analysis relates to specific loans where the Company has deemed it probable that it will not be able to collect all amounts due according to the contractual terms of the loan. Any resulting loan specific loss is measured based on the present value of expected future cash flows from the loan or the fair value of the loan collateral, if the loan is collateral dependent. Significant judgment is required in determining any resulting loan specific loss, including factors such as the status of the loans (i.e., current or actual or expected payment or other defaults), the credit quality of the underlying tenants, the present value of expected future cash flows on the loans, the fair value of any collateral, and the amount and status of any senior debt. These estimates are highly subjective and could differ materially from actual results. The Company's accounting policy is to continue to accrue interest income on specific impaired loans as long as it concludes it is likely to collect it. As of March 31, 2012, the Company did not have any asset-specific loan loss reserves.

Commercial Mortgage-Backed Securities

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

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

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

In estimating credit or other-than-temporary impairment losses, management considers a variety of factors including (1) the financial condition and near-term prospects of the credit, including credit rating of the security and the

underlying tenant and an estimate of the likelihood, amount and expected timing of any default, (2) whether the Company expects to hold the investment for a period of time sufficient to allow for anticipated recovery in fair value, (3) the length of time and the extent to which the fair value has been below cost, (4) current market conditions, (5) expected cash flows from the underlying collateral and an estimate of underlying collateral values, and (6) subordination levels within the securitization pool. These estimates are highly subjective and could differ materially from actual results. The Company had no other-than-temporary impairment losses on securities charged to the Statement of Operations during each of the quarters ended March 31, 2012 and March 31, 2011.

Deferred Fees and Costs

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

In accordance with applicable accounting guidance, the Company defers the recognition of fees and expenses associated with the origination of its loans held for investment. These items include lender fee income, rate lock income, direct loan origination costs, certain legal 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.

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

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

Risk Management Transactions

The Company may enter into risk management transactions as part of its overall portfolio financing strategy. These transactions are intended to manage the Company's exposure to changes in interest rates associated with its expected future debt issuances.

If the Company employs risk management transactions, they will be treated as cash flow hedges under applicable accounting guidance as long as they have been designated and qualify as such, which basically means so long as the Company has satisfied a variety of technical accounting requirements, such as hedge documentation requirements and initial and subsequent quarterly hedge effectiveness tests. If the cash flow hedge criteria are met, the transactions are marked to fair value at each reporting date and recorded as an asset or liability, depending on the Company's rights or obligations under the applicable contract. The effective portion of the Company's realized and unrealized gains and losses on such transactions are treated as a component of "Other Comprehensive Income (Loss)" on the Company's Consolidated Balance Sheet and are not reported as a component of current income or loss on the Company's Consolidated Statement of Operations. The effective portion of the Company's realized gains and losses, which generally represent the net payments the Company makes or receives on the interest rate swaps, are then reclassified and amortized as part of interest expense on the Company's Consolidated Statement of Operations beginning at issuance of the related debt and continuing over the expected term of such debt. Upon the retirement of the related debt obligation, any unamortized portion of realized gains or losses on derivatives included in "Other Comprehensive Income (Loss)" are charged off as a component of gain or loss on extinguishment of debt.

If cash flow hedge criteria are not met or the hedge is deemed ineffective, some or all of the realized and unrealized gains and losses on such transactions are treated as a component of current income or loss on the Company's Consolidated Statement of Operations.

If the Company employs risk management transactions, no assurance can be made that the Company will satisfy the cash flow hedge requirements and as to the portion of the Company's gains and losses that will be deemed effective under applicable accounting guidance. Changes in management's initial assumptions regarding any proposed debt

issuance (e.g., timing and the amount and type of debt) and changes in the shape of the swap curve (which represents the market's expectations for future LIBOR rates) are among the factors that could cause the Company to include a greater portion of its gains and losses from the associated risk management transactions as current income or loss.

Cash and Cash Equivalents

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

Revenue Recognition

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

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

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

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

Income Taxes

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

Earnings per Share

As required by GAAP, the Company presents both basic and diluted earnings per share ("EPS"). Basic EPS excludes dilution and is computed by dividing net income (loss) allocable to common stockholders by the weighted average number of shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock, where such exercise or conversion would result in a lower EPS amount. The Company's computation of diluted earnings per share does not include shares of common stock that may be issued in the future upon conversion of the convertible senior notes issued in October 2007, as the impact would not be dilutive. The number of weighted average common shares not included was 3,093,759 for each of the three months ended March 31, 2012 and March 31, 2011.

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The following summarizes the Company's EPS computations for the three months ended March 31, 2012 and March 31, 2011 (in thousands, except per share amounts):

| | For the three months ended March 31, | |
|---|---|-------------|
| | 2012 | 2011 |
| Net income (loss) allocable to common stockholders | \$ 430 | \$ (3,133) |
| Weighted average number of common shares outstanding, basic and diluted | 66,313 | 57,537 |
| Income (loss) per share, basic and diluted | \$ 0.01 | \$ (0.05) |
| Non-vested shares included in weighted average number of shares outstanding above | 1,571 | 1,617 |

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

Recently Issued Accounting Pronouncements

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

In June 2011, the FASB issued new accounting guidance ASU 2011-05, *Presentation of Comprehensive Income*, which amends various sections of ASC 220 and allows an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders’ equity. The amendments in ASU 2011-05 do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. ASU 2011-05 should be applied retrospectively. For public entities, the amendments in ASU 2011-05 are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company elected early adoption of this ASU for the reporting period ended December 31, 2011, as permitted by the ASU. The Company’s adoption of this ASU did not have a material effect on the Company’s consolidated financial statements.

In December 2011, the FASB issued new accounting guidance ASU 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standard Update No. 2011-05*, which amends various sections of ASC 220-10. The amended sections indefinitely defer the effective date of the presentation of reclassification adjustments out of accumulated other comprehensive income on the components of net income and other comprehensive income, which ASU 2011-05 would require. All other requirements of ASU 2011-05 are unaffected by this new guidance. For public entities, the

amendments in ASU 2011-12 are effective concurrent with ASU 2011-05, for fiscal years and interim periods within those years, beginning after December 15, 2011. The Company has elected to adopt this ASU for the reporting period ended December 31, 2011, as it is required to be adopted concurrently with ASU 2011-05. The Company's adoption of this ASU did not have a material effect on the Company's consolidated financial statements.

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

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

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

March 31, 2012 (unaudited)

Reclassifications

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

3. Real Estate Investments

Real estate held for investment and related intangible liabilities on real estate investments consisted of the following at March 31, 2012 and December 31, 2011:

| | Mar 31, 2012 Unaudited | Dec 31, 2011 |
|--|---------------------------|--------------|
| Real estate investments: | | |
| Land | \$ 203,184 | \$ 203,184 |
| Building and improvements | 1,304,803 | 1,304,655 |
| Construction in progress, land | 3,221 | 2,345 |
| Construction in progress, building and improvements | 11,199 | 6,277 |
| Intangible assets | 165,963 | 165,963 |
| Less: Accumulated depreciation and amortization | (293,312) | (280,898) |
| Real estate investments, net | \$ 1,395,058 | \$ 1,401,526 |
| Intangible liabilities on real estate investments: | | |
| Intangible liabilities | \$ 47,908 | \$ 47,908 |
| Less: Accumulated amortization | (13,236) | (12,689) |
| Intangible liabilities on real estate investments, net | \$ 34,672 | \$ 35,219 |

The Company did not make any real estate acquisitions during the quarter ended March 31, 2012 except that it continued to fund the construction of the office building for Cimarex Energy Co. described below.

Lease Extension

During March 2012, the Company entered into a five year lease extension for the 1,045,153 square foot warehouse property located in Breinigsville, Pennsylvania and leased to a subsidiary of Nestlé Holdings, Inc. The lease extension

commences January 1, 2013 and the rental rate is \$4.40 per square foot increasing 3% per annum.

Development Activities

During July 2011, the Company entered into a joint venture that is developing a 17 story office building primarily on a build-to-suit basis for Cimarex Energy Co. with an estimated total investment of \$55,000. The Company owns a 99% ownership interest in and is obligated to fund approximately one-half of the costs of the project, with the other half of the project costs to be funded by Bank of Oklahoma pursuant to a loan agreement it has entered into with the Company's 99% owned joint venture entity. The Company consolidates the joint venture for financial accounting purposes.

Construction activity and funding of the project commenced during the third quarter of 2011.

The table below details the Company's construction in progress associated with the Cimarex joint venture as of March 31, 2012. The information included in the table below represents management's estimates and expectations at March 31, 2012 which are subject to change. The Company's disclosures regarding certain projections or estimates of completion dates may not reflect actual results.

| Location | Tenant | Property Type | Approximate Square Feet | Lease Term (years) ⁽¹⁾ | Investment through 3/31/12 | Estimated Remaining Funding ⁽²⁾ | Estimated Total Investment ⁽³⁾ | Estimated Completion Date |
|-----------------|--------------------|-----------------|-------------------------|-----------------------------------|----------------------------|--|---|---------------------------|
| Tulsa, Oklahoma | Cimarex Energy Co. | Office Building | 324,000 | 12 | \$ 13,839 | \$ 41,161 | \$ 55,000 | Q1 2013 |

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

(1) The lease is in force and rent will commence as building floors are completed and delivered to the tenant and the 12 year lease term will commence upon completion and delivery of all building floors to the tenant.

(2) The Company has entered into a construction/term loan with Bank of Oklahoma to fund a portion of the total investment. Upon completion of construction, up to \$31,000 is expected to have been funded from borrowings under the loan agreement with Bank of Oklahoma. See Note 9.

(3) Interest and fees the Company will earn during the construction period are expected to reduce the total investment to \$53,000.

Straight-Line Rent Adjustment

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

| | Mar 31, 2012 | Dec 31, 2011 |
|------------------------|--------------|--------------|
| | Unaudited | |
| Accrued Rental Income | \$ 34,685 | \$ 41,387 |
| Deferred Rental Income | 6,397 | 2 |

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

Depreciation and Amortization Expense

Depreciation expense and amortization of intangible assets and liabilities on real estate investments for the three months ended March 31, 2012 and March 31, 2011, were as follows:

| | For the three months ended March 31, | |
|---|---|----------|
| | 2012 | 2011 |
| Depreciation on real estate (included in depreciation and amortization expense) | \$ 8,434 | \$ 8,154 |
| Amortization of in-place leases (included in depreciation and amortization expense) | 3,620 | 4,063 |
| Amortization of above-market leases (included as a reduction of rental revenue) | 361 | 966 |
| Amortization of below-market leases (included as an increase to rental revenue) | 547 | 547 |

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

As of March 31, 2012, the Company's weighted average amortization period on intangible assets was 7.6 years, and the weighted average amortization period on intangible liabilities was 25.5 years.

Scheduled amortization on existing intangible assets and liabilities on real estate investments as of March 31, 2012, was as follows:

| | Intangible Assets | Intangible Liabilities |
|------------|----------------------|---------------------------|
| 2012 | \$ 11,084 | \$ 1,640 |
| 2013 | 9,392 | 2,051 |
| 2014 | 9,034 | 1,954 |
| 2015 | 8,375 | 1,678 |
| 2016 | 6,789 | 1,614 |
| Thereafter | 19,398 | 25,736 |
| Total | \$ 64,072 | \$ 34,672 |

Owned Property Investment and Financing Strategy

Nearly all of the Company's owned properties are subject to financing and have been pledged as collateral to the Company's lender that has provided the applicable financing. In order to further reduce leverage, the Company may increase the number of properties it owns without financing in place in the future. When it decides to finance a property, the Company's strategy is to own and finance on a long-term basis such property through a separate and distinct special purpose entity, or SPE, with the property and the related lease or leases on the property generally representing the sole assets of the SPE and the sole collateral available to the Company's lender in the event the Company defaults on the debt that finances the property. Also see Note 9.

4. Loans Held for Investment

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

| | Mar 31, 2012 | Dec 31, 2011 |
|--------------------------------|--------------|--------------|
| | Unaudited | |
| Principal | \$ 36,096 | \$ 37,622 |
| Discount | (3,883) | (3,913) |
| Cost basis | 32,213 | 33,709 |
| Allowance for loan losses | (500) | (500) |
| Carrying amount of loans | 31,713 | 33,209 |
| Deferred origination fees, net | (67) | (70) |
| Total | \$ 31,646 | \$ 33,139 |

As of each of March 31, 2012 and December 31, 2011, the Company's loan investments carried interest rates ranging from 5.28% to 9.32%. At March 31, 2012 and December 31, 2011, the weighted average effective interest rate on the Company's loan investments, as measured against its cost basis, was 7.2% and 7.3%, respectively.

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

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

March 31, 2012 (unaudited)

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

| Credit rating (1) (2) | Carry Value | |
|---|-------------|----------|
| | 3/31/12 | 12/31/11 |
| | (unaudited) | |
| Investment grade rating of A- or A3 and above | \$16,545 | \$16,664 |
| Investment grade rating of below A- or A3 | 9,150 | 9,239 |
| Implied investment grade rating | - | - |
| Non-investment grade rating | 6,518 | 7,806 |
| Unrated | - | - |
| General loan loss reserve | (500) | (500) |
| | \$31,713 | \$33,209 |

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

The Company implies an investment grade credit rating for tenants that are not publicly rated by S&P or Moody's but (i) are 100% owned by an investment grade parent, (ii) for which the Company has obtained a private (2) investment grade rating from either S&P or Moody's, or (iii) for which it has evaluated the creditworthiness of the tenant and estimated a credit rating that is consistent with an investment grade rating from S&P or Moody's, or (iv) are governmental entity branches or units of another investment grade rated governmental entity.

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

During the quarter ended March 31, 2012, the Company received net proceeds of \$709 in satisfaction of the outstanding balance of its loan to the franchise lending venture. The amount received is included in "Gain (loss) on investments, net" in the Company's Consolidated Statement of Operations. The Company previously recorded aggregate losses of \$1,432 related to this investment, including \$444 during the quarter ended June 30, 2009 and \$988 during the quarter ended June 30, 2011.

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Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

5. Commercial Mortgage-Backed Securities

As of March 31, 2012, the Company classifies all of its commercial mortgage-backed securities as “available for sale” for financial accounting purposes and carries those securities on the Consolidated Balance Sheet at fair value with the net unrealized gains or losses included in Accumulated Other Comprehensive Income (Loss), a component of Stockholders’ Equity on the Company’s Consolidated Balance Sheet.

A detailed schedule of the Company’s securities investments at March 31, 2012 follows:

| Description | Face Amount (1) | | Cost Basis | | Fair Value | |
|--|------------------------------|-----------------|------------------------------|-----------------|------------------------------|-----------------|
| | Mar 31, 2012 Unaudited | Dec 31, 2011 | Mar 31, 2012 Unaudited | Dec 31, 2011 | Mar 31, 2012 Unaudited | Dec 31, 2011 |
| Certificated Mortgage Loan (with Alcatel-Lucent USA Inc. as tenant in Highlands Ranch, CO) (rated B) | \$23,487 | \$ 24,527 | \$23,759 | \$ 24,818 | \$21,543 | \$ 20,648 |
| Certificated Mortgage Loan (with CVS Corporation as tenant / multi-property) (rated BBB+) | 16,707 | 16,867 | 16,707 | 16,867 | 17,513 | 17,410 |
| Certificated Mortgage Loan (with Koninklijke Ahold, N.V. as tenant / multi-property) (rated BBB) | 6,805 | 7,489 | 6,884 | 7,578 | 7,676 | 8,395 |
| BACM 2006-4, Class H (rated CCC) | 4,000 | 4,000 | – | – | 100 | 800 |
| BACMS 2002-2, Class V-1 (7-Eleven, Inc.) (rated AA-) | 670 | 656 | 571 | 555 | 572 | 555 |
| BACMS 2002-2, Class V-2 (Sterling Jewelers) (not rated) | 1,023 | 1,001 | 853 | 828 | 853 | 828 |
| CALFS 1997-CTL1, Class D (rated B-) | 2,996 | 3,000 | 2,996 | 3,000 | 2,696 | 1,200 |
| CapLease CDO 2005-1, Class A (rated BBB+) | 2,427 | 2,661 | 2,092 | 2,326 | 2,148 | 2,345 |
| CapLease CDO 2005-1, Class B (rated BBB-) | 2,000 | 2,000 | 1,400 | 1,400 | 1,450 | 1,410 |
| CMLBC 2001-CMLB-1, Class H (rated B-) | 11,907 | 11,907 | 7,182 | 7,139 | 3,263 | 2,639 |
| CMLBC 2001-CMLB-1, Class J (rated D) | 6,383 | 6,383 | 657 | 756 | 447 | 672 |
| NLFC 1999-LTL-1, Class X (IO) (rated AAA) | 3,800 | 3,916 | 3,800 | 3,916 | 4,105 | 2,533 |
| Total | \$82,205 | \$ 84,405 | \$66,903 | \$ 69,181 | \$62,366 | \$ 59,435 |

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

All credit ratings in the above table are as of March 31, 2012.

The Company evaluated each of its securities for other-than-temporary impairment at March 31, 2012, and determined that no other-than-temporary impairment charges on its securities were appropriate.

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

| | Mar 31, 2012 | Dec 31, 2011 |
|--|--------------|--------------|
| | Unaudited | |
| Unrealized gains on securities available for sale | \$ 2,108 | \$ 2,189 |
| Unrealized losses on securities available for sale | (6,645) | (11,936) |

The following table summarizes the Company's securities in an unrealized loss position as of March 31, 2012.

| | Aggregate Fair Value | Aggregate Unrealized Loss | Number of Securities |
|---|----------------------|---------------------------|----------------------|
| In unrealized loss position 12 or more months | \$ 27,949 | \$ 6,645 | 4 |

Credit ratings on the 4 securities in a continuous unrealized loss position for more than 12 months as of March 31, 2012, range from B to D with a weighted average of B and those securities have a weighted average maturity of approximately 6.5 years. The Company believes that none of the unrealized losses on investment securities are other-than-temporary because management expects the Company will receive all contractual principal and interest related to these investments. In addition, the Company did not have the intent to sell the securities or believe it would be required to sell them as of March 31, 2012.

At March 31, 2012 and December 31, 2011, the weighted average effective interest rate (yield to maturity on adjusted cost basis) on securities was approximately 8.5% and 8.4%, respectively.

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

March 31, 2012 (unaudited)

6. Assets Sold and Discontinued Operations

Quarter Ended March 31, 2012

The Company did not sell any assets during the quarter ended March 31, 2012, and has not classified any assets as held for sale as of March 31, 2012.

Quarter Ended March 31, 2011

The Company sold two related securities investments during the quarter ended March 31, 2011. During February 2011, the Company sold two commercial mortgage-backed securities investments, both of which were secured by portions of the mortgage financing on the office building located at 180 Maiden Lane, New York, New York (WBCMT 2004-C15, Class 180ML-D and Class 180ML-E). The sale was executed primarily because the securities were beyond their original scheduled maturity date of November 2009 and the sale enabled the Company to realize a return of substantially all of the outstanding principal. The total of \$23,000 face amount of securities were sold at a dollar price of \$98 per \$100 of face amount, and the Company recognized a loss on investment during the quarter ended March 31, 2011 of \$490. The loss is included as a component of "Gain (loss) on investments, net" in the Company's Consolidated Statement of Operations. The aggregate carrying amount of these securities was \$22,236 as of December 31, 2010.

Income (loss) from discontinued operations for the quarter ended March 31, 2011, is comprised of the operating results of the following assets that were sold during subsequent periods.

the Company's former Hartford, Connecticut office property that was transferred to the lender in full satisfaction of the mortgage debt during December 2011;

- the Company's former Pennsauken, New Jersey retail property which was sold during August 2011; and
- the Company's former Simi Valley, California retail property which was sold during September 2011.

7. Fair Value

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

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

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

| | Carrying Amount | | Notional Amount | | Estimated Fair Value | |
|---------------------------------------|-----------------|------------|-----------------|------------|----------------------|-------------|
| | 3/31/2012 | 12/31/2011 | 3/31/2012 | 12/31/2011 | 3/31/2012 | 12/31/2011 |
| | (unaudited) | | (unaudited) | | (unaudited) | |
| Assets: | | | | | | |
| Loans held for investment | \$31,713 | \$ 33,209 | \$36,096 | \$ 37,622 | \$33,932 | \$35,120 |
| Commercial mortgage-backed securities | 62,366 | 59,435 | 82,205 | 84,405 | 62,366 | 59,435 |
| Liabilities: | | | | | | |
| Mortgages on real estate investments | \$957,407 | \$ 972,924 | \$955,944 | \$ 969,004 | \$1,005,216 | \$1,002,247 |
| Credit agreement | 68,399 | 70,668 | 68,399 | 70,668 | 68,399 | 70,668 |
| Secured term loan | 83,081 | 88,142 | 83,081 | 88,142 | 74,130 | 78,302 |
| Convertible senior notes | 34,678 | 34,522 | 35,009 | 35,009 | 35,002 | 34,997 |
| Other long-term debt | 30,930 | 30,930 | 30,930 | 30,930 | 29,498 | 29,421 |

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

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

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

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

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

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

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

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

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

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

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

Level 1 – Quoted prices are available in active markets for identical assets or liabilities at the reporting date. As of March 31, 2012, the Company has not classified any of its securities as Level 1.

Level 2 – Pricing inputs other than quoted prices included within Level 1 that are observable for substantially the full term of the asset or liability. Level 2 assets include quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities that are not active; and inputs other than quoted prices that are observable, such as models or other valuation methodologies. As of March 31, 2012, the Company has classified two certificated mortgage loans (one with CVS Corporation as underlying tenant and the other with Koninklijke Ahold, N.V. as underlying tenant), as well as its sole remaining generic commercial mortgage-backed security investment (BACM 2006-4, Class H), as Level 2.

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

Level 3 – Inputs reflect management’s best estimate of what market participants would use in pricing the asset or liability at the measurement date. These valuations require a considerable amount of judgment and assumptions. As of March 31, 2012, the Company has classified all of its securities that are backed primarily by single tenant loan collateral, other than the CVS and Ahold backed certificated loans discussed above, as Level 3. The valuation technique utilized by management is a discounted cash flow analysis. Management evaluates a variety of inputs to estimate the applicable discount rate. The primary inputs evaluated by management in estimating the discount rate are broker quotations (observable), collateral values (observable), subordination levels (observable), and liquidity of the security (unobservable). These inputs are the factors employed by management and to its knowledge other parties in determining where to price actual transactions. The Company’s securities available for sale that are classified as Level 3 are unique in that in most cases the Company owns the entire bond class. As a result, the broker quotes obtained by the Company reflect expected pricing rather than actual trades and may also reflect transactions in inactive markets. Therefore, the Company believes Level 3 is the appropriate classification in the fair value hierarchy for the Company’s available for sale securities.

The table below presents the fair value of the Company’s securities as of March 31, 2012, aggregated by the level in the fair value hierarchy within which those measurements fall.

| | Quoted Prices in Active Markets for Identical Assets and Liabilities (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Balance at March 31,2012 |
|-------------------------------|--|--|--|-----------------------------|
| Assets | | | | |
| Securities available for sale | \$ – | \$ 25,289 | \$ 37,077 | \$ 62,366 |

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CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

A 50 basis point (or 0.50%) change in the discount rate utilized to estimate fair value would result in a change in the fair value of securities that are classified as Level 3 of approximately \$741 as of March 31, 2012.

The following table summarizes the change in the fair value for Level 3 items for the quarters ended March 31, 2012 and March 31, 2011:

| | Three months ended March 31, | |
|---|------------------------------|-----------|
| | 2012 | 2011 |
| Securities available for sale | | |
| Beginning balance | \$ 32,829 | \$ 13,797 |
| Gains (losses) included in net income (loss): | | |
| Included in gains (loss) on investments | — | — |
| Included in interest income | 66 | 78 |
| Gains (losses) included in other comprehensive income | 5,673 | (172) |
| Purchases, sales, issuances and settlements (net) | (1,491) | (7,459) |
| Transfers in (out) of Level 3 | — | — |
| Ending balance | \$ 37,077 | \$ 6,244 |

8. Other Assets

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

| | Mar 31, 2012 | Dec 31, 2011 |
|----------------------------------|--------------|--------------|
| | Unaudited | |
| Receivables and accrued interest | \$ 7,266 | \$ 8,317 |
| Prepaid expenses and deposits | 1,252 | 1,381 |
| Reserve accounts | 26,925 | 17,393 |
| Restricted cash | 170 | 440 |
| Amounts held by servicer | 504 | 431 |
| Accrued rental income | 34,685 | 41,387 |
| Debt issuance costs, net | 3,999 | 3,889 |
| Deferred leasing costs, net | 2,672 | 1,483 |
| Investment in statutory trust | 930 | 930 |
| Other | 634 | 712 |
| Total | \$ 79,037 | \$ 76,363 |

9. Debt Obligations

Credit Agreement

The Company has entered into a credit agreement with Wells Fargo Bank, N.A. (as successor to Wachovia Bank, N.A.) and financed certain of its portfolio assets pursuant to the credit agreement. The Company may also utilize the undrawn amount of the lender's revolving credit commitment to finance assets approved by the lender in its sole discretion at an advance rate of 60% of the asset's value (as determined by the lender).

The credit agreement with Wells Fargo includes the following terms:

Size: maximum revolving credit commitment of \$140,000;

Maturity: maturity date of July 16, 2013; and

Interest Rate: floating rate LIBOR-based facility with interest rate on the Company's borrowings set at one-month LIBOR plus 275 basis points.

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

As of March 31, 2012, the Company's outstanding borrowings under the agreement were \$68,399 and its effective financing rate was 3.6%.

The Company's borrowings under the credit agreement are secured by a combination of first mortgage loan investments, intercompany mortgage loans on owned property investments, commercial mortgage backed securities and a first lien on the Company's ownership interest in the real property located in Johnston, Rhode Island.

The Company's obligations under the credit agreement are also fully recourse to all of its other assets. In the event Wells Fargo determines in its sole discretion that the value of the Company's collateral assets has declined, including as a result of an underlying tenant credit rating downgrade or other adverse tenant-credit event, Wells Fargo may require the Company to prepay a portion of its borrowings, provided that Wells Fargo may not reduce the value of any of the Company's collateral other than CMBS securities due to general credit spread or interest rate fluctuations.

The Company is required to comply with the following financial covenants under the credit agreement:

· minimum liquidity (basically cash and cash equivalents) of at least \$12,000;

· minimum consolidated tangible net worth (basically stockholders' equity before accumulated depreciation and amortization) of at least \$360,000 plus 75% of the aggregate net proceeds from equity offerings or capital contributions after July 16, 2010;

· maximum corporate leverage (basically total liabilities divided by total assets before accumulated depreciation and amortization) of 80%; and

· minimum interest coverage (basically EBITDA, or net income before income taxes, interest expense, and depreciation and amortization, divided by interest expense) of 105%.

As of March 31, 2012, the Company was in compliance with the above financial covenants.

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Amounts related to the Company's credit agreement as of March 31, 2012 and December 31, 2011, were as follows:

| | At March 31, 2012 | | At December 31, 2011 | |
|--|-------------------|---------------------------|----------------------|---------------------------|
| | Borrowings | Collateral Carry Value | Borrowings | Collateral Carry Value |
| | (unaudited) | | (unaudited) | |
| <u>Credit Agreement</u> | | | | |
| Loans held for investment | \$ 1,528 | \$ 4,109 | \$ 1,552 | \$ 4,111 |
| Intercompany mortgage loans on CapLease properties | 64,713 | 91,397 | 66,887 | 94,020 |
| Commercial mortgage-backed securities | 2,158 | 4,105 | 2,230 | 2,533 |
| Owned property | — | 25,164 | — | 25,494 |
| Total | \$ 68,399 | \$ 124,775 | \$ 70,669 | \$ 126,158 |

For the three months ended March 31, 2012 and March 31, 2011, the following interest rates applied with respect to the Company's credit agreement borrowings:

| | For the three months ended March 31, | | | |
|---|---|-------------|-------------|-------------|
| | 2012 | | 2011 | |
| | (unaudited) | (unaudited) | (unaudited) | (unaudited) |
| Weighted average effective financing rate | 3.60 % | 3.42 % | | |
| One-Month LIBOR rate | 0.27 % | 0.26 % | | |

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

Mortgage 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 summarized in the following table:

| Property Level Debt - Fixed Rate | Mar 31, 2012 | | Dec 31, 2011 | | Coupon | Effective Financing Rate (1) | Maturity Date |
|--|------------------------------------|------------------------------------|---------------------|---------------------|--------|------------------------------|---------------|
| | Face Amount of Debt (unaudited) | Carry Value of Debt (unaudited) | Face Amount of Debt | Carry Value of Debt | | | |
| Abbott Laboratories, Columbus, OH | \$- | \$- | \$5,080 | \$ 5,080 | 5.40 % | 6.1 % | Oct 2016 |
| Abbott Laboratories, Waukegan, IL | 14,344 | 14,344 | 14,440 | 14,440 | 5.11 % | 5.2 % | Aug 2015 |
| Aetna Life Insurance Company, Fresno, CA | 16,043 | 16,043 | 16,043 | 16,043 | 5.63 % | 5.7 % | Dec 2016 |
| Allstate Insurance Company, Charlotte, NC | 19,372 | 19,372 | 19,445 | 19,445 | 5.68 % | 5.7 % | Jan 2016 |
| Allstate Insurance Company, Roanoke, VA | 20,625 | 20,625 | 20,702 | 20,702 | 5.68 % | 5.8 % | Jan 2016 |
| AMEC plc, Houston, TX | 16,125 | 16,498 | 16,175 | 16,569 | 5.85 % | 5.3 % | Apr 2016 |
| Aon Corporation, Glenview, IL | 58,843 | 58,843 | 59,274 | 59,274 | 5.23 % | 5.8 % | Nov 2014 |
| Baxter International, Inc., Bloomington, IN | - | - | 4,407 | 4,407 | 5.40 % | 6.1 % | Sep 2016 |
| Bunge North America, Inc., Fort Worth, TX | 6,262 | 6,262 | 6,262 | 6,262 | 5.45 % | 5.5 % | May 2017 |
| Cadbury Holdings Limited, Whippany, NJ | 32,382 | 32,382 | 32,559 | 32,559 | 5.26 % | 5.3 % | Mar 2015 |
| Cadbury Holdings Limited, Whippany, NJ | 1,605 | 1,605 | 1,727 | 1,727 | 5.26 % | 6.5 % | Mar 2015 |
| Capital One Financial Corporation, Plano, TX | 19,201 | 19,201 | 19,344 | 19,344 | 5.24 % | 5.3 % | May 2013 |
| Choice Hotels International, Inc., Silver Spring, MD | 26,336 | 26,336 | 26,708 | 26,708 | 5.30 % | 5.3 % | May 2013 |
| Cooper Tire & Rubber Company, Franklin, IN | 17,606 | 17,606 | 17,690 | 17,690 | 5.54 % | 5.8 % | May 2021 |
| County of Yolo, California, Woodland, CA | 10,332 | 10,332 | 10,332 | 10,332 | 5.68 % | 5.7 % | Feb 2017 |

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| | | | | | | | |
|---|---------|---------|---------|---------|--------|-------|----------|
| Crozer-Keystone Health System, Ridley Park, PA | 2,892 | 2,892 | 2,964 | 2,964 | 5.40 % | 6.0 % | Apr 2019 |
| CVS Corporation, Randolph, MA | 7,521 | 7,521 | 7,601 | 7,601 | 5.40 % | 6.4 % | Jan 2014 |
| Farmers Group, Inc., Simi Valley, CA | 25,620 | 25,620 | 25,620 | 25,620 | 5.81 % | 5.8 % | Jan 2017 |
| Farmers New World Life Insurance Company, Mercer Island, WA | 29,801 | 29,801 | 29,889 | 29,889 | 5.69 % | 5.7 % | Jan 2016 |
| General Motors Financial Company, Inc., Arlington, TX | 26,537 | 26,327 | 26,672 | 26,454 | 5.28 % | 5.5 % | Sep 2017 |
| Invesco Holding Co. Ltd., Denver, CO | 43,700 | 43,700 | 43,700 | 43,700 | 6.03 % | 6.1 % | Jul 2016 |
| ITT Corporation, Herndon, VA | 39,595 | 39,595 | 39,764 | 39,764 | 5.33 % | 5.4 % | Jun 2015 |
| ITT Corporation, Herndon, VA | 2,813 | 2,813 | 2,995 | 2,995 | 5.33 % | 6.4 % | Jun 2015 |
| Johnson Controls, Inc., Largo, FL | 16,200 | 16,200 | 16,200 | 16,200 | 5.48 % | 5.5 % | Jan 2017 |
| Koninklijke Ahold, N.V., Levittown, PA | 13,762 | 13,762 | 13,820 | 13,820 | 6.05 % | 6.1 % | Jul 2016 |
| Lowes Companies, Inc., Aliso Viejo, CA | 41,145 | 41,145 | 41,299 | 41,299 | 5.10 % | 5.4 % | Jul 2015 |
| Lowes Companies, Inc., New Orleans, LA | 8,533 | 9,179 | 8,599 | 9,258 | 5.57 % | 4.7 % | Aug 2030 |
| Lowes Companies, Inc., New Orleans, LA | 7,641 | 8,066 | 7,702 | 8,135 | 5.32 % | 4.7 % | Aug 2030 |
| Lowes Companies, Inc., New Orleans, LA | 430 | 475 | 433 | 479 | 5.93 % | 4.8 % | Aug 2030 |
| Nestle Holdings, Inc., Breinigsville, PA; Fort Wayne, IN; and Lathrop, CA | 117,000 | 117,000 | 117,000 | 117,000 | 6.32 % | 5.7 % | Aug 2012 |
| Omnicom Group, Inc., Irving, TX | 12,391 | 12,391 | 12,472 | 12,472 | 5.24 % | 5.3 % | May 2013 |
| Pearson Plc., Lawrence, KS | 15,563 | 15,563 | 15,616 | 15,616 | 5.84 % | 5.9 % | May 2016 |
| Tiffany & Co., Parsippany, NJ | 57,275 | 57,275 | 57,482 | 57,482 | 5.33 % | 5.3 % | Oct 2015 |
| Time Warner Entertainment Company, L.P., Milwaukee, WI | 17,500 | 17,500 | 17,500 | 17,500 | 5.55 % | 5.6 % | Dec 2016 |
| Time Warner Entertainment Company, L.P., Milwaukee, WI | 2,334 | 2,334 | 2,473 | 2,473 | 5.83 % | 6.8 % | Dec 2015 |
| Time Warner Entertainment Company, L.P., Milwaukee, WI | 2,155 | 2,155 | 2,208 | 2,208 | 6.18 % | 6.8 % | Dec 2016 |
| TJX Companies, Inc., Philadelphia, PA | 68,663 | 68,663 | 68,847 | 68,847 | 5.57 % | 5.6 % | Mar 2016 |
| T-Mobile USA, Inc., Nashville, TN | 10,568 | 10,568 | 10,606 | 10,606 | 5.59 % | 5.7 % | Dec 2016 |
| United States Government (DEA), Birmingham, AL | 10,879 | 10,879 | 10,922 | 10,922 | 5.23 % | 5.4 % | Sep 2015 |
| United States Government (EPA), Kansas City, KS | 19,018 | 19,018 | – | – | 3.23 % | 3.8 % | Mar 2023 |
| | – | – | 18,395 | 20,806 | 7.57 % | 5.3 % | |

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| | | | | | | | | | |
|--|-----------|------------|-----------|------------|--------|-------|---|--|-------------|
| United States Government (EPA), Kansas City, KS | | | | | | | | | Oct 2022 |
| United States Government (FBI), Albany, NY | 10,137 | 10,137 | 10,137 | 10,137 | 5.50 % | 5.7 % | % | | Nov 2016 |
| United States Government (FBI), Birmingham, AL | 18,161 | 18,161 | 18,233 | 18,233 | 5.23 % | 5.3 % | % | | Sep 2015 |
| United States Government (NIH), N. Bethesda, MD | 57,505 | 57,505 | 57,908 | 57,908 | 5.32 % | 5.6 % | % | | Sep 2015 |
| United States Government (SSA), Austin, TX | 5,197 | 5,197 | 5,217 | 5,217 | 5.23 % | 5.5 % | % | | Sep 2015 |
| United States Government (VA), Ponce, PR | 3,893 | 3,977 | 4,062 | 4,154 | 7.30 % | 6.4 % | % | | Apr 2016 |
| Walgreen Co., Portsmouth, VA | 2,438 | 2,536 | 2,481 | 2,584 | 7.20 % | 6.2 % | % | | Jul 2018 |
| Total | \$955,944 | \$ 957,407 | \$969,004 | \$ 972,924 | | | | | |

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

CapLease, Inc. and Subsidiaries

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

March 31, 2012 (unaudited)

During the quarter ended March 31, 2012, the Company repaid at par the outstanding mortgage debt on the properties owned in Columbus, Ohio (leased to Abbott Laboratories) and Bloomington, Indiana (leased to Baxter International, Inc.), and now owns those assets unencumbered, and refinanced the mortgage debt on the property owned in Kansas City, Kansas (leased to the United States Government (EPA)). These transactions resulted in net gain on debt extinguishment of \$2,012, including primarily gain of \$2,392 on the reversal of the remaining unamortized balance of the fair value adjustment on the debt repaid on the EPA property, and losses of \$196 from the charge-off of deferred hedge and other costs associated with the debt repaid on all three properties. The net gain of \$2,012 is included in "Gain on extinguishment of debt, net" in the Company's Consolidated Statement of Operations.

The mortgage notes are non-recourse to the Company subject to limited non-recourse exceptions and are secured by the respective properties and an assignment of the relevant leases on the properties. See Note 3 regarding the separate and distinct nature of the Company's SPEs. The Company's book value before accumulated depreciation and amortization on owned properties encumbered with mortgage debt aggregated \$1,461,105 at March 31, 2012, and \$1,483,528 at December 31, 2011.

Loan Agreement for Tulsa, Oklahoma Development Project

During July 2011, the Company entered into a loan agreement with Bank of Oklahoma to provide construction financing of approximately one-half of the project costs related to the development of the property in Tulsa, Oklahoma for Cimarex Energy Co. See Note 3. Pursuant to the agreement, Bank of Oklahoma has agreed to fund up to \$24,000 of project costs beginning after the Company has funded an aggregate of \$24,000 to the project. During the construction period, interest only will be payable by the Company to the lender each month at a rate equal to the prevailing one month LIBOR rate plus 300 basis points (subject to a 4.00% floor). Upon completion of the project, the construction loan will automatically convert to a term loan of up to \$31,000 bearing interest at a rate equal to the prevailing one month LIBOR rate plus 275 basis points and maturing in July 2018. During the term loan period, in addition to monthly payments of interest, principal will also be payable by the Company to the lender based on a 25-year amortization period. Subject to customary non-recourse exceptions, the lender's recourse in the event of a default of the loan is limited to the property and the other assets of the Company's joint venture entity that owns the property. As of March 31, 2012, the Company had not drawn any amounts under the loan agreement with Bank of Oklahoma.

Secured Term Loan

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

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

Amounts related to the secured term loan as of March 31, 2012, were as follows:

| | Borrowings | Collateral Carry Value |
|--|------------|---------------------------|
| Loans held for investment | \$ 18,279 | \$ 28,104 |
| Intercompany mortgage loans on CapLease properties | 22,770 | 33,691 |
| Commercial mortgage-backed securities | 42,032 | 49,529 |
| Total | \$ 83,081 | \$ 111,324 |

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

Convertible Senior Notes

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

Since original issuance, CapLease has repurchased an aggregate of \$39,991 principal amount of the notes and, therefore, as of March 31, 2012, the Company had \$35,009 principal amount of convertible senior notes outstanding.

As of January 1, 2009, the Company adopted accounting guidance (codified primarily at FASB ASC 470) that retrospectively changed the accounting for the convertible senior notes. The guidance affected the accounting for the Company's convertible senior notes by requiring the initial proceeds from their issuance to be allocated between a liability component and an equity component in a manner that results in interest expense on the liability component at the Company's estimated nonconvertible debt borrowing rate on the date of issue. The liability component is initially recorded at a discount from the principal amount of the notes and is subsequently accreted back to the principal amount over its expected useful life as interest expense at the estimated nonconvertible debt borrowing rate is recorded. The initial bifurcation between the liability and equity components of the convertible senior notes at January 1, 2009, was \$67,761 and \$7,239, respectively.

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

| | Mar 31, 2012 | Dec 31, 2011 |
|--------------------------------|--------------|--------------|
| | (Unaudited) | |
| Convertible notes - principal | \$ 35,009 | \$ 35,009 |
| Unamortized debt discount | (331) | (487) |
| Convertible senior notes - net | \$ 34,678 | \$ 34,522 |

The remaining debt discount is scheduled to be amortized over the next 7 months, ending in October 2012, when the Company may be required to repurchase the outstanding notes at par as described below.

The carry value of the equity component of the convertible senior notes was \$6,189 at each of March 31, 2012 and December 31, 2011, with the decline from the initial bifurcation amount of \$7,239 caused by the Company's repurchase of convertible senior notes at par during 2010.

The notes bear interest at an annual fixed rate of 7.50% and are scheduled to mature on October 1, 2027, unless earlier converted, redeemed or repurchased. The Company's effective financing rate on the notes, which includes the effect of the commissions and other expenses of the transaction, is approximately 8.1%. The Company's effective interest rate on the liability component of the notes as measured under the January 1, 2009 accounting guidance was 10.2% and 10.2%, respectively, at March 31, 2012 and December 31, 2011. The Company recorded interest expense on the convertible senior notes for the three months ended March 31, 2012 and March 31, 2011 as follows:

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

| | For the three months ended March 31, 2012 | 2011 |
|---|---|--------|
| Interest expense paid or accrued at stated interest rate of 7.5% | \$ 657 | \$ 656 |
| Convertible senior notes issuance costs expensed as a component of interest expense | 54 | 49 |
| Interest expense at the nonconvertible debt incremental borrowing rate of 2.5% | 156 | 142 |
| Total convertible senior notes interest expense | \$ 867 | \$ 847 |

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

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

The initial conversion rate for each \$1 principal amount of notes is 88.3704 shares of CapLease's common stock, which is equivalent to an initial conversion price of approximately \$11.32 per share. As of March 31, 2012, the if-converted value of the convertible senior notes does not exceed the principal amount of the notes. The initial conversion rate will be adjusted for certain events, including in the event CapLease makes any quarterly cash dividend in excess of \$0.20 per share.

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

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

Trust Preferred Securities

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

CapLease, Inc. and Subsidiaries

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

March 31, 2012 (unaudited)

Scheduled Principal Payments on Debt Obligations

Scheduled principal amortization and balloon payments for all of the Company's outstanding debt obligations as of March 31, 2012, for the next five years and thereafter are as follows:

| | Scheduled Amortization | Balloon Payments | Total |
|-----------------------------------|---------------------------|---------------------|--------------|
| 9 months ending December 31, 2012 | \$ 25,986 | \$ 152,009 | \$ 177,995 |
| 2013 | 33,326 | 119,954 | 153,279 |
| 2014 | 30,302 | 60,379 | 90,681 |
| 2015 | 26,936 | 255,699 | 282,635 |
| 2016 | 17,623 | 303,544 | 321,167 |
| Thereafter | 39,360 | 108,246 | 147,607 |
| Total | \$ 173,533 | \$ 999,831 | \$ 1,173,364 |

10. Accounts payable and other liabilities

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

| | Mar 31, 2012 Unaudited | Dec 31, 2011 |
|--|---------------------------|--------------|
| Accounts payable and other liabilities | \$ 3,602 | \$ 3,781 |
| Accrued interest | 5,289 | 5,014 |
| Accrued expenses | 2,356 | 4,689 |
| Deferred rental income | 6,397 | 2 |
| Unearned rental income | 4,727 | 3,885 |
| Total | \$ 22,371 | \$ 17,371 |

11. Risk Management Transactions

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

As of March 31, 2012, the Company had \$1,251 of net realized losses on derivatives deferred on the Company's Consolidated Balance Sheet as a component of Accumulated Other Comprehensive Income (Loss) related to prior interest rate swaps for certain of the Company's long-term debt issuances. Within the next twelve months, the Company estimates that \$239 of realized losses on derivatives will be reclassified to the Company's Consolidated Statements of Operations as additional interest expense.

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

12. Commitments and Contingencies

The Company is committed to fund up to \$24,000 of project costs related to the Tulsa, Oklahoma development project described at Note 3 above. As of March 31, 2012, the Company had funded \$13,839 of such commitment.

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

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

As an owner of commercial real estate, the Company is subject to potential environmental costs. At March 31, 2012, the Company was not aware of any environmental concerns that would have a material adverse effect on the Company's business, results of operations or financial condition.

13. Stockholders' Equity

Stock Issuances

CapLease's authorized capital stock consists of 500,000,000 shares of common stock, par value \$0.01 per share, and 100,000,000 shares of preferred stock, par value \$0.01 per share. As of March 31, 2012, CapLease had issued and outstanding 66,766,965 shares of common stock, and 3,204,900 shares of 8.125% Series A cumulative redeemable preferred stock.

During the quarter ended March 31, 2012, CapLease did not issue any shares of common stock or Series A preferred stock through its "at the market offering" program. During the quarter ended March 31, 2011, CapLease issued an aggregate of 14,200 shares of common stock through its "at the market offering" program with Merrill Lynch, Pierce Fenner & Smith Incorporated, at an average price of \$6.00 per share of common stock, and aggregate net proceeds of \$84.

During the quarter ended March 31, 2012, CapLease did not issue any shares of common stock through its dividend reinvestment and stock purchase plan. During the quarter ended March 31, 2011, CapLease issued 27,697 shares of common stock through its dividend reinvestment and stock purchase plan, at a price of \$5.72 per share of common stock, and aggregate net proceeds of \$158.

During March 2012, CapLease issued 497,700 shares of common stock to its executive officers, other employees and directors pursuant to the Company's stock incentive plan. During March 2011, CapLease issued 392,500 shares of common stock to its executive officers, other employees and directors pursuant to the Company's stock incentive plan. As of March 31, 2012, the Company had awarded 4,243,005 shares of common stock under the stock plan, all in the form of stock awards to executive officers, other employees and directors of the Company (see Note 14 below).

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

Share Repurchase Program

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

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

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

Dividends

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

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

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

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

14. Stock Based Compensation

The Company adopted a stock incentive plan for its employees and directors during March 2004 in connection with its initial public offering. 5,123,000 shares of common stock are authorized for issuance under the stock plan. As of March 31, 2012, the Company had awarded 4,243,005 shares of common stock under the stock plan, all in the form of restricted stock awards to executive officers, other employees and directors of the Company. The Company has not awarded any options, stock appreciation rights or other stock based compensation under the stock plan.

CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

A summary of the Company's activity under the stock plan from January 1, 2011 through the three months ended March 31, 2012, is presented below:

| | Number of Shares |
|---|---------------------|
| Stock Awards at January 1, 2011 | 3,369,955 |
| Granted During the Year Ended December 31, 2011 | 392,500 (1) |
| Forfeited During the Year Ended December 31, 2011 | (10,880) |
| Stock Awards at January 1, 2012 | 3,751,575 |
| Granted During the Period Ended March 31, 2012 | 497,700 (2) |
| Forfeited During the Period Ended March 31, 2012 | (6,270) |
| Stock Awards at March 31, 2012 | 4,243,005 |

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

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

A summary of the status of unvested shares from January 1, 2011 through the three months ended March 31, 2012, is presented below:

| | Shares Awarded Under Plan | Shares Priced Under GAAP | Weighted Average Fair Value |
|------------------------------|------------------------------------|-----------------------------|-----------------------------------|
| Nonvested at January 1, 2011 | 1,739,367 | 1,122,282 | \$ 4.62 |
| Current period awards | 392,500 | 261,550 | 5.80 |
| Prior period awards | N/A | 223,635 | 5.80 |
| Vested | (514,970) | (514,970) | 5.14 |
| Forfeited | (10,880) | (10,880) | 3.43 |
| Nonvested at January 1, 2012 | 1,606,017 | 1,081,617 | 4.91 |
| Current period awards | 497,700 | 322,550 | 4.08 |
| Prior period awards | N/A | 257,760 | 4.08 |
| Vested | (526,220) | (526,220) | 5.37 |

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| | | | |
|-----------------------------|-----------|-----------|------|
| Forfeited | (6,270) | (6,270) | 5.80 |
| Nonvested at March 31, 2012 | 1,571,227 | 1,129,437 | 4.25 |

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

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

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Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

As of March 31, 2012, \$4,759 of unvested shares (fair value at the grant dates) is expected to be charged to the Company's Consolidated Statement of Operations ratably over the remaining vesting period (through March 2015) assuming vesting criteria are satisfied. In addition, as of March 31, 2012, the Company has not yet commenced expense accrual related to the following number of share awards because the applicable performance criteria have not yet been determined: 104,715 restricted shares made in 2009, 96,450 restricted shares made in 2010, 65,475 restricted shares made in 2011 and 175,150 restricted shares made in 2012.

15. Other Comprehensive Income (Loss)

Comprehensive income (loss) is defined under GAAP as the change in equity of a business enterprise during a period from transactions and other events and circumstances, excluding those resulting from investments by and distributions to owners, and is presented in the Company's Consolidated Statements of Comprehensive Income (Loss). For the Company's purposes, comprehensive income (loss) represents net income (loss) before non-controlling interest in consolidated subsidiaries, as presented in the Company's Consolidated Statements of Operations, adjusted for unrealized gains or losses on securities available for sale and amortization of unrealized losses on securities previously classified as available for sale, and amortization of realized losses on derivatives reclassified into interest expense.

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

| | Mar 31, 2012 | Dec 31, 2011 |
|--|--------------|--------------|
| | (Unaudited) | |
| Net unrealized losses on securities available for sale | \$ (4,537) | \$ (9,747) |
| Net realized losses on derivatives | (1,251) | (1,304) |
| Accumulated other comprehensive loss | \$ (5,788) | \$ (11,051) |

16. Non-Controlling Interests

During June 2006, CapLease's Operating Partnership issued 263,157 units of limited partnership to an unaffiliated third party. All of these units were issued as partial consideration for the Company's acquisition of a real property in June 2006 from the third party. During June 2008, the units of limited partnership became redeemable by the holder,

at its option, on the basis of one unit for either one share of CapLease common stock or cash equal to the fair market value of a share of common stock at the time of the redemption. The units of limited partnership do not have a liquidation preference. During September 2008, the holder redeemed 107,131 units for the same number of shares of CapLease common stock. As of March 31, 2012, the Operating Partnership had issued and outstanding 156,026 units of limited partnership.

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

17. Rental Income

The Company is the landlord to tenants under operating leases with expiration dates ranging from 2012 to 2030. The minimum rental amounts due under the leases are generally subject to scheduled fixed increases. The leases generally also require that the tenants pay for or reimburse the Company for the occupancy and operating costs of the properties, or in certain cases reimburse the Company for increases in certain operating costs and real estate taxes above their base year costs. Approximate future minimum rents to be received over the next five years and thereafter for non-cancelable operating leases in effect at March 31, 2012, are as follows:

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CapLease, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

March 31, 2012 (unaudited)

| | |
|-----------------------------------|-----------|
| 9 months ending December 31, 2012 | \$85,434 |
| 2013 | 110,315 |
| 2014 | 107,441 |
| 2015 | 105,023 |
| 2016 | 95,973 |
| Thereafter | 321,065 |
| Total | \$825,251 |

18. Segment Reporting

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

Selected results of operations by segment for the three months ended March 31, 2012 and March 31, 2011, are as follows:

| | Corporate / | | Operating | | Debt | |
|--|-------------|----------|-------------|--------------|-------------|--------------|
| | Unallocated | | Real Estate | | Investments | |
| | Mar 31, | Mar 31, | Mar 31, | Mar 31, 2011 | Mar 31, | Mar 31, 2011 |
| | 2012 | 2011 | 2012 | | 2012 | |
| Total revenues | \$ 161 | \$ 147 | \$ 36,964 | \$ 34,833 | \$ 1,861 | \$ 6,263 |
| Total expenses | 5,226 | 4,983 | 33,474 | 32,909 | 949 | 4,325 |
| Other gain (loss) | — | — | 2,012 | — | 709 | (490) |
| Income (loss) from continuing operations | (5,065) | (4,836) | 5,502 | 1,924 | 1,621 | 1,448 |
| Total assets | 64,609 | 62,614 | 1,466,051 | 1,460,992 | 94,803 | 330,321 |

19. Subsequent Events

Issuance of 8.375% Series B Cumulative Redeemable Preferred Stock

On April 19, 2012, CapLease issued and sold in an underwritten public offering 2,000,000 shares of 8.375% Series B Cumulative Redeemable Preferred Stock, \$0.01 par value per share (the "Series B Preferred Stock"). The Company received aggregate net proceeds in the offering of \$48,275, after deducting underwriting discounts and commissions and estimated offering expenses.

The Series B Preferred Stock ranks, with respect to the payment of dividends and the distribution of assets in the event of CapLease's liquidation, dissolution or winding up, senior to CapLease's common stock, \$0.01 par value per share (the "Common Stock"). The Series B Preferred Stock ranks pari passu with CapLease's 8.125% Series A Cumulative Redeemable Preferred Stock, \$0.01 par value per share (the "Series A Preferred Stock") and any other future equity securities that CapLease may later authorize or issue that by their terms are on a parity with the Series B Preferred Stock.

Holder of the Series B Preferred Stock are entitled to receive, when and as authorized by CapLease's Board of Directors and declared by CapLease, out of funds legally available for the payment of dividends, cumulative cash dividends at the rate of 8.375% per annum of the \$25.00 per share liquidation preference, equivalent to \$2.09375 per annum per share. Dividends of the Series B Preferred Stock will be payable quarterly in arrears on or about the 15th day of January, April, July and October of each year, commencing July 16, 2012.

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

March 31, 2012 (unaudited)

In the event of CapLease's liquidation, dissolution or winding up, the holders of the Series B Preferred Stock will be entitled to be paid out of assets legally available for distribution to stockholders (after payment or provision for payment of all debts and other liabilities) liquidating distributions in cash of \$25.00 per share, plus any accumulated and unpaid dividends to, but not including, the date of the payment. Holders of Series B Preferred Stock will be entitled to receive this liquidating distribution before CapLease distributes any assets to holders of its Common Stock or any other shares of stock that rank junior to the Series B Preferred Stock. The rights of holders of Series B Preferred Stock to receive their liquidation preference will be subject to the proportionate rights of each parity stock, including the Series A Preferred Stock, and preferential rights of the holders of any series of shares that are senior to the Series B Preferred Stock.

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

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

the quotient obtained by dividing (1) the sum of the \$25.00 liquidation preference plus the amount of any accumulated and unpaid dividends to the conversion date by (2) the Common Stock Price (as defined below); and

11.9904 (the "Share Cap"), subject to certain adjustments.

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

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

of Series B Preferred Stock, which may result in a holder receiving value that is less than the liquidation preference of the Series B Preferred Stock.

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

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

the acquisition by any person, including any syndicate or group deemed to be a “person” under Section 13(d)(3) of the Exchange Act of beneficial ownership, directly or indirectly, through a purchase, merger or other acquisition transaction or series of purchases, mergers or other acquisition transactions of shares of CapLease entitling that person to exercise more than 50% of the total voting power of all shares of CapLease entitled to vote generally in elections of directors (except that such person will be deemed to have beneficial ownership of all securities that such person has the right to acquire, whether such right is currently exercisable or is exercisable only upon the occurrence of a subsequent condition); and

following the closing of any transaction referred to in the bullet point above, neither CapLease nor the acquiring or surviving entity has a class of common securities (or American Depositary Receipts representing such securities) listed on the New York Stock Exchange (the “NYSE”), the NYSE Amex Equities (the “NYSE Amex”) or the NASDAQ Stock Market (“NASDAQ”), or listed or quoted on an exchange or quotation system that is a successor to the NYSE, the NYSE Amex or NASDAQ.

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March 31, 2012 (unaudited)

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

Lease Extension

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

Agreement to Purchase Real Properties

During May 2012, the Company entered into a purchase and sale agreement to acquire two adjacent office properties for a purchase price of approximately \$46,000. The purchase of the properties is expected to close during the second quarter and is subject to satisfactory completion of the Company’s due diligence and various customary closing conditions.

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

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

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

Overview

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

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

Our tenants are primarily large public companies or their significant operating subsidiaries and governmental entities with investment grade credit ratings, defined as a published senior unsecured credit rating of BBB-/Baa3 or above from one or both of S&P and Moody's. We also imply an investment grade credit rating for tenants that are not publicly rated by S&P or Moody's but (i) are 100% owned by an investment grade parent, (ii) for which we have obtained a private investment grade rating from either S&P or Moody's, (iii) for which we have evaluated the creditworthiness of the tenant and estimated a credit rating that is consistent with an investment grade rating from S&P or Moody's, or (iv) are governmental entity branches or units of another investment grade rated governmental entity.

As a result of lease non-renewals, we have classified three properties as “multi-tenant properties,” as each is no longer leased primarily by a single tenant. As of March 31, 2012, we had an approximately \$1.8 billion investment portfolio, including \$1.7 billion of owned properties and \$0.1 billion of loans and other debt investments.

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

The principal sources of our revenues are rental income on our owned real properties and interest income from our debt investments (loans and securities). In order to grow our revenues, we will be primarily dependent on our ability to add new assets to our portfolio. We are also intensely focused on growing revenues by re-letting vacant space within our portfolio. As of March 31, 2012, the occupancy rate in our owned property portfolio was 96.1% with virtually all of the vacant space being in our office property in Johnston, Rhode Island and one of the two office buildings in Omaha, Nebraska. We cannot provide any assurance as to when and on what terms we will be able to re-let properties that are or may become vacant in our portfolio.

The principal sources of our expenses are interest expense on our assets financed, depreciation expense on our real properties, general and administrative expenses and property expenses (net of expense recoveries). With the exception of our credit agreement with Wells Fargo Bank, all of our outstanding debt is currently fixed rate and, therefore, the interest expense we pay is not subject to fluctuation based on changes in market interest rates. Our credit agreement with Wells Fargo Bank is floating rate debt and, therefore, the interest expense we pay is expected to increase if interest rates, in particular the one-month LIBOR rate, increase.

The average remaining lease term on our owned properties is approximately 7 years, although we have some leases that are scheduled to mature over the next few years. We are subject to the risk that our tenants do not renew their leases at maturity and that we are unable to promptly re-let the property, or that the terms of renewal or re-letting may be less favorable to us than the current lease terms, any of which could result in a reduction in our revenues and an increase in our property operating costs.

We rely on leverage to allow us to invest in a greater number of assets and enhance our asset returns. Our overall portfolio leverage, expressed as a percentage of our total debt to our total assets before depreciation and amortization on owned properties and with other minor adjustments, was approximately 64% as of March 31, 2012. Our leverage ratios by segment as of March 31, 2012 were approximately 62% for the owned properties segment and 68% for the debt investments segment. See “Liquidity and Capital Resources—Leverage” below for information about our use of leverage ratios and how we compute them.

During 2011, we continued to grow our portfolio with approximately \$110 million of new investment transactions. We also reduced debt obligations by \$258 million, primarily through the sale of the mortgage assets and associated liabilities comprising our collateralized debt obligation, and brought down our leverage level by 600 basis points. During 2012, we expect to continue our portfolio growth momentum and continue to reduce our leverage.

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

Our portfolio financing strategy is to finance our assets with long-term fixed rate debt as soon as practicable after we invest, generally on a secured, non-recourse basis. Through non-recourse debt, we seek to limit the overall company exposure in the event we default on the debt to the amount we have invested in the asset or assets financed. We also had \$134.0 million of recourse debt obligations outstanding as of March 31, 2012, including \$68.4 million outstanding under our credit agreement with Wells Fargo Bank which is scheduled to mature in July 2013. We also hold certain assets unencumbered by debt which provides us with another source of available liquidity.

We will be required to repay or refinance our debt obligations at maturity, which we expect, although cannot provide any assurance, that we will be able to do. To the extent we are unable to refinance debt obligations, we may rely on a combination of cash on hand, cash from asset sales, and cash from future debt or equity capital raises to fund the liquidity needed to repay the obligations. Our ability to refinance debt, sell assets and/or raise capital on favorable terms will be highly dependent upon prevailing market conditions. We have two debt obligations scheduled to mature or potentially come due during 2012, comprised of \$117 million of non-recourse mortgage notes on our three Nestlé properties maturing in August and \$35 million of convertible senior notes that may be put to us by the holders in October.

Business Environment

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

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

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

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

Application of Critical Accounting Policies

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

Investment and Financing Activities

We did not make any real estate acquisitions during the quarter ended March 31, 2012 except that we continued to fund the construction of the office building for Cimarex Energy Co. described at Note 3 of the consolidated financial statements included in this Form 10-Q.

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

During January 2012, we refinanced the real property we own in Kansas City, Kansas and leased to the United States Government (EPA) through a \$19.2 million original principal balance fully-amortizing non-recourse mortgage note with a coupon of 3.23% and maturing in March 2023. During January 2012, we also repaid the outstanding mortgage debt on the properties we own in Columbus, Ohio (leased to Abbott Laboratories) and Bloomington, Indiana (leased to Baxter International, Inc.) and we now own those assets unencumbered.

Business Segments

We conduct our business through two operating segments:

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

Selected results of operations by segment for the three months ended March 31, 2012 and March 31, 2011, are as follows (dollar amounts in thousands):

| | Corporate / Unallocated | | Operating Real Estate | | Debt Investments | |
|--|----------------------------|-----------------|--------------------------|--------------|---------------------|--------------|
| | Mar 31, 2012 | Mar 31, 2011 | Mar 31, 2012 | Mar 31, 2011 | Mar 31, 2012 | Mar 31, 2011 |
| Total revenues | \$ 161 | \$ 147 | \$ 36,964 | \$ 34,833 | \$ 1,861 | \$ 6,263 |
| Total expenses | 5,226 | 4,983 | 33,474 | 32,909 | 949 | 4,325 |
| Other gain (loss) | – | – | 2,012 | – | 709 | (490) |
| Income (loss) from continuing operations | (5,065) | (4,835) | 5,502 | 1,924 | 1,621 | 1,448 |
| Total assets | 64,609 | 62,614 | 1,466,051 | 1,460,992 | 94,803 | 330,321 |

Comparison of the Quarter Ended March 31, 2012 to the Quarter Ended March 31, 2011

The following discussion compares our operating results for the quarter ended March 31, 2012 to the comparable period in 2011.

Revenue.

Total revenue decreased \$2.3 million, or 5%, to \$39.0 million. The decrease was primarily attributable to a decrease in interest income, offset in part by an increase in rental revenue and tenant reimbursements.

Rental revenue and tenant reimbursements, in the aggregate, increased \$2.3 million, or 7%, to \$36.8 million, primarily reflecting the addition of the property leased to Michelin North America, Inc. in May 2011, the property leased to a subsidiary of AMEC plc in June 2011, and the property leased to a subsidiary of Lowe's Companies, Inc. in November 2011.

Interest income decreased \$4.4 million, or 69%, to \$2.0 million, primarily as a result of lower balances on debt investments, including as a result of the CDO sale on September 1, 2011.

Expenses.

Total expenses decreased \$2.4 million to \$39.6 million, primarily as a result of lower interest expense, offset in part by an increase in depreciation expense.

Interest expense decreased \$3.1 million, or 15%, to \$17.0 million, from \$20.0 million. The decrease in the 2012 period resulted primarily from no interest expense on collateralized debt obligations (CDO) during the 2012 period due to the sale of the CDO on September 1, 2011. Adjusted to exclude the \$3.5 million of CDO interest expense in the 2011 period, interest expense increased \$0.5 million, primarily driven by \$0.9 million of additional interest expense on property mortgages, partially offset by \$0.2 million of reduced interest expense on the secured term loan and \$0.2 million of reduced interest expense on the Wells Fargo Bank credit agreement (in each case driven by lower amounts borrowed). The increase in interest expense on property mortgages was driven by new mortgages on three recent property acquisitions: properties leased to Cooper Tire & Rubber Company, AMEC plc and Lowe's Companies, Inc. Our average balance outstanding and effective financing rate under the Wells Fargo Bank floating rate credit agreement was approximately \$69 million at 3.60% during the 2012 period (average one-month LIBOR of 0.27%), compared with approximately \$104 million at 3.42% during the 2011 period (average one-month LIBOR of 0.26%).

Property expenses decreased slightly by \$0.1 million, or 2%, to \$6.8 million. The net amount of property expenses we incurred (net of tenant reimbursements) was \$3.0 million in the 2012 period, down from \$3.5 million in the 2011 period, primarily due to the timing of certain tenant reimbursements.

General and administrative expense increased \$0.2 million, or 7%, to \$3.0 million, primarily due to the timing of certain expense items.

General and administrative expense-stock based compensation increased 5%, to \$0.7 million. The increase was primarily a result of a shorter amortization period for the more recent share grants issued in March 2011 and 2012 (three year vesting period for the more recent grants, compared to a five year vesting period for the grants made prior to 2011). As of March 31, 2012, \$4.8 million of unvested shares (fair value at the grant dates) is expected to be charged to our Consolidated Statement of Operations ratably over the remaining vesting period (through March 2015) assuming vesting criteria are satisfied. As of March 31, 2012, we have not yet commenced expense accrual related to the following number of share awards because the applicable performance criteria have not yet been determined: 104,715 restricted shares made in 2009, 96,450 restricted shares made in 2010, 65,475 restricted shares made in 2011 and 175,150 restricted shares made in 2012.

Depreciation and amortization expense on real property increased \$0.4 million, or 4%, from \$11.7 million to \$12.1 million, primarily reflecting the addition of the property leased to Michelin North America, Inc. in May 2011, and the

property leased to a subsidiary of AMEC plc in June 2011, and the property leased to a subsidiary of Lowe's Companies, Inc. in November 2011.

Other gains (losses).

We had gain on investments of \$0.7 million in the 2012 period, comprised of the net proceeds from the franchise lending venture (see Note 4 of the consolidated financial statements included in this Form 10-Q). We had loss on investments of \$0.5 million in the 2011 period, comprised of losses on two securities sold (see Note 6 of the consolidated financial statements included in this Form 10-Q).

We had \$2.0 million of net gain on extinguishment of debt during the 2012 period, primarily representing the reversal of the unamortized fair value adjustment on a mortgage debt obligation that was refinanced during the quarter (see Note 9 of the consolidated financial statements included in this Form 10-Q).

Net income (loss).

Net income (loss) increased \$3.6 million, to \$2.1 million, from \$(1.5) million, primarily as a result of the net impact of other gains (losses) between the periods. Net loss allocable to common stockholders was \$0.4 million in the first quarter of 2012, reflecting dividends to preferred stockholders of \$1.6 million.

Funds from Operations

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

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

The following table reconciles our net income (loss) allocable to common stockholders to FFO for the three months ended March 31, 2012 and March 31, 2011.

| (Amounts in thousands, except per share amounts) | For the Three Months Ended March 31, | |
|--|---|-------------|
| | 2012 | 2011 |
| Net income (loss) allocable to common stockholders | \$ 430 | \$ (3,133) |
| Add (deduct): | | |
| Non-controlling interest in consolidated subsidiaries | 1 | (9) |
| Depreciation and amortization expense on real property | 12,144 | 11,717 |
| Depreciation and amortization expense on discontinued operations | – | 613 |
| Funds from operations | \$ 12,575 | \$ 9,188 |
| Weighted average number of common shares outstanding, basic and diluted | 66,313 | 57,537 |
| Weighted average number of OP units outstanding | 156 | 156 |
| Weighted average number of common shares and OP units outstanding, diluted | 66,469 | 57,693 |
| Net income (loss) per common share, basic and diluted | \$ 0.01 | \$ (0.05) |
| Funds from operations per share | \$ 0.19 | \$ 0.16 |

Liquidity and Capital Resources

Short-Term Liquidity

We define our short-term liquidity as our ability to generate adequate amounts of cash to meet day-to-day operating expenses and material cash commitments over the next twelve months. Our primary sources of short-term liquidity are available cash and cash equivalents, cash provided by operations, and a portion of the cash proceeds from issuances of debt and equity capital. We may also use revolving loan borrowings under our credit agreement with Wells Fargo Bank to finance, likely on a short-term basis, a portion of our new investment activity. As of March 31, 2012, we had \$57.4 million in available cash and cash equivalents. As of May 8, 2012, we had \$98.0 million in available cash and cash equivalents. We believe that our sources of short-term liquidity will be sufficient to enable us to satisfy our short-term liquidity requirements, including the payment of our dividend.

As a REIT, we are required to distribute at least 90% of our taxable income to our stockholders on an annual basis, and we intend to distribute all or substantially all of our REIT taxable income in order to comply with the distribution requirements of the Code and to avoid federal income tax and the nondeductible excise tax. We declared a cash dividend of \$0.065 per share of common stock during the quarter ended March 31, 2012. We also declared a cash dividend of \$0.5078125 per share of 8.125% Series A cumulative redeemable preferred stock during the quarter ended March 31, 2012. Our dividend policy is subject to revision at the discretion of our Board of Directors. All distributions will be made at the discretion of our Board of Directors and will depend on our cash available for distribution, our funds from operations, our maintenance of REIT status, market conditions and such other factors as our Board of Directors deems relevant.

While we believe we will be able to satisfy our short-term liquidity requirements, the following are the primary factors that we believe could have a material adverse effect on our plans:

· payment defaults on our assets which we expect could be triggered primarily in the event of the bankruptcy of the underlying tenant or tenants;

· unexpected capital expenditures on our owned properties;

· margin calls on our Wells Fargo Bank credit agreement; or

· margin calls on any future risk management transactions.

Long-Term Liquidity

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

Our primary long-term liquidity requirement is repayment of our debt obligations. We intend generally to manage our debt maturities by refinancing or repaying the related debt at maturity. We expect to utilize a combination of (i) cash on hand, (ii) cash from sales of assets which may include the collateral for the debt, and (iii) cash from future debt or equity capital raises, to fund any liquidity needed to satisfy these obligations. These actions, however, may not enable us to generate sufficient liquidity to satisfy our borrowings and, therefore, we cannot provide any assurance we will be able to refinance or repay our debt obligations as they come due. Our ability to refinance debt, sell assets and/or raise capital on favorable terms will be highly dependent upon prevailing market conditions. See “Item 1A—Risk Factors—Our use of debt financing could have a material adverse effect on our financial condition.” in our most recent Annual Report on Form 10-K.

We have two recourse debt obligations that are scheduled to mature or potentially come due over the next 15 months. Our convertible senior notes can be put to us at the option of the note holders for a repurchase price of 100% of the principal amount of the notes in October 2012 and our credit agreement with Wells Fargo Bank is scheduled to mature in July 2013. See Note 9 of the consolidated financial statements included in this Form 10-Q. The convertible senior

notes are unsecured obligations and the credit agreement with Wells Fargo Bank is a secured borrowing agreement. With respect to the convertible notes, we have through various repurchase transactions reduced the principal amount of notes outstanding to \$35.0 million as of March 31, 2012 (from \$75 million at original issuance in October 2007). To the extent the notes are put to us in October, we intend to repay that obligation. With respect to the Wells Fargo Bank credit agreement, the principal amount of the debt is scheduled to decline modestly over time until maturity as we receive principal payments on the assets financed and apply a portion of that principal to the outstanding debt. We intend to repay or refinance (which may include extending) our borrowings under the credit agreement at or prior to the maturity date in July 2013.

While we believe we will be successful in either refinancing or repaying these obligations at or prior to maturity, we cannot provide any assurance we will be able to do so. If we are unsuccessful in refinancin