CapLease, Inc.
Form 10-Q
November 08, 2011

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

OR

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

For the transition period from ____________ to _____________

Commission file number 001-32039

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

Maryland (State or Other Jurisdiction of Incorporation or Organization)	52-2414533 (I.R.S. Employer Identification No.)
1065 Avenue of the Americas, New York, NY (Address of Principal Executive Offices)	10018 (ZIP Code)
Registrant’s Telephone Number, Including Area Code:	(212) 217-6300

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during

the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files).
Yes x No ¨

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

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

As of November 7, 2011, there were 66,309,317 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 September 30, 2011 (unaudited) and December 31, 2010

(Amounts in thousands, except share and per share amounts)	As Of September 30, 2011	As Of December 31, 2010
Assets		
Real estate investments, net	$ 1,381,683	$ 1,398,399
Loans held for investment, net	34,612	210,040
Commercial mortgage-backed securities	60,969	145,965
Cash and cash equivalents	92,333	32,742
Other assets	77,249	83,125
Total Assets	$ 1,646,846	$ 1,870,271
Liabilities and Equity		
Mortgages on real estate investments	$ 978,783	$ 928,429
Collateralized debt obligations	–	254,210
Credit agreement	71,487	105,345
Secured term loan	91,350	101,880
Convertible senior notes	34,366	33,926
Other long-term debt	30,930	30,930
Total Debt Obligations	1,206,916	1,454,720
Intangible liabilities on real estate investments	35,765	37,405
Accounts payable and other liabilities	22,184	21,134
Dividends and distributions payable	5,958	5,373
Total Liabilities	1,270,823	1,518,632
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.01 par value, 100,000,000 shares authorized, Series A cumulative redeemable preferred, liquidation preference $25.00 per share, 3,204,900 shares issued and outstanding	73,880	73,880
Common stock, $0.01 par value, 500,000,000 shares authorized, 66,472,338 and 57,471,268 shares issued and outstanding, respectively	666	576
Additional paid in capital	311,323	296,232
Accumulated other comprehensive loss	(10,927)	(20,216)
Total Stockholders' Equity	374,942	350,472
Non-controlling interest in consolidated subsidiaries	1,081	1,167
Total Equity	376,023	351,639
Total Liabilities and Equity	$ 1,646,846	$ 1,870,271

See notes to consolidated financial statements.

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

(Amounts in thousands, except per share amounts)	For the Three Months Ended September 30, 2011	2010	For the Nine Months Ended September 30, 2011	2010
Revenues:				
Rental revenue	$33,288	$31,204	$98,080	$94,133
Interest income from loans and securities	4,774	6,888	17,385	20,902
Tenant reimbursements	3,574	2,982	10,072	8,775
Other revenue	156	218	601	645
Total revenues	41,792	41,292	126,138	124,455
Expenses:				
Interest expense	19,511	20,990	60,340	63,974
Property expenses	6,990	6,189	20,295	18,486
General and administrative expenses	2,559	2,462	8,064	7,899
General and administrative expenses-stock based compensation	796	662	2,264	1,879
Depreciation and amortization expense on real property	12,600	12,101	37,307	36,194
Other expenses	38	67	167	201
Total expenses	42,494	42,471	128,437	128,633
Other gains (losses):				
Gain on investments, net	5,287	–	2,074	–
Provision for loss on property investment	(14,119)	–	(14,119)	–
Loss on extinguishment of debt	(3,698)	(14)	(3,698)	(293)
Total other gains (losses)	(12,530)	(14)	(15,743)	(293)
Loss from continuing operations	(13,232)	(1,193)	(18,042)	(4,471)
Income from discontinued operations	26	32	82	121
Net loss before non-controlling interest in consolidated subsidiaries	(13,206)	(1,161)	(17,960)	(4,350)
Non-controlling interest in consolidated subsidiaries	36	8	55	23
Net loss	(13,170)	(1,153)	(17,905)	(4,327)
Dividends allocable to preferred shares	(1,627)	(1,625)	(4,882)	(3,992)
Net loss allocable to common stockholders	$(14,797)	$(2,778)	$(22,787)	$(8,319)
Earnings per share:				
Net loss per common share, basic and diluted	$(0.22)	$(0.05)	$(0.35)	$(0.15)
Weighted average number of common shares outstanding, basic and diluted	67,615	57,185	64,238	55,822
Dividends declared per common share	$0.07	$0.06	$0.20	$0.18
Dividends declared per preferred share	$0.51	$0.51	$1.52	$1.52

See notes to consolidated financial statements.

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

	Stockholders' Equity					
	Preferred Stock	Common Stock at Par	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Non-controlling Interest	Total Equity
Balance at December 31, 2010	$73,880	$576	$296,232	$ (20,216)	$ 1,167	$351,639
Incentive stock plan compensation expense	–	–	2,264	–	–	2,264
Incentive stock plan grants issued and forfeited	–	4	(4)	–	–	–
Net loss	–	–	(17,905)	–	–	(17,905)
Non-controlling interest in consolidated subsidiaries	–	–	–	–	(55)	(55)
Issuance of common stock	–	102	54,167	–	–	54,269
Repurchase of common stock	–	(16)	(6,039)	–	–	(6,055)
Dividends declared-preferred	–	–	(4,882)	–	–	(4,882)
Dividends declared-common	–	–	(12,510)	–	–	(12,510)
Distributions declared-operating partnership units	–	–	–	–	(31)	(31)
Amortization of unrealized loss on securities previously classified as available for sale	–	–	–	150	–	150
Increase in fair value of securities available for sale	–	–	–	5,595	–	5,595
Reclassification of derivative items into earnings	–	–	–	3,544	–	3,544
Balance at September 30, 2011	$73,880	$666	$311,323	$ (10,927)	$ 1,081	$376,023

See notes to consolidated financial statements.

CapLease, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)
(in thousands)

	For the Nine Months Ended September 30, 2011	2010
Operating activities		
Net loss	$(17,905)	$(4,327)
Adjustments to reconcile net loss to cash provided by operating activities:		
Depreciation and amortization	37,240	36,317
Stock based compensation	2,264	1,879
Amortization of above and below market leases	1,258	1,247
Gain on investments, net	(2,074)	–
Provision for loss on property investment	14,119	–
Loss on extinguishment of debt	3,698	293
Loss attributable to non-controlling interest in consolidated subsidiaries	(55)	(23)
Straight-lining of rents	3,271	1,371
Amortization of discounts/premiums, and origination fees/costs, net	(419)	(417)
Amortization of debt issuance costs, leasing commissions and fair market value of debt issued or assumed	1,789	2,188
Changes in operating assets and liabilities:		
Other assets	(4,434)	(1,540)
Accounts payable and other liabilities	614	483
Deposits and escrows	45	1
Net cash provided by operating activities	39,411	37,472
Investing activities		
Proceeds from sale or prepayments of loans	86,946	–
Principal received from borrowers	8,525	8,274
Proceeds from sale of securities	31,285	–
Repayments of commercial mortgage-backed securities	3,409	2,664
Proceeds from sale of real estate investments	5,171	3,410
Purchases of real estate investments	(9,576)	(951)
Real estate improvements, additions and construction in progress	(14,386)	(2,636)
Proceeds from sale of CDO, net of liabilities assumed	22,273	–
Leasing commission costs	(118)	(1,070)
Deposits on potential equity investments	(600)	(50)
Return of deposits on potential equity investments	550	50
Purchases of furniture, fixtures, equipment and leasehold improvements	(11)	(29)
Net cash provided by investing activities	133,468	9,662
Financing activities		
Borrowings from mortgages on real estate investments	19,318	1,296
Repayments of mortgages on real estate investments	(15,653)	(11,151)
Funds held by trustee of CDO pending distribution	3,757	(218)
Repayments of collateralized debt obligations	(105,266)	(6,835)
Collateralized debt obligations repurchased	(1,605)	–
Repayments on credit agreement	(33,858)	(33,170)
Repayments on secured term loan	(10,530)	(9,288)

Convertible senior notes repurchased	–	(17,335)
Debt issuance costs	(829)	(804)
Common stock issued, net of offering costs	54,269	23,459
Common stock repurchased	(6,055)	–
Preferred stock issued, net of offering costs	–	40,118
Distributions to non-controlling interest	(30)	(28)
Dividends paid on common and preferred stock	(16,806)	(13,926)
Net cash used in financing activities	(113,288)	(27,882)
Net increase in cash and cash equivalents	59,591	19,252
Cash and cash equivalents at beginning of period	32,742	38,546
Cash and cash equivalents at end of period	$92,333	$57,798

See notes to consolidated financial statements.

CapLease, Inc. and Subsidiaries
Consolidated Statements of Cash Flows – continued
(Unaudited)
(in thousands)

	For the Nine Months Ended September 30,	
	2011	2010
Supplemental disclosure of cash flow information		
Cash paid for interest expense	$58,580	$60,253
Cash paid for income taxes	–	200
Distributions declared but not paid	10	10
Dividends declared but not paid	5,948	5,056
Supplemental disclosure of noncash operating, investing and financing information		
Mortgage notes payable assumed on properties acquired	$16,706	$–
Collateralized debt obligations transferred on sale (notional)	152,950	–
Collateralized debt obligations reclassified to mortgages on real estate investments (notional)	30,718	–
Collateralized debt obligations reclassified to commercial mortgage-backed securities (fair value)	4,903	–

See notes to consolidated financial statements.

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

September 30, 2011 (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 the third quarter of 2011 as a result of the Company's sale of the assets and associated liabilities comprising its collateralized debt obligation. See Notes 4, 5 and 9. 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.

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, 2010 and notes thereto, included in the Company's Form 10-K filed with the SEC on February 18, 2011.

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 CapLease and its majority-owned subsidiaries. Results of operations of properties acquired are included in the

Consolidated Statements of Operations from the date of acquisition. All significant intercompany transactions, balances and accounts have been eliminated in consolidation.

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

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

September 30, 2011 (unaudited)

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 has allocated the purchase price of its owned properties to the following based on estimated fair values on the acquisition date: land (no depreciation), building and improvements (depreciated over periods not exceeding 40 years), above-market leases (amortized as a reduction of base rental revenue over the remaining term of the respective lease), below-market leases (amortized as an increase to base rental revenue over the remaining initial term plus the term of any below-market renewal options of the respective lease), and in-place leases (amortized as a component of depreciation and amortization expense over the remaining initial term of the respective lease). 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.

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. The Company recognized impairment losses of $14,119 on one long-lived asset located in Hartford, Connecticut during the three and nine months ended September 30, 2011. See Note 3. The Company did not recognize any impairment losses on long-lived assets during the three and nine months ended September 30, 2010.

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.

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. As of September 30, 2011, the Company has not classified any of its loans as held for sale.

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

September 30, 2011 (unaudited)

The Company evaluates its loan investments for possible impairment on a quarterly basis. The Company's impairment analysis includes both a general reserve component and an asset-specific component. The general reserve component covers performing loans and in accordance with relevant accounting guidance an allowance for loan losses is recorded when (i) available information as of each balance sheet date indicates that it is probable a loss has occurred in the portfolio and (ii) the amount of the loss can be reasonably estimated. Actual loan losses are then charged against the allowance when management believes that uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Significant judgment is required in determining reserve balances for the performing loan portfolio, including estimates of the likelihood of default and lease rejection given the credit characteristics of the tenant, and estimates of stressed collateral values and potential bankruptcy claim recoveries. These estimates are highly subjective and could differ materially from actual results. As of September 30, 2011, the Company has a general loan loss reserve of $500. See Note 4.

The asset-specific component of the loan loss impairment analysis relates to specific loans where the Company has deemed it probable that it will not be able to collect all amounts due according to the contractual terms of the loan. Any resulting loan specific loss is measured based on the present value of expected future cash flows from the loan or the fair value of the loan collateral, if the loan is collateral dependent. Significant judgment is required in determining any resulting loan specific loss, including factors such as the status of the loans (i.e., current or actual or expected payment or other defaults), the credit quality of the underlying tenants, the present value of expected future cash flows on the loans, the fair value of any collateral, and the amount and status of any senior debt. These estimates are highly subjective and could differ materially from actual results. The Company's accounting policy is to continue to accrue interest income on specific impaired loans as long as it concludes it is likely to collect it. As of September 30, 2011, the Company did not have any asset-specific loan loss reserves.

Commercial Mortgage-Backed Securities

GAAP defines two classifications that are relevant with respect to the Company's historical accounting for its securities investments:

- "Held to maturity" are those securities that the Company has the positive intent and ability to hold until maturity.

- "Available for sale" are those securities that the Company does not hold for the purpose of selling in the near-term, but may dispose of prior to maturity.

As of December 31, 2010, the Company classified its securities investments that are financed in its March 2005 collateralized debt obligation, or CDO, or in the December 2007 secured term loan transaction discussed at Note 9, as "held to maturity," and all of the Company's other securities investments, including those financed within the credit agreement discussed at Note 9, were classified as "available for sale."

During the second quarter 2011, the Company reclassified all of its securities investments that are financed in its March 2005 CDO or in the December 2007 secured term loan transaction discussed at Note 9, to "available for sale." As a result, all of the Company's securities investments are now classified as "available for sale." The Company's decision to reclassify such securities was based on its judgment that as a result of a variety of factors it is possible that the Company would execute on a sale of such securities prior to maturity.

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. Securities classified as "held to maturity" are carried on the Company's Consolidated Balance Sheet at estimated fair value on the date of transfer to such classification. Securities transferred into the available for sale classification from the held to maturity classification are transferred at fair value, and the unrealized gain or loss at the date of transfer is included in Accumulated Other Comprehensive Income (Loss).

Securities investments in the Company's CDO transaction reduced the amount of debt the Company had outstanding in such transaction until the CDO was sold during September 2011. Upon the CDO sale, the securities were classified as "available for sale" and initially recorded at fair value on the date of the sale.

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

September 30, 2011 (unaudited)

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 $48 of other-than-temporary impairment losses on securities charged to the Statement of Operations during the three and nine months ended September 30, 2011. See Note 5. The Company had no other-than-temporary impairment losses on securities charged to the Statement of Operations during the three and nine months ended September 30, 2010.

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.

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.

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

September 30, 2011 (unaudited)

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 derivates 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.

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.

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Income Taxes

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

Earnings per Share

As required by GAAP, the Company presents both basic and diluted earnings per share ("EPS"). Basic EPS excludes dilution and is computed by dividing net income (loss) allocable to common stockholders by the weighted average number of shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock, where such exercise or conversion would result in a lower EPS amount. The Company's computation of diluted earnings per share does not include shares of common stock that may be issued in the future upon conversion of the convertible senior notes issued in October 2007, as the impact would not be dilutive. The number of weighted average common shares not included was 3,093,759 for each of the three and nine months ended September 30, 2011, and 3,154,408 and 3,835,804, respectively, for the three and nine months ended September 30, 2010.

The following summarizes the Company's EPS computations for the three and nine months ended September 30, 2011 and September 30, 2010 (in thousands, except per share amounts):

	For the three months ended September 30,		For the nine months ended September 30,	
	2011	2010	2011	2010
Net loss allocable to common stockholders	$ (14,797)	$ (2,778)	$ (22,787)	$ (8,319)
Weighted average number of common shares outstanding, basic and diluted	67,615	57,185	64,238	55,822
Loss per share, basic and diluted	$ (0.22)	$ (0.05)	$ (0.35)	$ (0.15)
Non-vested shares included in weighted average number of shares outstanding above	1,617	1,739	1,617	1,739

Recently Issued Accounting Pronouncements

In July 2010, the Financial Accounting Standards Board ("FASB") issued new accounting guidance ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, which amends various sections of FASB Accounting Codification Statement ("ASC") 310-10 and outlines specific disclosures that will be required for the allowance for credit losses and all finance receivables. Finance receivables includes loans, lease receivables and other arrangements with a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset on an entity's statement of financial position. The amendment requires companies to provide disaggregated levels of disclosure by portfolio segment and class to enable users of the financial statement to understand the nature of credit risk, how the risk is analyzed in determining the related allowance for credit losses and changes to the allowance during the reporting period. The required disclosures under this amendment as of the end of a reporting period are effective for the Company's December 31, 2010 reporting period and disclosures regarding activities during a reporting period are effective for the Company's March 31, 2011 interim reporting period. The Company’s adoption of this ASU did not have a material effect on the Company’s consolidated financial statements.

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In May 2011, the 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 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 is currently evaluating the potential impact of adopting this guidance 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 believes the adoption of this guidance concerns disclosure only and will not have a material impact on the Company’s consolidated financial statements.

Reclassifications

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

3. Real Estate Investments

Real estate held for investment and related intangible liabilities on real estate investments consisted of the following at September 30, 2011 and December 31, 2010:

	Sep 30, 2011 Unaudited	Dec 31, 2010
Real estate investments:		
Land	$ 193,184	$ 190,521

Building and improvements		1,291,120		1,268,320
Construction in progress, land		845		951
Construction in progress, building and improvements		3,040		5,557
Intangible assets		183,382		183,543
Less: Accumulated depreciation and amortization		(289,888)		(250,493)
Real estate investments, net	$	1,381,683	$	1,398,399
Intangible liabilities on real estate investments:				
Intangible liabilities	$	47,908	$	47,908
Less: Accumulated amortization		(12,143)		(10,503)
Intangible liabilities on real estate investments, net	$	35,765	$	37,405

Except for the development project described below, the Company did not make any real estate acquisitions during the quarter ended September 30, 2011. During the quarter ended September 30, 2010, the Company did not make any real estate acquisitions except that it commenced funding the development of a warehouse/distribution building for Michelin North America, Inc., which project was subsequently completed and the tenant commenced paying rent during the second quarter of 2011.

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During September 2011, the Company entered into a purchase and sale agreement to acquire a retail property for a purchase price of approximately $30,000. The property is leased for a remaining lease term of approximately 19 years to a subsidiary of Lowe's Companies Inc. who has guaranteed all of the tenant's obligations under the lease. The closing of the purchase of the property is scheduled for November 2011 and is subject to satisfactory completion of the Company's due diligence and various customary closing conditions.

The Company sold two small owned property investments during the quarter ended September 30, 2011. See Note 6.

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 a project budget of $51,837. 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 September 30, 2011. The information included in the table below represents management's estimates and expectations at September 30, 2011 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 Termin (years)(1)	Construction Progress at 9/30/11	Estimated Remaining Funding(2)	Estimated Total Investment(3)	Estimated Completion Date
Tulsa, Oklahoma	Cimarex Energy Co.	Office Building	324,000	12	$ 3,409	$ 51,591	$ 55,000	Q1 2013

(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.

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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 September 30, 2011 and December 31, 2010, were as follows:

	Sep 30, 2011 Unaudited	Dec 31, 2010
Accrued Rental Income	$ 36,617	$ 39,506
Deferred Rental Income	389	-

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 and nine months ended September 30, 2011 and September 30, 2010, were as follows:

	For the three months ended September 30,		For the nine months ended September 30,	
	2011	2010	2011	2010
Depreciation on real estate (included in depreciation and amortization expense)	$ 8,426	$ 8,024	$ 24,809	$ 24,054
Amortization of in-place leases (included in depreciation and amortization expense)	4,055	3,992	12,173	11,977
Amortization of above-market leases (included as a reduction of rental revenue)	966	962	2,898	2,887
Amortization of below-market leases (included as an increase to rental revenue)	547	547	1,640	1,640

As of September 30, 2011, the Company’s weighted average amortization period on intangible assets was 7.4 years, and the weighted average amortization period on intangible liabilities was 25.7 years.

Scheduled amortization on existing intangible assets and liabilities on real estate investments as of September 30, 2011 was as follows:

	Intangible Assets	Intangible Liabilities
2011	$ 4,310	$ 547
2012	14,959	2,186
2013	9,286	2,051
2014	8,929	1,954
2015	8,270	1,678
Thereafter	24,674	27,350
Total	$ 70,428	$ 35,765